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The Joy of Sachs

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The American economy remains in dire straits, with one worker in six unemployed or underemployed. Yet Goldman Sachs just reported record quarterly profits — and it's preparing to hand out huge bonuses, comparable to what it was paying before the crisis. What does this contrast tell us?

First, it tells us that Goldman is very good at what it does. Unfortunately, what it does is bad for America.

Second, it shows that Wall Street's bad habits — above all, the system of compensation that helped cause the financial crisis — have not gone away.

Third, it shows that by rescuing the financial system without reforming it, Washington has done nothing to protect us from a new crisis, and, in fact, has made another crisis more likely.

Let's start by talking about how Goldman makes money.

Over the past generation — ever since the banking deregulation of the Reagan years — the U.S. economy has been "financialized." The business of moving money around, of slicing, dicing and repackaging financial claims, has soared in importance compared with the actual production of useful stuff. The sector officially labeled "securities, commodity contracts and investments" has grown especially fast, from only 0.3 percent of G.D.P. in the late 1970s to 1.7 percent of G.D.P. in 2007.

Such growth would be fine if financialization really delivered on its promises — if financial firms made money by directing capital to its most productive uses, by developing innovative ways to spread and reduce risk. But can anyone, at this point, make those claims with a straight face? Financial firms, we now know, directed vast quantities of capital into the construction of unsellable houses and empty shopping malls. They increased risk rather than reducing it, and concentrated risk rather than spreading it. In effect, the industry was selling dangerous patent medicine to gullible consumers.

Goldman's role in the financialization of America was similar to that of other players, except for one thing: Goldman didn't believe its own hype. Other banks invested heavily in the same toxic waste they were selling to the public at large. Goldman, famously, made a lot of money selling securities backed by subprime mortgages — then made a lot more money by selling mortgage-backed securities short, just before their value crashed. All of this was perfectly legal, but the net effect was that Goldman made profits by playing the rest of us for suckers.

And Wall Streeters have every incentive to keep playing that kind of game.

The huge bonuses Goldman will soon hand out show that financial-industry highfliers are still operating under a system of heads they win, tails other people lose. If you're a banker, and you generate big short-term profits, you get lavishly rewarded — and you don't have to give the money back if and when those profits turn out to have been a mirage. You have every reason, then, to steer investors into taking risks they don't understand.

And the events of the past year have skewed those incentives even more, by putting taxpayers as well as investors on the hook if things go wrong.

I won't try to parse the competing claims about how much direct benefit Goldman received from recent financial bailouts, especially the government's assumption of A.I.G.'s liabilities. What's clear is that Wall Street in general, Goldman very much included, benefited hugely from the government's provision of a financial backstop — an assurance that it will rescue major financial players whenever things go wrong.

You can argue that such rescues are necessary if we're to avoid a replay of the Great Depression. In fact, I agree. But the result is that the financial system's liabilities are now backed by an implicit government guarantee.

Now the last time there was a comparable expansion of the financial safety net, the creation of federal deposit insurance in the 1930s, it was accompanied by much tighter regulation, to ensure that banks didn't abuse their privileges. This time, new regulations are still in the drawing-board stage — and the finance lobby is already fighting against even the most basic protections for consumers.

If these lobbying efforts succeed, we'll have set the stage for an even bigger financial disaster a few years down the road. The next crisis could look something like the savings-and-loan mess of the 1980s, in which deregulated banks gambled with, or in some cases stole, taxpayers' money — except that it would involve the financial industry as a whole.

The bottom line is that Goldman's blowout quarter is good news for Goldman and the people who work there. It's good news for financial superstars in general, whose paychecks are rapidly climbing back to precrisis levels. But it's bad news for almost everyone else.