

# Will A Great Recovery Follow The Great Recession?

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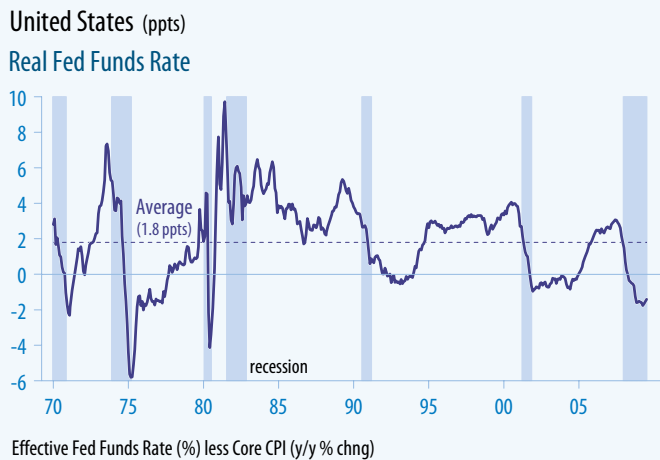
Amid growing signs that the U.S. economy is emerging from recession, the debate has shifted from the depth of the downturn to the speed of the recovery. To be sure, the proponents of a strong recovery have a legitimate case. History suggests the harder you fall, the faster you snap back—and we are coming off the worst economic face-plant in seven decades. Further, the monetary and fiscal medicine is unprecedented, and will likely remain in place well into next year. As well, a weaker dollar and faster growing developing economies should boost exports. Indeed, the current quarter could well print 4% GDP growth due to inventory re-stocking, the cash-for-clunkers' lift to auto sales, and firmer housing markets. Still, the recovery is likely to be mild, not wild, in 2010 owing to the following factors:

**The Great Recession was not caused by tight policies:** The real fed funds rate peaked at 3% before the current recession, less than half the rate that prevailed prior to severe downturns in 1975 and 1982 (*Chart 1*). The cause of the Great Recession was not tight monetary policy but lax lending standards, which pumped the housing/credit bubble and required subsequent deleveraging by homeowners and lenders. The corollary is that low interest rates—which foster re-leveraging—likely won't drive the current recovery as much as past ones.

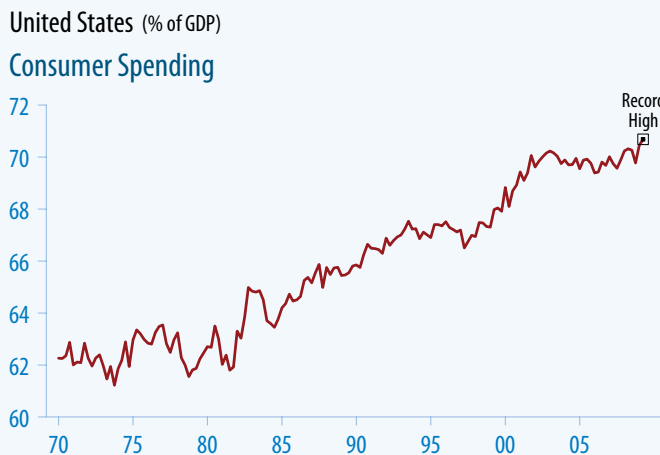
**Households need to save more:** The four-percentage-points increase in the savings rate during the recession largely stems from a tax-cut boost to disposable income. Spending out of pre-tax personal income actually hasn't fallen, which explains why consumers still account for a record 71% of GDP (*Chart 2*). The savings rate likely needs to climb much further to return household debt ratios to the more sustainable, pre-credit boom days of the mid-1990s.

**Lenders deleveraging too:** The Fed's latest lending survey found that banks continued to tighten credit standards, and plan to remain tight-fisted well into next year. Meantime, securitization markets remain anaemic, outside of those backed by the government (the GSEs

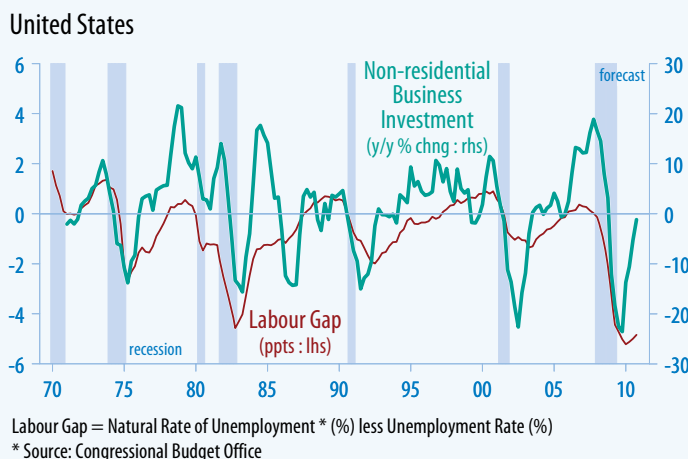
**CHART 1**  
HIGH RATES DIDN'T CAUSE THE RECESSION



**CHART 2**  
WHO'S SAVING?

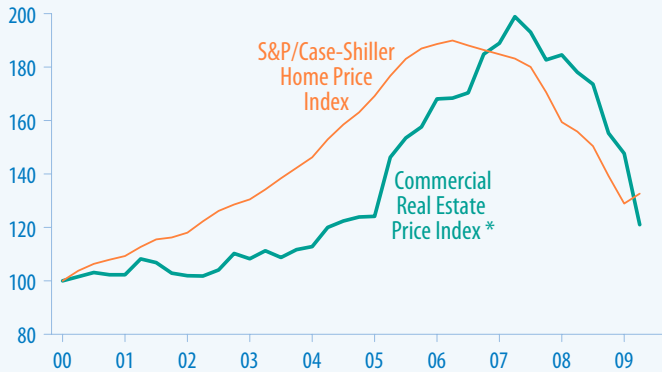


**CHART 3**  
CAPACITY TO SPARE



**CHART 4  
THAT OTHER BUBBLE**

United States (Q1:2000 = 100)

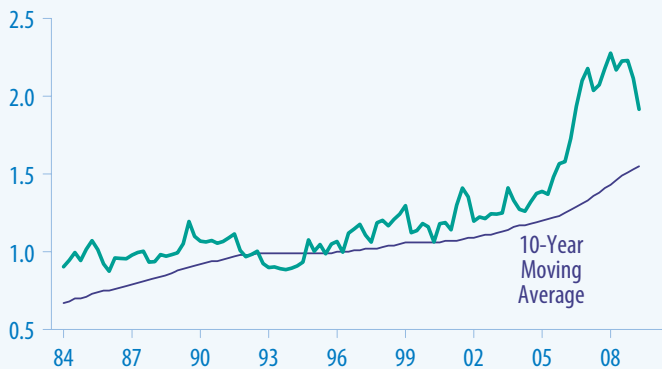


\* Source: MIT Center for Real Estate

**CHART 5  
PRETTY VACANT**

United States (mlns of units)

Vacant Homes for Sale



account for nine of every ten new residential mortgages). Although private investors are buying corporate bonds again, this type of financing largely benefits large, rather than small and mid-sized, companies.

**Too much slack could hold investment back:** The largest output gap in more than half a century might discourage companies from expanding capacity for a while. To be sure, capacity could be overstated given the vast amount of restructuring in this cycle, and history suggests that slack has only been a minor deterrent of business spending (*Chart 3*). However, firms will likely delay buying some new machines or building new plants as long as roughly one in three is currently sitting idle.

**Commercial real estate more bust than robust:** Spare capacity isn't just a problem for manufacturers. Apartment vacancies are at record highs, as investors buy up bargain-priced properties to lease out. Rising office and industrial vacancies will keep commercial building plans on hold for some time, possibly even after the credit taps re-open. Commercial real estate values have plunged 39% in the past two years, even outpacing the slide in house prices (*Chart 4*).

**Homebuilders have that vacant stare:** Though well off the peak, the number of vacant homes for sale remains high at 1.9 million units, about 300,000 above the trend line (*Chart 5*). And, with a record one-in-eleven mortgages delinquent, foreclosures likely haven't peaked. This should keep the resale market flush with supply, restraining residential construction.

**Oil prices have consumers in the tank:** The sharp pullback in crude oil prices last year was the sole bright spot on an otherwise bleak consumer landscape. However, the subsequent doubling in oil prices since December has pumped gasoline prices by one dollar to \$2.60/gallon, implying a 1½% hit to spending power. If gasoline prices continue to climb, as we anticipate, then the positive impact on spending of last year's drop in prices will turn negative next year.

**Bottom Line:** The legacy of the credit and housing bubbles is a mountain of debt that will likely keep consumers tight-fisted and banks risk-averse for some time. Meantime, the legacy of the Great Recession is a chasm of spare capacity that could cause businesses and builders to defer spending for a while. These factors, along with rising oil prices, will likely limit U.S. growth to about 2½% in 2010.

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