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The productivity–wage gap and the recent stock price increase: An analysis

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Abstract

We analyze the effect of the productivity–wage gap on share prices. Batra argues that the productivity–wage gap may be the main factor behind the stock market bubble of the 1990s. We employ both multiple regression analyses and Granger Causality/impulse response function (IRF) analyses to examine the relationship between share prices and the productivity–wage gap, using quarterly data for the U.S. economy for 1970–2000. Our empirical findings are somewhat supportive of this hypothesis. The influence of the productivity–wage gap on stock prices is significant; however, the rise in stock prices may also have an effect on the productivity–wage gap. © 2004 Elsevier Inc. All rights reserved.

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1. Introduction

The last 30 years have witnessed significant changes in economic conditions around the world. For example, while the 1970s were an era of increasing inflation, the second half of the 1980s and the entire decade of the 1990s experienced decreasing inflation in many countries. The U.S. unemployment rate stood at a low 4% by the end of 1998, while the inflation rate continued to decline or remain stable. Corporate profits increased as a result of increased labor productivity, interest rates fell to their lowest levels in 30 years, while the stock market reached its peak in early 2000.

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Some economists argued that under such economic conditions, business cycle theories no longer hold, and the economy has the ability to sustain continuous growth without the interruptions of recessions or inflation. Some even seriously doubted the existence of what is known as the natural rate of unemployment. For example, in 1999, the U.S. unemployment rate was below any natural rate found in contemporary economics textbooks. Standard macroeconomic theory suggests that a low unemployment rate usually leads to a higher unit labor cost, followed by rising inflation, because with tighter labor markets, one should anticipate an increase in real wages. However, wages have remained steady in a growing U.S. economy (the average wage in the manufacturing sector hardly grew between 1970 and 2000; see [Table 1](#)).

Standard economic theory fails to explain this phenomenon; it also cannot explain the recent behavior of the equity markets. In the general Keynesian model, if the public saves excessively, the interest rate rises substantially, the government spending falls, or taxes rise, then aggregate demand (AD) in the economy declines, leading to a fall in GDP and employment. However, why such events should occur is not explained. Therefore, the explanation of recession or inflation requires some exogenous factors not inherent in the model. Of course, Keynes blamed rising income inequality for the rise in savings over time; therefore, his analysis includes a mechanism that can partly explain the fall in AD relative to aggregate supply (AS). However, the latest experience of the Asian Tigers and Japan reveal no sudden rise in their saving rates, and yet they suffered rising unemployment for several years. The neoclassical model is also not of much help, because, as [Batra \(2003\)](#) demonstrates, it suffers from several logical inconsistencies. It too requires exogenous factors to explain the decline in economic activity and stock market crashes. According to neoclassical ideas, random technological shocks are the prime cause of short-term fluctuations around the long-term trend.

Recently, in a series of books and articles, Batra has offered a different explanation for the cause of recession or depression in an economy. According to his analysis, the real wage is the main source of AD, whereas labor productivity is the main source of AS. Therefore, for an economy to remain healthy, there must be some balance between AD and AS. Over time, if productivity rises, then real wages should rise approximately in the same proportion; otherwise, an imbalance will eventually develop in the economy, causing a discrepancy between demand and supply, a recession, and possibly a depression.

Just as what happened during the 1920s (see [Batra, 2003](#)), real wages have lagged behind productivity all over the industrial world since the early 1970s. When the real wage falls behind productivity growth, the demand–supply equality at each point in time may be maintained only through exogenous interventions. These interventions may take the form of investment stimulation through an easy

Table 1
Statistical summary

| Series | Number of observation | Mean | S.E. | Minimum | Maximum |
|--------|-----------------------|---------|---------|---------|---------|
| PR | 117 | 0.0811 | 0.01056 | 0.0599 | 0.1023 |
| WG | 117 | −0.0346 | 0.7137 | −2.4572 | 1.6339 |
| PROD | 117 | 1.8367 | 3.2693 | −5.0000 | 13.2000 |
| GAP | 117 | 1.8713 | 3.2291 | −5.4584 | 11.5670 |
| LP | 117 | 7.5390 | 0.8200 | 6.4100 | 9.3880 |

LP is the log of stock price (measured by DJ Industrial Average), PR is the profit–GDP ratio, WG is the rate of growth of the real wage rate measured in percentage, PROD is the rate of growth of the productivity, GAP is the productivity–wage gap (which is measured by the difference between the percentage growth of labor productivity and wage rate).

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