Pessimism and paralysis in the aftermath of the financial crisis

By Paul Krugman
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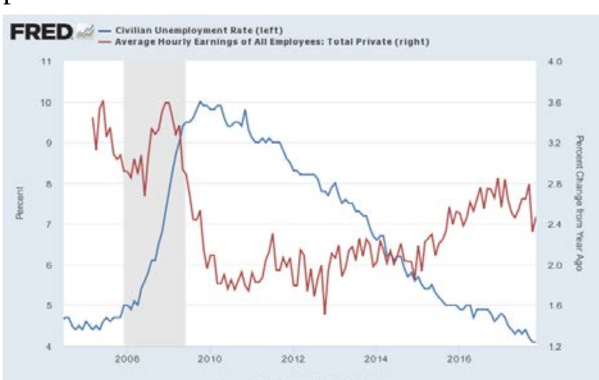
The latest job report was very good, except for one thing: wage growth is still much lower than it was before the financial crisis. And this reminds me of a controversy that raged around four or five years ago, during what now seems like a golden age – an era when it seemed as if facts and reasoned debate might actually matter for policy.

Anyway, at the time unemployment was still very high compared with its pre-crisis level, and some of us were urging strong policies – especially infrastructure spending — to boost demand. But some economists argued that high unemployment was "structural" – that there was a mismatch between the skills the workforce had and those the economy needed. This was probably a minority view within the profession, but was pretty much dominant among Beltway pundits.



The structural view had clear policy implications, because if you believed it the case for employment-boosting stimulus was much weaker than if you believed that high unemployment really, truly represented lots of Americans willing to work.

Anti-structuralists – demand siders? – tried to point out that if the structural story were true, there should be a lot of upward pressure on the wages of those workers who *did* have the right skills; in fact, nobody was seeing much in the way of wage gains. But this argument made little headway among Serious People.

But here we are: there hasn't been a significant change in the skills of the workforce, but unemployment is now lower than it was in 2007, and wage growth is still low. The demand siders were right.

Does it matter? After all, at this point we are indeed more or less back to full employment, although those wage numbers suggest that we still have a bit further to go. But we spent a long time with supernormal unemployment: it was 9 years before the unemployment rate got back down to its December 2007 level of 4.7 percent, and the average rate over that period was 7.3 percent. Using Okun's Law, this implies something like average underutilization of capacity by 5 percent over that period – so a loss of 45 percent of one year's GDP, say $8 trillion.

And this $8 trillion loss didn't have to happen: adequate, sustained stimulus could have eliminated most of it.

So why did the structuralist view prevail? There was some left-right aspect, as there is with everything these days – any analysis suggesting that the government can do positive things is automatically rejected by half the political spectrum. But there was also the problem Keynesian economics always faces: it just doesn't sound serious enough to Serious People. The idea that mass unemployment is fundamentally just a problem of inadequate demand – that all we have is magneto trouble – and that it is easily solved by spending more, sounds too easy.

I'd like to think that the way things turned out would serve as a lesson in future crises. But I wouldn't bet on it.