Expansion and Employment

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Abstract

The money supply is an important determinant of output, income, prices, and employment. Therefore, when the Fed drains reserves from the banking system or when the banking system refuses to provide entrepreneurs, merchants, and consumers with credit (money), output and hence employment diminishes.

Keywords: Full employment, money supply, inflation targeting, Federal Reserve

Classical economists believed that forces operate on the economic system that leads to full employment and the maintenance of full employment output (Hagen, 1949). However, for economies to create full employment output, they require competent individuals committed to economic growth and transformation, and capable of developing and implementing an agenda that maintains a full-employment economy.

The classical theory of employment, based on "Say's Law," refuted the claim that depressions were caused by overproduction; the production of more goods and services than people could afford to purchase. Rather, Say argued that supply creates its demand (Hagen, 1949). Domar (1947) noted that the Great Depression disproved the efficacy of Say's Law; it demonstrated that supply does not automatically create its demand.

Today, politicians and some economists claim that excess bank credit caused the Great Recession and that austerity and tax cuts create economic growth. However, excess credit cannot cause recessions, since credit expands the money supply and increases demand and income. It is the lack of credit that restricts the growth of the money supply and aggregate demand.

According to Domar (1947), if unemployment were present yesterday, it would still be present today; and if yesterday's income were at full employment level, that income level would be retained today. However, it might not be at the full employment level due to an expanding labor force. Domar argued that rising employment is contingent on increases in real income. Thus, if money income remains flat, due to the Federal Reserve (Fed) inflation targeting (IT) policies, as it did between 2005 through the third quarter of 2008, an increase in real income can only occur by a fall in the general price level (deflation). Domar noted that a falling price level would cause unemployment because there would not be enough income (money) to maintain a high level of demand.

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Domar (1947) also indicated that if the money stock remains fixed, the creation of new capital equipment would either (1) remain unused; (2) be used at the expense of previously constructed capital, or (3) new capital equipment would substitute labor. For Domar, the first case is wasteful; the second case is desirable if it does not occur on a large scale, if it occurs on a large scale it is wasteful; and the third case is desirable if the substitution results in a voluntary reduction of the labor force.

A growing economy abates unemployment and it can only occur if the real money supply is increasing. If the real money supply is decreasing, unemployment will increase and the level of demand will fall. Inflation targeting by the Fed reduces the real money supply, and hence the level of demand. However, the concept of the money supply is not well understood. Thus, it is frequently argued that open market purchases, where the Fed exchanges fiat money for bonds do not stimulate the economy. However, it is high-powered money that expands the economy. High-powered money is the currency in circulation plus bank reserves. When banks use reserves to make in-country loans, the economy and employment expand.

Therefore, when the Fed expands the money supply by providing banks with reserves, there is no guarantee that the expansion of reserves will become in-country loans. It is only when the banking system provides loans to the public that demand increases. In essence, the Fed could increase banking reserves ad-infinitum without economic expansion if the public is unable to get bank loans. For fiat money to affect the economy, it must be converted to currency. Ironically, the Fed and Congress provided banks with a disincentive for loaning money by paying interest on bank reserves.

Some economists believe that if the real currency in circulation (income) is inadequate to create a high level of demand, the government should stand ready to stimulate demand, and hence employment by using fiscal policy to increase income. The irony, here, is that it is a branch of government, all be it independent, the Fed, which deliberately caused the real money supply to decline between 2005 and the fourth quarter of 2008. The Fed, although an independent agency, is accountable to Congress, and the President appoints its chairperson. Therefore, Fed policies should only be anti-expansionary if the real output exceeds potential output.

Nonetheless, when Fed policies destabilize the economy, Congress and the President should stand ready to provide work to all who seek employment and cannot find jobs (Sawyer, 2003). Thus, Sawyer argued that the government should act as the employer of last resort (ELR), a terminology drawn from the central bank acting as lender of last resort. He also noted that the idea that the government should use a fiscal stance to support a high level of demand emanated from Abba Lerner (1943) under the heading of functional finance. According to Sawyer, “The basic justification for using the budget deficit to support a high level of employment is that private sector demand is inadequate to generate such levels of employment” (p. 882). Likewise, Davanzati, Pacella, and Realfonzo (2009) also

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believe that expansionary fiscal policies increase employment in the public and private sectors as long as the banking system is accommodating.

However, using fiscal policy to expand employment when the Fed is restricting monetary growth is counterproductive. First, as previously stated, the Fed is the branch of the government that restricts the flow of money (income) and it is this income restriction that causes a low level of demand and unemployment. Secondly, fiscal expansion often misallocates resources; it is often based on political allocation, rather than efficiency. Therefore, its effect on employment is often discrete and not continuous. Moreover, the government would have to use deficit financing to support a high level of demand. And, deficit financing causes intertemporal challenges, such as higher tax rates for future generations.

The solution is for Congress to force the Fed to anticipate changes in economic conditions using condition-based techniques that would monitor degradations in the economy and provide effective intervention regimes to eliminate or mitigate degradations (downward business cycles –negative income shocks).

Inflation targeting

Inflation targeting (IT) is a monetary strategy, introduced in New Zealand in 1990 and adopted by more than 20 industrialized and non-industrialized countries (Svensson, 2007). Formerly, it is characterized by the central bank public announcement of a numerical inflation target (Bernanke, Laubach, Mishkin, and Posen, 1999; Svensson, 2007; Little and Romano, 2009) and informally a numeric target is not made explicit.

According to Bernanke et al. (1999), the new consensus model (NCM) is that low and stable inflation is important for market-driven growth and that monetary policy is the most important determinant of inflation. Likewise, inappropriate monetary policy is an important determinant of recessions. Bernanke et al. further argued that IT has achieved lower inflation rates in countries that used it. Thus, their rationale for using IT as the primarily long-run goal of monetary policy is price stability. They failed to recognize that there is a tradeoff between price stability (restricting the money supply) and employment. To date, their argument on IT has not proven to be valid.

Davanzati, et al. (2009) noted that Post Keynesian economists raised several theoretical and empirical criticisms against the NCM. They argued that restrictive monetary policy does not necessarily reduce demand if agents have positive expectations, but it could negatively reduce output in the long run, because it forces economies to decrease capital accumulation. Thus, according to Keynesian economists, the output is demand-driven (Davanzati, et al., 2009).

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The recession of 2008 and the subsequent economic problems refuted Bernanke et al. position on IT. Low and stable inflation has not proven to be important for market-driven growth. On the contrary, it has caused low aggregate demand and, hence high unemployment worldwide (Epstein, 2007). It is a mistake to assume that price stability is an engine of economic growth. Galbraith (1999), Epstein, as well as Ellis (2009), argued that IT undermines robust employment generation.

Galbraith (1999) believes that the single-mindedness of the Fed in controlling inflation is contrary to federal law. Federal law stipulates full employment as a Fed goal. He noted that Republican proposals often argue for IT and reject the virtues of monetary policies for rising standards of living, full employment, declining inequality in pay, or other recent improvements in American material well-being.

According to Ellis (2009), "Any central bank whose central premise is to control inflation by maintaining a tight monetary policy, such as what Bernanke and colleagues have done (between 2005 and 2008, see Figure 1) would cause the level of demand for goods and service to diminish over time and result in a recession." Figure 1 shows that flat monetary growth leads to recessions.

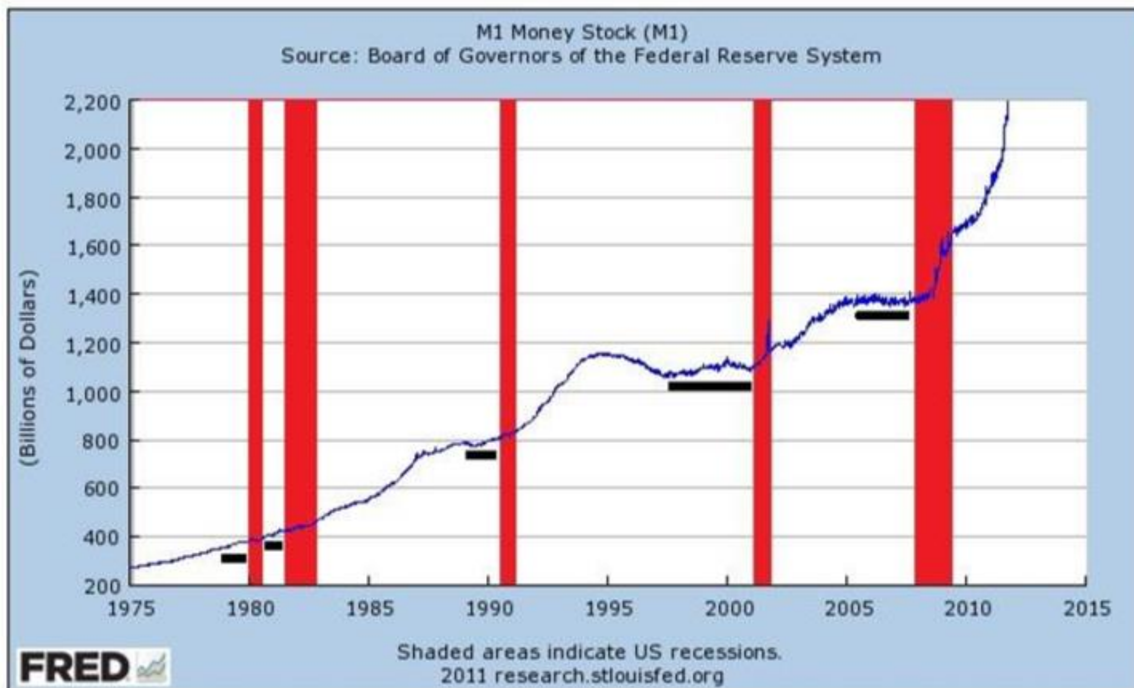

Figure 1 – Growth M1 Money Stock (St. Louis Fed)[1]

Bernanke et al. (1999) claimed that "economists and policy-makers are considerably less confident today than they were thirty years ago that monetary policy can be used

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effectively to moderate short-term fluctuations in the economy, except perhaps fluctuations that are particularly severe and protracted" (p. 10). Thus, it appears that he is unwilling to use monetary policy to increase employment.

Michael Woodford (2008) points to Chairman Bernanke's and Governor Mishkin speeches and indicates that these two Federal Open Market Committee members make it clear that the Fed conducts policy in the way advocated by proponents of "flexible inflation targeting," albeit without any official announcement of targets for the policy.

The IT strategy keeps unemployment high enough to avoid inflation (Galbraith, 2009). Stiglitz (2008) notes that inflation targeting has been put to the test and failed. He argues that recent inflation is an imported phenomenon due to soaring crude oil and food prices. Therefore, when the Fed raises interest rates to reduce imported crude oil and food inflation, it can only slow the economy and eliminate jobs; and, it is unlikely to significantly affect imported inflation. Thus, the Fed IT policy contributed to the Great Recession.

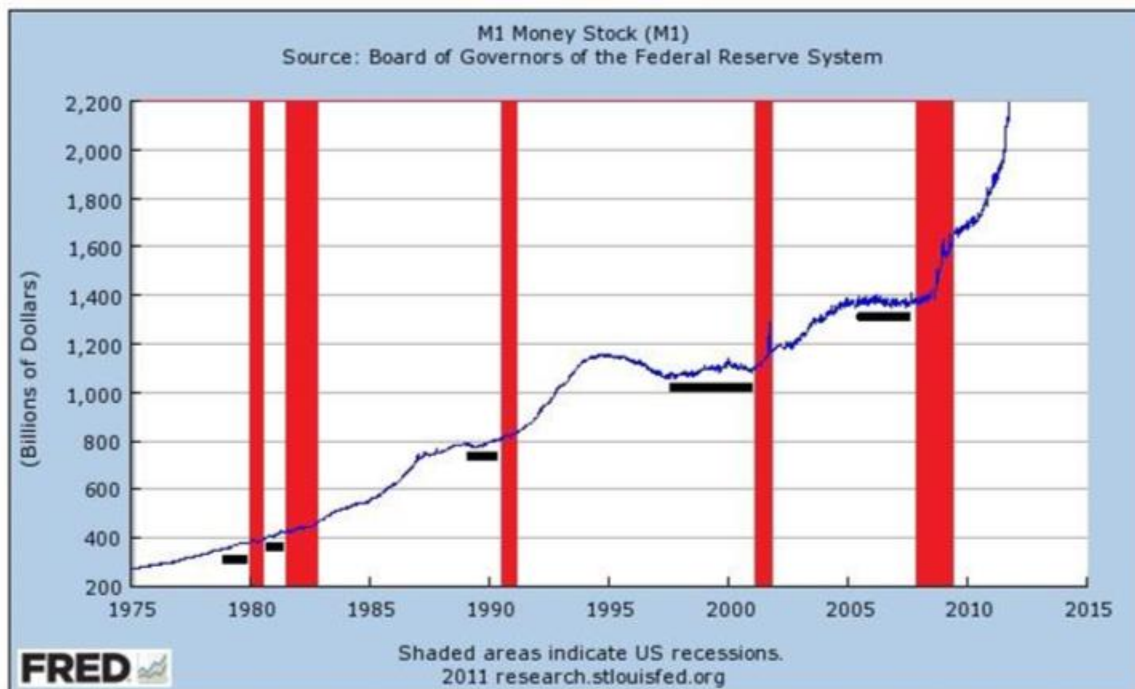

Figure 1 – Growth M1 Money Stock (St. Louis Fed)[1]

[1] The data can be downloaded from the Federal Reserve Bank of St. Louis at http://research.stlouisfed.org/fred2/series/M1.

The Fed IT policy is immoral and counterproductive and may even be unlawful; when the Fed raises interest rates to control inflation it imposes a cost on the American public: loss

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of business and jobs. Thus, it sacrifices access to employment for inexperienced and older job applicants, as well as for minorities and women. And, when IT spiral out of control, it adversely affects the entire country and the world.

Employment Creation

The standard self-serving American narrative on job creation is that politicians and the wealthy create jobs. The Democrats often argue that more government spending creates jobs and the Republicans that lower taxes and less spending (austerity) creates jobs. However, they seldom, if ever, provide a step-by-step job creation process. And, that is because both arguments are somewhat deceptive.

Following Layard and Walters (1976), let's assume a closed economy endowed with two factors, capital, and labor. Entrepreneurs use these factors, which are available in fixed quantities at any given time, to produce products.

If we represent capital as the available money supply, M, and the time citizens allocate to employment as L, it is clear that to produce corn, x^c, and meat, x^m, in a closed economy we would need to allocate money and labor to produce both goods. Thus, we would need to allocate Mc and Lc to produce corn and Mm and Lm to produce meat.

The amount of money that we would need to produce corn and meat would be $M = M^c + M^m$ and the labor required would be $L = L^c + L^m$. If, however, the money supply M were less than required ($M< M^c + M^m$), we would not be able to produce all the corn and meat to satisfy consumers. Thus, when the money supply is insufficient to produce goods and services, prices initially rise and output, as well as, employment falls. This is the so-called bubble effect, caused by insufficient money in circulation.

Given the available labor in a closed economy, the money supply is an important determinant of output, income, prices, and employment. Therefore, when the Fed drains reserves from the banking system or when the banking system refuses to provide entrepreneurs, merchants, and consumers with credit (money), output and hence employment diminishes.

Layard and Walters (1976) noted that in an ideal economy the outputs from production should be allocated among employees (consumers), as well as owners of production and merchants. However, if this allocation is skewed and the owners of production receive the greatest share of outputs, consumption, as well as consumers' level of satisfaction and well-being diminishes over time.

Hicks (1967) also argued that changes in the level of output and employment are a function of monetary factors. Likewise, Wicksell's (1898, 1936) pure credit economy described the banking system as the grantor of loans to entrepreneurs, which they use as an input in the production process to pay for the wages of workers. He also argued that the velocity of

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money is important, in particular, if the velocity of money is large, the rate of growth of the money supply could be low, and economic and employment expansion could still occur.

Thus, when the banking system refuses to supply credit to entrepreneurs, merchants, and consumers, the economy cannot expand, even when confronted with a large infusion of post-Great Recession reserves from the Fed. In essence, banks can adversely affect economic growth, particularly if the Fed policies allow them to do so.

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