

PIMCO Veteran Paul McCulley: A New Model for Understanding Geopolitical Crises Reply

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As a former portfolio manager, I know that practitioners often pay too much attention to the micro-level issues of individual securities and not enough attention to the broader macro-level context. Investors often reach for a microscope when they should be using a telescope. The consequences of this narrow focus can be disastrous, as the sovereign debt crises in the U.S. and Europe have amply demonstrated.

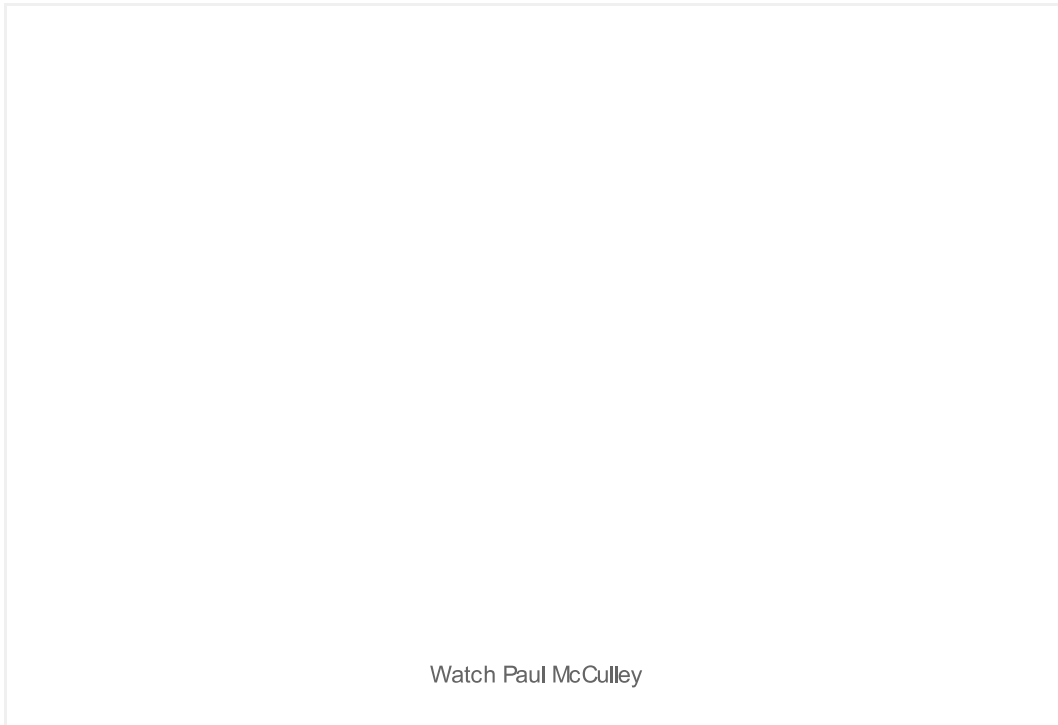
[Paul McCulley](#), a former senior partner at bond fund giant PIMCO, has a novel framework for bringing the macro context into focus. At the [CFA Institute 2011 Fixed-Income Management Conference](#) in Boston this past fall, McCulley — who now chairs the Society of Fellows of the [Global Interdependence Center](#), a nonprofit think tank based in Philadelphia — argued compellingly and convincingly that the broader global context is governed by the interoperability of three key power structures: democracy, capitalism and sovereignty.

With democracy, the founding principle is “one person, one vote.” Yet at its heart this is a socialist system, McCulley argued, because it emphasizes the equal distribution of power. Capitalism operates differently: the founding principle of power allocation is “one dollar, one vote.” So power in capitalism is not about equal shares, but about the accumulation of power. Democracy and capitalism, therefore, work at cross purposes.

How can the two coexist? Democracy and capitalism need each other. The two power structures create for each other that which they cannot create for themselves, McCulley contended. Democracy — as irritating as it can be to capitalists — provides the rule of law. Yet democracy is very inefficient and democratic decision-making can take many years to produce policy. Capitalism’s gift to democracy is

efficiency. Together, democracy and capitalism create private property rights. With property rights there is an environment in which capitalists can trust one another and thrive, McCulley said.

Last, when it comes to sovereignty, McCulley explained, power is allocated by “one gun, one vote.” The power to maintain and protect one’s rights relies upon the ability to defend one’s will through military power. Sovereignty is about the accumulation of power, not the equal distribution of power.



For these three overlapping power structures to operate well there need to be clearly delineated areas of responsibility and rules of engagement. But because these three overlapping power structures often operate at cross purposes, investors should expect “unsmooth and strange outcomes,” McCulley told conference delegates. In fact, inherent tension is built into the system. Therefore, to identify potential problems simmering below the surface — such as the European sovereign debt crisis — investors must look to where these three systems clash or where there are imbalances between the power structures.

Consider the sovereign debt crisis in this context. Democratic, sovereign powers are clashing because more solvent nations like Germany are being asked to bail out less solvent ones like Greece. The argument in favor of a bailout put forward by the less solvent nations is essentially a democratic argument; conversely, the argument put forward by solvent nations is a sovereign one.

The interests of sovereign nations are also at odds with those of investors, who want compensation for their risks and are asking for (perhaps onerous) budget cuts in troubled nations. Yet these nations want to preserve their sovereign right to self-determination. Powers are also clashing on another level as the International Monetary Fund — a quasi-democratic, capitalistic, and sovereign entity — puts conditions on further distribution of capital and seeks to impose its will on nation-states.

Unfortunately, in Europe, the boundaries between the three power structures are not well defined. There is neither an understanding of how to get these power structures to work with one another to share power nor a will to come together to solve problems, McCulley told delegates.

Consequently, any problem large enough to affect more than one of the power structures in Europe will create turbulence for investors. Sovereign debt woes may be the latest crisis to afflict global markets.

But a look through McCulley's geopolitical telescope suggests that it won't be the last.

European sovereign debt crisis, geopolitical risk, Greece, securities



About Jason Voss, CFA

Jason Voss, CFA, is a content director at CFA Institute, where he focuses on fixed income, behavioral finance, corporate finance, and quantitative methods. He is the author of *The Intuitive Investor*, and he also ran a successful blog titled *What My Intuition Tells Me Now*. Previously, he was a portfolio manager at Davis Selected Advisers, L.P., where he built an impressive track record co-managing the Davis Appreciation and Income Fund. Mr. Voss earned a BA in economics and an MBA in finance and accounting from the University of Colorado. **Topical Expertise:** [Behavioral Finance](#) · [Corporate Finance](#) · [Fixed Income](#) · [Quantitative Methods](#) | [Follow Jason on Twitter](#)

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• [November 2011](#) (25)

• [October 2011](#) (5)

• [September 2011](#) (1)

• [August 2011](#) (5)

• [July 2011](#) (4)

- [June 2011 \(3\)](#)

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