

Product Markets, Labor Markets, and Financial Markets, for Business Students

by Anne Emerson

This essay explains how buying and selling differs among products, services, and financial instruments. Mostly, it is for people who believe in “free markets,” and its purpose is to explain that free-market ideas apply mostly to product markets. Labor Markets and Financial Markets behave differently from Product Markets, and interact differently with the Big Picture. I assume you understand what a “market” is in the jargon of economic theory. It is not the local farmers’ market.

The first and most obvious difference between the buying and selling of labor (workers) and the buying and selling of products is that workers work “per hour” and products are sold “in the moment.” (Let us set aside the fact that workers are human and products are not; that raises many issues we won’t address here. But, to give you a hint – we can own a product; it’s hard to justify ownership of a person, including one who is technically free to quit and find another job, but won’t be able to do so if business managers pull strings to make sure leavers never get other jobs.)

The most obvious difference between financial markets and other types of exchange is that buying and selling financial instruments does not involve making anything or serving anyone (ignoring things like the operators and infrastructures of stock markets). It is merely the exchange of a paper (or similar) that expresses an ownership or investment interest in a corporation that DOES make something or serve someone.

Economic theory typically starts with the “pin” story. There are many ways to make pins, but we say that the most efficient one is where one person specializes in making pin heads, another specializes in making the long part of the pin, another puts the two together, and then they are sold in batches of suitable size for different customers. In short, much goes on behind the scenes, but at the point of sale, *the exchange is pretty much instantaneous – money for pins*. And, the sales price is somewhat related to the cost of making the pins. According to theory, there is an amount of profit that the system allows the owner of the pin factory to receive. That profit is a reward for his or her management skills. Thus, the system rewards people appropriately and any incentive for price gouging is rapidly taken away by eager copycats.

We then add more products to our story – each one involving different specializations – and then we trade among ourselves for the various different products, because pin-makers don’t need all the pins they make. Then we add money to the story, because it might be hard for a pin-maker to find a bread-maker that wants to trade exactly the right amount of bread for the available number of pins. And this is the kind of economic theory that has taken hold of many hearts and minds – a product-based theory. The products are made in factories or on farms, and are traded “instantaneously.”

So our basic theory says that, with a money-economy, we can distribute everything so that it satisfies everyone, and the market price is the great equalizer – it is the thing that moves to reflect our changing tastes and interests; it adjusts as we grow and change, so that everyone’s tastes and preferences continue to be satisfied because, if supply and demand are out of whack, the price will rise or fall until all buyers and sellers are in synch again. Intuitively, this is very nice. But it essentially describes a moment in time – the moment when everyone is satisfied. This theory has a hard time explaining the PATH of change – how we move from one point of mutual satisfaction to another.

So, let's think about labor markets. Economic analysts often assume that labor markets adjust in a way that is (almost) as instantaneous as adjustment in product markets. When we calculate our state of "instantaneous mutual satisfaction," (a.k.a. general equilibrium) we have assumed that wages and salaries, which are prices for labor, adjust in a similar way to product prices – pretty quickly.

But a moment's reflection will suggest that labor markets don't often work like that. Workers are given contracts for a specified period of time. If labor market conditions change over time, we will have different workers, whose different contracts were negotiated at different times over a period of several years, all working in the same type of job. And, if a labor contract is a negotiation between candidate and employer, it will be subject to the relative power and preferences of the two parties, as well as to the prevailing wage-level in that type of job.

So, there is no one "market" wage or salary – there is a spread of wages; it's more of a statistical situation than a fixed wage or salary (that is, price for labor). Statisticians trying to explore what goes on in labor markets will encounter something called statistical "noise" – much variation around the various possible causes of the phenomenon we want to investigate.

We will leave it there for now. Let us consider the exchange of financial instruments, such as stocks and bonds – types of "stakes" in a corporation or business. These depend, to some extent, on whether or not other people like the particular stock or bond we are buying. Stock and bond prices can change very quickly. By and large, stockbrokers value stocks reasonably well (around a statistical variation, such that few money managers stand out above the others), but they can be mistaken. If a stock is overpriced for too long and many people buy at a too-high price, we call the situation a bubble. A colorful bubble story is the "tulip bulb" bubble – you are welcome to look it up if you have not heard of it already.

Sooner or later, a bubble bursts, meaning that over-priced stocks plummet in price. If the whole stock market is overvalued, there can be rapid falls in stock prices across much of the stock market. If buyers and sellers are sufficiently out of synch with the real world (what actually goes on in businesses), so that stock prices don't represent a company's true financial situation, the price can drop precipitously when the truth is discovered. (Think of Enron shares – you can look that up too.)

So, the main point of this essay was to explain that many mainstream economic models assume that everything that is bought and sold, including financial instruments and worker contracts, can be described by the idea of instantaneous mutual satisfaction (or "general equilibrium theory"). When we explore things that don't match that situation, we adapt the basic theory to try to handle the more-messy nature of the real world. We add, elaborate, complicate; perhaps into lots of computer-solved math. Eight pages filled with equations, just to set up the model, was not unusual in my day.

But I will add a footnote – Annie's model addresses many of the challenges of the real world in a different way from adapting the "instantaneous mutual satisfaction" framework to deal with, say, skilled workers and their educations, or the fact that humans live for a lifetime whereas governments last forever (if they survive social unrest). Annie's model explores how ownership of wealth might dictate the path of resource-flows through time, rather than showing how instantaneous mutual satisfaction looks, when it has been achieved.