

Attempts to Suppress Volatility Could Lead to a Crash in Existing Economic and Political Systems

By [Washington's Blog](#)

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Suppressing Financial Instability Increases Risk of Market Breakdown

Financial analyst and author Nassim Taleb [demonstrated](#) that suppressing market volatility in the short-run leads to much more violent bursts of dislocation and chaos in the long run.

Taleb learned many of his ideas from mathematician Benoit Mandelbrot (who discovered fractals). As Scientific American [noted](#) in 2008:

One of those long-time market watchers is fractal pioneer Benoit Mandelbrot. In 1999, [Scientific American](#) published an [article by Mandelbrot](#) that showed how fractal geometry can model market volatility, while revealing the intrinsic deficiencies of a cornerstone of finance called modern portfolio theory (for which there has been awarded more than one Nobel Prize in Economics).

Mandelbrot, 83, contends that portfolio theory, which tries to maximize return for a given level of risk, treats extreme events (like, say, yesterday's market shockers) with "benign neglect: it regards large market shifts as too unlikely to matter or as impossible to take into account." The faulty assumption of modern portfolio theorists, in Mandelbrot's view, is that price changes do not drift far from the mean when observing daily ups and downs—so extreme events are exceedingly rare. "Typhoons, in effect, are defined out of existence," he wrote.

Similarly, Graham Giller - from Oxford University in experimental elementary particle physics, then strategy researcher and portfolio manager for Morgan Stanley - [writes](#) today:

The Greenspan [and Bernanke] era monetary policy has altered the distribution of changes in interest rates in a way that exchanges a reduction in day-to-day 'normal' variability for a considerably higher (perhaps catastrophically higher as we are finding out this week) likelihood of extreme shocks.



I first made the attached chart in 2004 after attending a lecture by Benoit Mandelbrot, and reading his "Fractals and Scaling in Finance."

So a narrative for what the Greenspan era monetary policy has done to the

distribution of changes in rates is to exchange a decreased daily variability for a higher (perhaps catastrophically higher as we have found out) likelihood for extreme shocks. [And nothing has changed under Bernanke.]

The whole enterprise of bond portfolio risk management is intrinsically unreliable.

It is this constant papering-over of the day-to-day cracks (and business cycle) that is supposedly so beneficial for our society (and central planners) as a whole that creates a building tension as the underlying causes grow larger and larger and are never purged until in one fell swoop, the market mechanism finds a way.

And as I noted last year, [interest rate derivatives – like portfolio insurance in the 1980s – might also be creating huge risks, while appearing in the short-run to be reducing risks.](#)

Of course, Taleb, Mandelbrot and Giller’s analysis of volatility means that the Fed and other central planners’ attempts to prop up some asset prices or drive some indicators down as a way to reduce volatility could well lead to a more explosive crash of the entire financial system.

Suppressing Political Volatility Increases the Risk of a Breakdown in Existing Social Order

This principle not only applies to markets and finance, but also to sociology and politics.

“Those who make peaceful revolution impossible will make violent revolution inevitable.”
– President John F. Kennedy

“If you shut up the truth and bury it under the ground, it will but grow, and gather to itself such explosive power that the day it bursts through it will blow up everything in its way.”
– French author Emile Zola

Indeed, Taleb co-wrote an article in May with Mark Blyth – Professor of International Political Economy at Brown University – [stating](#):

Why is surprise the permanent condition of the U.S. political and economic elite? In 2007-8, when the global financial system imploded, the cry that no one could have seen this coming was heard everywhere, despite the existence of numerous analyses showing that a crisis was unavoidable. It is no surprise that one hears precisely the same response today regarding the current turmoil in the Middle East. The critical issue in both cases is the artificial suppression of volatility — the ups and downs of life — in the name of stability. It is both misguided and dangerous to push unobserved risks further into the statistical tails of the probability distribution of outcomes and allow these high-impact, low-probability “tail risks” to disappear from policymakers’ fields of observation. What the world is witnessing in Tunisia, Egypt, and Libya is simply what happens when highly constrained systems explode. [Well, Al Qaeda also [had a role in creating chaos in Libya](#), that’s beyond the scope of this post.]

Complex systems that have artificially suppressed volatility tend to become

extremely fragile, while at the same time exhibiting no visible risks. In fact, they tend to be too calm and exhibit minimal variability as silent risks accumulate beneath the surface. Although the stated intention of political leaders and economic policymakers is to stabilize the system by inhibiting fluctuations, the result tends to be the opposite. These artificially constrained systems become prone to “Black Swans” — that is, they become extremely vulnerable to large-scale events that lie far from the statistical norm and were largely unpredictable to a given set of observers.

Such environments eventually experience massive blowups, catching everyone off-guard and undoing years of stability or, in some cases, ending up far worse than they were in their initial volatile state. Indeed, the longer it takes for the blowup to occur, the worse the resulting harm in both economic and political systems.

Seeking to restrict variability seems to be good policy (who does not prefer stability to chaos?), so it is with very good intentions that policymakers unwittingly increase the risk of major blowups. And it is the same misperception of the properties of natural systems that led to both the economic crisis of 2007-8 and the current turmoil in the Arab world. The policy implications are identical: to make systems robust, all risks must be visible and out in the open — fluctuat nec mergitur (it fluctuates but does not sink) goes the Latin saying.

So the efforts of governments, powerful corporations and mainstream media all over the world [to stifle dissent](#) could backfire ... and lead to a wholesale dissolution of the entrenched systems of power.

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