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Contaminated Vegetables and Toxic Assets

The e coli scare in Europe right now has thrown governments and their health services into crisis, devastated Spanish agriculture and changed a continent's eating habits overnight. And yet, the risks, viewed in any objective sense, of eating a cucumber in Germany are minuscule: there are, in that country at this moment, thousands of intrepid cigarette smokers who are shying away from the salad course in the name of health safety. Not that I would behave any differently: the slight chance of a devastating outcome is enough to make me boil my vegetables as well.

But it is noteworthy how news of such a low probability event can cause such enormous economic dislocation. There are millions and millions of cucumbers out there; the odds of any particular cucumber being toxic are vanishingly small, and yet since we can't know which is the lethal cucumber, we avoid them all. Result: localized disaster leading to economy wide disruption. The situation is familiar to all the souvenir salesmen in Cairo--reports of a dramatic incident of tourists' deaths in a terrorist incident lead to decline in foreign visitors for months or years.

In both of these cases the fundamental problem is contamination: the inability to sort out the good apples from the bad apples means all must be regarded as tainted. The same situation arose in the recent financial crisis. Somewhere out there lurked toxic assets--mortgage backed securities where the underlying loans were badly supervised or fraudulently arranged or insufficiently diversified. While the pile of toxic assets was enormous, it was still a very small part of the entire financial sector. But for the average investor--even for the expert investor--the problem was that there was no way to tell which financial institution was actually contaminated--so all are tainted. (This phenomenon is not particular to the recent crisis: observers of earlier banking crises in the U.S., back into the nineteenth century, also noted similar problems.)

In the case of the financial crisis, there is a potential strategy, for those of stong constitution. After all you can tell the magnitude of the problem at the outside--calculate the number of troubled mortgages. The total fall in the value of the financial assets at the height of the crisis is much greater than this underlying amount of damage. So there are profits to be had if you can just figure out which financial assets to buy. But you don't know which. The solution: you just buy a little of every one of them, hold on to them all, and hope your stomach is up to the challenge.