Economic Commentary

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Fed Likely to Stay the Course, Despite Katrina

The FOMC, the Federal Reserve Board's policy setting arm is holding its 6th scheduled meeting tomorrow and is widely expected to deliver its 11th consecutive quarter-point hike in its target for the US overnight rate -the fed funds rate- to 3.75%, and this despite concerns over the economic impact of hurricane Katrina, the worst natural disaster to hit the USA in recent history. Although many analysts and the market saw a high probability that the Fed might choose to pause for at least this meeting in the days immediately following the catastrophe, now nearly 90% of economists polled by Bloomberg News expect the Fed to proceed with its planned rate hike.

Although the Fed seems likely to tighten monetary policy another notch tomorrow, the decision is certainly not an easy one to make. Katrina delivered a supply shock to the US economy similar to the two supply shocks of the 1970s, though of a much more modest size. The shock has had the effect of knocking the aggregate supply curve to the left, which means a reduction in output over the next six months at least but more worrisome, a hike in the inflation rate and worse of all, in inflation expectations. The effects on output were discussed in our previous Commentary: a 0.5 – 0.7 percent drop in output in the second half of this year followed by a boost in output in 2006 as reconstruction efforts fall in place. But this is only one of the impacts. The second is the effect it is having on gasoline, jet fuel and home heating prices, not to mention natural gas prices that are near double last year's levels.

Although gasoline prices have already started to recede from the peak reached following the storm, inflation expectations by US consumers have jumped dramatically to the highest level in many years. For example, US consumers now expect inflation of 4.6% for 2006, up from 3.1% in August, and, they expect inflation to average 3.1% over the next five years, up from 2.8% in August. The concern here is that if these expectations are translated into higher prices and wages it might trigger higher inflation as it did in the 1970s. Inflation expectations tend to be sticky and, once formed, difficult to erase. The problem for monetary policy authorities is that they can't treat simultaneously the effects of both of these impacts at the same time, as we learned in the 1970s. Lowering interest rates to absorb the drop in output accentuates inflation, while raising rates to slow inflation, accentuate the slowdown. The Fed is forced to choose between two conflicting objectives.

As if this is not a big challenge in itself, Katrina has also had a third impact, that on consumer confidence. The Survey Research Institute (SRI) of the University of Michigan, the pioneer in surveys of consumer expectations, said last Friday that its preliminary index of consumer sentiment plunged 14% in September from August to 76.9, - a 13-year low-. Since July, the index is down 20%, the largest decline over a two-month period since 1978. Richard Curtin, the head of the institute, said that the drop parallels the decline experienced following Iraq's invasion of Kuwait in 1990 and said that "such steep and widespread declines in confidence have typically triggered recessions," in the past, a recession is not "pre-ordained" at the moment. The concern obviously is that unless this hit on US consumer confidence is reversed quickly, all the money that will be spent on reconstruction in the US Gulf coast might not be enough to offset a country-wide retrenchment in consumer spending, which creates the risk of substantial slowdown in the US economy.

Even before the consumer sentiment numbers were released, the Chief Economist of the OECD Philippe Cotis advised the US Federal Reserve last week to ease the pace at which it is raising interest rates in the wake of the devastation caused by Katrina. The risk as the OECD sees it, is that if the spike in world oil prices to nearly $70 a barrel was not a concern already, Katrina's effects might prove to be the last straw in tipping the US economy and by extension the world economy off course on a path toward recession.

The way I see it is that although the US economy has proved to be quite resilient in the past and although the current expansion has a lot of momentum still left in it, the total strain on the economy is continuing to mount to un-tested and dangerous levels. In less than four years since the 9/11 attacks the US is faced with a shock of greater proportions, it has gone to war with Iraq and is still mired there at a huge cost to the US economy, the war on terrorism and the increased costs and disruptions caused by security are slowly taking their toll, the budget deficit although falling, still remains huge, the current account deficit is set to reach $800 billion or 6.5% of US GDP with to signs of abating, how much more can the powerful US economy take? Even the strong have their limits. Add to this the move of the powerful US Fed towards a less accommodating monetary policy, the highly indebted US consumer and the inflated and vulnerable housing market, then one must wonder how much more resilience does the US economy still have left? My concern is that in the context of all these strains, the US consumer might run out of steam and throw in the towel, and if that happens, so will the US economy.

Although the wiser choice might be to pause tomorrow, and in so doing give consumer confidence a boost, the Fed will choose to stay the course in their rate tightening plan on the belief that if they can hold down inflation expectations now, they can always cut rates later if the need occurs.

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