Mortgage Corner

HURRICANE AFTER EFFECTS COULD BOOST REAL ESTATE

The economy must now deal with the double-barreled whammy of hurricanes Katrina and Rita, says the Mortgage Bankers Association's chief economist, David Duncan. Rita tore through an area less densely populated than Katrina, so that the loss of life and the amount of damage created were far smaller. Nevertheless, the impact on crude oil and natural gas production was substantial, as was the effect on refinery output. The nation now faces the possibility of continued lofty prices for gasoline, home heating fuel, natural gas and other refined products for many months to come.

As yet, there are only a few bits of hard data reflecting the impact of these two hurricanes on the macro economy. Weekly initial claims for unemployment insurance shot up by more than 100 thousand before retreating again in the week ended September 24. Payroll employment declined by 35,000 in September. Consumer confidence plummeted in September by amounts reminiscent of the declines that followed September 11, 2001. Consumer spending fell sharply in August, largely because of declining auto sales, and auto sales fell further in September-but these events probably reflect mainly the response of car buyers to pricing practices of auto manufacturers. Hurricane Katrina, on the other hand, directly accounted for the decline in personal income in August. According to the Commerce Department, the damage from Katrina reduced August personal income by almost $100 billion at an annual rate.

While there is surely more negative news coming down the pike during the next month or two, some of the incoming data may reflect the positive economic impact of the response to the human tragedy and its aftermath. Many evacuees are being lodged in hotels, with expenses paid by private charities or governmental funds. Large-scale purchases of mobile homes by FEMA to house displaced persons will likely increase manufacturers' shipments in the next month or two. The ISM index for manufacturing rose significantly in September, with increases in production, employment, orders and prices; some of that increase may stem from early demands on the manufacturing sector that will inevitably stem from the reconstruction effort.

At this juncture, forecasting the response of the economy to these two natural disasters remains largely an educated guess. The best guess would seem to be a period of slower economic growth followed by a resurgence when the impact of the reconstruction effort outweighs the negative effects of the loss of employment and output in the affected region. That is the pattern that has followed previous natural disasters. The Congressional Budget Office has updated its estimate of the macroeconomic impact of Hurricanes Katrina and Rita. The two hurricanes are expected to reduce the annualized growth rate of GDP in the second half of the year by about 1/2 percentage point, with essentially all of the impact occurring in the third quarter. By the fourth quarter, the negative effects of the hurricanes and the positive effects of the reconstruction should be largely offsetting. By early next year, economic grow this expected to be accelerated, on balance, as the reconstruction effort hits full stride. Ironically, by the middle of 2006, the level of real GDP could well be higher than it would have been in the absence of these two horrific natural disasters.

Katrina and Rita will also alter the trajectory of prices in the months ahead in ways that will clearly raise the rate of inflation at least temporarily. Higher prices for gasoline, home heating fuel and natural gas will be the most obvious manifestation. But higher energy costs have already forced airlines and other transportation companies to raise prices, and other industries that have a heavy energy input are facing cost pressures that may result in higher prices down the road. Moreover, the expected impact of the reconstruction on prices of a wide variety of basic materials-lumber, cement, steel and other metals-will be compounded by slow recovery of the port facilities on the Gulf coast.

These cost and price increases associated with the supply shock of the two hurricanes are occurring in an environment in which the risks are increasing of a spillover into core inflation. The economy is approaching full employment of its labor and capital resources. The Federal Reserve staff forecast prepared for the August 9, 2005 Federal Open Market Committee meeting argued that "The output gap was predicted to be essentially closed by the end of this year." Productivity growth is slowing, and unit labor costs are now rising, after several years of decline. Since corporate profits are a high level, cost pressures may be at least partly absorbed by reduced profit margins. But the possibility that the supply-reducing effects of Katrina and Rita may permanently increase core inflation poses a challenge to the Fed.

That is probably the reason why the 25 basis point increase in the funds rate on September 20 was accompanied by a statement that gave no indication that the Fed was about to pause in its ongoing program of raising interest rates to more normal levels. The Fed will no doubt be tracking with acute interest, not only the behavior of the major price indexes, but also evidence regarding inflation expectations. The September 20 press release noted that ".longer-term inflation expectations remained contained," but the previous statement had declared that such expectations remain "well" contained.

As noted earlier, the economy's response to Hurricanes Katrina and Rita cannot be predicted with confidence. It may follow the model of previous natural disasters, but then again it may not. The reaction of consumers to elevated prices of energy products, and to the recognition that all or a large segment of one's accumulated wealth can be wiped out overnight, will be crucial. The Fed is well aware of the uncertainties of economic forecasting at a time like the present, and will modify its planned course of monetary policy in response to incoming developments. But its attitude towards monetary management during periods of supply shocks was set forth in blunt language a year ago by former Governor Edward M. Gramlich. In a speech in Kansas City in September 2004, Governor Gramlich said the following: "It is virtually inevitable that [supply] shocks will result in some combination of higher inflation and higher unemployment for a time. But I must stress that the worst possible outcome is not these temporary increases in inflation and unemployment. The worst possible outcome is for monetary policy makers to let inflation come loose from its moorings."

Since the impact of Hurricanes Katrina and Rita on the macro economy still remains quite uncertain, we have made little effort to fine-tune this month's forecast from that of a month ago. The economy's growth is expected to be slowed in the second half of the year, especially in the third quarter, and then to accelerate early next year. Increased residential construction is expected to be a substantial part of the total expenditures on reconstruction. The Fed is expected to continue raising interest rates in response to the threat of higher inflation, with the funds rate reaching 4-3/4% by the end of next year