ADVISOR PERSPECTIVES

Michael Lewis on the True Depth of the Crisis in Europe

By Larry Siegel
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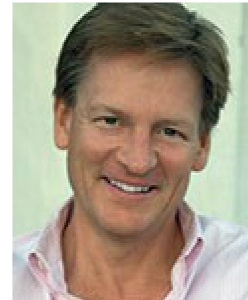


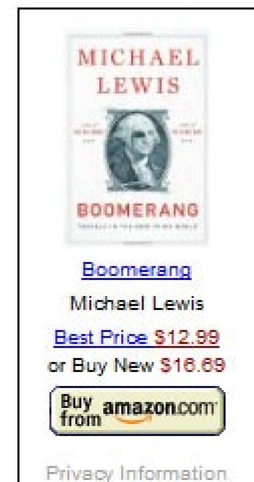
Michael Lewis is a financial writer and author, most recently of Boomerang: Travels in the New Third World, *in which he reported on the European debt crisis from several of the affected countries. His previous books include* The Big Short, Liar's Poker, Moneyball *and* The Blind Side. *He is a contributing editor to* Vanity Fair *and a columnist for* Bloomberg *and* The New York Times.

I spoke to Lewis on January 17.

I want to ask you about your experience as a financial writer. I will start with your most recent book, *Boomerang,* and then move to some more general questions.

Did your interview in *Boomerang* of Kyle Bass, the founder of Hayman Capital Management in Dallas and one of the first investors to develop a bearish view on European sovereign debt, come from the cutting-room floor of your work on *The Big Short*?

Kind of. I went back to him. So a lot of the interview in *Boomerang* came after I finished *The Big Short,* but he was, in fact, on the cutting-room floor of *The Big Short*. I talked to him about the subprime trade mainly, not the European debt trade.



Is there any leftover material from your discussion with Kyle Bass that you wanted to use in *Boomerang*, but that you just couldn't or didn't?

It's funny you ask that, because the world would benefit from Kyle Bass getting up on a podium and presenting the research that he did at his firm, showing the inevitability of sovereign default. They were trying to see if there was a quantitative tipping point with sovereigns. Bass looked at sovereign debt differently than the markets, because he was counting not just the sovereign debt itself, but also debt in the banking sector that he thought the government would be responsible for.

I thought that the sovereign debt problem was a fiscal problem, caused by entitlement spending.

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But when you look at, for example, France, you can't ignore the government assuming bank debts. If Credit Agricole or BNP goes down, the liabilities of those banks will become a French government liability.

What I didn't do in the introduction to *Boomerang,* because I didn't want to lose the general reader, is to report on a conversation with Bass in which he walked me through the numbers, and he explained the argument.

Bass' firm, Hayman Capital – and there must be other firms with this position – is holding long-dated put options on this sovereign debt, so they can afford to wait, but they are still trying to figure out when default happens. Bass thought the endgame would be the end of last year or the beginning of this year, and he may be right; he was talking about Greece. But his argument applies to other countries, and I didn't have the time or energy to lay out his argument in great detail. I was interested in conveying his general argument to the reader, because it was so breathtaking.

If I were to write it again, I might go more deeply into it.

The subtitle of *Boomerang* is "Travels in the New Third World." Based on your observations, is peripheral Europe really going to have a third-world economy or is that just hyperbole?

Just hyperbole.

But will peripheral Europe become a two-tiered society? The wealthy have already figured out how to protect and extricate their capital, and pay little in taxes. The so-called austerity programs largely affect the working class. Can you reflect on wealth inequality and whether the debt crisis is creating a deeper division in Europe than what the U.S. faces?

Is the debt crisis creating deeper inequality in Europe than in the United States? There is a factual answer to that, which I don't know off the top of my head. But, just looking at the policies that Europe is pursuing versus the policies that we are pursuing, it makes a lot of sense that inequality is being exacerbated there. Take a place like Greece, which is probably the purest example of a sovereign debt crisis. The rich people in Greece are already out of reach of the government. They are not only not taxed; they don't even have their assets in Greece, having fled the banking system long ago. The people who are exposed are the people who can't get out. It's fair to say that the more a country is like Greece, the worse it is on a relative basis for the lower 99% versus the upper 1%.

My perception of the crisis in the U.S. and globally, at least until I read your book, has been a little different than yours seems to be. I've said there were two almost unrelated financial crises. One was a short-term problem caused by leveraged

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speculation on home mortgages. The other is a long-term, ongoing problem caused by massive entitlement spending, which taxpayers are unwilling to fund. Are these one crisis or two?

The two crises are related. The last chapter of *Boomerang* is about California's long-term problems – specifically, how the housing crisis hit at a time when the state's long-term fiscal position is finally being shown to be unsustainable. Public sector and private sector debt didn't mysteriously increase at the same time. Governments, and the individuals that put governments in power, were both living beyond their means. So, the two crises are obviously related.

What, if anything, does the collapse of the Japanese bubble – which has been going on for about 20 years now – have in common with the bubbles that you write about in *Boomerang*, and what is different?

Kyle Bass would be a good person to ask about this; he is at least as interested in the Japanese debt crisis as he is in the European one, if not more so. I haven't been to Japan in 20 years, so I haven't actually written about that.

In both the Japanese and European cases, a fiction was sustained because people couldn't imagine that sovereigns would default. The amazing thing in Japan is that, given the fiscal reality, the market hasn't panicked yet. The market in Japanese government bonds hasn't reversed yet, and the minute it does, the Japanese government will be insolvent. If interest rates go up only a little bit in Japan, they are in real trouble.

But what is behind all these crises is the idea that a riskless asset exists, and that sovereign debts are riskless assets. This is what unites these crises.

Let's move beyond *Boomerang*. You've written about the end of Wall Street since you quit your job at Salomon Brothers to write *Liar's Poker*. Why is Wall Street taking so long to go away, and what would the end of Wall Street look like?

I thought of *The Big Short* as a bookend to *Liar's Poker*. Wall Street is still going to be there as a physical place, so we are talking figuratively about the end of an era on Wall Street. The start date for the era that is going to end is the end of the 1970s or the early 1980s.

There are five defining characteristics of the era:

1. Breathtakingly complicated risk-taking at publicly traded investment banks, risk-taking that shareholders do not understand. The big proprietary trading operations are essentially black boxes to the shareholders that are funding it.

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2. Unlimited demand for bright young people. They get paid huge sums of money, without knowing very much, as soon as they get themselves seats in these places.

3. A seemingly out-of-control rate of growth in the financial sector. All over the world, financial sectors are getting bigger and bigger in relation to the surrounding economy.

4. A kind of numbness to the consequences of debt. There was a period in the late 1970s and early 1980s where, all of a sudden, people started talking about leverage like it was a good thing. The Protestant aversion to borrowing money you couldn't repay became an anachronism and a different attitude replaced it.

5. A blind faith that financial innovation was necessarily a good thing, that the complex securities and practices that were dreamed up on Wall Street were a sign of progress. This crisis that we are still going through is our society recalibrating and processing a change, and we are watching the end of this era unspool right now.

I don't know how long it takes; I'm a little surprised that the big firms weren't broken up in 2008 and that we're sitting here today with these institutions that would have failed if they had been left to the mercy of the marketplace.

Do you think Goldman Sachs and Morgan Stanley would've failed?

Yes.

There were a few days when those firms would have rightly been concerned about insolvency if there hadn't been some hope or faith that the government would protect them *in extremis*.

Yes, that's right. I'm not as sure about J.P. Morgan, but if everybody else fails and J.P. Morgan is exposed to everybody else – they were all so intertwined. Nobody knows exactly how intertwined. Is it not amazing that we are sitting here watching Europe try to resolve its problems in a way that doesn't trigger credit default swaps, because nobody knows how many there are on the books of financial institutions?

We are at the end of the era of stunning complexity. It may take some years before we sort out what the financial industry is going to look like, but it will look different. You may still have big institutions, but they are going to look much more like boring utilities than like sexy science labs where every kid from Harvard, Princeton and Yale wants to work.

Wasn't it Calvin Trillin, the *New Yorker* reporter, who said that this problem arose when smart people began to be attracted to work on Wall Street?

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Yes. My father said that once too, and he is a contemporary of Calvin Trillin, almost exactly the same age. (Trillin was born in 1935.) And my father, who went to Princeton, said to me – even when I went to Salomon Brothers – that Wall Street was where the dummies used to go, and now all the smart people want to go there; this is not a good sign.

I thought it *was* a good sign that finance was attracting smart people. Finance is important. Let's not let the dummies run it!

But when you take all these really smart people who jumped into Wall Street at a young age, and give them bosses who were the dumb people from the previous generation, the bosses had no ability to supervise.

The bosses said, "Whatever you are doing is making money, so please don't stop."

That's right, and that was not a bad description of what I witnessed firsthand. So anyway, I don't think we will ever see the end of Wall Street, but there will be profound change.

From your work and that of others, we know the hall of shame for financial villains fairly well. Who are the good guys and the good gals? Who should President Obama, or whoever the next president happens to be, choose to help fix the remaining problems? I'm thinking not just of people in public life, but bankers, economists, investment managers – whoever comes to mind.

Well, there's a whole world of independent financial advisors, community banks and midsize banks that had nothing to do with any of this nonsense – reasonable people outside the too-big-to-fail institutions. The administration could access them and, for all I know, maybe they are.

You are asking a question that is bothering me right now – I may write an article about it – because the Dodd-Frank legislation, the attempt to reform Wall Street, became at some point to me a black box. I couldn't understand why it was changing, how it was changing, and who was doing what in the Senate to rewrite the bill. I couldn't understand who was doing what out in the regulatory agencies to interpret the bill, what pressures were being put on them, and so forth.

I don't know who's behaving nobly and who is behaving badly.

I don't think self-sacrificing nobility is necessarily required. What we need is people who do their jobs and don't just act in their own narrow self-interest.

Yes, but if you are at Treasury or the FDIC, the next step in your career may well be to go work for Goldman Sachs, so you are in a difficult position. You don't want to make enemies of all of these people, and you might be easily buffaloed because you feel

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compelled to go to them for advice. You tend to believe what they are telling you. If they kept telling you that you were going to freeze liquidity in the market with a particular policy – that's one of their favorite things to say – you could very sensibly respond, "We've got too much liquidity. I don't give a damn about liquidity." But you don't know enough to say that. You think, "Oh no! I cannot allow that to happen."

I've admired Elizabeth Warren. I admired Carl Levin, as much trouble as he was causing for Goldman Sachs, as caustic as he was. And I admired Dick Durbin.

If I were the Treasury or if I were Obama, I would go looking for heads of well-run commercial banks that didn't get themselves deeply involved in the subprime mess. There are plenty of those, who are being punished by regulation that is a response to things they didn't ever do, and who find themselves on an ever-more unlevel playing field.

The playing field is unlevel because the very big competitors have preferential access to capital, due to everybody assuming that the government is behind them. I would bring that sort of person into the middle of the conversation, because what's needed is insiders who aren't going to be buffaloed by the jargon, who actually know how to run a bank, and who understand how pernicious it is to have this too-big-to-fail problem, because the bad drives out the good.

When institutions can be too big to fail, markets don't work.

That's right. You don't get the creative destruction that you need for capitalism to work in the financial sector.

When you don't allow a business to fail, it's not capitalism.

It's not capitalism. And the people who do fail are people who may be doing a better job at delivering financial services, but who have this disadvantage that they are not supported by the government. That is insane.

Having written about many of the worst offenses on Wall Street, if you could put in place one regulatory change from where we are now, what would it be?

You could redraw Glass-Steagall along the following lines: You could say to Wall Street firms, you can either take positions in securities, or you can broker and serve as a financial intermediary, but you can't do both. This goes well beyond the Volcker Rule.

It's saying, you can't even make markets in these things. You can be Charles Schwab or you can be a hedge fund, but you can't be the Charles Schwab hedge fund.

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I would cleave Wall Street in two this way. You are not allowed to hold positions in securities, even just as a market maker, if you are simultaneously advising investors what to do with securities.

Let's change the subject a bit. I think Alan Greenspan is getting a bad rap. The Nobel Prize-winning economist Robert Lucas famously said that economic growth is so important that it is hard to think about anything else. Under Greenspan's watch, the U.S. economy grew tremendously. When there isn't a crash, when we are having a normal growth period, isn't it important for that growth to be very strong so we have a margin of safety?

It's good to have growth, yes. But Greenspan made the right trade-off. He had one lever to pull and it was the interest rate. It's hard for me to fault him for what he did, because at the time I didn't think he was doing anything horrible – I can't Monday-morning quarterback that decision.

What troubles me, however, was that he didn't regulate the subprime lending market in the way that he could have. I made the same mistake that he did. The reason I wrote *The Big Short*, the reason I got interested in the topic, was that I was shocked that these big Wall Street firms, filled with all these really smart and totally self-interested people, people who are so good at getting what they want, collectively came together to commit suicide. I couldn't believe it.

Then, when I thought about it again, I concluded that it actually did make sense. The incentive structure was so screwed up that it led to ruin.

But, until that point, I thought mortgage securities were an unreservedly good thing. This came out of my experience on the ground at Salomon. I thought options and futures, and swaps and derivatives, were more efficiently distributing risk. Alan Greenspan thought that too. So he wasn't looking very closely at what was going on, because he thought that markets would function – that people had an interest not to get themselves in trouble. I made the same mistake, so it's hard for me to get really worked up about him making that mistake.

With respect to the housing bubble, I thought that if a house has a fundamental value of $500,000 and some darned fool wants to pay $1,000,000 for it, let him. The market will show him that he was wrong, and why should anyone else care?

Yes, why should anybody else care? That's right. So I have a hard time getting worked up about Alan Greenspan.

How do you invest your own money? Based on your experience, what is the best way for financially unsophisticated investors to find an advisor in whom they can place their trust, or, barring an advisor, a process for investing?

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I don't take financial advice, but I don't do anything interesting myself either. I invest in stock market indices, so the decisions I'm making are basically asset allocation decisions. I don't put all my eggs in one basket.

The one thing I've done since the crisis that probably goes against my core belief (that no one can predict where individual securities are going) is that I've skewed my portfolio toward blue-chip, large-cap stocks, because I think that we are in for a long period of economic misery, and the big battleships are more likely to survive than small startups, but only slightly.

I just try not to lose money. I don't think I'm supposed to make lots of money by investing my money. I'm very conservative with it and don't do anything interesting. I read Burton Malkiel as a youth, and I haven't read anything much in the way of investment advice that has interested me since.

People know that you are going to write about them and yet they agree to be interviewed, and often tell you stories that reflect on them in less than flattering ways. How do you get them to talk?

I try to tell them what I'm doing. If you read something that you think is an unflattering description of a person, some other reader may read it as a flattering description and the person himself may not think it is unflattering. What people think is unflattering or flattering is highly variable. But getting people to talk, especially getting people to let me into their lives – not to just talk to me, but really give me an inside view of what they are doing so I can kind of inhabit them – requires them to understand the spirit in which I am operating, and what I am trying to do.

And that is about it. If they approve of the spirit in which I am operating and what I am trying to do, they are usually all for it. They usually see what I see, that it's a great story that they've been a part of, and it is fun to have it told. Having said that, people turn me down. So what you are seeing is the people who have said yes; I am not perfectly successful at talking people into doing this.

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