Finance and Labor Market Outcomes: A Theoretical Analysis

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Abstract: An efficient financial market allocating resources in right direction may boost investment and output, and thereby enhancing the demand for labor. As financial market develops the risk in investment becomes mitigated, increasing investment and fuelling the rate of growth of the economy, which in turn increases the demand for labor. This paper intends to present theoretical underpinnings of relation between the financial and labor market.

Key Words: Finance, Labor Market, Demand for Labor, Economic Growth, Investment, Efficiency

I. Introduction

Conventionally every economy is composed of three markets viz. product, factor and financial. . Activities in the financial market oil the activities of other two markets in the best interest of the economy. With finance becoming all pervasive thanks to recent developments in terms of both product and instrument wise, financial market has begun assuming somewhat disproportionate importance in recent times, and hence every economic crisis has had its roots in the financial market. An efficient financial market allocating resources in right direction may boost investment and output, and thereby enhancing the demand for labor. Notwithstanding this constructive interplay between financial market and labor market, a policy of 'hiring and firing' of labor in pursuit of maximizing the efficiency in allocation, especially allocating financial resources, may end up with labor unrest and turn to the disadvantage of labor. Moreover, it is obvious that economic crisis always badly hit the labor market with consequences on labor market outcomes in terms of swelling unemployment rate and slashing wages and perks. Indisputably, these consequences in turn pour oil on the flames of financial crisis. In this backdrop, this paper intends to elaborate on the repercussions that have been produced on the labor market outcomes viz. wages, employment /unemployment rate, productivity etc. by the financial crisis triggered in 2008 the signs of which still haunt the economies today. Apart from this core purpose, the paper also examines the interconnection between the financial market and the labor market. The paper employs secondary data for analytical purpose.

II. Labor and Finance

It is curious to dwell into the association between labor and finance particularly because a bird's eye view of economic literature hardly shows a much detailed description and analysis of the connection between these two aspects. But a close looks at the recent development especially the financial meltdown and consequent economic slowdown that have been ravaging many of the economies whatsoever and howsoever 'tigers' they are, reveals the impeccable connection that fiancé and labor have got between each other. It is however quite interesting to note that production models in economics from the time of the so called orthodox economists, the Classical, have placed significant role for labor and capital as the two chief inputs which transform themselves into output, given technology, leading to the generation of income and output. Often, it is obvious, the production function is written as a function of three variables viz. Labor, Capital and Technology.

In the short turn, Labor is regarded as the only variable input, and therefore short run variation in quantity produced solely depends on the quantity of labor employed. In those days that is in the time of Classical economics, economists emphasized more on capital accumulation and appeared to have not given much thought on the existence and the scope of developing financial market. In those days, the amount of capital required for production was used to be sourced mainly from banking institutions and surplus group in the economy such as land lords. But with the development of financial market, today companies have an array of sources to choose from with regard to the sourcing of capital. In this circumstances, it is quite natural whatever happens in the financial market will have its far reaching repercussions on the labor market as well. Hence, different from the orthodox production functions, contemporary production functions have to take note that the variation in the quantity of labor being put to production could also be determined by the dynamics of financial market. This ultimately takes us to the inference that the short run production function of the sort which the Classical economists had presented ought to be reformulated taking into account the fact that variation in the quantity of labor is not only related to the labor market dynamics [i] but also to the changes in the financial market. Undoubtedly, any untoward changes in financial market are likely to affect the labor market, thereby leading to changes in the quantity of output produced in the economy. Precisely, it could be said that even in the short run, the interaction between the labor and finance has implication on the outcome of various economic variables like income, output and employment. Our discussion in this paper takes off from this presumption.

III. Efficient and Inefficient Firms

Having reestablished the connection between labor and finance it seems imperative to look into how financial market could impact the labor market. Needless to say, an efficient financial market allocates financial resources efficiently and fully so that whoever demands it legitimately and reasonably has the right to be endowed with the necessary financial resources. This efficient allocation of financial resources has two fold effects: One is that when financial resources are efficiently allocated, deserving or efficient firms get access to as much finance as they require which help them to enhance the demand for labor in an attempt to increase output and income. This will surely add to the aggregate income of the country. Surely, this is a favorable effect of the efficient allocation of resources by the financial market, forcing the labor market to demand more labor and thereby reducing the number of unemployed in the economy. However, problem crops up when some firms, which are unable to access the financial market primarily because of them being relatively inefficient, start facing problems in their production and inventory plans, leading eventually to the adoption of layoffs by these firms (Pagano, 2008). This will by any count increase unemployment and decline in output generation. This is the second effect, of course an unfavorable effect, of the association between the labor market and financial market. The above said second effect, the unfavorable one, could be mitigated if resources are reallocated from failing or incompetent firms to the competent firms, creating newer employment avenues in such firms leading to the absorption of employees overthrown from the incompetent firms. In this way, overall employment could be restored although intermittently, employment shocks are likely to be created due to the failing of the incompetent firms. In this way, efficient financial market creates efficiency in production and employment through restructuring of the financial resources across different units of production and by facilitating the mobility of labor from the apparently inefficient production units to the efficient and well paying units of production.

IV. Finance and Economic Growth: Certain Evidences

It is an altruism that finance helps economies to grow provided all other impediments of development that are likely to adversely affect this positive correlation stand nullified. Obviously, there exists a theoretical route to this positive correlation between finance and growth which none can prove otherwise. As financial market develops, the elements of risks may be mitigated through well-developed rules and regulations, and distortions and oscillations in price movements may be calmed down owing to the movement closer to financial information symmetry. This will not only increase the prospects of the access of financial resources to the existing and established production units but also motivate the establishment of venture units, the cumulative effect of which will be multiple increases in the number of employment opportunities at all levels. In this way, finance not only aids economies to foster its growth but also makes jobs available to all[ii].

Let us put across some empirical evidence both country and sector wise to the effect that better financial market developments lead to faster and steady ups in economic growth. Truly speaking, financial development has been much highly correlated with the economic performance of many economies (King & Levine, 1993). Going much beyond the casual connection between economic growth and financial development, literature shows that studies have gone much deep into the relation that financial development has established with both per capita GDP and total factor productivity (TFP), and unsurprisingly, the relation has been found to be positive. Applying the same logic to the firms' level, studies have shown that financial development occupies a greater role in shaping the variables that are relevant for the performance of firms' at large (Rajan & Zingales, 1998).

It is true that liberalization has been instrumental in making the financial sector efficient in most of the economies, besides widening the size of the financial market in terms of the number of institutions participating, the volume of transactions taking place and the diversity of financial products in use. It has been well proved that the unleashing of the liberalization forces has tremendously helped financial market to blossom to the beneficial effects of the economic performance of emerging economies. More specifically, owing the existence of better financial market the share of investible surplus going to the production units having higher marginal return of capital has gone up, leading to an increase in the efficiency in the allocation of precious investible financial resources (Galindo, Schiantarelli, & Weiss, 2007). Firm level studies also throw light on the fact that better financial sector in many economies has spawned the number of new firms entering new areas of production besides increasing the size of existing firms.

V. The other side of the story!

In short, better financial market leads to increase in investment, both existing and new investment, leading to increase in the demand for labor, lowering unemployment, increasing total factor productivity, accelerating output generation and income, and finally resulting in faster and quality economic growth which will further increase the fortunes of employment opportunities. Economists often speak of this positive association between financial development and the economic growth, resulting in better labor market outcomes both in terms of increase in employment and compensation to the employees. All these rosy aspects notwithstanding, what is important is how the common mass perceives these outcomes. It is true that politicians and the trade unions do not optimistically perceive the finality of the above process but they are likely to ill-perceive the immediate negative consequences of the relation between the financial market and growth plus employment outcomes. Let us look at the rationale of this labor-unfriendly dimension of the relation between finance and growth in detail.

It is well known that in an effort to weed out the inefficiencies of the companies, financial restructuring of the assets and liabilities of entities needs to be executed which leads to takeovers, acquisitions and mergers. Most of these restructuring takes place when the companies go bankrupt owing to the long time inefficiencies in its operation, resulting in loss of income, profit and employment opportunities. This kind of restructuring may lead to layoffs and existing employees may go unemployed for a while. On account of the possibility of these ‘employment shocks', that trade unions and vested interest groups often voice against restructuring of companies especially loss making companies. Certain interventionist devices have been put in place in countries like India to ponder over the possibilities of not indulging in taking 'discomfort' decisions before a Sick company is liquidated[iii]. Nonetheless, if one is to consider the long term gains of such restructuring on account of the efficiency of financial market, it is obvious that the short term labor discomfort in the form of employment shocks would be more offset by the long term gains in the form of increasing job opportunities, pay hike and the other perks that the companies may chip in order to attract highly skilled workers to the companies. But for those who look at short sighted individual economic gains, such distortions arising out of financial restructuring[iv] may turn out to be more disappointing.

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[i] In the Labor market, market forces, the demand for labor and the supply of labor which depend on the real wage rate determines the quantity of labor that the firms employ at a given point of time. The short run production function is supposed to be connected with the labor market. But, in the context of the increasing importance of financial market in determining the labor market outcomes, it seems not plausible to limit the demand for and supply of labor as the determinant of real wage rate alone; it has to be considered as a determinant of financial market as well.

[ii] This of course contradicts with the emerging phenomenon of 'jobless growth' in developing economies, where jumps in economic growth have not been commensurate with jobs. The reason for this needs to be unearthed as other factors including policy shocks might have been at play to make jobs lesser despite high growth rate.

[iii] Board of Industrial Financial Reconstruction (BIFR) has been in place in India for this purpose. It may be mentioned here that BIFR is post-reform mechanism devised to decide the future of a Bankrupted company.

[iv] Again at this juncture it may be pointed out that the disinvestment of Public Sector Units in India which has been under way ever since the inception of neo-liberal economic reforms should not be reckoned as financial restructuring emanating from the betterment of financial market. Disinvestment has been undertaken to satisfy certain fiscal motives of the Governments. It needs to be necessarily distinguished from the kind of financial restricting with which we are concerned in this paper.

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