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## A Flock of Black Swans

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By Jeffrey Frankel      Wed, Aug 22, 2012

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*Forget the Ides of March. Beware of the entire month of August, says Harvard's Jeffrey Frankel. That's when the doctors are away and the lunatics take over the asylum.*

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Throughout history, major political and economic shocks have often occurred in August, when leaders have gone on vacation believing that world affairs are quiet. Consider World War I's outbreak in 1914, the Nazi-Soviet pact in 1939, the Sputnik launch in 1957, the Berlin Wall in 1961, and the failed coup in Moscow of 1991. Then there was the Nixon shock of 1971 (when the American president took the dollar off the gold standard and imposed wage, price, and trade controls), the 1982 international debt crisis in Mexico, the 1992 crisis in the European Exchange Rate Mechanism, and the 2007 subprime mortgage crisis in the United States.

Many of these shocks constituted events that had previously been considered unthinkable. They were not even on the radar screen. Such developments have been called "black swans" – events of inconceivably tiny probability.

But, in my view, "black swan" should refer to something else: an event that is considered virtually impossible by those whose frame of reference is limited in time and geographical area, but *not* by those who consider other countries and other decades or centuries.

The origin of the black swan metaphor was the belief that all swans are white, a conclusion that a nineteenth-century Englishman might have reached based on a lifetime of personal observation and David Hume's principle of induction. But ornithologists already knew that black swans existed in Australia, having discovered them in 1697. They should not have been viewed as "unthinkable."

Before September 11, 2001, some experts warned that foreign terrorists might try to blow up American office buildings. Those in power did not take these warnings seriously. After all, "it had never happened before." Many Americans did not know the history of terrorist events in other countries and other decades.

Likewise, until 2006, most Americans based their economic behavior on the assumption that nominal housing prices, even if they slowed, would not fall, because they had not done so before – within living memory in the US. They may not have been aware that housing prices had often fallen in other countries, and in the US before the 1940's. Needless to say, many indebted homeowners and leveraged bank executives would have made very different decisions had they thought that there was a non-negligible chance of an outright decline in prices.

From 2004 to 2006, financial markets perceived market risk as very low. This was most apparent in the implicit volatilities in options prices such as the VIX. But it was also manifest in junk-bond spreads, sovereign spreads, and many other financial prices. One reason for this historic mispricing of risk is that traders' models went back only a few years, or at most a few decades (the period of the late "Great

Moderation"). Traders should have gone back much further – or better yet, formed judgments based on a more comprehensive assessment of what risks might confront the world economy.

Starting in August 2007, supposedly singular black swans begin to multiply quickly. "Big banks don't fail?" No comment. "Governments of advanced countries don't default?" Enough said.

Debt troubles in Greece, especially, should not have surprised anyone, least of all northern Europeans. But, even when the Greek crisis erupted, leaders in Brussels and Frankfurt failed to recognize it as a close cousin of the Argentine crisis of 2001-2002, the Mexican crisis of 1994, and many others in history, including among European countries.

Nowadays, a eurozone breakup has become one of the most widely discussed possible shocks. Considered unthinkable just a short time ago, the probability that one or more euro members will drop out is now well above 50%. A hard landing in China and other emerging markets is another possibility.

An oil crisis in the Mideast is the classic black-swan event. Each one catches us by surprise: 1956, 1973, 1979, 1990. Oil prices can rise for many other reasons, as they have in recent years. But the most likely crisis scenarios currently stem from either military conflict with Iran or instability in some Arab country. The threat of a supply shock typically fuels a sharp increase in demand for oil inventories – and thus in prices.

The most worrisome financial threat is that currently over-priced bond markets will crash. In theory, inflation (particularly commodity-induced inflation, as in 1973 or 1979) could precipitate a collapse. But this seems unlikely. Default in some euro countries or political dysfunction in the US is a much more likely trigger.

Evidence of extreme dysfunction in US politics is already plain to see, reaching a low in 2011 during the debt-ceiling showdown (also in August), which cost America its AAA sovereign rating from Standard & Poor's. In theory, as the "fiscal cliff" set for January 1, 2013, approaches, fearful investors should start dumping bonds now. But investors still believe that politicians, aware of the dire consequences of going over the cliff, will again find a last-minute way to avoid it.

Perhaps observers believe that a clear result in November's elections, one way or the other, would help to settle things. A true black swan – low probability, but high enough to think about – would be a repeat of the disputed 2000 presidential election. There has been no reform since then to ensure that people's votes will be counted or that a disputed outcome will not be resolved by political appointees.

Scariest on the black-swan list is a terrorist attack with weapons of mass destruction. There is a long-standing gap between terrorism experts' perception of the probability of a nuclear event and the probability as perceived by the public. (Admittedly, the risk is lower now that Osama bin Laden is dead.)

Last on the list is an unprecedented climate disaster. Environmentalists sometimes underestimate the benefits of technological and economic progress when they reason that a finite supply of resources must imply their eventual exhaustion. But it is equally mistaken to believe that a true climate disaster cannot

happen simply because one has not already occurred.

Have a nice vacation.

*Jeffrey Frankel, a professor at Harvard University's Kennedy School of Government, previously served as a member of President Bill Clinton's Council of Economic Advisers.*

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