# At the Mercy of the Market:
# Capital Structure and Volatility in the Global Periphery

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> For Colombia the [1872] loan was not a great success, since its novelty and the uses of the proceeds ensured that Colombia was saddled with a large debt from which it derived little in the way of actual proceeds. For the capital markets, however, the Colombia loan was an unqualified success. Bankers made very large profits on limited risks. Investors. . . were eager to purchase. . . The Colombia bond quickly traded up in the secondary market.
>
> — Michael Pettis, The Volatility Machine,[1] pp. 73-74.

In *The Volatility Machine*, Michael Pettis provides a valuable perspective on the troubles that have beset peripheral economies in earlier days of globalization. Notably he absolves the much-battered boom and bust victims of most of the blame, as booms were fed and busts were triggered mainly by events external to what he calls "less developed countries" (LDCs). Those external events were primarily monetary developments in global money centers. What part of the blame does devolve to weaker peripheral counterparts is particular to poor choices of

[1] https://global.oup.com/academic/product/the-volatility-machine-9780195143300

capital structure, especially foreign-denominated debt.

Although the book is nearing 20 years of age, its lessons are still pertinent. The historical recountings are brief but illuminating, ranging over eurodollar recycling after the 1970s oil shock, the LDC lost decade of the 1980s, the Mexican peso crisis of the early 1990s, and the Asian crises of the later 1990s. Further reaches back into history, all the way to classical Rome, provide deep background for the situations under consideration. The pre-twentieth century relationship between money center Britain and the rumbustiously developing USA is especially notable:

> A typical relation between a leading financial center and a volatile emerging market country is that between Great Britain and the United States during the eighteenth and nineteenth centuries, during which the U.S. and British economic cycles were highly correlated for countries with such different economic and political conditions. . . . [E]conomic crises and panics in the United States were linked primarily to British market panics and gold imbalances, and it is the liquidity expansion in Britain that seems to have driven both economies. (p. 53)

What has made peripheral crises bite so hard has been the self-reinforcing nature of adverse reactions to external shocks. That's the eponymous "volatility machine." Pettis lays out a variety of such dark patterns, in which vicious circles of woe play out as a typically external negative liquidity shock (e.g. currency devaluation, interest rate spike, commodity price crash) launches a stampede of actions and consequences that tend to amplify the original triggering condition. Such spirals of doom run until external intervention or collapse breaks the feedback loop. These booms and busts are magnified in peripheral economies whose capital markets are dwarfed by those of the money centers of the day, and whose dependence on money center capital is a crucial weakness and point of failure.

To formalize these notions of external monetary shocks driving boom and bust in peripheral economies, Pettis offers a fairly detailed "liquidity model" which draws on Minsky and Kindleberger:

> The "liquidity" model, which in its purest form, can be associated with the works of Charles Kindelberger and with Hyman Minsky's "financial instability hypothesis," begins with the assumption of a liquidity expansion in the global financial centers, which Minsky calls a "displacement." The displacement or impetus for the liquidity expansion can be fairly complex. . . . Risky structures are usually built up by risky financial practices during periods of financial tranquility—this concept is sometimes summarized as "stability is destabilizing." . . . [A]t some point the "shift" in usage can have a monetary impact that is hard to predict and that can lead to fragility in the financial system during boom periods, so that, in Minsky's words, "a slight reversal of prosperity can lead to a financial crisis." When that happens, the previous expansion of liquidity rapidly becomes a liquidity contraction. (p. 38)

Pettis offers an options-oriented theory for understanding valuation of financially distressed entities that has its origins in corporate finance, but also has some explanatory value for sovereigns. Succintly put, investors are very reluctant to invest where defaults are probable, mainly because losses are borne solely by the investor, but gains are shared with clamouring creditors. This rather technical approach might be useful for those who are unwilling to take historical lessons, but immersion into its mysteries is not prerequisite to appreciation of the crucial messages of the text. The proposition that sovereigns in repayment distress would have difficulty attracting new investment scarcely needs finance mathematics to bolster its plausibility. But for those with a taste for such, the options-oriented analysis is elegant, compelling, and reasonably accessible.

Pettis prescribes a variety of finance hacks to prevent self-destructive cycles from breaking out, of which the most important is probably avoidance of borrowing in

foreign currencies, especially by the sovereign and too-big-to-fail institutions. Pettis also urges the creation of medium and long-term local currency debt markets which allow sharing of risk between borrowers and lenders, particularly interest rate risk, but also, indirectly, currency and commodity price risk.

Pettis tiptoes around the vacuity of neoliberal development dogma (the Washington Consensus) but he does reveal his skepticism in a few places. From the introduction:

> An examination of sovereign debt history suggests that there is no obvious conclusion to be drawn about the correlation between, on the one hand, liberal economic policies and sustainable economic growth, and, on the other hand, industrial policies and economic stagnation. During periods of ample global liquidity, most economic policies seem to "work" because of foreign capital inflows, while they all "fail" when liquidity dries up. Perhaps more important, Latin American countries, contrary to popular belief, actually have a long and not very successful history of experimentation with liberal economic models. On the other hand, successful former emerging market countries like the United States, Germany, France, Japan, Taiwan, and Korea have all followed to varying degrees policies of export encouragement, import substitution, protectionism, industrial targeting, and credit manipulation. (p. xvi)

What imagineers of post-capitalism[2] might care to explore is the extent to which easy credit and loose money engender economic booms and conversely tight money ushers in the busts. Under the gold standard, tight money was almost a real thing. But under fiat, it's a matter of policy and sentiment.[3] Even under the gold standard, when technology or policy created newly monetizable instruments, booms often followed. Regrettably, privately created credit has a pronounced

[2] ../purpose.html

[3] ../money/is-money-finite.html

tendency to instability, as Minsky teaches.[4] Greed giving way to fear charts the way from boom to bust.

Although Pettis directs his policy suggestions to finance ministers and central bankers of peripheral economies, there are lessons that are applicable to a broader context, including a pluralistic world of overlapping monetary sovereigns. We are not actually constrained[5] to rely on greedy, fearful, swarming bankers for creation of money[6] under a fiat system. We have the potential to claw our monentary sovereignty back from unelected, oligarchic banksters[7] and to redirect the resources of society away from war and concentrated wealth towards democratically determined public ends. We can take the reins of policy into public hands under democratic sovereignty,[8] and harness the creation of money to social ends, of which full employment, universal health care, free education, revitalized public housing, and environmental stewardship might be obvious policy goals. Public money invested responsibly in pursuit of these goals could be a basis for widespread prosperity and sustainable economic growth.[9]

This is a valuable book and Pettis earns our gratitude. The history is pertinent and compelling. The options-based theory is elegant and provides an analytic complement to the historical retellings. The writing is clear and forceful, and Pettis is to be congratulated for his avoidance of excessively technical language, however some degree of familiarity with finance may be necessary for a full appreciation.

[4] ../money/minsky-moment.html

[5] ../money/can-we-afford-that.html

[6] ../well-and-truly-buried.html

[7] ../money/unelected-sovereigns.html

[8] ../money/democratic-sovereignty.html

[9] ../getting-money-right.html

But the crucial message requires no specialized knowledge. Peripheral economies dependent on foreign capital are peridically whipsawed by events beyond their control. Weak sovereigns and peripheral economies, beware foreign currency borrowings from far-away money centers, lest you find yourself busted, at the mercy of the market.