Economic Sleight of Hand
By Byron A. Ellis – February 25, 2010

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According to Federal Reserve Chairman Bernanke, the recession is abating, but the job market remains weak. Bernanke said he is worried about the long-term impact of the recession on workers' skills and wages.

CNN-Money indicated that several Republican lawmakers wanted to ask why the job market remained weak even though Congress passed a massive $700 billion stimulus package last year.

The Federal Reserve is responsible for conducting the nation's monetary policy by influencing the financial and credit conditions in the economy in pursuit of maximum employment, stable prices, and moderate long-term interest rates.

The Federal Reserve restricted the growth of the money supply (M1) from 2003 until 2008. However, limiting the monetary base affects the production process. When there is less money (income) in the economy, the effective demand for goods and services diminishes. As demand declines, business inventories accumulate, and layoffs are inevitable.

In a monetary economy, money and credit are necessary to expand the economy. Both are controllable by the Federal Reserve and the banking system.

The Federal Reserve creates fiat money, and the banking system, using the credit market, expand the monetary base. For instance, if the Federal Reserve increases the money supply by $1,000 by buying securities from banks and banks loaning those funds, the banking system would expand the monetary base by $10,000.

The availability of credit is a necessary condition for consumers, entrepreneurs, and businesses spending decisions. The Washington Post reported that lending by the banking industry fell by $587 billion in 2009.

The recession resulted from a lack of income, caused by restrictive Federal Reserve policies to control non-existing inflation.

Congressional lawmakers, on the other hand, do not understand how the economy works. Thus, they believe that fiscal policy, a blunt tool, would stimulate the economy. As a result, they are still passing fiscal bills, such as the jobs bill, as if businesses will increase employment in the absence of sufficient demand.

The way to increase demand is to facilitate consumer and business credit, particularly to restructure wealth losses resulting from Federal Reserve policies. If consumers remain strapped with upside-down mortgages, the economic recovery will be slow and painful.

A lengthy recovery could lead to social instability and loss of human capacity. Thus, the administration and Congress need to facilitate consumer and business credit, whether through the existing banking system or a federal bank.

The economic sleight of hand and the unwillingness of the monetary authority to force the banking system to increase credit to Main Street could have unpredictable and lasting repercussions.