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The Skills Deficit

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Two years after the world economy suffered a nervous breakdown in the wake of the collapse of Lehman Brothers, global financial markets remain unsettled, and the recovery that started so vigorously in 2009 seems to be stalling.

The slowdown has predictably led to calls for further fiscal and monetary stimulus. The argument seems simple: only a massive dose of government spending and massive central-bank support for the financial system prevented a slide into a second Great Depression, so more of the same medicine is now needed to prevent a slide back into recession.

This argument seems particularly strong in the United States, which during the long boom years grew accustomed to unemployment rates of around 5% and steady growth in consumption. But, in assessing the outlook for the US economy, one should not compare quarterly growth rates and the current unemployment rate of almost 10% to the 'goldilocks' bubble period. A longer-term view is required, since the US is facing a structural adjustment challenge that will be accompanied by high unemployment.

The key challenge for the US economy (as for Southern Europe) is to move away from the consumption and housing-led growth model of the last decade. President Barack Obama has encapsulated this challenge by setting the goal of doubling US exports over the next decade. But this is easier said than done.

The structural shift towards exports will be difficult and time-consuming, mainly because producing the high-tech goods that the US should be exporting requires a skilled workforce, which has largely been lost and cannot be re-created overnight. During the ten years preceding the peak of the bubble in 2007, about four million jobs were lost in the US manufacturing sector, whose share in total employment fell from more than 17% to 12%. Unemployment remained low because the booming domestic economy created enough jobs in services and construction.

Reversing this shift would seem to be impossible. Most construction workers are rather low-skilled and thus cannot be re-deployed to modern high-tech manufacturing. The same applies to real estate agents, social workers, and managers of credit card accounts.

During the bubble years, the situation was exactly the opposite: most of the workers released by a rapidly shrinking manufacturing sector could be employed easily in construction and social services, which require only low skills (likewise, real estate services demand only rather general skills.)

The key point is not that manufacturing jobs are somehow better, but rather that we must consider the asymmetry in the structural adjustment process. It is relatively easy to manage a structural shift out of manufacturing during a real estate boom, but it is much more difficult to re-establish a competitive manufacturing sector once it has been lost.

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Post-bubble economies thus face a fundamental mismatch between the skills available in the existing work force and the requirements of a modern export-oriented manufacturing sector. Unfortunately, there is very little that economic policy can do to create a strong exporting sector in the short run, except alleviate the social pain. Labour market flexibility is always touted as a panacea, but even the highest degree of it cannot transform unemployed realtors or construction workers into skilled manufacturing specialists. Experience has also shown that retraining programmes have only limited success.

Ironically, Germany might provide the most useful template for the problems facing US policy-makers. Germany experienced a consumption and construction boom after unification, with full employment and a current account deficit. After the boom peaked in 1995, one million construction workers were laid off and could not find jobs elsewhere. The German economy faced a decade of high unemployment and slow growth.

Exports did not constitute a path to recovery because the DM was overvalued, and some manufacturing capacity had been lost during the unification boom. 'International competitiveness' became the mantra of German economic policy-making. But it still took more than ten years for Germany to become the export powerhouse it is today.

It is unlikely that the adjustment process will be much faster in the US, where the manufacturing base has shrunk much more sharply. Moreover, with the introduction of the euro, Germany had the advantage of pegging its currency to Southern Europe, which was experiencing a housing boom even more extreme than in the US, thus providing German exporters with growing markets and little competition. By contrast, the US dollar is tied to the renminbi, whose issuer – China – has the world's largest and fastest-growing export sector.

How long will the US adjustment take? Since the peak of the bubble, the US economy has not even been moving in the right direction. The contraction in manufacturing output and employment has actually accelerated – and faster than output and employment have fallen in the sectors on which the economy remains dependent for much of its growth: domestic services, such as health care, and finance, insurance, and real estate services (the sector responsible for the crisis).

As long as this trend continues, only high and continuing doses of fiscal and monetary expansion will be able to sustain domestic demand. A self-sustaining recovery requires structural adjustment first.