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Weathering the Storm

Hurricane Katrina's broader impact on the economy is coming into view, showing that the strong economy preceding the storm is helping to buffer the economic shock afterward.

By October, business confidence was weaker than it was prior to the storm, but it remained within the range that had prevailed since the beginning of the year, according to Economy.com's Survey of Business Confidence.

CEOs of the largest U.S. companies said in a survey that before Katrina they anticipated the U.S. economy would grow at an annual rate of 3.5% this year, and they now expect it to grow at a 3.3% rate. Analysts at Standard & Poor's forecast that economic growth will amount to 3.1% in the second half of 2005 compared to the 3.8% they had estimated before the hurricanes.

Two-thirds of the 97 CEOs surveyed by the Business Roundtable in September said that the hurricane will have a negative effect on their operations, but only 4% said the effect would be "strongly negative." They said the storm will have a catastrophic regional effect, a significant but not catastrophic national effect, and that the impact will last from three to 12 months. The executives were most concerned about rising prices for oil, gasoline, and natural gas.

Moreover, the survey found that fewer companies are expecting increased sales or capital spending over the next six months compared with their expectations just prior to the hurricane. Before Katrina, 83% of executives expected sales to increase, and 54% planned higher capital spending. After the storm hit, the numbers dropped to 74% and 40%, respectively.

The CEOs' hiring plans remained fairly steady, with 33% of respondents planning higher employment rather than 35%. Employment fell by 35,000 in September, according to the Bureau of Labor Statistics, and was likely to fall again in October, but the job losses were concentrated entirely on the Gulf Coast. Hiring in the rest of the country seemed unaffected. Claims for unemployment insurance outside of those filed by displaced Gulf residents had, if anything, fallen. In fact, companies in-

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volved in the hurricane recovery, such as energy, equipment manufacturing, and construction, had plans to increase their hiring.

But consumer behavior is a wild card. Consumer prices rose 4.7% in the 12 months through September and 1.2% from August to September alone, the largest one-month increase in more than 25 years. The Conference Board's consumer confidence data for September plummeted to 86.6 from 105.6 in August, the third largest one-month drop on record and the lowest level since October 2003. The expectations component of the survey, which is a gauge of consumers' view of economic conditions in the coming months, fell to 71.7 from 93.3. The component measuring consumers' outlook of current employment and business conditions fell to 108.9 from 123.8. While this "present situation" level was at its lowest level of 2005, it was well above all 12 readings from 2004 when consumption grew solidly.

The upward pressure on oil, gasoline, electricity, and natural gas prices that existed before the storm is expected to continue and should weigh on the economy's performance in coming months. With oil refineries running at more than 96% of capacity, gasoline price spikes are predicted to last for months. Economists expect that higher fuel prices for trucks, buses, and airlines will translate into higher consumer prices across the board. Most vulnerable to higher prices are year-end holiday sales as households devote a rapidly rising share of their budgets to filling their gasoline tanks and heating their homes.

In August, even before the storms, consumer spending on all energy, including gasoline, home heating, and electricity, soared to an annualized $525 billion, the highest it has been since early 2001, according to the Bureau of Economic Analysis. This is equal to nearly 6% of the average household's budget. Three years ago, energy spending accounted for only 4% of budgets. The all-time peak was in the early 1980s when just over 9% of budgets went to energy.

The surge in energy prices could lead to higher inflation expectations and underlying inflation. In September, the University of Michigan found that consumers expect inflation of 4.6% in the coming year, a near-15-year high, and expect average inflation of 3.1% over the next five years, a four-year high. Inflation expectations as implied by yields on Treasury Inflation Protected Securities have moved steadily higher during the past two years. One year ahead, inflation expectations are now as high as they have been since late 1990.

Indeed, minutes from the Federal Reserve Board's Federal Open Market Committee (FOMC) meeting on September 20 said that Hurricane Katrina added to "already considerable" inflation pressures and that more interest-rate increases will be needed—in addition to the Fed's 11th consecutive rate increase of overnight federal funds to 3.75% from 3.5% that day. In June of last year, the federal funds rate was 1%, a 46-year low. In response to the federal funds rate increase, commercial banks raised their prime lending rate to 6.75% from 6.5%. Longer-term lending rates were little affected, however, because bond markets, where long-term rates are set, had anticipated the September 20 increase.

In continuing to boost rates, the Fed is more concerned with the hurricane's effect on inflation than growth. But even 3.75% "would likely be below the level that would be necessary to contain inflationary pressures, and further rate increases probably would be required," members of the FOMC said in the meeting. They highlighted federal and private spending on Gulf Coast rebuilding and higher energy prices as inflationary, and they revised upward the inflation forecasts for 2005.

Yet although the hurricane has increased risks of inflation, the Fed staff said "the longer-term path of the economy probably had not been affected by the hurricane." They lowered the Fed's estimate for U.S. economic growth for 2005 because of Hurricane Katrina but lifted their growth forecast for 2006 "to reflect the boost to economic activity from the rebuilding effort." By 2007, the Fed staff expects the U.S. economy to move back to the growth path it would have been on if Katrina hadn't hit. ■