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Is Our Economy Healing?

By PAUL KRUGMAN

How goes the state of the union? Well, the state of the economy remains terrible. Three years after President Obama’s inauguration and two and a half years since the official end of the recession, unemployment remains painfully high.

But there are reasons to think that we’re finally on the (slow) road to better times. And we wouldn’t be on that road if Mr. Obama had given in to Republican demands that he slash spending, or the Federal Reserve had given in to Republican demands that it tighten money.

Why am I letting a bit of optimism break through the clouds? Recent economic data have been a bit better, but we’ve already had several false dawns on that front. More important, there’s evidence that the two great problems at the root of our slump — the housing bust and excessive private debt — are finally easing.

On housing: as everyone now knows (but oh, the abuse heaped on anyone pointing it out while it was happening!), we had a monstrous housing bubble between 2000 and 2006. Home prices soared, and there was clearly a lot of overbuilding. When the bubble burst, construction — which had been the economy’s main driver during the alleged “Bush boom” — plunged.

But the bubble began deflating almost six years ago; house prices are back to 2003 levels. And after a protracted slump in housing starts, America now looks seriously underprovided with houses, at least by historical standards.

So why aren't people going out and buying? Because the depressed state of the economy leaves many people who would normally be buying homes either unable to afford them or too worried about job prospects to take the risk.

But the economy is depressed, in large part, because of the housing bust, which immediately suggests the possibility of a virtuous circle: an improving economy leads to a surge in home purchases, which leads to more construction, which strengthens the economy further, and so on. And if you squint hard at recent data, it looks as if something like that may be starting: home sales are up, unemployment claims are down, and builders' confidence is rising.

Furthermore, the chances for a virtuous circle have been rising, because we've made significant progress on the debt front.

That's not what you hear in public debate, of course, where all the focus is on rising government debt. But anyone who has looked seriously at how we got into this slump knows that private debt, especially household debt, was the real culprit: it was the explosion of household debt during the Bush years that set the stage for the crisis. And the good news is that this private debt has declined in dollar terms, and declined substantially as a percentage of G.D.P., since the end of 2008.

There are, of course, still big risks — above all, the risk that trouble in Europe could derail our own incipient recovery. And thereby hangs a tale — a tale told by a recent report from the McKinsey Global Institute.

The report tracks progress on "deleveraging," the process of bringing down excessive debt levels. It documents substantial progress in the United States, which it contrasts with failure to make progress in Europe. And while the report doesn't say this explicitly, it's pretty clear why Europe is doing worse than we are: it's because European policy makers have been afraid of the wrong things.

In particular, the European Central Bank has been worrying about inflation — even raising interest rates during 2011, only to reverse course later in the year — rather than worrying about how to sustain economic recovery. And fiscal austerity, which is supposed to limit the increase in government debt, has depressed the economy, making it impossible to achieve urgently needed reductions in private debt. The end result is that for all their moralizing about the evils of borrowing, the Europeans aren't making any progress against excessive debt — whereas we are.

Back to the U.S. situation: my guarded optimism should not be taken as a statement that all is well. We have already suffered enormous, unnecessary damage because of an inadequate response to the slump. We have failed to provide significant mortgage relief, which could have moved us much more quickly to lower debt. And even if my hoped-for virtuous circle is getting under way, it will be years before we get to anything resembling full employment.

But things could have been worse; they would have been worse if we had followed the policies demanded by Mr. Obama's opponents. For as I said at the beginning, Republicans have been demanding that the Fed stop trying to bring down interest rates and that federal spending be slashed immediately — which amounts to demanding that we emulate Europe's failure.

And if this year's election brings the wrong ideology to power, America's nascent recovery might well be snuffed out.