OP-ED COLUMNIST

On the Edge

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A not-so-funny thing happened on the way to economic recovery. Over the last two weeks, what should have been a deadly serious debate about how to save an economy in desperate straits turned, instead, into hackneyed political theater, with Republicans spouting all the old clichés about wasteful government spending and the wonders of tax cuts.

It's as if the dismal economic failure of the last eight years never happened — yet Democrats have, incredibly, been on the defensive. Even if a major stimulus bill does pass the Senate, there’s a real risk that important parts of the original plan, especially aid to state and local governments, will have been emasculated.

Somehow, Washington has lost any sense of what’s at stake — of the reality that we may well be falling into an economic abyss, and that if we do, it will be very hard to get out again.

It’s hard to exaggerate how much economic trouble we’re in. The crisis began with housing, but the implosion of the Bush-era housing bubble has set economic dominoes falling not just in the United States, but around the world.

Consumers, their wealth decimated and their optimism shattered by collapsing home prices and a sliding stock market, have cut back their spending and sharply increased their saving — a good thing in the long run, but a huge blow to the economy right now. Developers of commercial real estate, watching rents fall and financing costs soar, are slashing their investment plans. Businesses are canceling plans to expand capacity, since they aren’t selling enough to use the capacity they have. And exports, which were one of the U.S. economy’s few areas of strength over the past couple of years, are now plunging as the financial crisis hits our trading partners.

Meanwhile, our main line of defense against recessions — the Federal Reserve’s usual ability to support the economy by cutting interest rates — has already been overrun. The Fed has cut the rates it controls basically to zero, yet the economy is still in free fall.

It's no wonder, then, that most economic forecasts warn that in the absence of government action we're headed for a deep, prolonged slump. Some private analysts predict double-digit unemployment. The Congressional Budget Office is slightly more sanguine, but its director, nonetheless, recently warned that “absent a change in fiscal policy ... the shortfall in the nation’s output relative to potential levels will be the largest — in duration and depth — since the Depression of the 1930s.”

Worst of all is the possibility that the economy will, as it did in the ’30s, end up stuck in a prolonged
deflationary trap.

We’re already closer to outright deflation than at any point since the Great Depression. In particular, the private sector is experiencing widespread wage cuts for the first time since the 1930s, and there will be much more of that if the economy continues to weaken.

As the great American economist Irving Fisher pointed out almost 80 years ago, deflation, once started, tends to feed on itself. As dollar incomes fall in the face of a depressed economy, the burden of debt becomes harder to bear, while the expectation of further price declines discourages investment spending. These effects of deflation depress the economy further, which leads to more deflation, and so on.

And deflationary traps can go on for a long time. Japan experienced a “lost decade” of deflation and stagnation in the 1990s — and the only thing that let Japan escape from its trap was a global boom that boosted the nation’s exports. Who will rescue America from a similar trap now that the whole world is slumping at the same time?

Would the Obama economic plan, if enacted, ensure that America won’t have its own lost decade? Not necessarily: a number of economists, myself included, think the plan falls short and should be substantially bigger. But the Obama plan would certainly improve our odds. And that’s why the efforts of Republicans to make the plan smaller and less effective — to turn it into little more than another round of Bush-style tax cuts — are so destructive.

So what should Mr. Obama do? Count me among those who think that the president made a big mistake in his initial approach, that his attempts to transcend partisanship ended up empowering politicians who take their marching orders from Rush Limbaugh. What matters now, however, is what he does next.

It’s time for Mr. Obama to go on the offensive. Above all, he must not shy away from pointing out that those who stand in the way of his plan, in the name of a discredited economic philosophy, are putting the nation’s future at risk. The American economy is on the edge of catastrophe, and much of the Republican Party is trying to push it over that edge.