Economists can engineer full employment
By Byron A. Ellis – July 04, 2011

Modern economies cannot operate without money. Economies endowed with insufficient money have limited productive capacity and are unable to meet their employment needs.

Central banks are responsible for maintaining an adequate supply of money in the economy. The performance of central banks in managing money and the banking system in managing credit determine the levels of productivity and employment.

Societies have many resources, such as land, capital, and the time of citizens—these resources, when used appropriately, produce societal benefits. However, many societies do not effectively use the resources at their disposal. Thus, economies with inferior strategies end up with weak productivity and surplus labor (high level of unemployment).

Nevertheless, if the money supply and income velocity were adequate, modern economies would be able to exploit comparative advantages in the land, capital, and labor, which would lead to full or more employment. The income velocity of money is the number of time money turns over per year in financing the annual flow of income.

We could use the average aggregate full employment wages to determine the value of the economy's full employment productive capacity, which would be the full employment gross domestic product (GDP); that is, the level of GDP that leads to full or maximum employment

It is, therefore, possible to estimate the full employment income, as well as the nominal money supply required to achieve it. That is, the money in circulation that would be sufficient to cover full employment wages for all employable labor.

GDP is the economy's income, and income velocity is the ratio of nominal income to the nominal money supply. Thus, given the full employment income and income velocity, economists can estimate the nominal money supply required for full employment.

An expansion in fiscal policy can increase income velocity if it causes the interest rate to rise. However, the Federal Reserve's (Fed) propensity to keep interest rate low decreases the velocity of money. It causes money holders to use money less intensely.

If we can estimate the income necessary for full employment, and the high-interest rate causes money to work harder, the Fed could deliver full employment. So, why Congress and the President allowed the Fed and the banking system to starve the economy?

The answer is simple. Full employment does not benefit the owners of capital; it causes wealth transfer from the rich to the less affluent by causing wages to rise.

Thus, the Fed's inflation targeting (IT) policy conflicts with full employment and rising wages since it restrains inflation, whether it exists or not. Restraining inflation requires the Fed to limit bank credit expansion. That is money in circulation and hence demand.

The Fed pretends to be an activist entity by increasing the money supply in vaults of banks at the Fed. However, increasing the money supply without increasing credit does not increase the amount of money in circulation or employment. When the Fed restrain credit expansion, it also controls inflation, and wages do not rise.

The public has difficulty separating money supply expansion from the increase of money in circulation, which is two distinct processes. The Fed expands the money supply, and the banking system expands money in circulation by issuing credit. And, it is credit expansion that causes demand and radically increases production and employment.

The Fed and Congress prevent credit expansion by paying interest on bank reserves. The Fed prints money and loan it to banks at close to zero interest rate and pays banks interest on the loaned funds. By doing so, they discourage banks from lending to the public and hence expansion of money in circulation.

The monetary expansion by the Fed is a mirage since it does not put money into the hands of most consumers, merchants, and entrepreneurs. Likewise, the Fed reduced the effectiveness of Obama's fiscal expansion by deliberately keeping interest rates low. When the interest rate is low, the money turnover is also low.