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Win Together or Lose Together

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IN the wake of the hugely disappointing budget deal and the S.& P.'s debt downgrade, maybe we need to hang a new sign in the immigration arrival halls at all U.S. ports and airports. It could simply read: "Welcome. You are entering the United States of America. Past performance is not necessarily indicative of future returns."

Because our country is now finding itself in the worst kind of decline — a slow decline, just slow enough for us to keep deluding ourselves that nothing really fundamental needs to change if our future is to match our past.

Our slow decline is a product of two inter-related problems. First, we've let our five basic pillars of growth erode since the end of the cold war — education, infrastructure, immigration of high-I.Q. innovators and entrepreneurs, rules to incentivize risk-taking and start-ups, and government-funded research to spur science and technology.

We mistakenly treated the end of the cold war as a victory that allowed us to put our feet up — when it was actually the onset of one of the greatest challenges we've ever faced. We helped to unleash two billion people just like us — in China, India and Eastern Europe. For us to effectively compete and collaborate with them — to maintain the American dream — required studying harder, investing wiser, innovating faster, upgrading our infrastructure quicker and working smarter.

Instead of doing that at the scale we needed — that is, building muscle — we injected ourselves with massive amounts of credit steroids (just like our baseball players). This enabled millions of people to buy homes they could not afford and to fill jobs in construction and retail that did not require that much education. Our European friends went on a similar binge.

All this debt blew up in 2008 in the U.S. and Europe, and that led to the second problem: Homeowners, firms, banks and governments are all now "deleveraging" or trying to — meaning that they are saving more, shopping less, paying off debts and trying to dig out from mortgages that are under water.

No one better explains the implications of this than Kenneth Rogoff, a professor of economics at Harvard, who argued in an essay last week for Project Syndicate that we are not in a Great Recession but in a Great (Credit) Contraction: "Why is everyone still referring to the recent financial crisis as the 'Great Recession?' " asked Rogoff. "The phrase 'Great Recession' creates the impression that the economy is following the contours of a typical recession, only more severe — something like a really bad cold. ... But the real problem is that the global economy is badly overleveraged, and there is no quick escape without a scheme to transfer wealth from creditors to debtors, either through defaults, financial repression, or inflation. ...

“In a conventional recession,” Rogoff noted, “the resumption of growth implies a reasonably brisk return to normalcy. The economy not only regains its lost ground, but, within a year, it typically catches up to its rising long-run trend. The aftermath of a typical deep financial crisis is something completely different. ... It typically takes an economy more than four years just to reach the same per capita income level that it had attained at its pre-crisis peak. ... Many commentators have argued that fiscal stimulus has largely failed not because it was misguided, but because it was not large enough to fight a ‘Great Recession.’ But, in a ‘Great Contraction,’ problem No. 1 is too much debt.” Until we find ways to restructure and forgive some of these debts from consumers, firms, banks and governments, spending to drive growth is not going to come back at the scale we need.

Our challenge now, therefore, is to deleverage the economy as fast as possible, while, at the same time, getting back to investing as much as possible in our real pillars of growth so our recovery is built on sustainable businesses and real jobs and not just on another round of credit injections.

Regarding deleveraging, Rogoff suggests, for example, that the government facilitate the writing down of mortgages in exchange for a share of any future home-price appreciation.

Regarding growth, we surely need a much smarter long-term fiscal plan than the one that just came out of Washington. We need to cut spending in areas and on a time schedule that will hurt the least; we need to raise taxes in ways that will hurt the least (now is the perfect time for a gasoline tax rather than payroll taxes); and we need to use some of these revenues to invest in the pillars of our growth, with special emphasis on infrastructure, research and incentives for risk-taking and start-ups. We need to offer every possible incentive to get Americans to start new businesses to grow out of this hole.

If juggling all these needs at once sounds hard and complicated, it is. There is no easy, one-policy fix. We need to help people deleverage, cut some spending, raise some revenues and reinvest in our growth engines — as an integrated strategy for national renewal. Something this big and complex cannot be accomplished by one party alone. It will require the kind of collective action usually reserved for national emergencies. The sooner we pull together the better.