Prosecuting Wall Street Fraud: The US Economy is A Giant Ponzi Scheme

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Bill Gross, Nouriel Roubini, Laurence Kotlikoff, Steve Keen, Michel Chossudovsky and the Wall Street Journal all say that the U.S. economy is a giant Ponzi scheme.

Virtually all independent economists and financial experts say that rampant fraud was largely responsible for the financial crisis. See this and this.

But many on Wall Street and in D.C. – and many investors – believe that we should just "go with the flow". They hope that we can restart our economy and make some more money if we just let things continue the way they are.

But the assumption that a system built on fraud can continue without crashing is false.

In fact, top economists and financial experts agree that – unless fraud is prosecuted – the economy cannot recover.

Fraud Leads to a Break Down in Trust and Instability in the Markets

As Alan Greenspan said recently:

> Fraud creates very considerable instability in competitive markets. If you cannot trust your counterparties, it would not work

Similarly, leading economist Anna Schwartz – co-author of the leading book on the Great Depression with Milton Friedman – told the Wall Street journal in 2008:

> "The Fed … has gone about as if the problem is a shortage of liquidity. That is not the basic problem. The basic problem for the markets is that [uncertainty] that the balance sheets of financial firms are credible."
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> So even though the Fed has flooded the credit markets with cash, spreads haven't budged because banks don't know who is still solvent and who is not. This uncertainty, says Ms. Schwartz, is "the basic problem in the credit market. Lending freezes up when lenders are uncertain that would-be borrowers have the resources to repay them. So to assume that the whole problem is inadequate liquidity bypasses the real issue."
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> Today, the banks have a problem on the asset side of their ledgers — "all these exotic securities that the market does not know how to value."

> "Why are they 'toxic'?" Ms. Schwartz asks. "They're toxic because you cannot sell them, you don't know what they're worth, your balance sheet is not credible and the whole market freezes up. We don't know whom to lend to because we don't know who is sound. So if you could get rid of them, that would be an improvement."

And economics professor and former Secretary of Labor Robert Reich [wrote](#) in 2008:

> The underlying problem isn't a liquidity problem. As I've noted elsewhere, the problem is that lenders and investors don't trust they'll get their money back because no one trusts that the numbers that purport to value securities are anything but wishful thinking. The trouble, in a nutshell, is that the financial entrepreneurship of recent years — the derivatives, credit default swaps, collateralized debt instruments, and so on — has undermined all notion of true value.

Robert Shiller – one of the top housing experts in the United States – [said](#) recently that failing to address the legal issues will cause Americans to lose faith in business and the government:

> Shiller said the danger of foreclosuregate — the scandal in which it has come to light that the biggest banks have routinely mishandled homeownership documents, putting the legality of foreclosures and related sales in doubt — is a replay of the 1930s, when Americans lost faith that institutions such as business and government were dealing fairly.

Nobel prize-winning economist Joseph Stiglitz [says](#) about the failure to prosecute Wall Street fraud:

> The legal system is supposed to be the codification of our norms and beliefs, things that we need to make our system work. If the legal system is seen as exploitative, then confidence in our whole system starts eroding. And that's really the problem that's going on.
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> I think we ought to go do what we did in the S&L [crisis] and actually put many of these guys in prison. Absolutely. These are not just white-collar crimes or little accidents. There were victims. That's the point. There were victims all over the world.
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> Economists focus on the whole notion of incentives. People have an incentive sometimes to behave badly, because they can make more money if they can cheat. If our economic system is going to work then we have to make sure that what they gain when they cheat is offset by a system of penalties.

Wall Street insider and New York Times columnist Andrew Ross Sorkin [writes](#):

> "They will pick on minor misdemeanors by individual market participants," said David Einhorn, the hedge fund manager who was among the Cassandras

> before the financial crisis. To Mr. Einhorn, the government is “not willing to take on significant misbehavior by sizable” firms. “But since there have been almost no big prosecutions, there’s very little evidence that it has stopped bad actors from behaving badly.”
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> Fraud at big corporations surely dwarfs by orders of magnitude the shareholders’ losses of $8 billion that Mr. Holder highlighted. If the government spent half the time trying to ferret out fraud at major companies that it does tracking pump-and-dump schemes, we might have been able to stop the financial crisis, or at least we’d have a fighting chance at stopping the next one.

Economics professor James Galbraith says:

> There will have to be full-scale investigation and cleaning up of the residue of that, before you can have, I think, a return of confidence in the financial sector. And that’s a process which needs to get underway.

No wonder Galbraith says that economists should move into the background, and “criminologists to the forefront”

Failure to Stop Fraud and Prosecute Criminals Causes a Loss of Trust in Government, Which Makes Government Less Effective

As Shiller stated in the quote above, the failure of government officials to stop fraud and prosecute the financial fraudsters has caused a lack of trust in government itself.

Indeed, polls show that people no longer trust our economic “leaders”. See this and this.

A psychologist wrote an essay published by the Wharton School of Business arguing that restoring trust is the key to recovery, and that trust cannot be restored until wrongdoers are held accountable:

> According to David M. Sachs, a training and supervision analyst at the Psychoanalytic Center of Philadelphia, the crisis today is not one of confidence, but one of trust. “Abusive financial practices were unchecked by personal moral controls that prohibit individual criminal behavior, as in the case of [Bernard] Madoff, and by complex financial manipulations, as in the case of AIG.” The public, expecting to be protected from such abuse, has suffered a trauma of loss similar to that after 9/11. “Normal expectations of what is safe and dependable were abruptly shattered,” Sachs noted. “As is typical of post-traumatic states, planning for the future could not be based on old assumptions about what is safe and what is dangerous. A radical reversal of how to be gratified occurred.”
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> People now feel more gratified saving money than spending it, Sachs suggested. They have trouble trusting promises from the government because they feel the government has let them down.
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> He framed his argument with a fictional patient named Betty Q. Public, a librarian with two teenage children and a husband, John, who had recently lost his job. “She felt betrayed because she and her husband had invested

> conservatively and were double-crossed by dishonest, greedy businessmen, and now she distrusted the government that had failed to protect them from corporate dishonesty. Not only that, but she had little trust in things turning around soon enough to enable her and her husband to accomplish their previous goals.
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> "By no means a sophisticated economist, she knew … that some people had become fantastically wealthy by misusing other people's money — hers included," Sachs said. "In short, John and Betty had done everything right and were being punished, while the dishonest people were going unpunished."
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> Helping an individual recover from a traumatic experience provides a useful analogy for understanding how to help the economy recover from its own traumatic experience, Sachs pointed out. The public will need to "hold the perpetrators of the economic disaster responsible and take what actions they can to prevent them from harming the economy again." In addition, the public will have to see proof that government and business leaders can behave responsibly before they will trust them again, he argued.

Government regulators know this – or at least pay lip service to it – as well. For example, as the Director of the Securities and Exchange Commission's enforcement division told Congress:

> Recovery from the fallout of the financial crisis requires important efforts on various fronts, and vigorous enforcement is an essential component, as aggressive and even-handed enforcement will meet the public's fair expectation that those whose violations of the law caused severe loss and hardship will be held accountable. And vigorous law enforcement efforts will help vindicate the principles that are fundamental to the fair and proper functioning of our markets: that no one should have an unjust advantage in our markets; that investors have a right to disclosure that complies with the federal securities laws; and that there is a level playing field for all investors.

If people don't trust their government to enforce the law, government will become more and more impotent in addressing our economic problems. If government leaders take action, the market will not necessarily respond as expected. When government leaders make optimistic statements about the economy, people will no longer believe them.

Trying to Cover Up the Truth Extends Financial Crises

Elizabeth Warren, William Black and others say that attempting to cover up the truth extended Japan's financial problems into an entire "Lost Decade".

As Joseph Stiglitz said about Wall Street fraud:

> So the whole strategy of the banks has been to hide the losses, muddle through and get the government to keep interest rates really low.
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> As long as we keep up this strategy, it's going to be a long time before the economy recovers ….

Pam Martens – who worked on Wall Street for 21 years – writes:

> The massive losses by big Wall Street firms, now topping those of the Great Depression in relative terms, have yet to be adequately explained. Wall Street power players are obfuscating and Congress is too embarrassed or frightened to ask, preferring to just throw money at the problem and hope it goes away. But as job losses and foreclosures mount and pensions and 401(k)s shrink, public policy measures to address the economic stresses require a full set of unembellished facts…
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> It was four years after the crash of 1929 before the major titans of Wall Street were forced to give testimony under oath to Congress and the full magnitude of the fraud emerged. That delay may well have contributed to the depth and duration of the Great Depression. The modern-day Wall Street corruption hearings in Congress … must now resume in earnest and with sworn testimony if we are to escape a similar fate.

To the extent that the government tries to cover up – instead of openly discuss – financial fraud, it will only extend America's economic malaise.

Failing to Prosecute Fraud Encourages Financial Players to Take Bigger and More Blatantly Illegal Actions

Nobel prize winning economist George Akerlof has demonstrated that failure to punish white collar criminals – and instead bailing them out- creates incentives for more economic crimes and further destruction of the economy in the future. Joseph Stiglitz, Professor Black, and many others agree. See this, this and this.

It was largely fraud which brought down the financial system in 2008. Unless we prosecute the fraudsters, they will do even bigger, stupider and more blatantly illegal things in the future which will lead to even bigger crises.

Failure to Prosecute Fraud Exacerbates the Sovereign Debt Crisis

The governments of the world have spent trillions trying to paper over the fraud and prop up the big, insolvent banks, instead of forcing them to restructure and forcing bondholders and shareholders to take a haircut.

A study of 124 banking crises by the International Monetary Fund found that propping banks which are only pretending to be solvent drives up the costs to the country:

> Existing empirical research has shown that providing assistance to banks and their borrowers can be counterproductive, resulting in increased losses to banks, which often abuse forbearance to take unproductive risks at government expense. The typical result of forbearance is a deeper hole in the net worth of banks, crippling tax burdens to finance bank bailouts, and even more severe credit supply contraction and economic decline than would have occurred in the absence of forbearance.
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> Cross-country analysis to date also shows that accommodative policy measures (such as substantial liquidity support, explicit government guarantee on financial institutions' liabilities and forbearance from prudential regulations) tend to be fiscally costly and that these particular policies do not necessarily accelerate the speed of economic recovery.
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> All too often, central banks privilege stability over cost in the heat of the containment phase: if so, they may too liberally extend loans to an illiquid bank which is almost certain to prove insolvent anyway. Also, closure of a nonviable bank is often delayed for too long, even when there are clear signs of insolvency (Lindgren, 2003). Since bank closures face many obstacles, there is a tendency to rely instead on blanket government guarantees which, if the government's fiscal and political position makes them credible, can work albeit at the cost of placing the burden on the budget, typically squeezing future provision of needed public services.

The American banks and government have certainly pretended that all of the big banks are solvent. As ABC wrote in October 2009:

> The Treasury Department and the Federal Reserve lied to the American public last fall when they said that the first nine banks to receive government bailout funds were healthy, [the special inspector general for the Troubled Asset Relief Program] states in a new report released today.

Similarly, the stress tests were a complete and utter sham.

The government has given the giant banks huge amounts in loans and guarantees based upon their false representations about their financial health. The Fed has larded up its balance sheet with toxic assets from the banks.

Debt levels are also getting dangerously close to the level that they become a drag on the economy. See this and this. When Keynesian economists argue that debt does not harm the economy, they are talking about debt incurred to pay for stimulus and productive things for the economy. But throwing trillions at the giant banks – who are mainly using the money to gamble – is not stimulus. It helps the executives of the big banks and their shareholders and bondholders, but not the broader economy.

Indeed, attempting to prop up big, insolvent banks is preventing stimulus from getting out into the economy.

Fraud Causes Growing Inequality, Which Undermines the Economy

Growing inequality is very harmful to our economy. Indeed, if wealth is concentrated in too few hands, the "poker game" ends, as only too few fat cats are left with all of the chips. See this, this, this and this.

Fraud benefits the wealthy more than the poor, because the big banks and big companies have the inside knowledge and the resources to leverage fraud into profits. Joseph Stiglitz noted in September that giants like Goldman are using their size to manipulate the market. The giants (especially Goldman Sachs) have also used high-frequency program trading (making up between 40- 70% of all stock trades) which not only distorts the markets, but which also lets the program trading giants take a sneak peak at what the real traders are buying and selling, and then trade on the insider information. See this, this, this, this and this.

Similarly, JP Morgan Chase, Bank of America, Goldman Sachs, Citigroup, and Morgan Stanley together hold 80% of the country's derivatives risk, and 96% of the exposure to credit derivatives. They use their dominance in the market to manipulate the market.

Fraud disproportionally benefits the big players (and helps them to become big in the first place), increasing inequality and warping the market.

Fraud Increases the Severity of Boom-Bust Cycles

More and more people – such as the Bank of International Settlements and Barons – are saying that bubbles inevitably lead to busts, thus destabilizing the economy.

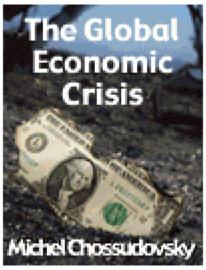
Professor Black says that fraud is a large part of the mechanism through which bubbles are blown.

Without strong laws against fraud, bubble after bubble will be blown, guaranteeing that the financial system cannot be stabilized in a fundamental sense.

Failure to Prosecute Fraud Is Worsening the Housing Crisis

Finally, failure to prosecute mortgage fraud is arguably worsening the housing crisis. See this and this.

The Global Economic Crisis



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