Everybody's Business

The Long and Short of It at Goldman Sachs

By BEN STEIN
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FOR decades now, as a writer, economist and scold, I have been receiving letters from thoughtful readers. Many of them have warned me about the dangers of a secret government running the world, organized by the Trilateral Commission, or the Ford Foundation, or the Big Oil companies or, of course, world Jewry.

I always scoff at these letters. The world is far too complex a place to be run by any one group. But the closest I have recently seen to such a world-running body would have to be a certain large investment bank, whose alums are routinely Treasury secretaries, high advisers to presidents, and occasionally a governor or United States senator.

This all started percolating in my fevered brain last week when a frequent correspondent, a gent in Florida who is sure economic disaster lies ahead (and he may be right, but he's not), forwarded a newsletter from a highly placed economist at Goldman Sachs named Jan Hatzius.

That worthy scholar recently wrote a detailed paper about how he thought the subprime mess would get worse and worse. It would get so bad, he hypothesized, that it would affect aggregate lending extremely adversely and slow down growth.

Dr. Hatzius, who has a Ph.D. in economics from "Oggsford," as they put it in "The Great Gatsby," used a combination of theory, data, guesswork, extrapolation and what he recalls as history to reach the point that when highly leveraged institutions like banks lost money on subprime, they would cut back on lending to keep their capital ratios sound — and this would slow the economy.

This would occur, he said, if the value of the assets that banks hold plunges so steeply that they have to consume their own capital to patch up losses. With those funds used to plug holes, banks' reserves drop further. To keep reserves in accordance with regulatory requirements, banks then have to rein in lending. What all of this means — or so the argument goes — is that losses in subprime and elsewhere that are taken at banks ultimately boomerang back, in a highly multiplied and negative way, onto our economy.

As the narrator in the rock legend "Spill the Wine" says, "This really blew my mind."
So I started an e-mail correspondence with Dr. Hatzius, pointing out what I believed were a few flaws in his paper. Among them were his hypothesis that home prices would fall an average of 15 percent nationwide (an event that has never happened since the Depression, although we surely could be headed in that direction), and that this would lead to a drastic increase in defaults and losses by lenders.

This, as I see it, is a conclusion that is an estimation based upon a guess. I found especially puzzling the omission of the highly likely truth that the Fed would step in to replenish financial institutions' liquidity if necessary. In a crisis like that outlined by the good Dr. Hatzius, the Fed — any postwar Fed except perhaps that of a fool — would pump cash into the system to keep lending on track.
I mentioned this via e-mail to Dr. Hatzius. He generously agreed that there was some slight merit to my arguments and that he was merely pointing out tendencies and possibilities (if I understand him correctly).

BUT forecasting is tricky, and I have a hard time believing that financial events to come will be qualitatively different from those that have already happened.

I do want to emphasize Dr. Hatzius's gentlemanliness and intelligence. But I also want to emphasize that, as I see it, his document was mostly about selling fear. A spokesman for Goldman Sachs categorically denies this point and says that the firm's economic research is held to the highest levels of objectivity and that its economists' views are completely independent.

As I interpret it, Dr. Hatzius was saying that the financial system would possibly not be able to adjust to a level of financial losses that are large on an absolute scale but small compared with aggregate credit or the gross domestic product. He is also postulating that lenders would have to retrench so deeply that lending would stall and growth would falter — an event that, again, has not happened on any scale in the postwar world, except when planned by the central bank.

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In other words, with the greatest possible respect to Dr. Hatzius, his paper is not really what I would call a serious overview of the situation. It is more a call to be afraid and cautious based on general principles that he embraces and not on the lessons of history. (In this respect, he is much like many economic journalists and commentators who sell newsprint by selling fear. The common cause of journalists and Wall Streeters in this regard is a subject I will address in the future.)
Now, let me make a few small points here and then get to my own big point.

Goldman Sachs is a huge name in terms of moneymaking and prestige. I totally understand the respect it receives for its financial dexterity. The firm is a superstar in that regard, and I, a small stockholder, am grateful. But it has never been clear to me exactly why its people are considered rocket scientists in any other area than making money.

Dr. Hatzius's paper is a prime example of my puzzlement. It shows extreme intelligence but basically misses the point: yes, there are possible macro dangers, but you have to go all the way around Robin Hood's barn to get to them, and you have to use what I think are extremely far-fetched hypotheticals to get to a scary situation. (This is not to diminish the real risks in today's economy, I'm just not as gloomy about them as Dr. Hatzius.)

Why, then, is his document circulating? Perhaps as a token of Dr. Hatzius's genuine intelligence, which is fine. But to me, his paper seemed like a selling document in the real Wall Street sense of selling — namely, selling short. (Dr. Hatzius notes that he has long been bearish on housing, since faraway 2006, but I respectfully note that that is a lot different from predicting a credit catastrophe. The spokesman for Goldman also noted the company's bearishness on housing since 2006. He also noted that in the recent past, Goldman Sachs has moved to a considerably larger short posture and that the firm is net short.)

More thoughts came to me as I read a recent piece in Fortune by my colleague Allan Sloan, a veteran financial writer. Mr. Sloan traces the life and death throes of a Goldman Sachs-arranged collateralized mortgage obligation. He shows how truly toxic waste was sold to overly eager investors who now have major charge-offs, and he also points out that some parts of the C.M.O. were indeed safe and were either current or had been paid off.

But what leaps out at me from this story is that Goldman Sachs was injecting dangerous financial products into the world's commercial bloodstream for years.
My pal, colleague and alter ego, the financial manager Phil DeMuth, culled data from a financial Web site, ABAlert.com (for "asset-backed alert"), that Goldman Sachs was one of the top 10 sellers of C.M.O.'s for the last two and a half years. From the evidence I see, Goldman was doing this for years. It might have sold very roughly $100 billion of the stuff in that period, according to ABAlert. Goldman was doing it on a scale of billions even when Henry M. Paulson Jr., the current Treasury secretary, led the firm.

The Goldman spokesman would not comment on this except to note that other firms sold C.M.O.'s too.

The point to bear in mind, as Mr. Sloan brilliantly makes clear, is that as Goldman was peddling C.M.O.'s, it was also shorting the junk on a titanic scale through index sales — showing, at least to me, how horrible a product it believed it was selling.

The Goldman Sachs spokesman said that the company routinely shorts the securities it underwrites and said that this is disclosed. He noted candidly that Goldman is much more short in this sector than usual.

Here is my humble hypothesis, even after talking to Goldman: Is it possible that Dr. Hatzius's paper was a device to help along the goal of success at bearish trades in this sector and in the market generally? His firm says his paper, like all of its economists' work, was not written to support any larger short-trading strategy. But economists, like accountants, are artists. They have a tendency to paint what their patrons, who pay them, want to see.

From what I have observed over the years, Goldman has a fascinating culture. It is sort of like what I imagine the culture of the K.G.B. to be. You always put the firm first. The long-ago scandal of the Goldman Sachs Trading Corporation, which

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raised hundreds of millions just before the crash of 1929 to create a mutual fund, then used the fund's money to prop up stocks it owned and underwrote, was a particularly sad example. The fund, of course, went bust.

Now, obviously, Goldman Sachs does many fine deals and has many smart, capable people working for it. But it's not the Vatican. It exists to make money for the partners and (much farther down the line) the stockholders. The people there are not statesmen. They are salesmen.

To my old eyes, the recent unhappiness about mortgages and Goldman's connection with them are not examples of sterling conduct. It is bad enough to have been selling this stuff. It is far worse when the sellers were, in effect, simultaneously shorting the stuff they were selling, or making similar bets.
Doesn't this bear some slight resemblance to Merrill selling tech stocks during the bubble while its analyst Henry Blodget was reportedly telling his friends what garbage they were? How different would it be from selling short the junky stock that your firm is underwriting? And if a top economist at Goldman Sachs was saying housing was in trouble, why did Goldman continue to underwrite junk mortgage issues into the market?

HERE is a query, as we used to say in law school: Should Henry M. Paulson Jr., who formerly ran a firm that engaged in this kind of conduct, be serving as Treasury secretary? Should there not be some inquiry into what the invisible government of Goldman (and the rest of Wall Street) did to create this disaster, which has caught up with some Wall Street firms but not the nimble Goldman?

When the Depression got under way, the government created the Temporary National Economic Committee to study just what had happened on the Street to get the tragedy going. Maybe it's time for an investigation of just what Wall Street and Goldman did to make money as they pumped this mortgage mess into the economic system, and sometimes were seemingly on both sides of the deal.

Or is Goldman Sachs like "Love Story"? Does working there mean never having to say you're sorry?

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