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We're Spent

By DAVID LEONHARDT

THERE is no shortage of explanations for the economy's maddening inability to leave behind the Great Recession and start adding large numbers of jobs: The deficit is too big. The stimulus was flawed. China is overtaking us. Businesses are overregulated. Wall Street is underregulated.

But the real culprit — or at least the main one — has been hiding in plain sight. We are living through a tremendous bust. It isn't simply a housing bust. It's a fizzling of the great consumer bubble that was decades in the making.

The auto industry is on pace to sell 28 percent fewer new vehicles this year than it did 10 years ago — and 10 years ago was 2001, when the country was in recession. Sales of ovens and stoves are on pace to be at their lowest level since 1992. Home sales over the past year have fallen back to their lowest point since the crisis began. And big-ticket items are hardly the only problem.

The Federal Reserve Bank of New York recently published a jarring report on what it calls discretionary service spending, a category that excludes housing, food and health care and includes restaurant meals, entertainment, education and even insurance. Going back decades, such spending had never fallen more than 3 percent per capita in a recession. In this slump, it is down almost 7 percent, and still has not really begun to recover.

The past week brought more bad news. Retail sales in June were weaker than expected, and consumer confidence fell, causing economists to downgrade their estimates for economic growth yet again. It's a familiar routine by now. Forecasters in Washington and on Wall Street keep saying the recovery's problems are temporary — and then they redefine temporary.

If you're looking for one overarching explanation for the still-terrible job market, it is this great consumer bust. Business executives are only rational to hold back on hiring if they do not know when their customers will fully return. Consumers, for their part, are coping with

a sharp loss of wealth and an uncertain future (and many have discovered that they don't need to buy a new car or stove every few years). Both consumers and executives are easily frightened by the latest economic problem, be it rising gas prices or the debt-ceiling impasse.

Earlier this year, Charles M. Holley Jr., the chief financial officer of Wal-Mart, said that his company had noticed consumers were often buying smaller packages toward the end of the month, just before many households receive their next paychecks. "You see customers that are running out of money at the end of the month," Mr. Holley said.

In past years, many of those customers could have relied on debt, often a home-equity line of credit or a credit card, to tide them over. Debt soared in the late 1980s, 1990s and the last decade, which allowed spending to grow faster than incomes and helped cushion every recession in that period.

Now, the economic version of the law of gravity is reasserting itself. We are feeling the deferred pain from 25 years of excess, as people try to rebuild their depleted savings. This pattern is a classic one. The definitive book about financial crises has become "This Time Is Different: Eight Centuries of Financial Folly," published in 2009 with exquisite timing, by Carmen M. Reinhart, now of the Peterson Institute for International Economics, and Kenneth S. Rogoff, of Harvard.

Surveying hundreds of years of crises around the world, Ms. Reinhart and Mr. Rogoff conclude that debt is the primary cause and that the aftermath is "deep and prolonged," with "profound declines in output and employment." On average, a modern financial crisis has caused the unemployment rate to rise for more than four years and by 7 percentage points. (We're now at almost four years and 5 percentage points.) The recovery takes many years more.

THE notion that the United States needs to begin moving away from its consumer economy — toward more of an investment and production economy, with rising exports, expanding factories and more good-paying service jobs — has become so commonplace that it's practically a cliché. It's also true. And the consumer bust shows why. The old consumer economy is gone, and it's not coming back.

Sure, house and car sales will eventually surpass their old highs, as the economy slowly recovers and the population continues expanding. But consumer spending will not soon return to the growth rates of the 1980s and '90s. They depended on income people didn't

have.

The choice, then, is between starting to make the transition to a different economy and enduring years of stop-and-start economic malaise.

The easy thing now might be to proclaim that debt is evil and ask everyone — consumers, the federal government, state governments — to get thrifty. The pithiest version of that strategy comes from Andrew W. Mellon, the Treasury secretary when the Depression began: “Liquidate labor, liquidate stocks, liquidate the farmers, liquidate real estate,” Mellon said, according to his boss, President Herbert Hoover. “It will purge the rottenness out of the system.”

History, however, has a different verdict. If governments stop spending at the same time that consumers do, the economy can enter a vicious cycle, as it did in Hoover’s day.

The prospect of that cycle is one reason an impasse on the debt ceiling, and a government default, could do so much damage. Global investors may be the only major constituency that has been feeling sanguine about the American economy. If Washington unnerves them, and sends interest rates rising, the effect really could be calamitous.

But the debt-ceiling debate doesn’t have to be yet another problem for the economy. The right kind of agreement could help soften the consumer bust and also speed the transition to a different kind of economy.

What might that agreement look like? First, it could reduce deficits in future years, to keep investors confident that Washington too could begin living within its means after years of excess.

Second, a deal could avoid the Mellon-like problem of having government cut back at the same time as consumers. The Federal Reserve, the Obama administration and Congress seemed to learn this lesson in 2009, when they aggressively responded to the crisis, only to turn more passive in 2010 and spend much of the year hoping for the best. It didn’t work out. Today, the most obvious options for stimulus are extensions of jobless benefits and of a temporary cut in the Social Security tax.

But they probably shouldn’t be the only options. The biggest flaw with the past stimulus was that it imagined that the old consumer economy might return. Households received large tax rebates, usually with little incentive to spend the money (the cash-for-clunkers program being the exception that proves the rule). People did spend some of these across-the-board

rebates, and kept economic growth and unemployment from being even worse, but also saved a sizable portion.

A more promising approach could instead offer a tax cut to businesses — but only to those expanding their payrolls and, in the process, helping to solve the jobs crisis. Along similar lines, a budget deal could increase funding for medical research and clean energy by even more than President Obama has suggested. These are the kinds of investments that have brought huge returns in the past — think of the Internet, a Defense Department creation — and whose price tags are tiny compared to, say, Medicare or the Bush tax cuts.

Politics, of course, makes many of these ideas unlikely to happen anytime soon. Unfortunately, though, these debt-ceiling talks won't be the final chance for Washington to help the country recover from the great consumer bust. That's the thing about consumer busts. They last for a very long time.

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