

Goldman's Defense — Innocent Fraud?

By Harlan Green

The U.S. Senate has finally begun debate on financial reform, but only after eye-opening testimony at Senator Carl Levin's Permanent Subcommittee on Investigations by Goldman Sachs' executives, who claimed that hedging their bets on subprime mortgages was perfectly legal, while not believing that telling clients what they thought of the securities or derivatives sold to them was relevant.

Why their belief that they were innocent of any fraud? This is when economic theory gets mixed up with ideological belief systems. Economist John Kenneth Galbraith labeled it "The Economics of Innocent Fraud" in his book of that title (2004, Houghton Mifflin, Boston). "Most progenitors of innocent fraud...are not deliberately in its service. They are unaware of how their views are shaped, how they are had. No clear legal question is involved. Response comes not from violations of law but from personal and social belief. There is no serious sense of guilt; more likely, there is self-approval."

The inherent conflict in Goldman's case was that of the classic inside trader, who believed that free, unregulated market forces should determine investor behavior. We now know that unregulated 'free markets' are a vehicle for manipulation by insiders. Goldman had inside information that their buyers didn't—i.e., that there was a great likelihood the underlying subprime mortgages might have very high default rates. And as 'market-makers', their function as a pure trader was to find buyers for sellers and vice versa, without evaluating the underlying worth of the assets being traded.

Of course there were other conflicts of interest. Goldman was both an unregulated securities' trader and an investment bank regulated by the Federal Reserve, which gave them a source of very cheap funds (i.e., because tax payer guaranteed). Until the Depression era Glass-Steagall Act was repealed in 2000, commercial banks regulated by the Fed could not also be securities' traders. The reason was that stock, bond, and derivatives' trading was a very risky business where caveat emptor prevailed—"buyer beware", in other words.

This was precisely why Senate members used the Las Vegas casino analogy at the Goldman hearings. Bets were being placed on which direction the subprime market would go, without the bettors having any 'skin' in the game—i.e., no equity or ownership interest in the underlying securities—just like placing a horse racing bet. It was gambling, in a word, but Las Vegas gamblers knew they were gambling as Nevada's Senator John Ensign said at the hearings, whereas Wall Street investors did not at the time.

And, more importantly, because derivatives' trading was unregulated, no one knew how much was bet for or against subprime mortgages at the time. It was being transacted through a shadow-banking system specifically set up to escape regulation. Whereas horse race bettors know exactly what the odds are, because regulations require the odds to be publicly posted.

The result was that traders' profited, but

those pension funds and foreign banks that had no real knowledge of the risks inherent in such trades did not. That is why this 'last bastion of free enterprise', as some traders call it has to become more transparent. Financial markets are now as interconnected as our environment. What happens in one part of the financial environment can affect other parts not directly involved.

The environmental analogy is apt here. Financial markets have become an internationally connected financial ecosystem subject to 'pollution' with toxic securities, just as our environment has become polluted with toxic chemicals. The world has become 'flat' and interconnected, said columnist and author Thomas Friedman, precisely because information is now transmitted at light speeds in our new digital world.

The Darwinian world's survival of the fittest analogy was true 100 years ago when Capitalism was an infant struggling to survive in a post-feudal age world where ownership was still in the hands of the few—whether monarchs or military dictators. But once the Industrial Revolution prevailed over the feudal age, laws regulating private property rights and controlling predatory behavior became necessary.

In fact, markets only function well when there is transparency. Otherwise assets become mispriced, bubbles formed, and greater losses ensue. Nobelist George Akerlof knew this best when he did groundbreaking research on how asset markets really function. He studied the Lemon used-car market, of all things, which before it became regulated meant buyers had no knowledge whether a new or used car was a lemon—had some undetectable defect, in other words. And because buyers therefore discounted the price of those unguaranteed cars, it drove sellers with vehicles of better quality out of the market.

And that is why state vehicle Lemon Laws now require some guarantee or warranty of quality for each vehicle for sale. Professor Akerlof's seemingly innocuous research, along with that of Joseph Stiglitz and Michael Spence won them the 2001 Nobel Prize in the Economic Sciences "for their analysis of markets with asymmetric information", and proved that insider trading will always harm markets, if not regulated.

Professor Akerlof, also the co-author with behavioral economist Robert Shiller of "Animal Spirits", has been very vocal about the need for regulations and laws to keep up with financial innovations. One of his favorite sayings first appeared in a New York Times editorial.

"If you let your toddler out of her playpen, you need to watch her more carefully. This wisdom is known by every American parent but has been systematically ignored in economic deregulation...Now is the time to remember the lessons of the playpen: increased scope for action must be accompanied by increased regulatory oversight."

JK Galbraith's innocent fraud is the reason ideology may trump economic reality. Those AAA ratings on subprime mortgage securities were an illusion, fostered by Goldman's traders that generated tremendous



The inherent conflict in Goldman's case was that of the classic inside trader, who believed that free, unregulated market forces should determine investor behavior. We now know that unregulated 'free markets' are a vehicle for manipulation by insiders. Goldman had inside information that their buyers didn't—i.e., that there was a great likelihood the underlying subprime mortgages might have very high default rates.

profits. There is a 'snake oil' element in all financial markets that free market ideologues are loath to admit. "...those employed or self-employed who tell of the future financial performance of an industry or firm, given the unpredictable but controlling influence of the larger economy, do not know and normally don't know they do not know." Those predictions "are thought to reflect economic

and financial expertise. And there is no easy denial of an expert's foresight."



Harlan Green is a syndicated columnist and owner of Bankers Pacific Mortgage, Inc. Questions and comments are welcome, please email Editor@populareconomics.com

JUMBO LOANS UP TO \$3,000,000

FIXED FOR 5 YEARS AT: **4.875%** • Full Documentation
• Cash Out Available
• 2nd and Vacation Homes

5.16% A.P.R.

then converts to 1 year CMT
(.45)+ 3.00 margin

Rates as of 5/13/10. Subject to change without notice. UNISON Financial Group Real Estate Broker, California Department of Real Estate. #01818741

UNISON FINANCIAL GROUP

YOUR DISCOUNT BROKER

John Entezari

President/Broker

Lic #01113108

Serving S.B. for 18 Years

805-689-6364

john@west.net • www.unisonfinancial.com

