April 2010

The Goldman Sachs Case

Part One: Clowns to the Left of Me

James S. Henry

Submerging Markets

April 2010

© Submerging Markets 2010

Well, we no longer have to worry only about corrupt bankers in Kyrgystan. It turns out that there's plenty of fresh banker blood in the water right here at home, with scores of financial pundits, professors-*cum*-prosecutors, and political *piranha* swirling around the wounded giants in our financial services industry as if they were a herd of cattle crossing a tributary on the upper Rio Negro.

This feeding frenzy was of course precipitated by last Friday's surprising SEC announcement of civil fraud charges against Goldman Sachs – heretofore, at least since the 1960s, by far the most profitable, highly-respected, and, indeed, *public-spirited* investment bank in the US.

Despite -- or more likely *because* of -- Goldman's *relatively* clean track record and illustrious credentials, many commentators have assumed an almost *Madame Defarge*-like vengeful tone, reigning down condemnation and derision from the penultimate rungs of their moral pedestals.

Over the weekend, for example, Huffington ran at least a half dozen vituperative columns on the subject, including a Vanity Fair contributing editor's feverish claim that the whole affair was *somehow deeply connected* to a high-level Wall Street marriage; an MSNBC host's denunciation of Goldman for refusing to appear on his show -- *his* show!; -- and a plea by Ariana herself for criminal charges.

In fact, this is a case where, as we'll see in Part II, the SEC's civil charges against Goldman are not only highly debatable, but largely beside the point.

Meanwhile, Bob Kuttner, another Huffy perennial, and one of our most prolific *popularizers* of conventional liberal economic dogma, claimed that the Goldman charges demonstrate once and for all that Wall Street *en tout* is nothing but an on-going criminal enterprise, up to its eyeballs in outright fraud.

In a lurch toward financial Ludditism, Bob figuratively placed his hands on his hips, stomped his feet, and demanded nothing less than a "radical simplification of the financial system" -- leaving it up to the reader's imagination to determine what the hell that means.

Will we still be permitted to use ATMs, checking accounts and paper currency, or will we all be compelled to return to wampum beads and n-party barter?

Elsewhere, in the Daily Beast, we came across a kind of de facto job application from Harvard Law's Prof. Alan Dershowitz -- otherwise best known in the legal profession as "*He whose key clients are either fabulously wealthy or innocent*."

Prof. Dershowitz argues -- quite rightly, though his analysis of the case doesn't go nearly far enough -- that Goldman Sachs' behavior, while *no doubt* morally reprehensible, was *also by no means clearly* illegal.

That's fine -- except for the faint suggestion that perhaps for a modest fee, our country's finest criminal lawyer might just be available to help explain all this to a judge -- and perhaps also to demonstrate that, after all, "only a tiny fraction of investment bankers who abuse their clients actually commit murder."

THE CRUCIBLE

Finally, there is the omni-present, virtually *unavoidable* Simon Johnson, a Peterson Institute Fellow, MIT B-school Prof, book author, and "contributing business editor" at Huffington. This week has been Prof. Johnson's *heure de gloire*, and he is living it to the fullest.

All week long he could be found at all hours on nearly every cable news channel and web site, pitching his own increasingly Puritanical, neo-Manichean views of the banking crisis and Goldman's role in it.

At first Prof. Johnson simply expressed delight that the US had finally reached a "Pecora moment" -- referring to the 1933-34 US Senate investigation of Wall Street that, indeed, makes the modest $8 million Angelides Commission look like a California '68 love-in.

But by mid-week he had moved on to a much harsher assessment.

Not only was Goldman guilty as sin, but the hedge fund investor John Paulson, one of the key parties to the Goldman transaction, **deserves to be "banned for life" from the securities industry** -- even, if necessary, by having Congress pass an ex post facto bill of attainder.

Of course Prof. Johnson hails from the UK. He may not be aware of the fact that the US Constitution (Article 1, Section 9) has explicitly prohibited both ex post facto laws and bills of attainder (legislative decrees that punish just one individual or group without trial) since 1788.

Just this month, a US federal district court in New York struck down Congressional sanctions that singled out ACORN, the community organizing group. This important case is now on appeal.

Indeed, even in the UK, there have been no bills of attainder since 1798.

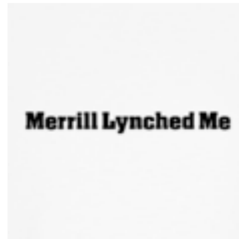
In any case, despite Prof. Johnson's limited grasp of US or even UK law, and his Draconian appetites, I've actually grown rather fond, or at least understanding, of him.

This is especially true since he left the IMF in September 2008 and had a kind of road-to-Damacus epiphony, suddenly realizing, as if for the first time, the enormous carnage inflicted by giant banks, as well as the huge potential rewards, in these times, of decrying them from the roof tops.

One of only nine "former IMF Chief Economists" who still grace us with their presence and boundless wisdom, Prof. Johnson only served in that post from

March 2007 until September 2008. But that 1+ year was more than enough time for him to leave a lasting impression at the IMF.

He is still fondly remembered not only for having entirely missed the 2007-08 mortgage crisis even as it was unfolding, but also for deciding in July 2008, less than 3 months before the entire global financial system nearly collapsed, to **sharply increase** the IMF's growth forecast for **both 2008 and 2009.**



Indeed, this was just one month before even the otherwise-unbelievably feckless Bush SEC decided to initiate the 18-month investigation of Goldman Sachs that led us, ultimately, to last week's charges.

If and when the Goldman Sachs case ever comes to trial, it may be interesting for Goldman's attorneys -- who will by then no doubt include Prof. Dershowitz -- to call Prof. Johnson as a witness for the defense.

He appears to be an expert on **just how difficult it was even for highly-trained experts to have clear peripheral vision, much less perfect foresight,** back in those days.

He may also be able to instruct the jury on the **fine art of concealing what one really believes to be true,** in order to get by and provide services to a variety of clients -- in his case, the IMF's management, its executive directors, and a myriad of particular country interests that influenced the information actually disclosed in all sorts of ways.

In any case, even in the dark days ahead, it appears that Goldman Sachs executives can still rely on a few consolations.

"After all," they can tell themselves, "There are very few heroes in this story. Indeed, John Paulson may have been one of the few who consistently called it like he saw it, at least in his own investing, rather go along with the systematic distortions – dare one say fraud? – that led institutions like Prof. Johnson's IMF to propagate inflated estimates and false hopes.

And, indeed, things might easily have been worse. **We might have decided to bet on Prof. Johnson's bullish forecasts, instead of on John Paulson's honest shorts. How much money would we have all lost then?"**