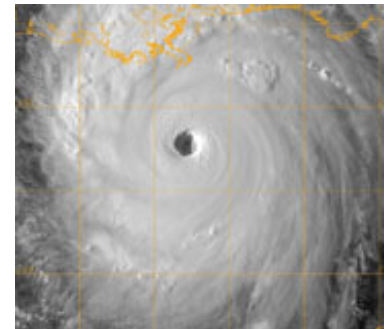




Picking Up the Pieces from Katrina: What Lies Ahead

Published : November 21, 2005 in [Knowledge@Wharton](#)

When Hurricane Andrew struck south Florida in 1992, it caused what was then the largest natural disaster in American history, with more than \$30 billion worth of damage. In the storm's aftermath, the state's property-and-casualty insurance industry fell into a tailspin. Several small insurers collapsed. Big companies began dropping Florida policies by the thousands. State regulators declared a moratorium on cancellations and created a state pool to cover uninsured homeowners. But try as they might, the regulators could only slow, not stop, the cancellations, and the largely unfunded state pool swelled to hundreds of thousands of policies over the next several years. A decade later, the storm's effects continued to ripple through the state's insurance sector.



This is a single/personal use copy of Knowledge@Wharton. For multiple copies, custom reprints, e-prints, posters or plaques, please contact PARS International: reprints@parsintl.com P. (212) 221-9595 x407.

The economic damage from Hurricane Katrina looks to be larger, and many commentators already are calling it the costliest natural disaster ever to strike the United States. Indeed, some estimates put the damages/losses as high as \$200 billion. Meanwhile, the oil-and-gas industry has reported serious setbacks, with oil-drilling platforms toppled and refineries knocked out of commission. The insurance industry will suffer, too, in the next few months as businesses and homeowners file claims for their losses. And regionally, of course, the damage is cataclysmic. Much of New Orleans remains flooded, and an industry on which the city and its people depend - tourism -- has no clear path for returning to viability. The French Quarter may have been spared, but many of the owners and employees of its restaurants, bars and hotels are holed up, for the foreseeable future, in faraway places like Houston and Dallas.

Katrina's economic impact is therefore likely to be lasting and large, says Wharton finance professor [Jeremy Siegel](#). "Everyone in that area of the country -- all their purchases are going to be curtailed until they know where they are going to live," he says. "Several million people aren't going to be buyers in the near future." Even worse could be the national impact on gas prices and thus household and corporate costs. "We were already at the limit of our refining capacity. So this couldn't have happened at a worse time in terms of the oil markets."

But unlike Andrew, Katrina may end up largely sparing private insurers, says [Howard Kunreuther](#), Wharton operations and information management professor and an expert on insurance. The first week's reports suggest that flooding from Lake Pontchartrain, after levees broke, caused much of New Orleans' destruction. Private insurance doesn't cover flood losses; the federal flood insurance program does. "If the damage to a property was caused by water, the industry won't have to pay a dime," he says.

Of course, the havoc that a hurricane wreaks on real estate rarely fits neatly into one category. Often, a building will be flooded but also lose part of its roof on account of the wind, according to Kunreuther. That ambiguity may cause squabbles between the private sector and the government and between homeowners and their insurers. "There are going to be many lawsuits," Kunreuther predicts. "If it turns out that flood insurance doesn't cover an entire house, will the insurance company step up? The irony of all this is that a poorly built house, which lost its roof, is more likely to get that coverage than a well-built one that didn't lose its roof."

Flood-caused losses are probably so large that they may outstrip the flood insurance program's ability to

pay, Kunreuther suggests. If that happens, federal lawmakers will have to come forward with more funds. In addition, private insurers could feel the brunt of Katrina in their business interruption coverage since many firms, small and large, in New Orleans and along the Gulf Coast may be closed for months.

Hurricane-prone Real Estate

Longer term, Hurricane Katrina could induce property-and-casualty insurers to re-examine the geographic distribution of their policies and raise premiums, Kunreuther says. Even if these insurers escape large payouts for the storm, it will remind them of the ever-growing risks they face. As the country's population increasingly shifts to the Sunbelt, "people are moving into harm's way," he says.

Take Florida, which has been called the most hurricane-prone piece of real estate in the world. Its population swelled by more than a third from 1990 to 2004. The bulk of that growth has occurred along its nearly 1,200 miles of coastline. Southern seaports such as Charleston, S.C., and Wilmington, N.C., have also boomed during the same period.

Unlike private insurers, the oil-and-gas industry -- concentrated along precisely the stretch of Gulf of Mexico coastline that the storm slammed -- wasn't spared by Katrina. According to the U.S. Department of Energy, Katrina cut Gulf oil production by 90% and has shuttered or seriously hampered refineries, reducing the nation's gasoline production by 10%.

"Before Katrina, we were running flat out in the U.S. on refining," says Siegel. "Since the storm, the President had said he is releasing oil from the strategic reserve. The problem with the reserve is that it's oil, not refined products. The only way we can get the refined products is to shift them from other countries. And that takes time because they have to go on tankers."

As prices for gasoline and other refined petroleum products rise, so will costs across the transportation sector. "All forms of transportation -- cars, buses, trucks, airplanes and diesel trains -- are going to be affected and will have to raise prices to cover their costs," Siegel says. With such a hefty hit in the form of fuel prices, many economists are puzzling over the effect on the nation's economic growth, he adds. "My estimate is that this could take 1 to 2 percentage points off second-half GDP. Does that push you into recession? Unless the psychological impact flips people overboard -- like the hysteria that existed during the 1970s energy crisis -- I don't think so."

One positive sign is that bond investors have responded calmly to Katrina and the attendant economic news, Siegel notes. "Even though oil and gas prices are shooting up, interest rates aren't. The bond market seems to be seeing this as a temporary increase. And there appears to be a feeling in the market that the Federal Reserve will pause in its interest-rate increases after its September 20 meeting."

What about the economic future of the Crescent City itself, home to one of America's most storied urban cultures, with its zydeco and voodoo, crawfish gumbo and oyster po'boys? "New Orleans will be rebuilt and will be as vibrant as it was in the past," Siegel predicts. "The French Quarter, the draw for tourists, has been relatively undamaged. But there will have to be a few billion dollars spent on making those levees work. They probably would have held if they had been in [better] condition."

[Witold Rybczynski](#), a Wharton real-estate professor, agrees. "Cities almost always come back," he says. "In a city, the investment in infrastructure, both physical and legal, is so great that it always seems to outweigh the destruction." A city, for example, already has had neighborhoods and thoroughfares mapped out and public rights of way established. In addition, cities seem to have a natural lifecycle that favors their endurance, Rybczynski added. They can grow quickly -- think of a boomtown like, say, Las Vegas in recent years -- but tend to decline slowly. "There's an inertia built in with cities; people have homes and jobs. When decline happens, it's very slow."

The Will to Rebuild

A classic example of the human impulse to preserve cities was Warsaw after World War II, Rybczynski notes. "The city was virtually 100% destroyed. The Germans essentially razed it. But there was no question that the city would be rebuilt. I think the same thing will be true in New Orleans."

[Todd Sinai](#), also a Wharton real estate professor, cites the smaller but more recent example of Oakland Hills, Calif., where a wildfire consumed about 3,000 homes in 1991. There, as with New Orleans and its flood-prone location, the community had physical features that exacerbated its plight. "In part, the houses burned down because the roads were too narrow and winding, and the fire trucks had trouble getting to the fire," he says. "Electric poles and wires also fell, blocking the roads. But what the community did was put it back the way it was. They didn't straighten the streets or bury the utility lines, though some neighborhoods did end up paying to have those lines buried."

Even if New Orleans ends up looking much like it did before Katrina, the storm still could wallop the local economy, Rybczynski says. The city could lose population and may have difficulty jumpstarting its tourist industry. Photos of flooded streets and floating bodies do little to entice visitors. And New Orleans probably won't be functioning normally by February when its biggest annual event, Mardi Gras, rolls around. As Wharton real estate professor [Georgette Poindexter](#) notes, "we're not talking about any city. This is a city with a unique identity in the U.S. Its product is its flavor -- its culture, its architecture, the experience of walking through the French quarter," all of which may be difficult to recreate.

What, then, should local and national leaders do to rebuild New Orleans and ensure, as much as possible, the future health of its economy? "A lot of it has to do with what the reconstruction is; a business center is different from a neighborhood, and a middle-class neighborhood is different from a poor one," Rybczynski adds. "They will require different solutions. Reconstructing neighborhoods isn't done through attracting corporate money. And it's going to require a type of social housing, a strategy that recognizes that some people are poor, and that there is no miracle that will turn them into rich people. Trying to get tourism back on track quickly will be very important. You have got to focus on that. When the enormity of this sinks in, my guess is that there will be a rallying around. At that point, the resources of the whole country can be brought to bear."

When that realization comes -- if it isn't already dawning -- companies must take an ethical accounting and assess their obligations to people in New Orleans, says [Thomas W. Dunfee](#), Wharton professor of legal studies and business ethics. "I would distinguish between companies with vitally needed resources, like a nearby clinic, and other companies." For example, firms without critical resources - such as a snack food manufacturer -- should assess what they can afford and balance the needs of the people in New Orleans against their obligations to shareholders, employees and customers. At the same time, Dunfee adds, "firms with essential resources have an affirmative duty of rescue and should redirect resources that they normally give to philanthropy toward this disaster."

A View from Europe

October 1998 is a month that Juan Carlos Martínez Lázaro will never forget. A professor of economics at the Instituto de Empresa, the Madrid-based business school, he was paying a personal visit to Guatemala when Hurricane Mitch devastated several countries in Central America. In Guatemala, Honduras, Nicaragua and El Salvador, the countries that suffered the greatest damage, 10,500 people died and close to another 10,000 disappeared. Overall, some seven million people were affected by Mitch.

In addition to the tremendous human tragedy, the hurricane was a genuine economic disaster for the region. "The GDP fell by approximately 20%," notes Martínez Lázaro. "The economic impact is much greater on small countries," he adds, comparing the impact of Mitch with the impact of Hurricane Katrina in the United States. While Katrina hit the Gulf coast area hard, "Mitch destroyed the economies of all those countries in every sector, not just in tourism. It was total and comprehensive, and it also led to an enormous wave of emigration." Furthermore, the U.S. "will be able to rebuild the devastated zones while

Central America, in contrast, relied entirely on foreign aid. In the U.S., there will be refugees, but the people who have been displaced will be going back to their houses sooner or later. Katrina will not produce the same wave of emigration that occurred in Central America."

The entire world, Martínez Lázaro adds, "is surprised by the magnitude of the tragedy. If this had happened somewhere else, particularly in a developing country, we would not have been so surprised. This has shattered the image [that people have of the U.S.]....Everyone thought that the country could control the situation and that it did not need help."

As to the ripple effects of Katrina worldwide, Martínez Lázaro believes "the cost is going to be very high; it will have a major impact on the American economy and from there, the impact will spread to the rest of the world. It will restrain rising interest rates in the United States and raise the price of crude oil, which will affect us in Europe. In addition, the hurricane happened at a bad time, after 15 months of continuous increases in petroleum prices, just when the winter season is about to begin in the Northern Hemisphere and indoor heating is used the most." The rising price for petroleum will mean an upturn in inflation, Martínez Lázaro predicts, which is already worrying all of Europe.

This is a single/personal use copy of Knowledge@Wharton. For multiple copies, custom reprints, e-prints, posters or plaques, please contact PARS International: reprints@parsintl.com P. (212) 221-9595 x407.