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

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It is ironic that pundits and politicians of goodwill talk about job creation, but do not understand the job creation mechanism. They often believe that the government or taxpayers' funds can expand the economy and increase employment. Government spending can only reallocate resources from the private sector to the public sector. When it borrows to do so, it causes interest rates to rise and crowds out private investments. Nonetheless, some have argued that during economic slowdowns, the 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 money depends on the income (output) available to the population, and the income available is a function of the money supply. Before 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 supply was less than the real money balances that the public demanded. When the real value of M1 decreases, as occurred between 2003 through 2007, the price level (inflation) and output (income) decreases.

When the price level falls, say for housing, homeowners lose wealth, and when income (output) falls, consumption falls, and unemployment rises. Conversely, when income rises, consumption, output, and employment rise. It is the expansion of the money in circulation through the bank credit channel that increases 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 circulation; it requires the banking system to loan and the public to borrow. The 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. 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 change in income.

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