The Hurricane Effect

By: Andrew Brod

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Four years ago, soon after September 11, I was one of many columnists who speculated about the economic damage caused by the terrorist attacks. But in economic terms, the attacks had relatively little effect. The financial and trading companies that had been located in the World Trade Center soon set up operations elsewhere, Wall Street was up and running the next week, and the recession of 2001 ended a couple of months later.

Depending on where they hit, major hurricanes like Katrina and Rita are more serious threats to the economy. Some analysts have described New Orleans as a “choke point” in the American transportation system. More broadly, the Gulf Coast figures prominently in the national economy, from oil imports to grain exports, from shrimp harvesting to oil drilling. And of course there’s gasoline refining.

Most economists are predicting that Katrina-caused supply disruptions will lead to inflation, if only temporarily. Some products will be in short supply, while others will have to be shipped via more expensive modes and routes. Consequently, most forecasters have adjusted downward their projections of economic growth this year. The Congressional Budget Office, for example, has said that Katrina’s effect on growth will be “significant but not overwhelming.”

Here are some other aspects of “the economics of Katrina.”

Price Gouging

One of the more persistent economic myths is that sharply rising prices imply gouging, i.e. extraordinary profits resulting from the misfortune of others. But it’s not gouging when rising prices result from rising costs. After the hurricane knocked out roughly 11 percent of U.S. refining capacity, wholesale gasoline markets reacted quickly and drove prices up.

Moreover, the rising gasoline prices were a *good* thing in that they prevented widespread gasoline shortages. When prices rise, people have an incentive to drive less. The less people drive, the more likely supply and demand will be in line at the gas pump. This is why I didn’t cancel plans to drive to the beach on Labor Day weekend. In fact, I went precisely *because* prices had risen so much. Sure, it cost more than I would have liked, but at least I didn’t have to worry about finding gasoline.

A recent Slate.com article by economist Austan Goolsbee pointed out that gasoline price gouging is rare during the initial run-up in prices, as retailers scurry to keep up with rising costs. But when the crisis is over, retail prices tend to fall more slowly than the improving supply conditions would warrant, and *that’s* when retailers’ profit margins often expand. When there’s gouging, it takes place on the “back end” of the crisis. But by then few people complain.

Sure enough, by the Friday after Labor Day, the wholesale price of regular self-serve gasoline had fallen nearly to pre-Katrina levels, roughly 30 cents below its peak during the crisis. But according to AAA, the average retail price had fallen only 4 cents from its peak and was still about 40 cents *higher* than before the hurricane.

In Greensboro, retail prices fell more than the national average but remained well above the pre-Katrina level. According to GreensboroGasPrices.com, by the Friday after Labor Day the average price in the area had fallen below $3, nearly 30 cents below the peak. But that was still nearly 50 cents higher than before Katrina.

Market Psychology

The temporarily high gasoline prices prevented widespread gasoline shortages. That's a fact. But they didn't prevent widespread *fear* of shortages. Instead of partying like it was 1999, we freaked out like it was 1973.

Since federal restrictions on oil prices were lifted in 1981, fuel prices have been free to spike upward in the wake of dramatic world events. One of those times was in 1990, after Saddam Hussein's invasion of Kuwait. Thanks to the demand-curtailing effects of rising prices, there were no widespread shortages or gas lines during any of these episodes. Oil markets in the U.S. have changed dramatically since the 1970s, but for some reason the gas-shortage mentality is still with us.

The Reconstruction Fallacy

Whenever a disaster hits and causes great damage, some analysts claim that recovery efforts will be good for the economy because they'll spur employment and activity in the construction industry. The second part is true, because of course there will be a lot of rebuilding in the Gulf region.

But as a rule, the part about this being good for the economy is silly. If not for disasters, funds devoted to reconstruction could be used for other purposes. Instead, disasters force society to use those funds for reconstruction. The elimination of options is almost never a good thing.

If hurricanes are so darned beneficial, why merely hope that Mother Nature will bless us with them? If reconstruction is so good for the economy, then our task is obvious: we should demolish our own buildings periodically. I'll let you go first.

The reconstruction fallacy persists because of how we measure our economy. When reconstruction takes place, it adds to Gross Domestic Product. But GDP does a bad job of measuring the lost value of the housing stock that was destroyed in the disaster. So even if the Katrina disaster's effect on GDP is mitigated by all the reconstruction, there's no getting away from the reality that its overall effect will be decidedly negative.

There is one sense, however, in which Katrina might be a little different. There is substantial slack on the employment side of the economy, which is still feeling a hangover from the 2001 recession. While not a great idea in general, public-works projects can make sense in special situations like this. Post-Katrina rebuilding could serve as a kind of public-works program, a spur to the hiring side of the economy. Katrina was an economic disaster, but perhaps we can make the best of a bad situation.

Gambling vs. Insurance

Failing to buy health insurance means you're making a bet that you won't get seriously ill and incur large medical bills. This is the kind of bet made by governments at all levels when they failed to prepare for a category-4 hurricane in or near New Orleans. Levees could have been strengthened, salt marshes replenished, etc., but those efforts weren't made.

Of course it's easy now, after the fact, to condemn those bets. And it's possible that domestic politics and our adventures in Iraq played some role. But whether the bets were wise or unwise, it would have been good if we'd built up some sort of reserve in case disaster did strike. After all, if you don't buy health insurance, it makes sense to keep some savings on hand in case of a medical disaster.

Unfortunately, the federal government has been doing the opposite. Before Katrina, the Congressional Budget Office predicted that the budget deficit for 2005 would be about $330 billion. That's $80 billion less than the all-time high (in dollar terms) set last year, but it's still really big. And now the government's relief efforts will make it bigger. Currently, the federal government has promised over $60 billion, and some analysts think the ultimate price tag will approach $200 billion.

Because the government's fiscal year is nearly over, the 2005 deficit will be only slightly bigger than projected. It'll be a different story in 2006, when we could challenge the record set in 2004. After all, no one in a position of power in Washington is talking about tax increases.

The upshot is that the government will put even *more* Treasury bills up for sale and hope that foreign investors like the Chinese government will continue to buy them. We apparently can't depend on Americans to save money, and so now we'll have to draw even more savings from abroad. If you like low interest rates, I hope you appreciate what China is doing for you.

The Possible Role of Global Warming

No one with any sense denies that man-made global warming is a reality. The only remaining debate is how it will affect us. We know that warmer ocean water tends to make hurricanes more severe, but it's far too early to conclude that global warming has caused the increase in the number of major hurricanes in recent years.

Because the effects of global warming are uncertain, we once again face an insurance question. Does it make sense to continue to ignore the possibility of global warming, to continue *not* "buying insurance" against it? Or should we reassess our policies? Is it time to review the federal government's flood-insurance program and the way it essentially encourages homeowners to live in flood-prone zones? Is it time to factor in the costs as well as the benefits of dramatic population increases in coastal areas?

No one knows for sure what the future will bring, but the Katrina disaster has shown us what can happen if nothing is done.