KPMG Economics

The broken window fallacy
Hurricanes and the economy

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October 11, 2024

In an 1850 essay entitled "That Which is Seen and that Which is not Seen," French economist Frédéric Bastiat laid out what he called the broken window fallacy. In it, a child breaks a window of his father's shop. A neighbor commiserates with the father but tells him the accident is really a blessing in disguise.

He argues that the money the father must now spend to repair the window creates jobs. It will create a job for the glassmaker, who will then spend the proceeds of their work elsewhere in the community. The result multiplies and ripples throughout the community.

That is important for economic growth, which counts activity, but is only a part of the story. It focuses only on what is seen.

What is unseen is that the father could have spent the funds needed to fix his window on something else. Maybe he needed a new pair of shoes. That would still create jobs but leave him better off than spending funds for repairs. He would have both a functioning window and new shoes.

That provides a useful context for understanding the economic fallout from natural disasters. They trigger spending via a drawdown of savings, often rapidly, but ultimately leave us with less wealth. Those opportunity costs leave us worse off over time. That is on top of the grief and devastation created by disasters.

Wealthy countries tend to rebuild more rapidly after disasters than those with less wealth. However, the US has been much slower to rebuild than it did in the past, in part due to the surge in the frequency and ferocity of natural disasters in recent years. (See Chart 1.)

Triumph amidst turbulence

Preliminary data for the third quarter suggests that real GDP rose at a 2.8% pace, close to the 3% pace of the second quarter. Consumer spending accelerated on the heels of discounts. Housing activity continued to languish. Business investment moderated and inventories remained elevated. Government spending posted solid gains. The trade deficit held to the highs of the second quarter but did not widen further.

Real GDP growth is forecast to rise 1.8% in the fourth quarter, driven by gains in consumer spending. Housing is expected to pick up modestly in response to lower rates and repairs. Business investment could surprise to the upside as firms rush to make repairs to critical infrastructure. Inventories will be drained – some were destroyed. Government spending will moderate as Congress is dragging its feet on a fiscal year 2025 budget. The trade deficit is expected to widen in response to stronger growth at home than abroad.

The Fed's job gets complicated. The Fed still looks poised to cut, but the impact of the hurricanes and shifts in fiscal policy post-election could complicate that calculus. Another one-half percent in cuts seems in the bag by year-end. After that is a much harder call. Inflation could reignite in response to supply chain problems and a shift in trade policy.

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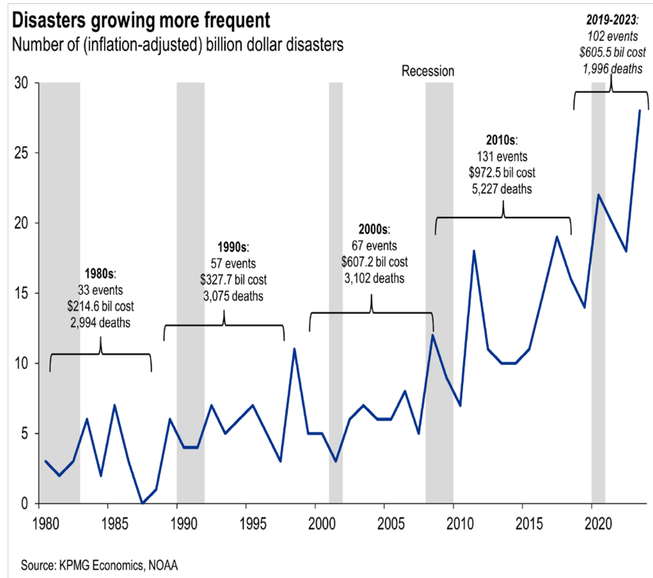
Chart 1



The cost of climate change is already being felt in escalating insurance costs. Flood and fire insurance are particularly prohibitive.

Those most exposed to climate-related risks tend to be lower income households. Foreclosures surged in the wake of Hurricane Harvey in Houston, as many of those hit hardest lacked the means to rebuild.

It is still too early to assess the damages. Hurricane Milton was barreling toward the coast of Florida as I was penning this report. Many of the same communities were still reeling from Hurricane Helene, which hit less than two weeks prior. Hurricane season is not over.

The Federal Emergency Management Agency (FEMA) has funds for immediate disaster relief. However, Congress punted on the fiscal year 2025 budget and opted to keep the government open with a continuing resolution. Congress did not approve supplemental disaster relief funds; those will be needed for longer-term recovery and rebuilding efforts.

This edition of *Economic Compass* provides a closer look at our baseline forecast prior to the hurricanes. Special attention will be paid to how the damages and efforts to rebuild could impact that outlook by sector. There is both an upfront blow to activity, and a bump in spending as wealth is depleted to make repairs. Supply chains could also be affected.

Baseline outlook moves up

Chart 2 compares the outlook in the wake of benchmark revisions relative to where we were last month. Upward revisions to overall GDP growth and incomes put us on a stronger trajectory for growth than just a few months ago. That is somewhat reassuring for the overall economy, as it suggests we have more resources to weather the storms.

The focus of the Federal Reserve shifted from containing inflation to hedging against a further weakening of employment. It cut rates for the first time since March 2020 and signaled the start of a "rate cutting cycle."

Real GDP is forecast to rise 2.7% in 2024, only slightly below the revised 2.9% pace of 2023. We now have more strength over the summer and less weakness in the fourth quarter than a month ago. Annual growth in 2025 and 2026 is expected to come in at about 2%. The Fed is forecast to slow the pace of rate cuts after an outsized one-half percent cut in September.

The forecast does not reflect major shifts in policy in 2025 or specific proposals by the presidential candidates. What a candidate says doesn't always match what they can accomplish. The extremes of the proposals being offered up are quite costly.

Potential distortions

Historically, natural disasters have shown up more in the communities hit hardest than the national economic data. However, little about the post-pandemic economy has aligned with historic norms. We have proven more resilient than expected, with the Fed stemming the rise in prices without pushing the economy into recession. The challenge will be to keep it that way.

Separately, an escalation of the war in the Middle East has rocked the oil markets. The largest threat is a blockage of the Strait of Hormuz, which is only 21 nautical miles wide at its narrowest point. More than 20% of the global oil supply traverses those waters.

Consumer spending moderates

Consumer spending is expected to moderate but remain a driver of growth in the fourth quarter and in 2025. Wages have outpaced inflation for the better part of a year, which is boosting purchasing power, while the cushion of savings that consumers amassed is much greater than previously reported.

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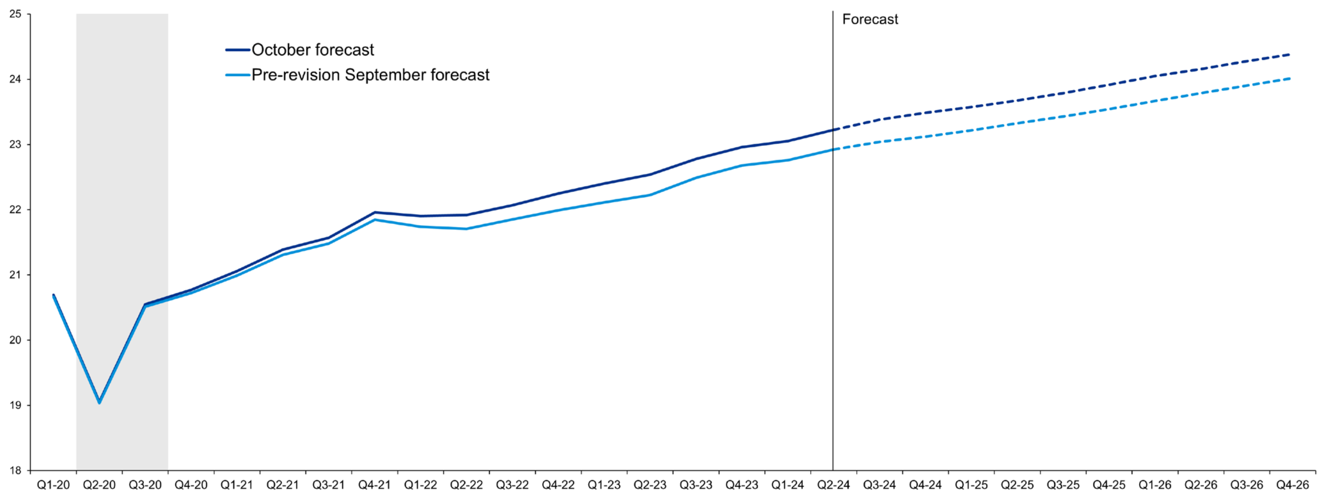
Chart 2

GDP revised higher
GDP, 2017$, trillions



Source: KPMG Economics, Bureau of Economic Analysis

Recent revisions suggest that consumers had $318 billion more in savings as of August than previously reported. Household wealth likely hit yet another record high in the third quarter. The blow due to hurricane losses will show up as a loss in real estate wealth in the fourth quarter but will be dampened by ongoing gains in other financial assets.

CoreLogic estimates that the losses triggered by weather disruptions due to Helene alone could reach $30 billion. Many homes lacked flood insurance, which could increase mortgage foreclosures.

Consumers scrambled ahead of Helene to erect barriers and stock up on supplies. Shortages of toilet paper emerged in some areas, evoking memories of the pandemic. The unusual path of the storm inland and through the mountains left many unprepared. Whole communities that had never seen flooding were wiped out, with major destruction to basic infrastructure including roads, cell towers and electricity.

Spending on repairs and clean-up will partially offset the disruption to businesses. The larger concern is the fallout for employment and earnings and how long those effects last. Employment in October is expected to be particularly weak. (See box.)

Older homeowners, with more accumulated wealth, have begun to tap their wealth via home equity lines of credit. That is adding to spending as they are remodeling to age in place, which is exacerbating the shortfall in homes for sale.

Rate cuts are lowering the cost of taking on new debt but not doing much to alleviate the burden that higher rates had on existing borrowers. Delinquencies have risen but remain historically low.

Many were worried that an end to the moratorium on student loan payments on October 1 could add to delinquencies. However, loan forgiveness and a shift to income-driven repayment plans have reduced the risk of a spike in delinquencies. The larger issue is the near-term threat to delinquencies and foreclosures triggered by the hurricanes.

Another near-term hurdle for spending is an unusually late Thanksgiving. That has compressed the holiday shopping season. Major retailers have announced they plan to hold holiday hires to the same level, or slightly below last year's.

A slow ramp-up in housing

Home buying and construction activity are beginning to pick up in response to lower rates, but affordability remains low. Millennials are aging into their peak home buying years and want to buy. Supply remains constrained and suffered yet another blow due to the hurricanes.

Single-family home construction has a speed limit of about one million per year. The costs of new construction remain elevated while labor shortages are acute. Construction materials were still up 30% from 2019 levels in August. The surge in rebuilding associated with the hurricanes will worsen the upward pressure on costs and could further constrain new supply.

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An October chill for employment

The survey for the employment report is always conducted the week that contains the 12th of each month. That is less than two weeks after Helene hit; Milton hit midweek. The Bureau of Labor Statistics said that Hurricane Beryl did not affect their survey collection, which left more than a million without electricity during the week of the July survey.

Still, the survey revealed 461,000 were unable to work due to bad weather in July. That was eleven times the average pace. The peak was 1.93 million in January 1996 due to a blizzard on the East Coast. The second largest figure was 1.49 million in September 2017 in the wake of Hurricanes Harvey, Irma and Maria. We could easily set a new record.

Layoffs are already rising, which will boost unemployment in October. Disruptions due to the hurricanes and the spillover effects of strikes in the aerospace industry are the reasons for that increase.

Hurricane-related losses could push the overall payroll figures into the red. We saw a dramatic slowdown in payrolls after Katrina. Strike related losses will exacerbate that weakness.

Hourly earnings could accelerate as low-wage workers are more likely to be displaced in response to the hurricanes. Workers in the leisure and hospitality sector are the most vulnerable.

Historically hurricanes were little more than a blip on the radar screen of national data. This time feels different.

Smaller builders, who rely less on public debt markets and more on bank credit, are already struggling. They are unable to offer the mortgage rate buy-downs and deals that large, publicly traded companies can provide, while unsold inventories have soared. This makes the industry ripe for consolidation, despite the demand for new home construction.

Listings of existing homes and inventories among smaller builders have picked up faster than buyers have returned. Intergenerational wealth transfers are helping first-time buyers get their toes in the door. Higher income, largely white households dominate those shifts.

The multifamily market is less supply constrained. An estimated 700,000 multifamily units are slated to come on line in 2024, the highest level since the 1970s. Those increases pushed down rents in what were some of the hottest post-pandemic markets, but only temporarily.

The pipeline for 2025 is weak, which will reduce supply and trigger a rebound in rents as we move into 2026. Demand is expected to get an extra boost from those who lost their homes to the hurricanes. The excess supply is largely in the South, near those who lost the most from hurricane damages.

Rate cuts take time to boost investment

Business investment has slowed from its pace earlier in the recovery and is poised to further weaken. Durable goods orders have decelerated, while the purchasing managers' indices for manufacturing remain weak.

Strikes, an overhang of vehicle inventories on dealer lots and the election itself are expected to compound the weakness in investment in the fourth quarter. It is hard to make big investments until the cloud over the course of policy lifts post-election. Tariffs and the risks of a full-blown trade war are particularly difficult to hedge.

The exceptions are investments in chip plants and data centers, which are soaring. Anecdotal reports indicate that even some vacant office space is being converted to data centers. Hence, the jump in hiring for specialty nonresidential projects we have seen in recent months.

We are likely to see funds for investment siphoned to make repairs to damaged infrastructure. That could pull some investment from 2025 into late 2024. The priority will be to reopen idled stores and plants but leave less for long-term investments.

Falling rates, an easing of bank lending conditions and more clarity on fiscal policy post-election should boost business investment in 2025. The baseline forecast assumes very few changes to trade policy and the lapsing corporate tax cuts are not renewed. Anti-corporate sentiment has soared across party affiliation, which makes it harder for Congress to cut corporate taxes.

Inventories drain in the near-term

Retailers stocked up for the holiday season ahead of the East Coast port strikes. Those inventories will be liquidated now that negotiators have returned to the table. Strikes elsewhere and damages due to Helene and Milton could accelerate that drawdown.

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Beyond the fourth quarter, much depends on rate cuts and inventory costs. The baseline has the Fed continuing to cut rates at a moderate pace in 2025 and into 2026. That should allow inventories to stabilize at slightly higher levels than they were pre-pandemic.

Companies are hedging supply chain shocks by carrying a bit more in inventory than they did before the pandemic. The goal now is to return to the just-in-time inventory systems not the just-in-case models touted during the pandemic.

Government spending weakens

Congress punted on a budget yet again and opted to keep the government open via a continuing resolution in the fourth quarter. That suppresses federal spending.

The wildcard is disaster relief. Congress is in recess until November. Leaders in the House and Senate have said they could revisit the issue after the election.

State and local governments, which make up the lion's share of government spending, should slow. Revenues fell short of expectations across states in fiscal 2024, which are expected to be a drag on spending.

Repairs to infrastructure triggered by the hurricanes could offset that weakness. "Rainy day funds" ballooned in the wake of the pandemic; this is what they are for.

The trade deficit widens

Earlier dollar appreciation and excess capacity abroad suggest that imports will swamp exports in the fourth quarter. Retailers continue to order for the holiday season, despite some stockpiling due to concerns over port strikes. The trade deficit will widen and act as a drag on overall growth.

Prospects for early 2025 are not much stronger, as rate cuts will take time to boost growth across many of our trading partners. Equity markets have rallied on the heels of stimulus in China. It is unclear how far that stimulus will go in fueling demand given the ongoing overhang of debt in the real estate market and across regional governments.

The largest threat to trade is a full-blown trade war. History is not kind to countries which engaged in such policies. Across-the-board-tariffs spur inflation, curb competition and invite retaliation. Vicious cycles of escalating costs and weaker growth tend to ensue.

Risks to the outlook

Disruptions due to the hurricanes could dampen growth in the fourth quarter of 2024 and boost growth in 2025. Much depends on how many communities can be rebuilt. Many will be displaced to neighboring cities and states. Some people never returned to New Orleans in the wake of Hurricane Katrina.

Those relocations will increase the demand for housing. The shortfall in affordable housing will worsen. More resources will be needed to make communities more resilient and mitigate the damages due to extreme weather events.

Subdued inflation

Overall inflation cooled, while core inflation, excluding food and energy, held close to the pace of August in September. The buoyancy of core inflation is largely due to a sharp improvement in inflation a year ago. Those "base effects," as they are known, fall out of the data at the start of 2025. After that, year-on-year measures of inflation move toward the Fed's 2% target.

The dispersion of outsized price increases has abated. The appreciation in the dollar we saw earlier in the year and excess capacity abroad should put downward pressure on prices.

Shelter costs finally cooled. That will provide some offset for the rise in costs due to the hurricanes. Disruptions due to supply chains are expected but firms have proven themselves nimbler than during the pandemic. That has muted the pass-through to consumers.

Productivity growth has picked up. That reflects investments made early in the recovery as firms pivoted online and we all learned to better leverage existing technologies. Tight labor markets and hybrid work arrangements better matched workers to their skills, which added to productivity. Those increases are enabling firms to absorb higher input costs without passing them onto consumers.

The last time we experienced that kind of a boost to productivity was in the late 1990s. Those shifts paid a dividend in higher productivity well after they faded in the early 2000s. We will need it, as disruptions due to weather are only one aspect of a host of disruptions that lie ahead.

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Upside risks. Inflation could cool less rapidly than forecast due to the ripple effects of recent disasters and escalating tensions in the Middle East. This is in addition to the threat that extreme weather events become more frequent and destructive, which will further stress existing resources and bid up insurance costs.

Separately, aggressive tariffs and curbs to immigration tend to stoke inflation and stem growth. Those pressures would add to the upside push on inflation associated with widening government deficits and debt. Both policies are more inflationary post-pandemic than they were pre-pandemic.

Fallout for the Fed

Thus far, leaders at the Fed have stuck to their expectation for more measured rate cuts going forward. We are still expecting an additional two quarter-point cuts in short-term interest rates at the Fed's last two meetings of the year.

Another one percent of cuts is forecast for 2025. The fed funds rate is expected to reach a non-inflationary rate of 2.75% - 3% range in early 2026. That is well above the 1.5% - 1.75% rate in February 2020.

Upside Risks. The Fed tends to look through supply-side shocks like disasters, but old rules of thumb no longer hold. Repeated disasters coupled with the move toward more protectionist policies on a global scale are expected to make the global economy experience disruptions and bouts of inflation. The risk is that the Fed slows or reverses cuts as we move into 2025, depending on recovery efforts and fiscal policy decisions post-election.

Bottom Line

Hurricane Andrew in August 1992 was the first major disaster I had to deal with as an economist. It was personal and professional, as my father and his side of the family all had homes in its path. He evacuated; the rest of the family stayed. After that, many scattered. Some moved to Asheville, North Carolina. They are safe, which is all I know at the moment.

The window is broken, along with my heart. We have reached a tipping point. Damages from natural disasters will wreak more havoc and become a larger determinant of how our economies perform going forward. That is true even if we were able to stabilize the rise in global temperatures. Be kind; pay it forward. Many will need that kindness as more livelihoods are disrupted in the months and years to come.

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Economic Forecast — October 2024												
	2023	2024	2025	2023:4(A)	2024:1(A)	2024:2(A)	2024:3	2024:4	2025:1	2025:2	2025:3	2025:4
National Outlook												
Chain Weight GDP[1]	2.9	2.7	1.9	3.2	1.6	3.0	2.8	1.8	1.5	1.7	1.9	2.2
Personal Consumption	2.5	2.6	2.4	3.5	1.9	2.8	3.1	2.3	2.3	2.1	2.1	2.2
Business Fixed Investment	6.0	4.1	2.7	3.8	4.5	3.9	5.3	2.4	2.1	2.3	1.9	2.1
Residential Investment	-8.3	3.0	-2.2	2.5	13.7	-2.8	-8.6	-4.5	-4.6	1.7	4.0	5.7
Inventory Investment (bil $ '17)	33	54	72	45	18	72	65	62	63	66	75	84
Net Exports (bil $ '17)	-933	-1023	-1080	-937	-977	-1036	-1034	-1045	-1061	-1076	-1089	-1095
Exports	2.8	3.4	4.2	6.2	1.9	1.0	8.6	3.9	3.7	3.8	3.9	4.4
Imports	-1.2	5.1	4.6	4.2	6.1	7.6	5.9	4.0	4.4	4.3	4.2	3.8
Government Expenditures	3.9	2.9	0.8	3.6	1.8	3.1	1.7	1.1	0.4	0.3	0.2	0.2
Federal	2.9	1.4	1.1	-0.3	-0.4	4.3	1.2	1.3	0.5	0.8	1.0	0.9
State and Local	4.4	3.7	0.6	6.1	3.1	2.3	2.0	1.0	0.3	0.0	-0.2	-0.2
Final Sales	3.3	2.6	1.9	3.7	2.1	1.9	2.9	1.8	1.5	1.7	1.7	2.0
Inflation												
GDP Deflator	3.6	2.4	2.1	1.5	3.0	2.5	1.7	1.8	2.0	2.3	2.5	2.6
CPI	4.1	2.8	2.0	2.7	3.8	2.8	1.1	1.6	1.3	2.4	2.9	3.2
Core CPI	4.8	3.3	2.3	3.4	4.2	3.2	2.1	2.2	2.3	2.3	2.4	2.4
Special Indicators												
Corporate Profits[2]	10.5	2.6	-0.9	10.5	8.2	10.8	7.4	2.6	3.4	-0.2	-1.2	-0.9
Disposable Personal Income	5.1	3.2	2.6	3.2	5.6	2.4	1.8	2.0	3.5	2.6	2.7	2.6
Housing Starts (mil)	1.42	1.35	1.35	1.48	1.41	1.34	1.32	1.32	1.34	1.34	1.35	1.36
Civilian Unemployment Rate	3.6	4.0	4.1	3.8	3.8	4.0	4.2	4.2	4.2	4.1	4.1	4.1
Total Nonfarm Payrolls (thous)[3]	2936	2311	616	617	771	577	502	461	320	35	133	128
Vehicle Sales												
Automobile Sales (mil)	3.1	2.9	2.9	3.1	3.0	2.9	3.0	2.9	2.9	2.9	2.9	2.9
Domestic	2.3	2.0	2.0	2.2	2.1	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Imports	0.9	0.9	0.9	0.9	0.9	0.9	1.0	0.9	0.9	0.9	0.9	0.9
LtTrucks (mil)	12.4	12.7	12.8	12.5	12.5	12.7	12.7	12.8	12.8	12.8	12.8	12.8
Domestic	9.9	10.0	10.0	9.8	9.9	10.0	9.9	10.0	10.0	10.0	10.0	10.0
Imports	2.5	2.7	2.8	2.6	2.6	2.8	2.7	2.8	2.8	2.8	2.8	2.8
Combined Auto/Lt Truck	15.5	15.6	15.6	15.6	15.5	15.7	15.6	15.6	15.6	15.6	15.6	15.7
Heavy Truck Sales	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Total Vehicles (mil)	16.0	16.1	16.1	16.0	16.0	16.2	16.2	16.1	16.1	16.1	16.1	16.1
Interest Rate/Yields												
Federal Funds	5.0	5.2	3.9	5.3	5.3	5.3	5.3	4.7	4.3	4.1	3.8	3.5
10 Year Treasury Note	4.0	4.1	3.4	4.4	4.2	4.4	4.0	3.9	3.7	3.5	3.3	3.1
Corporate Bond BAA	5.9	5.8	5.4	6.2	5.7	6.0	5.7	5.6	5.6	5.5	5.4	5.3
Exchange Rates												
Dollar/Euro	1.08	1.09	1.10	1.08	1.09	1.08	1.10	1.09	1.10	1.10	1.10	1.10
Yen/Dollar	140.5	150.0	142.8	147.8	148.6	155.9	148.9	147.0	145.0	144.0	142.0	140.0

[1] in 2023, GDP was $22.7 trillion in chain-weighted 2017 dollars.

[2] Corporate profits before tax with inventory valuation and capital consumption adjustments, quarterly data represents four-quarter percent change.

[3] Total nonfarm payrolls, quarterly data represents the difference in the average from the previous period. Annual data represents 4Q to 4Q change.

Quarterly data are seasonally adjusted at an annual rate. Unless otherwise specified, $ figures reflect adjustment for inflation. Total may not add up due to rounding.

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