STRATEGIES FOR OFFENSE AND DEFENSE IN GLOBAL CAPITAL MARKETS

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ABSTRACT

Common vision of warfare is strewn with troop movements, destructive technologies, ruined infrastructure and, naturally, physical violence. What is missing is another side of the story: the use of capital markets, financial instruments and financial institutions to wage a war that is just as violent as the physical one. The difference is the type of violence and the ultimate physical and nonphysical impact. Bloodletting gives way to financial resource destruction and demolishing of infrastructure is substituted by the destruction of assets, markets, institutions, jobs and ultimately individuals.

What constitutes offense and defense conditions in global capital markets and what are the respective strategies is the focus of the following article.

The article starts with a brief analysis of symptoms of disarray in today’s global capital markets and what constitutes strategies for aggression in those markets. This is followed by an analysis of the defense side of the equation. The articles go further to suggest a conceptual framework for those dynamics.

The article is based on contemporary capital market conceptual frameworks as well as case histories of countries as Thailand, Argentina and Russia. The warfare component is drawn from the observed behavior of players within those markets and the ultimate goals and outcomes of this behavior.

The article provides a new analytical framework for strategic thinking within global capital markets. The conceptual framework and its operational dimension have an immediate applied use in projecting country position and identifying country aggressive or defensive posture.

Strategies for aggressive capital market behavior: why?

War is an armed conflict between two or more non-congruous entities, aimed at reaching a subjectively designed, geo-political and economic desired end result. It is a "continuation of political course, carried on with other means." (Von Clausewitz, 1873) War like hostile behavior in the capital market is usually a scene within a comprehensive hostility laden scenario guided by a desire to achieve eco-political ends by exploiting market, asset, price and communication vulnerabilities within a global or the country specific framework.

Many governments regard capital warfare a conducive mode of hostile behavior (Washington Post Oct 12, 2008). An induced economic downturn within an “enemy” could lead to instability and opportunistic, politically motivated, power shifts (Bayulgen et al, 2005).

Global capital market disarray witnessed over the past decade has substantially increased resort to capital market hostilities. Structural shifts in capital market premises, operations and players altered positions and induced an urge for restructuring and, in the process, hostile behavior. Events of 2008 and beyond have resulted into the collapse of key capital market operators as Lehman Brothers and the dramatic decline of others as RBS (Royal Bank of Scotland) of Britain. Capital market instruments, especially the innovative structured finance genre, declined in appeal, scale and viability. Credit rating monitors failed to monitor and regulators from the FED to the SEC in the United States have failed to regulate. (El Namaki, 2014).

Disarray is enhancing aggression.

Strategies for aggressive behavior: what?

Aggression in capital markets can take a variety of form. The following are seven strategies identified by the authors as the most common and the most potent.

1. Reversible capital flaws

Reversible capital flaws or opportunistic short term capital in and out flow from a country could destabilize economies, erode reserves, undermine currencies and reduce investors’ confidence. They constitute a disruptive capital market strategy.

A characteristic of many of the recent emerging market currency crises is a preceding surge in capital inflows and their reversals or ‘sudden discontinuation’ during the crises. Empirical analysis of 38 emerging market economies between 1990 and 2003 revealed likelihood that a surge in capital inflows significantly increases the probability of a sudden stop. A surge accompanied by a high current account deficit or an appreciated real exchange rate is, moreover, very likely to be associated with a sudden suspension. Private loans and portfolio flows dominate those oscillations rather than direct investment as they have a higher probability of a sudden discontinuation. (Sula, 2006)

Reversible capital flows are considered the prime cause of the 1997-1998 Asian financial crises.

2. Competitive currency devaluation.

Currency hostilities or situations where countries compete in creating competitive exchange rates as a remedy to economic ills are deemed strategically aggressive if they are driven by strategic ulterior motives going beyond the requirements of the situation.

Debts generated in the course of quantitative easing processes triggered, very recently, a depreciation of the currencies of several countries providing them with a competitive
advantage. United States quantitative easing measures have followed this scenario with the added advantage of a reduced risk level made possible by US dollar dominance of international merchandise trade and capital flows. This has created a situation where the United States is probably the only country that could afford massive own currency debts and a de facto depreciation of the US dollar, without running a serious risk of retaliation or a need to settle debts in a foreign currency. No surprise that US quantitative easing measures prompted widespread criticism from China, Germany, and Brazil stating fear of impact of capital flight on their economies. (The Guardian, Nov 7, 2010)

3. Credit rating downgrade

Sovereign credit rating is vital to a country’s ability to borrow and the price it pays for this borrowing. Subjective rating could constitute a hostility strategy if it undermines the country’s ability to borrow and to establish a right “price” for this borrowing.

Country credit rating is a complex process subject to a variety of influences. A few US based operators dominate the industry and hold an overwhelming influence over performance and outcome (The Economist, 2007). The process and institutions were seriously questioned after the events of 2008 and consequent US government intervention. Subsequent analysis revealed a highly concentrated industry conducting what seemed to be subjective ratings of complex products and country situations. (Sandage, 2005) (El Namaki, 2011). Recent downgrading of the Russian state and key Russian corporations was certainly laced with political motives.

4. Logistics firewalls

A myriad of infrastructure institutions and arrangements support capital flow across borders. To deny countries access to one or more of these institutions could stifle cross border capital flows and constitute strategic aggressive behavior.

Take the case of SWIFT, the global cooperative set up under Belgian law in order to create a shared worldwide platform for international finance transactions. SWIFT provides services to an estimated 10,500 financial institutions and corporations in more than 200 countries. It is a pivot to international finance, commerce and trade. To exclude a country from the system could be construed as a gross act of aggression and a source of considerable economic damage.

European Parliament’s resolution suggesting that Russian banks could be expelled from the Swift system in protest at Russia’s incursions into Ukraine could be considered, within this context, an explicit aggressive move. Swift saved the day by refusing to comply (Financial Times Oct 2, 2014).

5. Vulture capital practices

Investors buying distressed country debt at a fraction of the nominal issue price and resorting to legal means to redeem the full value of the instrument are conducting “vulture capitalism”. Vulture capitalism belongs to an array of investment institutions practices constituting an aggressive capital market hostility mode.

Incidences of vulture capitalism are well documented and the latest is that of Argentina. Argentina’s 2001 default resulted into government bonds being sold on secondary markets, against a fraction of their nominal value. Most of the bondholders accepted an arrangement whereby their defaulted bonds were exchanged for new ones, at 35% of their nominal value. A few “vulture” investors held out, however, and demanded a full payment of the nominal value. Those paid, in 2008, an estimated $48.7 million for a slice of the Argentine debt and claimed, in 2014, $1.44
billion for the same slice. An all-out public relations campaign to harass, embarrass and pressure the Argentine government followed and Argentine President took the issue to the UN general assembly (Huffington post, 20 June, 2013)

Goldman Sack’s use, in another case, of swaps in order to create fictitious compliance by the Greek government with the membership conditions of the European Union has inflicted damage upon the country, the European Union and the Euro (New York Times, 13 Feb, 2010).

6. Conditionalities or multinational organizations dictates

Conditions established by international organizations as the IMF (International Monetary Fund) for loan granting to countries in economic difficulties, or the “conditionalities”, could constitute aggression by the “collective. The Trans-Pacific Partnership (TPP) a new genre of those organizations goes far beyond IMF’s dictates.

Conditionalities make loan granting dependent upon the implementation of a comprehensive set of “corrective” micro and macroeconomic policies that often constitute a serious constraint and have had, historically, adverse impact on many a country. Indonesia, Malaysia and Thailand were required by IMF, during the Asian economic crisis of 1997 and 1998, (Giancarlo Corsetti, 1999) to pursue tight monetary and fiscal policies with, as a consequence, a serious recession and years of recovery. Argentina was forced, in 2001, into a policy of fiscal restraint that led to a decline in investment in public services and a serious damage to the economy. Ukraine’s recent IMF loans conditions including the introduction of a flexible exchange rate, the downsizing of government employment and the partial privatization of health care and education will, undoubtedly, undermine economic recovery.

The Trans-Pacific Partnership (TPP) agreement currently being negotiated carries restrictive cross country intellectual property (IP) laws and adopts criminal sanctions for copyright infringement as well as a biased Investor State Dispute Settlement arrangement. (The Economist, 25 Feb., 2014)

7. Punitive economic sanctions

Economic sanctions or penalties applied unilaterally by a country (or a group of countries), against one or more other countries constitute a potentially potent strategy. The country specific variety could constrain investment, finance and intelligence flows. The individual and entity strategy, or smart sanctions, could undermine capital market operations and competencies.

The EU’s threat to cut off certain modes of financing to state-owned banks in Russia is a recent demonstration of sanctions. The US who has, today, 24 different sanction programs covering countries all the way from Côte d’Ivoire and Belarus to Russia and Syria. The US Treasury has devised an elaborate set of financial sanctions to cut off Iran from the global banking system and introduced, recently, a measure that would prevent key Russian corporations from raising capital in the American market (FT, March 30, 2015).

Hostile capital market sanctions applied unilaterally or multilaterally proved, historically, to be a potent strategy for capital market aggression.

Strategies for defense?

Defense mechanisms could be intricate and amorphous. The following are three of the most quoted, and applied, strategies be it by countries or international organizations.
1. **Capital controls**

Capital controls are prime modes of defense against malignant capital flows. Their span is wide as they could apply to any measure taken by a government, a central bank or a regulatory agency in order to limit in and outflow of foreign capital. They can also apply to all asset classes including equities, bonds and foreign exchange transactions. A variety of controls were imposed by many countries including Chile (1991), Malaysia (1998) and Brazil (2008-2009). Malaysia shut the door for foreign portfolio investors and pegged the ringgit to the US$ while declaring it illegal tender offshore.

Capital controls is generally contentious. Malaysia's decisions of 1997 ran against IMF “advice”. The global financial crisis of 2008, however, exposed risks associated with volatile capital flows and led many countries including those with relatively open capital account, to destigmatize capital control. IMF soul searching also followed.

2. **Reserve accumulation**

Enhancing foreign currency reserve level can provide a measure of defense against speculative or induced exchange rate fluctuations and the malignant capital flows associated with that. Higher levels of foreign exchange reserves can provide a hedge against undesirable currency manipulation and the defense posture that follows. The country’s central bank could, then, intervene and bring a measure of control to the unravelling devaluation scene. The Reserve Bank of India has very recently, and for instance, cited India’s comfortable level of foreign exchange reserves as one of the defense mechanisms adopted against volatile capital flows in global financial markets. (Reuters May 23, 2015)

3. **Solid banking system**

A solid banking system is a powerful deterrent to hostile capital market practices. For a banking system to be solid, however, the capital base should conform to commonly accept national and international standards and lending must adhere to a sound set of conditions. Post 2008 stress tests of US and some EU banks have revealed serious vulnerabilities, a situation that has been steadily improving ever since. Recent stress tests of 31 largest US banks have revealed an improved state of the industry. Those tests simulate “severely adverse” economic conditions including a severe recession and a serious stock market decline.

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A very broad framework for a relationship between aggressive strategies and modes of possible response is provided in the following figure. The figure relates the seriousness of the strategy to a mode or more of defense.
What the chart suggests is to think of the problem in terms prevention and protection. Both depend on the severity of the attack and the urgency of the issue. Provocative strategies could call for preemptive measures while lethal endgame strategies could call for protective measures.

### Summary and conclusions

A war is waged within global capital markets that are just as violent as the physical one. The difference is the type of violence and the ultimate physical and nonphysical impact. Bloodletting gives way to financial resource destruction and demolishing of infrastructure is substituted by the destruction of assets, markets, institutions, jobs and ultimately individuals. Why?? A prime trigger is instability in global capital markets at players, instruments, monitors and regulators levels. Strategies of aggression take a variety of forms starting with inconsistent capital flows and competitive devaluations to conditionalities, logistic firewalls and vulture capitalist practices among others. Defense? Possible but constrained. Capital controls, reserve accumulation and sound banking system could help. Some of those could be described as protective and the others as preemptive. Preemptive measures could possibly prevent the onslaught and protective measures may provide a response.

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