Book Synopsis

From Craig Weightman

Boomerang: Travels in the New Third World

by Michael Lewis - 2011

This is a book of stories and they are horror stories, not solutions or ideas. It is up to the reader to decide how they want to react, the author gives no clues. They are advised, however, to change their current lifestyles. The Preface is a critical part of the book because it gives the reason the author is focusing on countries and not individual people or businesses.

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Preface:

While working on 'The Big Short: Inside the Doomsday Machine' the author became interested in the handful of investors who made their fortunes from the collapse of the subprime mortgage market. In 2004 the Wall Street investment banks created the credit default swap, the instrument of their own destruction. People could now bet against the price of any bond, even if they didn't own that bond - like fire insurance on your neighbor's house.

By the end of 2008, when the author interviewed these investors, one of them, Kyle Bass, had moved on from the subprime mortgage bond debacle and had a new all-consuming interest - governments. Kyle Bass felt the financial crisis wasn't over; simply smothered by the full faith and credit of rich Western governments. They felt that from 2002 there had been a false boom in much of the rich, developed world and big banks were no longer being treated as private enterprises, but as extensions of their local governments, sure to be bailed out in a crisis. Therefore, public debt in these countries was no longer restricted to the official public debt, but included the debts inside each country's banking system. They found even the experts in sovereign debt had no idea the problem was as bad as it appeared. His new investment thesis: the subprime mortgage crisis was more symptom than cause. The moment investors woke up to this reality, they would demand higher rates of interest to lend to governments, and these governments would plunge further into debt.

In 2008, when the author interviewed Bass, he had just bought his first credit default swaps on the countries he and his team viewed as the most likely to be unable to pay off their debts: Greece, Ireland, Italy, Switzerland, Portugal, and Spain. He made his bets with the few big Wall Street firms he felt were least likely to be allowed to fail - Goldman Sach, J.P. Morgan, and Morgan Stanley - but, doubting their capacity to withstand a more serious crisis, he demanded that they post collateral on the trades every day. They paid $1100 a year to insure $1 million in Greek government bonds. They guessed that when Greece defaulted the country would be forced to pay down its debt by roughly 70% and his $1100 bet would return $700,000.

Kyle Bass was so far outside even the norm of other investors the author interviewed that his story was not included in the book. However, in the summer of 2011, the author returned to ask Kyle Bass; *how did a hedge fund manager in Dallas even think to imagine these strange events?* Iceland was the example that got Kyle Bass started. The government kept saving the banks, but suddenly the government went broke.

The author visited Iceland, Greece, Ireland, Germany, and California and found the problems were unique to each country and tied to the individual social structure, rather than being a single, financial problem.

Wall Street on the Tundra

Iceland went broke in October 2008. It was a nation of well-to-do, well-educated, historically rational human beings. In 2003 Iceland's three biggest banks had assets of only a few billion dollars, about 100% of the GDP, and over the next 3.5 years the assets grew to over $140 billion. The Icelandic stock market multiplied nine times and real estate prices tripled. A country of fishermen had suddenly become financial managers.

Iceland is less a nation, than it is one big extended family. When studying genealogy Iceland is often used because there is so little hereditary variation. The result of this is that Icelander's accept each other and do not question what they are doing or why they are doing it.

Iceland is a fishing culture and the reason for fishermen not becoming wealthy is that the fish are everyone's property and anyone can catch as many fish as they like, so everyone fishes right up to the point where fishing becomes unprofitable - for everybody. Fishermen are a lot like American investment bankers and their overconfidence leads them to impoverish not just themselves, but also their fishing grounds. The goal isn't to get fishermen to overspend on more nets or bigger boats, but to catch the maximum number of fish with minimum effort. This requires government intervention to attain. In the 1970s the Icelandic government took the radical step to privatize the fish. Each fisherman was assigned a quota, roughly based on his historical catches. This quota equated to a % of the total catch allowed. From year-to-year the number of fish you could catch changed, based on the Marine Research Institute's analysis of the long-term health of the fish population. If you didn't want to fish you could sell your quota to someone else who did want to fish. The quotas thus drifted into the hands of the people to whom they were of greatest value, the best fishermen, who could extract the fish from the sea with maximum efficiency.

People who were not fishing were getting educated and wanted something to do. The male culture in Iceland is based on a history of conflict and heroism. The Icelandic male is not predisposed to question himself or ask for help. This culture and this situation is tailor made for the high stakes, high risk hedge fund environment.

Young Icelanders went to American business schools and, in the early 2000s, took away the lesson that it was important to buy as many assets as possible with borrowed money, as asset prices only rose. Icelanders bought from each other and made as many foreign investments as they could. Since their currency was strong and other currencies were weaker, they converted their money and used deals in other currencies to make even more profit.

Actually, the people who saw the crisis coming had more to gain by taking short positions than they did by publicizing the problem. As alarm bells began sounding, Iceland's leaders attacked these messengers as trying to breakdown the Icelandic financial system.

And They Invented Math

Between 2002 and 2007 there was a tsunami of cheap credit rolling across the planet. This offered entire countries the ability to do whatever they desired with the money. It is instructive how each society chose to spend this money.

- Americans wanted to own larger home than they could afford and to allow the strong to exploit the weak.
- Icelanders wanted to stop fishing, become investment bankers, and to allow their alpha males to reveal a heretofore suppressed megalomania.
- Germans wanted to become even more German.
- Irish wanted to stop being Irish.
- Greeks, however, wanted to turn their government into a giant piñata, stuffed with fantastic sums, and give as many citizens as possible a whack at it.

The Greek government and culture is completely corrupt. Government jobs pay almost three times as much as the same private job, bribery is assumed, theft is taken for granted, and accounting is unheard of. Oddly enough, the financiers in Greece remain more or less beyond reproach. They, alone among Europe's bankers, did not buy U.S. subprime-backed bonds, or leverage themselves to the hilt, or pay themselves huge sums of money. However, they lent roughly 30 billion euros to the Greek government - where it was stolen or squandered. In Greece the country sank the banks.

This is a country where the first thing a government does in an election year is to pull the tax collectors off the streets. Tax collectors are reprimanded if they do their job too well. Greece has no working national land registry so real estate can be bought and sold without any government knowledge.

The structure of the Greek economy is collectivist, but the social structure is every man for himself. Greece is a nation of people looking for anyone to blame but themselves.

Ireland's Original Sin

In Ireland the banks sank the country. The three largest banks in Ireland had lent vast sums to Irish property developers and home owners. Ireland's financial disaster shared some things in common with Iceland's. It was created by the sort of men who ignore their wives' suggestions that maybe they should stop and ask for directions. But while the Icelandic male used foreign money to conquer foreign places, the Iris male used foreign money to conquer Ireland. The Irish really wanted to buy Ireland - *from each other*.

When the Irish banks failed they were not structurally connected as are the U.S. banks. However, the Irish parliament wanted to save their banks, not just the depositors, but also the bondholders, who owned roughly 80 billion euros' worth of Irish bank bonds. The parliament assumed 100% this debt - sort of like the AIG situation in the U.S. Ireland couldn't pay this debt and had to borrow from the European Central Bank. This debt becomes ever greater with time and Ireland is now nearing a default situation.

While it is interesting to see how nations reacted when money was made freely available, it is also instructive to see how they react when this money is taken away.

- In Greece the money was borrowed by the state: the debts are the debts of the Greek people, but the people want no part of them. The Greeks have taken to the streets and want to blame the foreign bankers.
- In Ireland the money was borrowed by a few banks, and yet the people seem not only willing to repay it but to do so without so much as a small moan.

The Secret Lives of Germans

Germany is the banker to Europe. It is to the Germans that all the struggling countries in the European Union turn/or swear at when debts become due. In effect, lots of non-Germans had used Germany's credit rating to indulge their material desires, while the Germans ignored the offer. The Germans, through their bankers, used their own money to enable foreigners to behave insanely. German banks, however, now have huge sums of uncollectible debt and are as endangered as other European banks.

As a result the financial markets have been trying and failing to get a read on the German people: while they can afford to help pay off the debts of their fellow Europeans, will they do it? Are they now Europeans, or are they still Germans (note: this question is now being asked regarding the different states in the U.S.)?

Germans have a gift for creating difficulties with non-Germans. Germans like order and cleanliness, but also seem to have an obsession with feces and dirt. This combination of a clean exterior and a dirty interior is very much a part of the German national character.

If the Germans are to help Greece pay off its debt, they want the Greeks to change how they handle their finances - in effect, to change Greek culture. This is not being well received. The bigger problem with a Greek default is that it might well force other European countries and their banks themselves into default. That is why Europe's money problems feel not just problematic but intractable.

Too Fat To Fly

In the United States, when a rating agency lowered its credit rating of the U.S. government, the market for U.S. Treasury bonds soared. This makes no sense unless looked at in comparison with what is going on in Europe. The U.S. is still a better bet to pay back its debts than other developed nations.

However, the ugly truth under the surface of American finance is the financial health of the individual states and, even more problematic, the individual counties and cities in these states. A key part of this ugliness is the collective annual deficit between what the respective governments owed retired workers and what they had on hand to pay them. At the local level this deficit was taking an ever increasing percentage of local budgets. This at a time when citizens are unwilling to increase taxes and demand services be maintained - sound a bit like Greece anyone?

In 1980 only 23% of state pension money had been invested in the stock market, but by 2008 the number had risen to 60% and an 8% return had been assumed by the individual cities and counties. Toss in underfunded health plans and a reduction in federal dollars available to the states and you are looking at losses that can only be dealt with in one of two ways - massive cutbacks on public services or default - or both.

The scariest state, according to Meredith Whitney - who investigated this problem - is California.

The author includes a conversation he had with ex-governor Arnold Schwarzenegger, where they discussed the seven years he spent as governor of California. Included in this discussion was the inability to get any legislative consensus regarding addressing the long-term problems facing the state and the 2005 initiative process when the citizens voted down changes that would help the state going forward. California had organized itself, not accidentally, into highly partisan legislative districts (gerrymandering) and then required these people to reach a two-thirds majority to enact any new tax or meddle with big spending decisions. Throw in term limits and the initiative process and you have a recipe for generating maximum contempt for elected officials. However, this system is very good at giving people what they want - having services, but not having to pay for them. This year the state will directly spend $32 billion on employee pay and benefits, up 65% over the past 10 years, while education is down 5%, health and human services up 5%, and parks and recreation is flat.

San Jose has the highest per capita income of any city in the U.S., after New York and the highest credit rating of any city in California over 250,000. This city owes much more money than it can afford to pay its employees and it could cut its debts in half and still wind up broke. Pay for public safety workers was negotiated like sports salaries - each raise was the starting point for the next contract and this was across the entire state. In 2000 the city's pension costs were projected to run $73 million a year and now they are projected at $245 million per year. Pension and health costs are now more than half the city's budget. Legally obliged to meet these costs, the city can respond only by cutting elsewhere. The city has cut staffing levels back to 1988 level, with 250,000 more residents today. Similar to the debt problem facing Ireland, this is a problem that will exponentially increase over time.

The worst city problems in California belong to Vallejo. This is a city that has already faced the problems currently dominating San Jose and it declared bankruptcy in 2008. All the traffic lights permanently blink, you can park anywhere as there are no police or meter maids, the city manager has a staff of one secretary and she locks the office when she goes to the bathroom, there is no street repair, there are essentially no city services save the fire department.

The problem with police officers and firefighters isn't a public-sector problem; it isn't a problem with government; it's a problem with the entire society. It's what happened on Wall Street in the run-up to the subprime crisis. It's a problem of people taking what they can, just because they can, without regard to the larger social consequences. It's not just a coincidence that the debts of cities and states spun out of control at the same time as the debts of individual Americans. Alone in a dark room with a pile of money, Americans knew exactly what they wanted to do, from the top of the society to the bottom - they wanted to grab as much as they could, without thinking about the long-term consequences.

The only chance of survival is to work together. Financial problems are only a symptom of the disease - our culture. Dr. Peter Whybrow, a British neuroscientist at UCLA, has a theory about American life. He thinks the dysfunction is a by-product of America's success. The human brain evolved over hundreds of thousands of years in an environment defined by scarcity - it was not originally designed for an environment of extreme abundance. We are set up to acquire as much as we can of things we perceive as scarce, particularly sex, safety, and food. The more we have, the more we want. What happens when a society loses its ability to self-regulate, and insists on sacrificing its long-term self-interest for short-term rewards? The bird that has all the food it wants gets bigger and bigger, until it finally cannot fly. Then the fox eats it.

In August 2011, the same week the debt of the U.S. government was downgraded, a judge approved the bankruptcy plan for Vallejo, California. Vallejo's creditors ended up with five cents on the dollar, public employees with something like twenty and thirty cents on the dollar. The author recently drove up to the city and called on the city Fire Chief. His department is half the size it used to be (121 to 67) and they handle roughly 13,000 calls a year. His challenge is how to cope with an environment of scarcity and still deliver good service. The number one cause of death in firefighting was heart attacks and the number two is truck crashes. His department would now be both overworked and in a hurry. He decided to tailor fitness regimens to fit the job. He was rethinking firefighting. He had to. We all have to.