GREECE IS THE WORD

In the second of a series on the markets' downfall, David Young says unfettered borrowing and soft regulation caused the crisis. Political prevarication is deepening it further

KYLE BASS cares about sovereign debt, probably a lot more than you or I do. That's perhaps the crux of the global financial crisis. You see, Kyle Bass isn't your neighbour, nor ever likely to cross your path. Bass is a Texan hedge-fund manager, who has a phenomenal interest in the welfare of other countries' fiscal fortunes.

Simply put, Bass has actually bet vast sums on states like Greece coming asunder and once the Greeks default — as perceived wisdom suggests, despite the bailout on offer — he'll make even more absurd amounts of money on the back of this man-made disaster.

For example, for every $1,100 wager he's placed, wrapped up in a complex financial derivative called a credit default swap, there'll be a whopping $700,000 to collect. He's placed quite a few.

"But I didn't go looking for this position. I was trying to understand the way the world was working, and this came to me," he says in Michael Lewis's new book, Boomerang. Bass says he couldn't understand how any sane person could do anything other than prepare for a bigger financial catastrophe, once Wall Street had collapsed.

When Bass sought out the world's leading expert on sovereign defaults, he found Harvard professor Kenneth Rogoff. "We walked Rogoff through the numbers and he just looked at them, then sat back in his chair and said, 'I can hardly believe it is this bad'. And I said, 'Wait a minute ... You are the go-to-guy for sovereign trouble ... If you don't know this, who does?' I thought, 'Holy shit, who is paying attention'?" Bass says.

Lewis's book describes how the developed world lost its financial reason in a false boom.

In 2002, what appeared to be growth was economic activity fuelled by people borrowing money they couldn't afford to repay. Worldwide debts, inside a few years, "more than doubled ... from $84 trillion to $195 trillion."

Who is exposed? "The US, oddly, we don't deserve to be in as good a shape as we're in," Lewis says. "America is better-placed than elsewhere to deal with the crisis; a crisis that never ended. Our banking system can handle the losses ... our economy won't be affected by a cataclysm in Europe the way it'll hit other countries ... and yet we're in some ways the cause of a lot of what's going on in the rest of the world."

"Yes. American fingerprints are all over this global crisis," says Dr Ray Donnelly, accounting and finance, University College Cork. "Europe's are too. As well as a debt crisis, we've also got a banking crisis. That's why IMF chief, Christine Lagarde, said 'we're entering a dangerous phase'. She's trying to concentrate minds on what we're facing into, because this problem is as much political as it is financial."

THE GREEK LEAK

Why is it so catastrophic for the rest of us that the Greeks cannot get their house in order? With 11m people, they are not populous. But of the 126 countries rated by Standard & Poor's, Greece is in last place — marking them the least likely nation to ever repay a loan.

Contemplate how instead of dutifully accepting Brussels' rescue package, thrashed out in the wee small hours only a week ago — bolstering markets briefly — the Greek government is going to confer with its people. In an ironic gamble, Greek PM George Papandreou's referendum pitch will make the trading world queasier than it is; 60% of Greeks aren't enamoured of the 'bailout'.

Lewis says: "If Greece walks away from $400bn in debt, then the European banks that lent the money will go down, and other countries now flirting with bankruptcy might easily follow."

This would destabilise regional and world economies. But it's baffling how one country could cause such a topple effect.

Dr Sheila Killian, department head in the Kemmy Business School, University of Limerick, compares European banking to plumbing. "It's kind of like the pipes in your house," she says. "You've got the bathroom, the kitchen, the sink in the en-suite. You put a hole in there, and before too long your kitchen taps run dry. There's a lot of talk about the exposure of French banks to Greek debt. Yet we don't know for how much. We're unsure of the connection. You see, there's an opacity built into the system." If Greece springs an unstoppable leak, it has the potential to drain the system.

"Greece could bring the whole house down because it's not just people you're talking about, it's banks," she says. "Banks. And they're joined onto other banks, through loans and owning each other's debt. It's just not very visible. The banks within the common currency are joined up in all sorts of opaque ways."

It's fuzzy. European banks are intricately entwined. This complex 'exposure' risk becomes more difficult to quantify — it involves tracing who owes whom money. 'Knowing' is key. Especially as France teeters on the brink of losing its AAA rating. A downgrade is 'unthinkable.'

"People just don't know where it's going," Dr Killian says. "This is a crisis that keeps developing new kinks."

It's an insight shared by Dr Constantin Gurdgiev, adjunct lecturer in finance, Trinity College Dublin. He says the European banks are keeping their books close to their chests: "There's certainly a lack of reporting. A lack of disclosure. And that's why we don't know. The banks aren't telling us how much of this debt is actually insured." Would it not be financial insanity to cover debt that's going to be met by the banks' own credit default swaps — the insurance policies they took out for this eventuality? "Correct. There is a lack of candour. A lack of honesty," he says.

IMF boss Christine Lagarde said "we're entering a dangerous phase" to emphasise that "the problem is as much political as it is financial".

"But, legally, there is only so much that is required to be made known by a bank. They are allowed a certain 'confidentiality' in their trading affairs." So who is taking control of the money problem?

DENIAL

"Either the Greeks pay for it," says Dr Donnelly, "and they obviously cannot, or the banks who lent get burnt. And if the German and French banks fail, well, quite simply that's going to affect not only their economies but the rest of the world. Yet, the Germans don't want to bail out Greece. And the German government is being quite cynical about this." This is echoed in Lewis' estimation of euro woe: he says the Germans have the financial wherewithal to effect a rescue plan. But they're averse to propping up a country they deem "profligate, indolent and irresponsible."

"Somebody's got to pick up the can. Somewhere. Instead of just kicking it down the street," Dr Donnelly says. "I can tell you, until this situation is sorted you're going to have this volatility in the markets. And until that's done, you're going to have this great uncertainty. But the Europeans can't get it together because of the politics."

Even with the consensus on the euro debt crisis, it remains unclear how the agreements reached are going to be achieved. Athens, not Rome, has burnt to the ground. To keep Greece in the EU, banks will have to be re-capitalised. This will demand weeks of Merkel and Sarkozy bending establishment elbows to accept a 50% write-down of Greek debt.

It's far from a done deal, even by Merkel's admissions. So too is the 'leveraging' of the EFSF (European Financial Stability Facility). More than doubling its coffers to an arbitrary €1trillion still hangs on persuading China to part with a phenomenal portion of its foreign wealth reserves. In exchange for investment, China will demand reforms, which the EU may not be able to deliver, such as the cutting of expensive pensions.

"Europe's in a state of denial," says Dr Gurdgiev. "That's why there's been no resolution. The European approach to this problem is but to re-name it in the hope that it'll go away. The problem is debt. Huge debt across the entire real economy. But we're in certain denial of that, and what needs to be done. It has to be bought."

How do you purchase this non-quantifiable monetary heap? "With the EFSF," he says. "Buy it with the EFSF. Use it as a toxic dump instead of a warehouse. And then bury it. Because the Greek debt owned by European banks has to be written off. Completely. But with caution. If a bank is guilty of having traded recklessly, then it too should be wound down."

"The current composition of the euro-zone cannot continue. Put it like this. That which cannot go on ... usually doesn't." — Dr Constantin Gurdgiev

What are the chances of such a decisive manoeuvre? "None," says Dr Gurdgiev. "Which brings us to the real issue here. Leadership. There's none in Europe. And the same goes for the G20. The politicians are simply not qualified to deal with the 'debt' problem. They're just not willing to listen to what economists and think-tanks are telling them."

Dr Gurdgiev says the mess is predicated on banking layers: "The genesis of the crisis, well, it's really to do with mis-priced assets, and the mis-pricing of those assets. That is — putting the wrong value on things, and allowing it to happen. Regulators — they have a duty of care. And they failed. The current composition of the euro-zone cannot continue. Put it like this — that which cannot go on ... usually doesn't." Professor Ray Kinsella of the Smurfit Business School says: "This is a crisis in corporate capitalism. And one that is deeper and darker than anything before, and of indefinite duration."

Most people are confused as to how this crisis came to pass; and what role they had in the fiasco, if any; and are left pondering the merits of blaming a ruthless handful of speculators for wrecking entire structures of decent behaviour. Maybe there's a deep-seated flaw in the human condition, which will be glossed over until the next time.

Dr Kinsella says we have to scrutinise our societal system, however heavy or unpalatable: "This is a malign model of corporate capitalism we're talking about. One that values markets above the dignity of people. Remember, economics can only get its legitimacy from the community. And so civilised society should be about the general good."

Take Iceland. In the United Nations' 2008 Human Development Index, the country ranked number one in the world. They were a well-to-do people, who were "well-educated, historically rational," writes Lewis. Yet something happened to their national psyche. They became bankers overnight.

With a tiny population of 300,000, little Iceland had a modest banking system. Between its three biggest institutions, there were assets of only a few billion dollars. That was 2003. Within three and a half years, these assets had mushroomed to $140 billion — an unprecedented expansion.

While this was taking place, British investors got a whiff and got in on the act: coughing up $30 billion, and entrusting Icelandic banks to make good on their promise of 14% annual returns. It's doubtful it had anything to do with the decency of these island people, 500 miles to the northwest of Scotland. There was a punt to be had and they wanted a part of that action.

Lewis writes of how pension funds, hospitals, public institutions, and universities were lured by the promise of extraordinary investment profits.

But Iceland went up in a spectacular ball of smoke. As it burned, so did those bets. Even Oxford University lost; and did so heavily, to the tune of $50m.

As for Ireland's financial disaster: "It was created by the sort of men who ignore their wives' suggestions that maybe they should stop and ask for directions ... Left alone in a dark room with a pile of money, the Irish decided what they wanted to do with it was buy Ireland. From each other," says Lewis. So, what comes next? Sooner rather than later, the banks will have to bite the bullet. But European politicians are still too busy prevaricating — brinkmanship that could scupper recovery.

"I reckon it'll make or break the euro," says Dr Donnelly. "If you've got a common currency, you've got to have common monetary policy. And the Germans don't want to pull out of Europe. It's been too good for their economy. They keep the rates nice and handy, and everyone's got euros to buy their goods."

Unfortunately, Ireland is set to lose even more economic sovereignty. Dr Donnelly says future financial policy will be made by a new reconstituted European Central Bank, with the Germans deciding how that's going to be run. Some say that what's on the table is just too little, too late.

"The ideal solution?" asks Dr Gurdgiev, teeing up an answer unpalatable to most politicians. "For the eurozone leaders to hold up their hands and say 'mea culpa' and set about developing a solution to transit out of the common currency. Unwind the system in a way that allows Europe to safeguard its market. And over time, phase out the euro."

A certain Mr Bass sits easy in Texas, just waiting for the Germans to steer the euro project to temporary safety, more out of curiosity than anything else. Greece still won't make good on its own debts, even if those debts are halved. Welching means winning for Bass and his kind.

Interesting to see where they're placing their chips next, as the casino moves on.

Hedge-fund manager Kyle Bass will profit enormously if Greece defaults.