

Broken Window Economics

There is no simple way to rapidly repair the losses from our recent hurricanes. What's gone isn't going to return tomorrow. People lost homes, belongings and loved ones—tragedy for sure. For those of us that were not materially affected, we must thank our lucky stars. For the less fortunate, we wish you a speedy and productive recovery.

As unfortunate as things are for those materially and/or emotionally affected by the hurricane's destruction, there may be a macroeconomic silver lining. An old economic "theory" seems to apply here: "broken window economics." It goes something like this...

To stimulate a sluggish economy, go out and break a bunch of windows. Doing so means the broken windows will have to be replaced. That effort is economically stimulating.

Labor is needed to take the old window out, dispose of it, clean the area and install a new window. A new window, of course, has to be purchased. After installing the new window, the surrounding area probably needs a little sealant as well as some new paint.

After all the new replacement windows are purchased and installed, building products companies will then be short on normal inventory, so they'll have to order more than their average number of new windows. Window makers will have to order more raw materials to make more windows. Raw material suppliers of wood, aluminum, plastics, glue and glass will then require more first stage raw material from natural resource processors, which will require more production from the lumber, mining and oil and gas companies.

Adding to more than normal window replacement inventory will require us to use more transportation and power to get the natural resources to the raw material makers to make the raw material, to get the raw material to the window making company to make the windows and then to send windows to the supply companies that have to replace inventory.

Sounds pretty neat, eh? Just break a bunch of windows and, voila, you have stimulated economy!

Traditional economists don't embrace this concept. To them it's not productive to break windows in order to stimulate demand and production. From a practical perspective, whose windows will be broken, and why? And where is the money going to come from to pay for these windows? Will it not be coming from a bucket of capital that was already allocated for something else? Are we just robbing Peter to pay Paul?

Official economic policy doesn't overtly embrace this "broken window" practice, but from time to time we find ourselves in comparable circumstances.

The most obvious example of "broken window" economic activity comes with war. War breaks a lot of "windows."

Many parts of Europe and Asia were leveled during World War II, as an example. That war, as all wars do, broke a whole lot of “windows”.

Once World War II ended, who led the rebuilding of Europe and Japan? Who had factories still standing that could immediately supply a lot of replacement “windows”? Who had the capital to reboot these war-ravaged economies? One could suggest it was “broken window” economics that helped pull the U.S. out of the Great Depression, providing a foundation to the Goldilocks economic period that followed.

War is an activity we seek to avoid whenever possible. No modern day person wants to go to war, certainly not purely for the purpose of stimulating economy. Even without war, there remains something many countries can't avoid that creates broken windows: Mother Nature. Mother Nature brings us earthquakes, tsunamis, volcanoes, droughts, floods, fires and hurricanes. She is always breaking windows.

It was a hurricane that inspired one of the Armchair's very first economic epiphanies.

In mid August of 1992, Hurricane Andrew, a category 5 hurricane, struck the Bahamas and then south Florida. Up to that point, Andrew was the costliest hurricane to hit the U.S. It destroyed more than 63,500 homes and damaged another 124,000. Along with the residential devastation came additional commercial, industrial and general infrastructure destruction that required repair or replacement.

All told, the “broken windows” from Andrew were estimated at something close to \$30B. Now \$30B may not sound like a lot to 1992's \$6.5T economy, but as is often the case, markets are made at the margin. In this case, that \$30B “broken window” stimulus from Andrew juiced U.S. economic momentum at a very opportunistic time.

Just before Andrew hit, the U.S. had been in a mild recession. Unemployment in the country actually peaked in June of 1992 at 7.8%. A bit over two months later all manner of workers traveled to south Florida to replace the “broken windows.”

Remember, activity waterfalls through economy once all those extra “windows” have to be replaced. We need more labor, more windows, more raw materials, more transportation, more power and more natural resources.

Andrew provided a spark that helped get economy moving again in the right direction. Since economic expansion has a tendency to feed off itself, Andrew helped put the recession permanently behind us.

Where did the money come from to pay for Andrew's destruction? Governments of course came to the table with rescue money. And then the insurance industry had to pay out claims. Private sector donations, savings and increased consumer debt added to the till of available capital to pay for reconstruction. The private sector had immediate cash to spend/invest, and it did.

Many people will point out that at some point taxes and insurance premiums have to be raised and debt repaid to recoup the costs, but if the economic waterfall of replacing a bunch of “broken windows” is worthwhile, there will be capital available to eventually pay the bill. If government deficit spending or quantitative easing is supposed to juice economy enough to cover the cost, then why not also “broken windows”?

We have recently experienced a nasty Mother Nature period. Billions of dollars will soon be available to pay for replacing all those “broken windows.” In doing so, the affected regional economies will at least employ a fair amount of extra labor and require extra inventory for numerous building materials. Replacing the “windows” broken by these recent hurricanes will trickle down not just to companies in the building products food chain, but more broadly to the economy as well.

As much as traditional economists don’t like “broken window” economics, when circumstances bring them out, economy is eventually stimulated. We should not be surprised if economic growth seems to improve over the next couple of quarters. And just maybe, this at-the-margin stimulus will cause our economy to keep growing for an even longer period.

A handwritten signature in black ink, appearing to read "Doug", written in a cursive style.

Douglas A, Leyendecker
713-862-3030
doug@armchaireco.com