Failure to understand the job creation mechanism
By Byron A. Ellis – June 11, 2011

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It is ironic that progressive pundits and politicians talk about job creation, but do not understand the job creation mechanism. Most believe that government spending can expand the economy and increase employment. Often, government spending only reallocates resources from the private sector to the public sector. Furthermore, when it borrows to do so, it crowds out private investments. Nonetheless, some argue that during economic slowdowns, government should be the spender of last resort.

Lack of jobs is an income or monetary problem that fiscal policy alone cannot correct. The demand for goods and services depends on the income available to a wide cross section of the population, and the income available is a function of the money in circulation.

Prior to the 2008 Great Recession, the Federal Reserve (Fed) and many Western Central banks restrained credit and hence the supply of money (M1) because they were engaged in inflation targeting. Thus, the money in circulation was less than the real money balances that the public demanded. When the real value of M1 decreases, as occurred between 2003 and 2007, the price level (inflation) or/and output (income) decreases.

When the price level falls, say for housing, homeowners lose wealth and when income (output) falls, unemployment rises. Conversely, when income rises, output and employment rises. It is the expansion of money in circulation, through the bank credit channel, that increases consumer demand and employment. However, if central banks mismanage the expansion of money in circulation by providing more money than the value of goods and services produced, inflation will occur. In a recession, however, rising inflation is often the antidote for a stagnant economy.

The Fed, by itself, cannot expand the quantity of money in circulation; it requires the banking system to loan reserves and the public to borrow. Thus, money supply expands when the Fed, through open market operations and other tools, provides liquidity to the banking system and the banking system provides loans to the public. Therefore, it is bank loans that expand money in circulation and allow consumers to demand more products and services and entrepreneurs and merchants to meet consumers' demand by increasing production, inventories and employment. Therefore, the job creation mechanism depends on the positive change in credit creation.

Unfortunately, Obama gave the job creation keys to two Republicans, Bernanke at the Fed and Geithner at Treasury and might have sealed his fate as a one-term President.