

## **It's An Ill Wind**

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The Tragedy of Hurricane Katrina is still with us and is likely to be for a while. The physical devastation and human suffering that the storm caused has eclipsed the Galveston flood of 1900 and the San Francisco earthquake of 1906. It is, simply, the worst natural disaster to affect the United States ever. New Orleans, that great city, has ceased to be what it was, and it's unclear what it will be in the future. The adjoining gulf coast was equally as devastated.

Although it might seem macabre in the light of the human suffering wrought by the storm, let's take a look at the economic impact of all this, starting with the short term and working our way out. New Orleans was more than just America's party town. It pumped oil, handled freight and shipped crops to the tune of one percent of the Gross Domestic Product. The gulf coast in Louisiana and Mississippi was the locus of a \$1 billion per year sea food industry. In macro terms, most economists expect that Hurricane Katrina will lower the growth rate of GDP in the second half of 2005 by 60 basis points. This number is only an estimate, since most forecasts are made by models that are arithmetic and linear.

What happened on the coast was anything but, so the confidence of most macro forecasters in their own predictions has gone down as well. The wild card here is consumer confidence, which had already been falling before the hurricane. So this 60 basis point decline in growth is only a starting point; it may likely be more.

As with any major event, there will be economic winners and losers. Clearly the hospitality industry on the gulf coast is ruined for the foreseeable future. The wrecked casinos in Mississippi and the restaurants and clubs in New Orleans are out of business for now. Banks and insurance companies will take large hits as households and firms suspend loan payments and file claims for physical damage. The seafood business will be lost for quite a while, as boats are repaired fish farms reconstituted and shellfish habitats renewed. But consumers who will now be faced with higher prices for imported products will also suffer.

Since the port of New Orleans was a thoroughfare for myriad commodities, consumers will pay higher prices for a range of goods. While the petroleum industry will recover, it has taken a physical hit that will require capital expenditures. Gas prices at the pump will also fall, but consumers have already taken a hit there. Finally, the residents of Louisiana and Mississippi who have been displaced will face a tough struggle to find jobs. Besides the normal issues, most of these workers lag the nation in education and skills, meaning that the process of reemployment may be delayed by the need for training in new skills.

There are few if any winners here. One might argue that the construction industry will benefit from the need for the physical repair and replacement of devastated buildings. But this will be constrained by the availability of labor and supplies, all of which must be taken from building projects in other parts of the country. To get an idea of how long this might take, remember that the damage caused by the Florida hurricanes of 2004, less in scope than that caused by Katrina, has still not been fully repaired.

In the longer term, there will be significant public policy fallout from Katrina. The Federal government will spend in excess of \$125 billion to repair damages and resettle affected households. This dwarfs the spending in the wake of 9/11 and comes at a time when the Federal deficit is in excess of \$300 billion. The ballooning deficit will put upward pressure on interest rates which will in turn dampen the real estate market. Households who were betting on appreciation to offset the risks of their interest only, adjustable rate, 100 percent mortgages will become stressed financially; there will be an increase in defaults and foreclosures.

The hurricane will also result in higher rates of inflation. The port closure and the damage to refineries and oil rigs will push up the prices of most commodities, and the uncertainty of what other natural disasters may inflict will make futures markets jittery. This all places the Fed in a tough position. With growth slowing, prices rising and the need to attract foreign capital to fund the rising deficit, should it continue its policy of gradually raising short term interest rates? Any answer to this question raises complications that need to be considered carefully if the economy is to avoid a (limited) return to the days of stagflation.

I don't think New Orleans will ever be what it was, but it will be rebuilt. From its inception to its end, Katrina lasted a bit over two weeks. But because of what it did, we will live with that storm for a long, long time.