
Paul Krugman

The Madoff economy

The revelation that Bernard Madoff — brilliant investor (or so almost everyone thought), philanthropist, pillar of the community — was a phony has shocked the world, and understandably so. The scale of his alleged \$50 billion Ponzi scheme is hard to comprehend.

Yet surely I'm not the only person to ask the question: How different, really, is Madoff's tale from the story of the investment industry as a whole?

The financial services industry has claimed an ever-growing share of America's income over the past generation, making the people who run the industry incredibly rich. Yet, at this point, it looks as if much of the industry has been destroying value, not creating it. And it's not just a matter of money: The vast riches achieved by those who managed other people's money have had a corrupting effect on our society as a whole.

Let's start with those paychecks. Last year, the average salary of employees in "securities, commodity contracts, and investments" was more than four times the average salary in the rest of the economy.

Earning a million dollars was nothing special, and even incomes of \$20 million or more were fairly common. The incomes of the richest Americans have exploded over the past generation, even as wages of ordinary workers have stagnated; high pay on Wall Street was a major cause of that divergence.

But surely those financial superstars must have been earning their millions, right? No, not necessarily. The pay system on Wall Street lavishly rewards the appearance of profit, even if that appearance later turns out to have been an illusion.

Consider the hypothetical example of a money manager who leverages up his clients' money with lots of debt, then invests the bulked-up total in high-yielding but risky assets, such as dubious mortgage-backed securities.

For a while — say, as long as a housing bubble continues to inflate — he will earn big profits and receive big bonuses. Then, when the bubble bursts and his investments turn into toxic assets, his investors will lose big — but he will keep those bonuses.

Maybe my example wasn't hypothetical after all.

So, how different is what Wall Street in general did from the Madoff

The fraud and abuse on Wall Street have had a corrupting effect on U.S. society as a whole.

affair? Well, Madoff allegedly skipped a few steps, simply stealing his clients' money rather than collecting big fees while exposing investors to risks they didn't understand. And while Madoff was apparently a self-conscious fraud, many people on Wall Street believed their own hype. Still, the end result was the same (except for the house arrest): The money managers got rich; the investors saw their money disappear.

We're talking about a lot of money. In recent years the finance sector accounted for 8 percent of America's GDP, up from less than 5 percent a generation earlier. If that extra 3 percent was money for nothing — and it probably was — we're talking about \$400 billion a year in waste, fraud and abuse. But the costs of America's Ponzi era surely went beyond the direct waste of dollars and cents.

At the crudest level, Wall Street's ill-gotten gains corrupted and continue to corrupt politics, in a nicely bipartisan way. From Bush administration officials like Christopher Cox, chairman of the Securities and Exchange Commission, who looked the other way as evidence of financial fraud mounted, to Democrats who still haven't closed the outrageous tax loophole that benefits executives at hedge funds and private equity firms (hello, Senator Schumer), politicians have walked when money talked.

Meanwhile, how much has our nation's future been damaged by the magnetic pull of quick personal wealth, which for years has drawn many of our best and brightest young people into investment banking, at the expense of science, public service and just about everything else?

Most of all, the vast riches being earned — or maybe that should be "earned" — in our bloated financial industry undermined our sense of reality and degraded our judgment.

Think of the way almost everyone important missed the warning signs of an impending crisis. How was that possible? How, for example, could Alan Greenspan have declared, just a few years ago, that "the financial system as a whole has become more resilient" — thanks to derivatives, no less? The answer, I believe, is that there's an innate tendency on the part of even the elite to idolize men who are making a lot of money, and assume that they know what they're doing.

After all, that's why so many people trusted Madoff.

Now, as we survey the wreckage and try to understand how things can have gone so wrong, so fast, the answer is actually quite simple: What we're looking at now are the consequences of a world gone Madoff.