Group Economics

Katrina: a natural but not an economic disaster

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Summary

In this short note we summarize our current thinking on an admittedly fast-moving situation. The US data-flow will be severely disrupted for the remainder of 2005, but the shock should not alter the business cycle dynamic in the US or global economy. The appropriate policy response is likely to be a fiscal package to clear and rebuild the immediately effected areas, not a change in monetary policy. This tragic event has caused great anguish in the USA but has not led to the economy-wide anxiety witnessed after 9/11. We therefore doubt the Fed will relax its policy of raising interest rates at each of its meetings. Fuel prices are a more worrisome and enduring source of risk, but are not yet at a level that could trigger a serious downturn. The future path of gasoline and heating oil prices is uncertain and vulnerable to any kind of "event". A mild US winter would be an enormous help.

US Economic Growth: down but not out in 2005

The US has proved to be remarkably resilient in recent years and we are optimistic that the impact of Hurricane Katrina will be predominantly temporary. Firstly, let's consider the impact on the directly affected areas. Louisiana and Mississippi together account for around 2% of US GDP. The Congressional Budget Office (CBO) estimate that if activity in these States declined by 50% over the September to November period, this would knock 1.3 percentage points off the nation's annualized growth rate in Q3 and 2.7 percentage points off the Q4 figure. This projection is probably on the high side - the downturn in production is unlikely to be this severe or so protracted. We expect the direct effects to knock around 0.8 percentage points off the Q3 growth rate and 1.0 percentage point off the Q4 outturn.

Secondly, we must consider the hit to growth from higher fuel costs. The damage caused by Katrina has resulted in a sharp increase in gasoline prices, which is likely to dent business and consumer spending across the nation. There are some grounds for optimism that these indirect effects will be fairly modest. Gasoline prices look to have peaked (albeit at a record high) – gasoline futures have already retraced around 80% of the post-Hurricane run-up. Crucially, consumers seem willing to go about their driving as usual, betting that prices will come off soon – the CEO of Valero, one of the largest retailers of gasoline in the US, indicated that he has seen no evidence that demand for gasoline has diminished noticeably in the wake of Katrina. If gasoline prices continue to edge down, indirect effects should only shave a few tenths of a percentage point off Q3 growth and half a percentage point or so off the Q4 number.

Prior to Katrina we had pencilled in 4.5% annualized growth for each quarter, putting together the direct and indirect effects, growth is now likely to come in at 3.5% in Q3 and 3% in Q4. This is a significant impact, but a long way short of pushing the economy into recession.

Increased inflation risk at the wrong time.....the Fed is likely to keep hiking rates

Gasoline prices constitute around 4% of the overall CPI index. Even before the hurricane hit, gas prices were running at 35% above last year's levels - now they are now running 65% higher. Before taking any second round effects into account, the hurricane-related jump in prices would add an additional 1.2 percentage points to US CPI. This suggests that if fuel prices maintain their recent highs, headline inflation could rise well above 4% in September. The spike has come at a bad time. Labour market conditions have tightened in recent months (unemployment dipped below 5% in August) increasing the risk that higher energy costs will pass through to wage claims. Moreover, productivity growth has already started to slow, which will further curb the economy's capacity to grow without generating price pressures. Financial market participants are alive to the risks – inflation expectations as measured by the difference between yields on ten-year government bonds and their inflation-protected equivalents moved up to 2.5% last week, up from 2.4% before the hurricane struck.

In our view there are two likely scenarios for monetary policy. Firstly (and our best guess), the Federal Reserve hikes rates by 25bps in September, November and December as we had expected before the hurricane struck, with US short-term interest rates ending the year at 4.25%. Alternatively, the Fed could call a time out in September, but resume tightening in November and December with rates ending the year at 4%. In our view, a fiscal rather than a monetary response is more appropriate in this situation given the localized nature of the shock.

A fiscal response is essential, despite the weak level of national savings

The impact on public finances is crucially dependant on the size of the federal aid package. Several legislators have suggested that the ultimate cost of the Katrina relief, cleanup and rebuilding effort to the federal government could reach $150 billion or $200 billion (equivalent to 1.4% to 1.9% of 2004 GDP). While it is true that this money will be flowing into the economy and boosting output, the deficit will swell and critical longer-term priorities (e.g. entitlement reform) are going to be pushed to the back burner for a considerable period. This poses some additional risk to the dollar. The savings-short USA is already running a record current account deficit of over 6% of GDP, and leaves the dollar more vulnerable to a shift in investor sentiment.

High energy prices remain the joker in the pact

Whereas last September's Hurricane Ivan mainly disrupted crude oil production in the Gulf of Mexico, Katrina appears to have impacted refinery production in the region and elsewhere (largely by shutting a major oil pipeline to the Mid-West refineries). 25% of the total US refinery capacity was initially affected and the impact on fuel prices was exacerbated by the fact that petroleum stocks were already below average, depressed by the traditional driving season. The current problem therefore relates to oil products rather than the supply of crude itself, and this fact has been reflected in relative price movements, with gasoline prices rising by around 25% in the week of the hurricane to reach a record nominal high of $3.07 per gallon on Labor Day, September 5th.

Gasoline prices have since stabilized, but have held above $3 per gallon, a figure some 65% above year earlier levels. Prices may soon begin to reduce as the physical delivery of the first stocks released by the International Energy Agency begins by mid-September, helping to relieve the initial shortfall in supply, although it is uncertain how easily stocks of imported gasoline can be integrated into the existing US distribution network. The crucial issue therefore remains one of how quickly the current reduction in refinery capacity will be restored over the coming weeks.

The Gulf of Mexico contains around 12% of US refining capacity. The US Department of Energy last week suggested that as much as half of this could be out of operation for a number of months - a less optimistic appraisal than initial reports suggested. Any signs of a prolonged shortfall in refinery capacity are likely to be reflected in gasoline future contracts, which have so far failed to indicate a substantial legacy supply issue. After reaching a peak of 261.45 on August 31st, the nearest month NYMEX gasoline contract had fallen to 195 by September 9th, only 5% above the comparable price from the first-half of August. Furthermore, following the decision to recalibrate refinery production in order to make good the current shortfall in gasoline production, it is feared that shortages may emerge in other oil products, particularly heating oil. A mild winter would be an enormous help.