



## **Harvard Experts: Economy is Like a Bus Winding Down a Mountain Road**

By Charlie Curnow  
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Members of a panel of five Harvard economists emphasized the need for U.S. policymakers and households to cut down on borrowing and increase savings during a panel discussion on Tuesday, October 13 at Harvard University in Cambridge, Massachusetts.

Panelists cautioned, however, that any financial rebalancing in the U.S. must be gradual in order to prevent a collapse of economic activity, and cautious in order to prevent damage to long-term growth. It will also require cooperation from other countries such as China, which need to rebalance their own economies in the opposite direction.

Speaking on the panel were economists John Y. Campbell and Richard Freeman of Harvard's Faculty of Arts and Sciences, public policy professor Kenneth Rogoff of the Faculty of Arts and Sciences, financial economist David S. Scharfstein of Harvard Business School and Bridgitte Madrian of Harvard's Kennedy School of Government.

"The U.S. economy is like a bus on a winding mountain road," said Campbell. "It needs to turn a corner, but it can't do so too quickly, or it will tip off the road altogether. And drivers coming the other way must give us the space we need to make the turn."

The economy has recovered faster than expected since spring 2009, Campbell said, as markets have rebounded and banks have rebuilt capital. In addition, the cost to taxpayers of government bailouts has been lower than originally feared. Recovery in the so-called "real economy," however, has been weak. Long-term unemployment remains very high. Meanwhile, the stagnant labor market has fueled populist anger against incumbent politicians, contributing to government paralysis and uncertainty over the direction of future policy, setting off a vicious circle that has undermined business confidence and further weakened the recovery.

While the TARP financial bailout helped resolve the acute problems that led to the financial crisis, Campbell said, chronic problems remain. Among the long-term issues Campbell identified are a low household savings rate, pension and health care entitlements that will become unaffordable as the population ages, an inefficient tax system, and insufficient investment in public goods such as research and infrastructure.

Freeman, a labor economist at Harvard, said the economy could take until the end of the decade to reach full employment, noting that payroll cuts in state governments are exacerbating problems in the labor market as the sluggish economy squeezes public



sector finances. In sharp contrast, he said, China's government instituted a wave of new infrastructure projects in the wake of the financial crisis and kept strict requirements that banks lend out government stimulus money instead of keeping it in reserve. These measures, in addition to strong international trade, helped set the stage for the current labor market boom in that country, he argued.

Other panelists pointed to different reasons for the lackluster performance of the U.S. and Europe relative to China and other Asian countries. Rogoff, a public policy professor in the Faculty of Arts and Sciences and co-author, with University of Maryland economics professor Carmen M. Reinhart of the 2009 book *This Time is Different*, argued that the hardest-hit economies, including the U.S. and Britain, were simply those that were closest to the financial crisis, and that China benefitted from its distance from the initial catastrophe.

Campbell noted that countries with large financial services sectors, including the U.S. and Britain, have been among the slowest to recover, as have countries that experienced significant consumption and housing booms over the past decade, such as Spain and Ireland. Meanwhile, thrifty, export-oriented countries such as Germany and China have recovered much faster. The contrast is compounded by the fact that the need of this latter group of countries to reinvigorate domestic consumption, Campbell said, is far easier to fulfill than the task faced by the U.S., which must shift spending away from areas such as retail and construction.

Panelists also debated budget reform. Rogoff warned against a sense of complacency that leads to the belief that China and other countries will lend the U.S. money forever. Years of large federal deficits have brought U.S. debt relative to gross domestic product close to records set during World War II. Eventually, he said, the U.S. will need to cut spending or raise taxes.

Madrian, a professor public policy and corporate management at Harvard's Kennedy School of Government, pointed to America's entitlement programs as a particular area of concern over the next few decades. If benefits and contribution rates remain unchanged, Madrian said, Social Security will run out of money by 2040, and Medicare will run out by 2030. If policymakers wait until 2040 to reform Social Security, she said, benefits will need to be cut by up to 25 percent, or payroll taxes will need to increase by up to 4 percentage points, in order to keep the system afloat.

Freeman, however, cautioned against cutting too much too soon. The economy falling into a double-dip recession, he noted, would only make the government's financial situation even worse. New austerity measures planned in Britain over the next year could therefore serve as a useful test case for U.S. policymakers. If new tax increases and spending cuts push Britain into another recession, it could serve as advance warning against a rush to austerity in America. Freeman placed the odds of a double-dip at less than 50 percent under current U.S. policies.



Campbell argued that low interest rates have been central to the U.S. recovery so far, pointing to Greece, where rates have been rising on bond investor fears of sovereign default, as a cautionary example for countries that fail to rein in their debts. Reforms that would cut U.S. deficits on a longer time horizon, perhaps over five years, he said, could be a good compromise between austerity and further stimulus. Measures such as increasing the retirement age, for example, could build confidence in government solvency without much of the pain of a British-style immediate austerity program.

"I think the economy is rather like a person with a chronic debilitating condition who has an acute crisis, let's say a stroke," said Campbell. "The patient is rushed to hospital, where emergency treatment is successful. Unfortunately, the crisis and the treatment have complications, which make the chronic problems much more serious. Now we have long-standing medical issues that can no longer be ignored and require urgent treatment."

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