JOINT ECONOMIC COMMITTEE

ROBERT F. BENNETT, VICE CHAIRMAN

RECENT ECONOMIC DEVELOPMENTS

SEPTEMBER 13, 2005

Economic Effects of Hurricane Katrina Continue

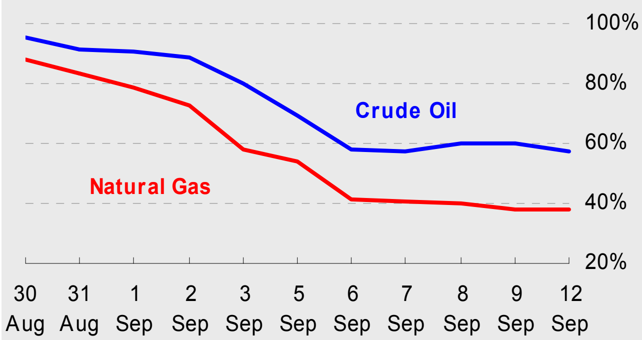
In addition to the human devastation from Hurricane Katrina, the storm caused significant damage to the nation's energy infrastructure in the Gulf of Mexico (GOM) coastal region and affected critical shipping routes. Energy prices spiked substantially higher in the immediate aftermath of the storm as almost all production of oil and natural gas in the GOM coastal region was shut down. The GOM coastal region supplies large fractions of domestic oil and natural gas production. Energy prices have receded from the highs seen earlier this month, but remain elevated, and energy production in the GOM has been gradually coming back on line as the region begins to recover. While it is still too early to assess the longer term macroeconomic effects of Katrina, there will likely be short-term declines in national employment and growth in the gross domestic product (GDP), upward pressure on inflation, and a possible pause by the Federal Reserve from its policy of steadily increasing short-term interest rates.

Highlights

- Significant fractions of daily GOM production of oil and natural gas have been "shut in" (Fig. 1). Production is gradually coming back on line.
- Energy infrastructure damage pushed prices of crude oil close to $70 per barrel, retail regular gasoline over $3 per gallon, and natural gas to around $12 per million Btus. Prices have receded recently, but remain elevated.
- Forecasters lowered their GDP-growth predictions for the second half of 2005 in light of Katrina, but still see a continuation of healthy growth. Growth was 3.3% in the 2nd quarter.

Daily Shut-In Production 1

(As a percent of daily GOM Production)



Source: Minerals Management Service

Shut-In Energy Production in the Gulf of Mexico Has Declined

The coastal region of the GOM supplies 29% of domestic oil production and 21% of domestic natural gas production. Katrina forced many production facilities to be "shut in." A shut in facility does not produce. Shut-ins for oil and gas production are procedures used by industry for safety and environmental reasons. Once facilities are inspected, production can be brought back on line. At the peak of *"shut-in" production* that resulted from Katrina, on August 30, over *95% of **daily** GOM oil production* and close to *88% of **daily** natural gas production* was shut in. As of September 12, shut-in oil was just above 57% of daily production and shut-in natural gas was just below 38% of daily production (Fig 1). *Cumulative shut-in production*, representing the percent of ***yearly*** GOM production shut in between August 26 and September 12, was 3.4% for oil and over 2.5% for natural gas.

Energy Price Effects of Katrina Have Subsided

Increases in energy prices that followed from Katrina seem to have peaked earlier this month. Since then, futures prices for crude oil, gasoline, and to a lesser extent natural gas, have receded. The futures price of crude oil to be delivered in October, after peaking earlier in the month at close to $70 per barrel, has receded to about what prevailed prior to the storm. The futures price of regular gasoline to be delivered in October similarly peaked earlier this month and has since receded. The futures price of October natural gas peaked at close to $12 per million British thermal units earlier this month and has remained elevated since that peak (Figs. 2 and 3, next page).

Employment and Katrina

The Congressional Budget Office projected that effects of Katrina could lower employment through the end of this year by about 400,000 jobs. The economy added 169,000 new *payroll jobs* in August and over 4.1 million in the past twenty-seven months of consecutive job gains. Over 1.5 million new jobs have been added to payrolls so far this year. The *unemployment rate*, based on a survey of households, fell to 4.9% in August, the lowest since September 2001.

GDP Growth and Katrina

Forecasters see continued strong growth with moderate inflation, but shaved about 0.3 percent from their annualized growth estimates for each of the final two quarters of this year in light of Katrina. The Blue Chip consensus forecast, based on survey conducted September 1st and 2nd, is for 3.6% annualized GDP growth in the 3rd quarter, 3.0% in the 4th quarter, and between 3.1% and 3.2% in the four quarters of 2006 (Fig. 4). GDP grew at a 3.3% annualized rate in the 2nd quarter, led by *consumer spending* (up 3.0%), *exports* (up 13.2%), *equipment and software investment* (up 10.4%), *residential investment* (up 9.8%), and *government spending* (federal spending up 1.6%; state and local spending up 3.3%). Subtractions from growth came from *inventories* and growth in *imports*.

Inflation and Katrina

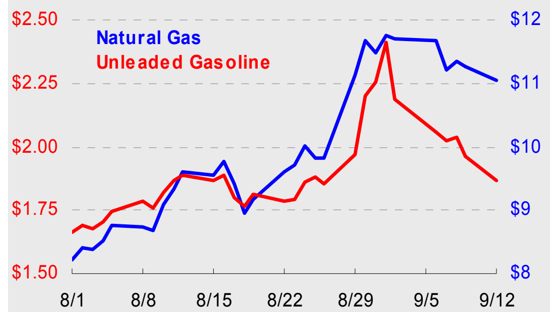
Price effects from Katrina will likely push inflation higher in the near term from its current moderate pace. Year-over-year inflation in the core *consumer price index* (CPI) was 2.13% in July. Core *personal consumption expenditure price index* (PCE) inflation, the Fed's preferred measure of consumer price inflation, was 1.84% in July.

The Fed May Pause From Its Measured Pace

The *Federal Reserve* has raised its target *overnight interest rate* from 1.00% to 3.50% in a sequence of ten ¼ - point increases that began in June 2004. The Fed will decide on interest rates on September 20 and again on November 1. Before Katrina, markets put odds of a 4.00% overnight interest rate in November (which would mean ¼ - point increases at each of the two upcoming meetings) at over 80%. Markets now put odds of 4.00% overnight rate in November at close to 20% and have substantially raised the odds of a 3.75% rate. So, many now expect a one-time pause by the Fed from its recent policy of increasing short-term interest rates at a "measured pace."

Natural Gas and Gasoline Oct. Futures Prices 2

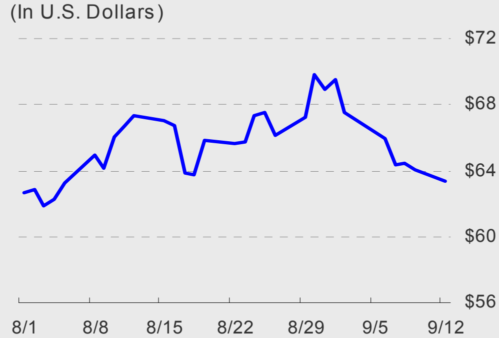
($/gallon gasoline, $/MMBtu natural gas)



Source: New York Mercantile Exchange

Light, Sweet Crude Oil Oct. Futures Prices 3

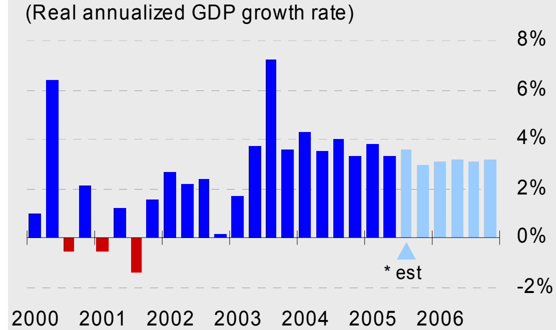
(In U.S. Dollars)



Source: New York Mercantile Exchange

Strong Growth Expected Through 2006 4

(Real annualized GDP growth rate)



Sources: Bureau of Economic Analysis *Blue Chip Economic Indicators

Upcoming Indicators

Federal Reserve – The Fed's next meeting is *September 20*.

Employment – The Bureau of Labor Statistics reports the September employment situation on *October 7*. Jobless claims data arrive every Thursday.

GDP – *A* first look at GDP for the 3rd quarter arrives *October 28*.

Inflation – The Producer Price Index for August is scheduled to be released on *September 13* and the Consumer Price Index on *September 15.*