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Falling Wage Syndrome

By PAUL KRUGMAN

Wages are falling all across America.

Some of the wage cuts, like the givebacks by Chrysler workers, are the price of federal aid. Others, like the tentative agreement on a salary cut here at The Times, are the result of discussions between employers and their union employees. Still others reflect the brute fact of a weak labor market: workers don't dare protest when their wages are cut, because they don't think they can find other jobs.

Whatever the specifics, however, falling wages are a symptom of a sick economy. And they're a symptom that can make the economy even sicker.

First things first: anecdotes about falling wages are proliferating, but how broad is the phenomenon? The answer is, very.

It's true that many workers are still getting pay increases. But there are enough pay cuts out there that, according to the Bureau of Labor Statistics, the average cost of employing workers in the private sector rose only two-tenths of a percent in the first quarter of this year — the lowest increase on record. Since the job market is still getting worse, it wouldn't be at all surprising if overall wages started falling later this year.

But why is that a bad thing? After all, many workers are accepting pay cuts in order to save jobs. What's wrong with that?

The answer lies in one of those paradoxes that plague our economy right now. We're suffering from the paradox of thrift: saving is a virtue, but when everyone tries to sharply increase saving at the same time, the effect is a depressed economy. We're suffering from the paradox of deleveraging: reducing debt and cleaning up balance sheets is good, but when everyone tries to sell off assets and pay down debt at the same time, the result is a financial crisis.

And soon we may be facing the paradox of wages: workers at any one company can help save their jobs by accepting lower wages, but when employers across the economy cut wages at the same time, the result is higher unemployment.

Here's how the paradox works. Suppose that workers at the XYZ Corporation accept a pay cut. That lets XYZ management cut prices, making its products more competitive. Sales rise, and more workers can keep their jobs. So you might think that wage cuts raise employment — which they do at the level of the individual employer.

But if everyone takes a pay cut, nobody gains a competitive advantage. So there's no benefit to the economy from lower wages. Meanwhile, the fall in wages can worsen the economy's problems on other fronts.

In particular, falling wages, and hence falling incomes, worsen the problem of excessive debt: your monthly mortgage payments don't go down with your paycheck. America came into this crisis with household debt as a percentage of income at its highest level since the 1930s. Families are trying to work that debt down by saving more than they have in a decade — but as wages fall, they're chasing a moving target. And the rising burden of debt will put downward pressure on consumer spending, keeping the economy depressed.

Things get even worse if businesses and consumers expect wages to fall further in the future. John Maynard Keynes put it clearly, more than 70 years ago: "The effect of an expectation that wages are going to sag by, say, 2 percent in the coming year will be roughly equivalent to the effect of a rise of 2 percent in the amount of interest payable for the same period." And a rise in the effective interest rate is the last thing this economy needs.

Concern about falling wages isn't just theory. Japan — where private-sector wages fell an average of more than 1 percent a year from 1997 to 2003 — is an object lesson in how wage deflation can contribute to economic stagnation.

So what should we conclude from the growing evidence of sagging wages in America? Mainly that stabilizing the economy isn't enough: we need a real recovery.

There has been a lot of talk lately about green shoots and all that, and there are indeed indications that the economic plunge that began last fall may be leveling off. The National Bureau of Economic Research might even declare the recession over later this year.

But the unemployment rate is almost certainly still rising. And all signs point to a terrible job market for many months if not years to come — which is a recipe for continuing wage cuts, which will in turn keep the economy weak.

To break that vicious circle, we basically need more: more stimulus, more decisive action on the banks, more job creation.

Credit where credit is due: President Obama and his economic advisers seem to have steered the economy away from the abyss. But the risk that America will turn into Japan — that we'll face years of deflation and stagnation — seems, if anything, to be rising.