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The economy

A faint sound of applause

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Some signs suggest that the recession is lifting, but the path to recovery is fraught with danger

Getty Images



THE current recession has broken many of the rules of business cycles, but not this one: when something gets cheap enough, buyers emerge.

America's housing bubble seems mostly deflated. According to the S&P/Case-Shiller 20-city index, house prices through January were down 29% from their all-time peak. Relative to incomes, houses are now 10% undervalued, and relative to rents they are fairly valued, thinks Paul Dales of Capital Economics, a consultancy.

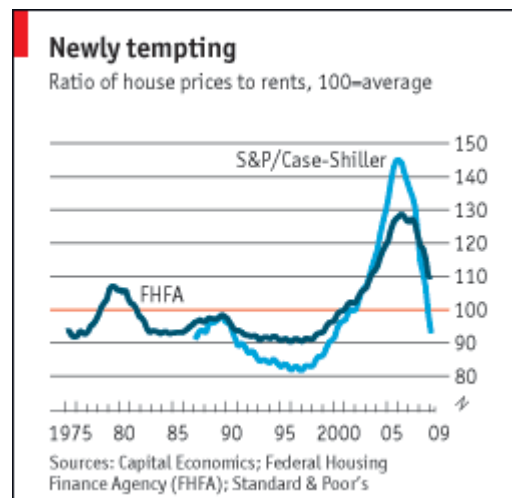
This is luring buyers back. House sales rose unexpectedly in February. The National Association of Realtors estimates that up to 45% of existing homes sold were "distressed" properties—those in, or close to, foreclosure. In Nevada, which with California, Florida and Arizona was the epicentre of the boom and bust, fourth-quarter sales were more than double their level a year earlier. Keith Kelley, a Las Vegas estate agent, has an investor interested in offering about \$80,000 for a foreclosed, four-unit apartment building which, fully let, could bring in over \$25,000 a year in gross rent. He has two buyers interested in paying \$220,000 for a five-bedroom house that sold in 2004 for more than triple that. Their monthly mortgage payment would be about half the rent on a similar property. Even so, he says, "I still talk to buyers waiting to see when we get to the bottom." Indeed, homes may be fairly valued now but could get dirt cheap if, as

commonly happens, prices overshoot.

The stabilising of the housing market is one of several tantalising glimmers that the end of the recession may be in sight. In March factory purchasing managers were their least gloomy about new orders since last August. Vehicle sales rose 8% in March from February. New claims for unemployment insurance have stopped rising. Gross domestic product, which shrank at a 6.3% annual rate in the fourth quarter, probably shrank at a similar rate in the first, but the composition of the drop was more encouraging; it was driven not by the collapse in consumer spending, but by sinking output as businesses sought to bring inventories into line with lower sales. Second-quarter growth “has a good chance of being positive”, according to Ian Morris and Ryan Wang, economists at HSBC, though “the risks...are still huge.”

What has brought this turnabout? In part, the normal corrective powers of the economy. Larry Summers, Barack Obama’s main economic adviser, has noted that current annualised vehicle sales of about 9m are well below the 14m necessary for replacement and rising population, while annualised housing starts are about a quarter of the rate needed to support the forming of new households.

The improvement is also the expected response to monetary and fiscal stimulus, both of which have been exceptionally aggressive. The Federal Reserve, having lowered short-term interest rates in effect to zero, has intervened in bond markets to push down long-term mortgage rates as well. On April 1st paycheques were due to begin reflecting the tax cuts in Barack Obama’s \$787 billion fiscal stimulus.



As investors have shifted their economic outlook from catastrophic to merely grim, the stockmarket has shot higher, by 19% on April 1st from its 12-year low on March 9th. Like houses, stocks look cheap. Strategists at Deutsche Bank estimate that investors can expect to earn an additional seven percentage points over the long run from holding stocks instead of Treasury bonds, the highest such “equity risk premium” in at least 25 years. Mr Summers says it may be “the sale of the century”.

Yet even if the bottom in economic activity is in sight, a robust recovery almost certainly is not. Housing usually leads the way out of recession as falling interest rates unleash pent-up demand. But easy credit in earlier years has turned many renters into homeowners already. At the end of last year 67.5% of households owned their home, down from a peak of 69% in 2006 but still well above the 64% that prevailed from 1965 to 1997. Moreover, many prospective buyers cannot take advantage of low mortgage rates because higher down-payments are now required.

The tonic of lower interest rates has been dulled by the dysfunctional financial system. That is why credit markets have not reflected the optimism of stocks and are forcing corporations to pay punitive yields on the bonds they issue (see chart).

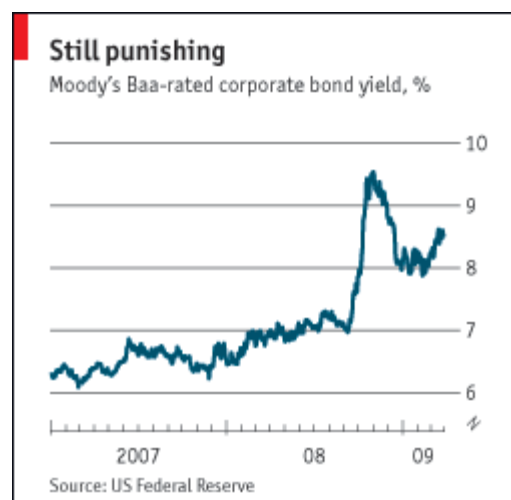
Consumer spending may also be depressed for some years to come by the record 18% collapse in household net worth over the course of last year, a drop of \$11 trillion. That is a chief reason why the OECD on March 31st released an exceptionally gloomy prognosis, predicting that the American economy would shrink by 4% this year and not grow at all next year. Deflation, it said, “may become a threat”.

The greatest risk of renewed recession or stagnation comes from the banking system. As long as home prices keep falling and unemployment keeps rising, banks’ bad loans will keep mounting. Huge questions hang over the Treasury’s plan to remove those

loans, and many economists think it must commit more public capital than the already authorised \$700 billion in TARP money. Perversely, a continued stockmarket rally could undermine the chances of more aid, lulling some in Washington to believe enough has been done.

Tim Geithner, the treasury secretary, understands that. "The big mistake governments make in recessions", he said on March 29th, "is...they see that first glimmer of light, and the impetus to policy fades." Yet he hurt his own case the same day by saying that more TARP money is not needed for now because some banks will repay the government capital they have previously received. That is bad news, not good news: banks are lining up to repay the money to free themselves from political interference, even though the loss of capital will constrain their lending. That increases the odds of a multi-year, Japanese-style credit crunch.

Even if the administration wants the money, Congress at present is in no mood to grant it. The Senate and House budget resolutions were silent on the administration's request for \$750 billion in extra funds (with a budgeted cost of \$250 billion). The administration is wisely waiting for tempers to cool before asking for the money.



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