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Ups and downs of the recovery

By Mark Zandi, October 28, 2012

To state the obvious, the economic recovery has been disappointing. The United States is growing and creating jobs, but growth has been slow and joblessness remains painfully high. Given the approaching election, it isn't surprising that each political party blames the other for the economy's problems, but in reality they largely reflect fallout from the Great Recession.

The housing crash is most clearly to blame. Housing normally leads the economy out of recession. It is the part of the economy most sensitive to interest rates: Home sales, construction, and prices generally perk up quickly after the Federal Reserve begins to ease monetary policy and mortgage rates fall. But this didn't happen after the Great Recession. The housing bust had been the cause of the economy's downturn in 2007, and housing remained flat on its back well into the recovery.

In earlier business cycles since World War II, housing accounted for about 1 percentage point of real GDP growth per year, on average, in the first three recovery years. That equals almost one-fourth of all the economic growth during these periods. Yet three years into the recovery that followed the 2007-2009 recession, housing had cut almost half a percentage point from annual growth. If housing had simply performed as it did in the average post-World War II recovery, unemployment would have been almost 2 percentage points lower three years in. The economy would have been weak, but not nearly as dysfunctional as it has been.

The good news is that housing is finally getting its bearings. Home sales, construction, and even house prices have improved across much of the country this year. Housing is turning from an economic headwind into a tailwind, and should be a significant source of jobs over the next several years.

The current subpar recovery can also be seen as the predictable consequence of the 2007-08 financial meltdown. Crises such as the one we suffered have led to similarly sluggish recoveries for hundreds of years, according to a comprehensive study by economists Carmen Reinhart and Kenneth Rogoff.

At least as far back as the 1400s, they found, excess borrowing and lending during good times have been followed by enormous losses and failures when times turn bad. Financial crises are economically debilitating because they choke off credit, an economy's lifeblood. Without credit, commerce stops. Households cannot buy homes, businesses cannot invest or trade, and governments can't finance themselves. Recovery is slow because overladen borrowers must reduce debts - a process called deleveraging - and surviving lenders must write off problem loans and raise fresh capital. If this sounds familiar, it should.

Yet there is also good news on this front. American businesses have done a marvelous job reducing debt and raising cash. Corporations have arguably never been in better financial shape. U.S. banks have also raised lots of capital and have ample financial cushions if their lending goes bad again.

Households too have cleaned up their financial affairs. The share of income needed to stay current on household debt obligations is approaching a record low. Too many families are struggling to pay student loans and home foreclosures are still high, but these problems aren't nearly as serious as those Americans faced a few years ago. The U.S. economy has deleveraged in record time.

Arguably, the most important factor holding back the recovery now is a lack of confidence. It is hard for businesses that came near to collapse and households that lost jobs and savings during the Great Recession to forget the experience. We are still somewhat spooked, and recoil when things don't go exactly right, thinking the bad times might return. Businesses don't hire and invest as they normally would and households stop spending.

Of course, the path hasn't been smooth. Europe's debt crisis has been especially unnerving, and the euro zone has come close to fracturing. Shock waves have affected emerging economies such as China and India, and reverberated back via slower growth in exports and corporate profits.

Even more nerve-wracking has been the political vitriol and brinksmanship in Washington, which has crippled efforts to address the nation's fiscal problems. The showdown over the Treasury's debt ceiling in 2011 was disturbing, and the tax hikes and spending cuts scheduled to take effect in early 2013 - nicknamed the fiscal cliff - are a big worry. If the next president and Congress don't come together and act, the economy will slide back into recession. Business managers who can't see how policymakers will come to terms are hunkering down, causing growth to sputter.

But there is good news even here. Businesses are perfectly able to invest and hire more, and households are in good position to spend more, once they conquer their fears. And that will happen if the president and Congress can only address our problems in a reasonably graceful way. The beauty of the American political system is that our elections, however contentious, have always shown us the way. I don't think this election will be any different.

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