

Suppression of volatility

Economic note

29th July 2011

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Nicholas Nassim Taleb, of Black Swan fame, has recently published a short article in Foreign Affairs that goes to the heart of the role governments attempt to play in modern society and the economy. His great concern is the attempt by policy makers to suppress volatility from everyday life with the consequence that suppressed volatility aggregates itself, only to appear sometime in the future.

In the parlance of today, it's kicking the can down the road.

Taleb uses the troubles in North Africa as an example of the problem. By failing to allow change within the societies and economies of North Africa, local rulers created, on the surface, very stable societies and economies. Stability was, generally, dependent upon a quasi-command based economy with limited market based allocation. This is in contrast to the more market based emerging economies in Asia. These economies do suffer greater short term volatility; markets change and businesses fail. But they benefit, however, from their ability to generate employment and less inflationary environments; the two factors that contributed most to the end of regimes in Tunisia and Egypt and revolution in Libya.

The debt ceiling debate in the US is another example. By raising the debt ceiling now, market stability is maintained. Global asset markets can rally on the basis of a more stable near term outlook. But such a solution, in the absence of a shift to a sustainable fiscal path, only makes the ultimate reckoning even more de-stabilizing. The volatility saved today potentially emerges in a larger event down the track.

Similarly in Europe, the current solution of avoiding a default in Greece and the other periphery economies suppresses volatility in the short term but, potentially, transfers it to a later date. By trying to avoid a default and an exit from the eurozone, Europe has forced an unprecedented austerity on the peripheral economies, with, as yet, unknown consequences.

It seems as if there is, globally, an attempt to remove volatility from everyday life. Certainly, a less volatile world seems attractive, but if it comes at the expense of large volatility events, it may not be worth it.

Liam O'Connor in the cash team offers an interesting perspective. Liam points out that in the debate over RBA policy settings, greater short term volatility might, indeed, be valuable. By minimising volatility in the short end of the market the RBA encourages the entrance of new market participants with marginal business models, reliant on low short term volatility. When short term volatility inevitably rises, these business models (think first home buyers, non-bank mortgage providers etc.) collapse and create substantial macro-economic problems. He argues that greater volatility in the short end would lead to more stable long term rates and economic outcomes by removing the more marginal players from the market.

This is the case across the history of the global economy. Periods of forced volatility, often created by governments aiming to reform productivity, tend to create, subsequently, more stable periods of economic growth while, alternatively, periods of forced stability have led to economic crises and, often, political revolution. The continued attempt by developed world governments to avoid a cleansing period of volatility poses a substantial risk to the expected (by policymakers) return to trend growth in coming years and raises the risk of a similarly intense period of volatility to that observed in 2008.

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