

CURRENCY STABILIZATION THROUGH FULL EMPLOYMENT: CAN EMU COMBINE PRICE STABILITY WITH EMPLOYMENT AND INCOME GROWTH?

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SUMMARY INTRODUCTION

The introduction of the EURO in 1999 will see the completion of a process initiated by Roy Jenkins' decision to breathe new life into the Treaty of Rome by reviving the project for a common currency. The path that has led from the Exchange Rate Mechanism, to the Single Market Act, to the revision of the original Treaty in Maastricht, has meant a transformation of the original objectives from a free trade zone to a zone of price stability. This has meant that other economic policy objectives have been subordinated to price stability and many countries have had to sacrifice growth and employment to attain the prerequisites for what the Germans call a "culture of stability". While these other policy objectives can be ignored for a short period, once the Euro is introduced they will have to be faced. The original project for price stability overlooked these problems because it was presumed that price stability was a necessary and sufficient condition for the resumption of the kind of growth and employment experience that Europe had experienced before the Vietnam war and the oil crisis. However, this has not been the case.

The process of globalization of trade and production has created additional difficulties for the European unification project. In particular, it has raised the question of competition from developing countries using cheap labor. This has created competitive pressure on firms as well as on the least skilled in the labor force. It has also brought to the forefront the importance of relative labor costs and the focused attention on the role of the behavior of wages and the labor market in attaining price stability. Most European countries now practice some sort of wage policy as the basis of maintaining price stability. Similar to the idea that price stability will produce growth, these seem to be based on the idea that wage stability will improve employment levels. Again, this has not been the case. Indeed, the stability of wages and prices appears to have been the result of creating excess supplies of both labor and productive capacity, both in Europe and abroad.

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It thus appears to many that the objectives of wage and price stability will be incompatible with the objectives of high growth and employment, with the Growth and Stability Pact introduced to ensure that priority is given to the former. Yet, it seems clear that this potential conflict will have to be resolved if the European project is to succeed. If this were only an internal European dilemma, the risks might be on the side of a repetition of the past experience of stagflation. However in an increasingly global environment, the risks seem to be tilted in the opposite direction of excessive unemployment, deflation or even depression. It is clear that the past methods for dealing with the social implications of this conflict will not be sufficient to the task. First, budget deficit limits written in the Growth and Stability Pact will increasingly impinge on social safety nets, so that attempting to ameliorate unemployment through income supplements and other benefits will eventually come into direct conflict with the objective of price stability. These same limits will apply to the use of fiscal expenditure policies to support aggregate demand.

A common currency represents a radical change in the monetary organization of Europe, designed to ensure that EMU produces a "stability culture". It will require a radical alternative approach to resolve the dilemma of combining price stability with full employment and achieving potential growth. Such an alternative has recently been advanced in the ELR proposal [cf. Mosler, 1997-8; Wray, 1999]. It suggests the application to the labor market of a simple principle already employed to provide price stability in most financial markets — the use of a market maker. The specialist in the New York stock market plays such a role when he buys or sells for his own account to dampen price fluctuations. He does not "fix" prices, in the sense of keeping them invariant, but rather counters random movements in an attempt to prevent them from becoming cumulative. Prices are thus stable when their variance is lower.

As Nobel prize winner John Hicks has pointed out, virtually every successfully functioning market in a capitalist economy has the equivalent of a specialist who administered prices by providing residual supply or demand. The basis of the radical alternative behind ELR is to turn the labor market into a full-fledged capitalist market with a market maker who would act as residual buyer and seller of labor, offering to employ any worker unable to find a job at a fixed wage or releasing any worker who chooses to leave for a better alternative. Just as the market price automatically eliminates excess supplies of product, such a proposal would eliminate the formal concept of involuntary unemployment — there would always be a supply of jobs to meet demand for them. By providing an administered residual wage, it would also reduce the variability of wages and thus provide stability to wage levels. The ELR proposal has been put forward as a means of providing full employment. But it can also be viewed as a means for introducing stability of wages which would make it easier to achieve the culture of stability in the absence of employment.

The next two sections of this paper deal with the reasons why a new approach to the unemployment problem is required. The third considered the ELR proposal as a means of combining price stability with high employment. The final section provides considerations on its introduction into the economic policy apparatus of the European Union.

WHY EUROPE NEEDS TO TRY A NEW APPROACH TO PRICE STABILITY

Throughout the 1980s European economic policy, largely under the direction of Margaret Thatcher, played a single tune called TINA. This is an acronym for the slogan "There Is No Alternative" to the policy of stable prices to achieve stable growth rates with high employment levels.¹ As a result, fiscal and monetary policy were increasingly directed towards reducing inflation rates to the exclusion of all other policy objectives because this was a precondition for all other policy objectives. Since inflation was considered to be caused by an excess supply of money financing an excess demand for goods, monetary growth was restricted, interest rates were raised and budgets were slashed in order to keep demand in line with available supplies.

In this context, the completion of the European Single Market, first broached in the Milan Summit in 1985 and initiated in 1993, was viewed as a measure that would promote economic growth without raising money supply growth or increasing fiscal deficits. But, it soon became clear that the benefits of increased intra-EEC demand from the creation of a Single Market could only be fairly shared among the member countries if relative price changes were determined by changes in productivity, rather than the increasingly variable and unpredictable exchange rates which resulted from the behavior of the United States dollar and differences in the evolution of member country policies. As a result, the Single Market policy to create non-inflationary demand was transformed into a project to establish a full Economic and Monetary Union² to reinforce the price stability that was considered a prelude to expanding output and employment. For almost all countries, meeting the convergence criteria involved reducing government spending and tightening monetary policy. Somewhat paradoxically, the policy which was meant to support demand by creating inflation was thus transformed into a policy to reduce demand and ensure nominal convergence of economic variables.

This policy has been successful beyond any expectation. The average rate of inflation for the European Union in the period 1975-84 was over 10 percent. For the period from 1984 to 1993, when the Single Market was due to take effect, it had fallen by more than half to 4.5 percent. The rate of price increase for the European Union is now below 2 percent, with Greece showing the highest rate of 3-4 percent. Taking the traditional measure of price stability as the 2 percent level that the Bundesbank reported to the German Constitutional Court as satisfying its responsibility under the Bundesbank Law to stabilize the value of money, the European Union countries that are likely to enter EMU have experienced conditions of price stability for around three years. However, the real rates of output growth, which averaged 3.2 percent during the dismal inflation decade of the 1970s, fell to an average of 2.25 percent for the decade of the 1980s, and in the first seven years of the current decade have collapsed to 1.7 percent. With stable prices Europe has grown only about half as fast as during the period of higher inflation.

The average unemployment rate for the period 1970-79 was barely over 4 percent; for 1980-89 it was just under 9 percent; while for the current decade to 1996 it has gone over 10 percent. The figures for 1997 and 1998 will average well over 11

percent. Employment, which had grown by only an annual average of 0.4 percent in the period 1979-89, has fallen to only 0.15 percent per year in the present decade to 1996. This is not really surprising, given the fall in the average rate of GDP growth in the face of high rates of productivity growth. But, even the rate of productivity growth has been declining, from an annual average rate of 5.8 percent in the period 1979-88 to 4.2 percent in 1990-1996.

That the present approach to price stability has not been able to produce high, stable growth may be seen in the simultaneous decline in output gaps (i.e. the difference between potential output and actual output) and average GDP growth rates, which indicate that potential output is converging downwards towards the declining rate of actual real output growth. The simplest explanation for this performance is the decline in investment which has accompanied the decline in inflation. For the first time in the post-war period, the share of investment in GDP is now higher in the United States than it is in Germany. Indeed, if one compares the experience of the United States and the European Union in the 1990s both experienced falling inflation rates, while in the United States investment and consumption have been rising along with the growth rate. In the United States the budget deficit and the inflation rate have been reduced by high growth, rather than being considered a prerequisite for high growth. And, inflation rates in the United States have been continually falling are currently near the 2 percent level. This suggests that there are alternative paths to the creation of stable growth and employment that are also compatible with price stability.

If Europe continues these trends, and potential growth falls towards a declining actual growth rate, with productivity expanding at rates that are roughly double GDP growth, the result can only be rising unemployment or lower labor force participation rates.³ Clearly, the Single Market and a "culture of stability" are not sufficient to allow Europe to exploit its potential income growth. Is there perhaps another way?

IS EXPORT-LED GROWTH A VIABLE ALTERNATIVE FOR EUROPE?

It has been suggested, also a favourite British position, that external demand could provide a source of non-inflationary growth, since it does not require fiscal deficits, faster money supply growth or increased household expenditures.⁴ Export-led growth usually involves exchange rate adjustment, but with Europe about to embark on an experience of irrevocably fixed exchange rates, the same result can be produced by a fall in the domestic rate of inflation caused by nominal wages rising at less than the rate of productivity growth providing a real depreciation of the currency and an increase in external demand to offset the decline in domestic demand. The problem with this approach is that it is virtually identical to the old-fashioned concept of beggar-thy-neighbor devaluations which plagued Europe in the 1920s. The current version, using wage reductions and real exchange rate changes rather than nominal exchange rate adjustments, is often defended as preferable to the earlier version since it produces the benefit of internal price stability and nominal exchange rate stability. Nonetheless, it remains a policy that can only be practiced successfully by a single

country relative to the rest of the world. It is wholly inappropriate for a country that is part of an integrated economic area that has a high proportion of its trade within the group and is about to introduce a single currency so that exchange rates will become irrevocably fixed. Export-led growth in the context of EMU can only mean relative to the rest of the world outside the EU. It is not a policy alternative that can be operated by any single member country. Yet this seems to be precisely the policy that some countries are employing to solve their unemployment problem. And it can only reduce the possibility of solving the problem for the Union as a whole.

As an example, consider current German wage policy.⁵ It is widely believed in Germany that its current difficulties of slow growth and rising unemployment are due to excessively high absolute wage levels. This is despite a persistent and rising trade surplus, a current account that has returned to surplus, a GDP deflator below 1 percent and a CPI inflation rate below 2 percent. Nonetheless, it is argued that recovery of employment levels will require lower wages. The results of a policy that has set the target for wage growth at the inflation target over the last two years has been a reduction in unit labor costs of around 3.5 percent over the period, a real depreciation of the DM by more than 10 percent, a continued fall in the inflation rate (abstracting from the impact of "fiscal" inflation caused by changed indirect taxation), and growth in exports at double digit figures.

This radical adjustment has occurred in the presence of stagnating consumption demand growth of less than 1 percent per annum; investment in manufacturing that has only recently started to respond in export sectors, and unemployment that has reached unprecedented levels and continues to rise. Rising net exports have not offset the negative impact on domestic demand of the decline in real wage growth, rising unemployment and the reduction in government expenditures.⁶ Despite real depreciation, increased international competitiveness and price stability, growth in output and employment remain historically low levels.

But, this policy is not only failing to operate successfully in Germany. As noted, this policy cannot be employed by a single country within a group of countries linked by a single currency without negative effects on the others, since all will eventually be forced to adopt the same policies. If the rest of Europe does not follow Germany in keeping wage increases down to the target inflation rate (which is lower than the rate of productivity growth) the result will be exactly the same as if their nominal inflation rates were excessive relative to the inflation rate in Germany, and they will be losing intra-EU competitiveness. The culture of nominal price stability would simply reproduce differentials in real terms. While previously these differences would have appeared as real appreciations of exchange rates relative to Germany, and have been eliminated by nominal appreciation of the DM before EMU, the differences will now appear in terms of differential real returns to capital and labor in Germany relative to the rest of the EMU. Although there will no longer be any national balances of payments to finance or exchange rates to defend, there will still be flows of funds among countries, and the same instability will result. In simple terms, Germany will be draining domestic demand from the rest of the EU.

Note that greater independence of any individual European Union country in managing its own fiscal policy would change this picture very little. If France or Italy decided to expand domestic demand, it would be quickly drained out of the country — it would no longer show up in the German balance of payments surplus and an Italian deficit as before EMU, but now appear as increased expenditure flows from Italy to Germany, with the Italian fiscal deficit deteriorating, and credit risks on Italian securities increasing. While both labor and capital costs will be rising in Italy relative to Germany, this will only exacerbate the divergences and make a policy of downward wage convergence more pressing. The single currency will bring the positive benefit of releasing European economies from having to contract their domestic expenditure policies to defend their exchange rates relative to the DM, but it brings with it the cost of requiring that they contract their nominal wages to defend the competitiveness of their domestic production against cheapening German imported goods.

Alternatively, Germany might be said to be exporting its unemployment to the rest of the EU member countries. The other members of EMU can only allow their nominal wage levels to evolve independently of Germany to the extent they can rely on productivity growth in excess of that in Germany. If productivity growth is roughly constant across countries, they will have to reduce their growth of wages below current inflation and productivity growth levels in their tradable sectors to defend their employment levels. The result will be that beggar-thy-neighbor nominal exchange rate depreciations are replaced by beggar-thy-neighbor reductions in wage costs and prices. Competition for foreign demand by wage reductions in a single country will produce competition within the single currency area fought through price deflation, and this will be the case irrespective of the fact that there is currently no question of excessive national rates of growth of wages or prices in Europe. As mentioned above, the inflation convergence for the potential members of the EMU has for some three years been within the 2 percent threshold considered as price stability by the Bundesbank. Restoring German external competitiveness will only produce internal deflation and increased competition for a falling aggregate total of EU demand, leading to further downward pressure on prices of manufactured goods and larger differences between manufactured and service prices.

The question then is whether the increase in demand from outside the European Union resulting from real depreciation of the EURO will be sufficient to offset the decline in internal demand. Whereas external trade was a very large proportion of each member country's GDP before unification, it will become a very small proportion after unification. The order of magnitude is not likely to be sufficient to offset the reduction in EU demand. Further, since the Euro will float against the dollar and the yen, and given the German obsession with a "strong" Euro as evidenced in recent Bundesbank policy, if the Euro were to appreciate relative to these currencies this would eliminate any benefits that might have accrued from the reduction in unit labor costs. If the Euro behaves as the German mark has done over the last twenty years, this means that in the medium term it will appreciate so as to maintain a roughly constant real effective exchange rate, with nominal appreciations offsetting any changes in relative unit labor costs. Export-led growth as a medium term policy

thus cannot produce any increase in EU demand and can only aggravate the conflict between growth and price stability by placing price stability in jeopardy of deflation.⁷

From the point of view of maintaining fiscal balance, deflation is just as damaging as inflation, for declining nominal GDP will reduce government receipts while the rising levels of unemployment will increase social transfer payments. Given the commitments in the Growth and Stability Pact, this will create even greater pressure for reform of the existing social welfare programs. Larger numbers of individuals will be provided with sharply reduced support programs.

If European economic and monetary union is to be successful it will require policies that prevent a weak Euro and excessive inflation, but it is even more likely to require policies which prevent excessive strength of the Euro and the risk of price deflation. Thus, the current policy of export-led growth based on increasing international competitiveness appears even less promising in reaching accommodation between price stability and growth and argues for a new approach to the issue.

SUPPLY-SIDE POLICIES FOR THE LABOR MARKET

The above discussion suggests that the key to price stability and to the problem of unemployment both lie in the evolution of wages. Increased wage flexibility is unlikely to provide a solution to rising unemployment and the increased competitiveness that downward flexibility is likely to produce is unlikely to generate sufficient external demand to offset the negative impacts on consumption growth and investment. Nonetheless, the current global environment of rapidly changing technological conditions and global competitiveness do suggest that there is a need for increased labor flexibility. In economic terms, this means that labor must return to being a variable factor whose use changes with the needs of current production plans. In crude terms, this means greater flexibility in laying off workers, in hiring and firing, and in temporary or part-time work contracts. Resisting these changes in the face of competition from emerging economies with diverse social and cultural support systems create the risk of higher levels of permanent unemployment.

The changes required to increase flexibility are often considered as supply-side changes — making labor supply more flexible. But they cannot be separated from demand-side changes since greater workplace flexibility makes labor incomes more variable and thus makes consumption expenditures more volatile and less predictable, which dampens the willingness of entrepreneurs to invest. To put the problem from a slightly different point of view, the worker and the employer are looking at the same market in two different ways. The employer is interested in an input that has a variable cost, while the worker is interested in a steady flow of income from employment. The employer is looking at the market for a variable resource input, labor, while the worker is looking at a market for a fixed income earning asset, a job. From the point of view of the worker, there is an insufficiently flexible supply of jobs, while from the point of view of the employer there is an insufficiently flexible supply of workers. Introducing flexibility in the labor market makes incomes and prices more variable; introducing flexibility in the job market makes incomes and consumption more stable.

There would seem to be an area of unexploited mutual advantage between labor and employers in making both side of the market more flexible. The free market mechanism does not seem to be capable of providing the solution, yet financial markets solve similar problems on a regular basis. Market makers exist to ensure flexible supplies at the same time as they dampen the price fluctuations from random variations in supplies and demands coming onto the market. The "specialist" on the New York Stock Exchange is an example. Most of these institutional arrangements rely on holding inventories, or what may be described as "buffer stocks", in order to provide a compromise between the competing needs of flexibility by buyers and sellers to be able to trade on a continuous basis in conditions of price stability.

While labor is not a storable commodity, and thus cannot be held in a buffer stock, the produce of labor is storable, substituting a variation in labor time for variations in inventories, or investment in increased labor skills that allow the transfer of present output into more valuable future output. Indeed, attempts have been made in this direction, in terms of "labor hoarding" by individual firms, but without much success. This is because the produce of labor is held in the specific form of the output of the individual firm. Since it is difficult for a firm to differentiate a random cyclical downturn from a decline in the demand for its own product such schemes can only be successful if demand patterns remain stable such that it is the general level of demand that adjusts, rather than a shift in tastes away from the product. In current conditions of high technological change, and Japanese just-in-time inventory management, labor hoarding in this way does not seem plausible.

Instead, the produce of labor would have to be for a "general" output, that is, something that is in general demand and will be required independently of both cyclical change and changes in demand patterns. In general, such goods are defined as "public" rather than "private" goods (note that this distinction refers to the characteristics of the demand for these goods, not to whether they are produced or supplied publicly or privately). While the idea of a buffer stock of goods may not be successful on a private basis, it may be more plausible if instituted on a public basis with the public sector playing the role of intermediary, providing the residual supply of jobs to offset the desired flexibility of the private sector. This would mean that although workers could not necessarily count on holding the same job through time, they could be certain that a job would always be available. Flexibility in labor supply, in the sense of being willing to shift more readily between employers would then be compatible with a more steady stream of wage incomes and a return to more stable patterns of consumption. Such a scheme has been suggested by Mosler [1997-8] and further elaborated by Wray [1999] as the "Employer of Last Resort" (ELR) proposal, with the government acting as the market maker to stabilize prices and to ensure flexibility of the supply of jobs as employer of last resort.

If such an ELR program of flexible residual government employment were to replace current unemployment and social support schemes, this would just be a return to the original intentions of employment insurance schemes which were meant to provide short-term income maintenance for periodic loss of a job due to the short-term cyclical fluctuations of the economy. The unemployment benefit was never con-

ceived to be a long-term support for the unemployed or to provide welfare to the needy. This is not to say that these schemes should not exist, only that they should be separate from the policy to ensure full employment.

An ELR program would resolve the problem of unemployment by definition, since the supply of private and public sector jobs would always be equal to the demand. Anyone who chose not to work would have made a voluntary decision to exit the active labor force, while anyone unable to work would be eligible for public welfare support.

But, the role of an intermediary is not only to absorb excesses and deficiencies of supply and demand relative to equilibrium, but also to smooth price differences around that equilibrium. If the public sector is to play this role and act to stabilize wages, there must be some conception of the equilibrium wage. Obviously, there is no single "equilibrium" wage in the economy, but a range of wage differentials for different labor skills that spreads out from some base wage. Just as the central bank sets the policy interest rate, and offers to buy or sell overnight money at that rate, leaving the private sector intermediaries to determine the rates on every other type of financial asset, the public sector could set the "policy" wage rate, and leave the determination of wage differentials to the private labor market. Many governments already do this implicitly when they set a minimum wage for private sector employment. But there is no need for the government to legislate the minimum wages that should be paid in the private sector. If the public sector becomes the residual job supplier, it only needs to set the rate at which it will buy labor. The private sector is free to set any rate it wishes for contracts undertaken in competitive markets on a free and voluntary basis. In more or less the same way that money market interest rates are today below the Fed funds rate, the private sector may set wages below the public sector rate, and if workers prefer these wages and conditions they are free to accept them. All that is required is the alternative of a public sector job at the policy rate.⁸

Setting a "policy" wage for ELR workers would then provide a fixed point around which the overall wage level would be determined. If the demand for labor is falling, workers will be moving increasingly into public employment at the policy wage, which will limit the downward movement in labor income as government deficits expand and provide automatic stabilization in domestic demand. The opposite will occur in periods of expansion. It is to be expected that the differentials would contract or spread out with the changes in private sector demand, but would be protected from absolute declines. This means that workers avoid "depreciation" in the value of labor on the downside and depreciation in the value of their wages on the upside of the cycle.

In another sense, the government has an advantage over individual private firms in acting as the market maker. Just as for any intermediary, there will be occasions in which wages will have to be adjusted to preserve a minimum buffer stock. But, instead of raising wages in cases of depletion of the pool of public sector employment, it would be possible to use fiscal restraint to dampen demand as the ELR wage is reduced, thus reducing the upward pressure on wages as lower-skilled workers are drawn into the labor force. Thus, private sector entry wages would not rise, with the

beneficial effect of offsetting the fall in productivity that occurs due to "hiring path diminishing returns" as lower-skilled, relatively untrained, labor enters the private sector labor force. Thus, fiscal policy remains necessary as a tool of restraint in an expansion, while the automatic stabilizers are free to operate in a decline. In a sense, the policy could be considered as one of using a NAIRU (Non-Accelerating Inflation Rate of Unemployment), but with the NAIRU set at zero unemployment.

There is one last advantage of such a proposal over traditional "Keynesian" fiscal policy measures. The use of government expenditure policy to offset cyclical fluctuations in demand has suffered from two nearly irremediable defects. The first is the time that is required to adopt the required legislation to change expenditure levels. The second is that expenditure levels have come to be determined primarily by political considerations rather than by the needs of the cyclical stability of the economy. The ELR scheme would eliminate both of these difficulties. First, the public employment programs would be prepared and legislated in advance — paradoxically this is very similar to the way the Hoover administration conceived of government intervention in the economy. Thus, there would be no delay in approving programs that would be implemented on a priority basis depending on the availability of ELR labor.

The second advantage is that the programs could not become self-perpetuating or politically motivated. Government expenditures would automatically contract as the economy expanded as the result of lack of labor to carry them out. If political considerations argued in favor of maintaining projects they would have to be justified and funded on the basis of private market costs and returns, which was the original intention of Keynes's stabilization policy through public works. This would be facilitated through the creation and evaluation of government expenditures on the basis of a capital and current account budget. The current account budget being roughly balanced within the limits of the 3 percent maximum given by the Growth and Stability Pact and the capital account budget determined by the cyclical movement of the economy where by definition deficits equal gross investment expenditures.

APPLICATION OF THE ELR PROPOSAL IN THE EUROPEAN UNION

The discussion of current policy in the European Union suggests that there is a more important issue that an ELR scheme would resolve. As argued above, differential wage policy in different countries may create a risk of deflation with the EU. The problem involves setting of the "policy" wage rates in different countries at the appropriate level with respect to differential national rates of productivity growth. Under a single currency one should expect convergence, not only of interest rates, but also of prices. The tendency towards deflation highlighted above is aggravated by German nominal wage growth being set at the target inflation rate of 2 percent when the rate of growth of productivity is substantially higher than this, with the result that German unit labor costs fall faster than in the rest of the European Union and have created a real depreciation of German produced goods.

From the point of view of the European Union there are two questions that have to be resolved. The first is the level at which the policy wage should be set in different

countries. The second is the adjustment of the policy wage through time. The level should be set with respect to unemployment benefits, or to minimum wages, or other criteria such as national wage scales. However the level is set, it should be adjusted over time on the basis of the national average growth of productivity in order to prevent beggar-thy-neighbor reductions in national wage scales. This should be done to ensure that the stability of nominal wages with respect to prices does not produce deflation.

A stabilization scheme patterned on the ELR proposal would have two clear benefits for the European Union. The first would be to reduce volatility in incomes while providing flexibility in labor supply. This should make consumption expenditures more stable, and be beneficial to investment expenditures, reinforcing the stability of domestic demand, the major requirement for European recovery. At the same time, the increased flexibility should provide higher productivity and this should also support investment. Together these two factors should allow potential capacity to grow and increase the private sector demand for labor, decreasing the number of residual jobs that have to be supplied by the public sector.

Second, it provides a mechanism for stabilizing wages and thus prices, at the same time as it provides a defence against the inbuilt tendency towards deflation in the European Union. By providing support for both investment and productivity, it also means that standards of living should be rising as prices remain stable in the medium term.

One advantage of such a program is that it increases the supply of public goods at virtually no cost, for it transfers idle workers receiving unemployment benefit to productive employment providing public infrastructure and training. One of the most undesirable impacts of the TINA policies has been an almost total absence of maintenance of public infrastructure. This proposal allows that problem to be met at minimal costs.

There is, of course, one remaining question. The program has potential costs to national government budget and there is the question of the permissibility of such expenditures under EU regulations. There is a static and a dynamic aspect to the first question. First, there will be a cost saving due to the reduction in unemployment benefit (which will vary from country to country depending on its existing system) for those who are truly involuntarily unemployed (those who are disabled or are receiving income support for other reasons, such as single parents, etc., should not be affected). Then there will be a dynamic effect due to the positive impact on tax receipts as a result of higher incomes, consumption and investment leading to higher productivity and higher potential growth rates. Against this must be set the static costs of paying for the labor employed and the organizational structure. The balance of these impacts, at least in the short term, are likely to create an increase in the government deficit which would be attenuated by the increased potential capacity and income growth over time.

However, attention must also be given to the accounting of the expenditures for ELR employment. When assessing a country's budget position with respect to the reference values for admission to phase three of EMU, both the Maastricht Treaty and

the Growth and Stability Pact instruct the Commission to take into account the relation between the government deficit and gross investment expenditures. The presumption is that a country would be permitted a deficit that is higher than 3 percent if this was committed to necessary public infrastructure investment expenditures. It is probable that most of the increased expenditures would be classified as investment or maintenance in physical or human capital. Indeed, it would be highly desirable that much of the residual supply of jobs would involve increasing the skill level of workers through education and on-the-job training in areas of labor market tightness.

Finally, although there is nothing to stop an individual country within the European Union from introducing such an ELR stabilization policy, the advantages for price stability clearly depend on it being introduced on a EU wide basis. Such a policy would render unnecessary any additional oversight of the European Central Bank or the creation of the a Euro-X committee to promote social policy.

NOTES

1. This is a modern version of the idea advanced in the 1930s that recovery could only occur if profits were increased by reducing wages. A variant was that investment could only occur if saving were increased by reducing consumption expenditures — since wage earners were the primary source of consumption and profit earners the primary source of saving, it came to the same thing. Kalecki argued against the former and Keynes argued against the latter. At about the same time Jerome Levy made the same discovery by answering the question of what determined profits.
2. Note that this is the correct specification of EMU, rather than the often used, but erroneous, European Monetary Union.
3. In a Ricardian world this would not be a problem, since none of the EU countries currently has a fertility rate that is even near the 2.1 replacement level, so the decline in population would eventually solve the unemployment problem if immigration can be limited. Only from this point of view does reducing foreign residents aid in solving the unemployment problem.
4. Note that this is little different from the justification for the Single Market Act as a means to increase economic integration and thus intra-EU exports.
5. It has been given official sanction during the presentation of the German Government's Annual Economic Report by economics minister Rexrodt who announced: "More jobs would be created only if wage increases lagged the growth of productivity for the foreseeable future. [Norman, 1998].
6. Nonetheless, despite monetary growth rates near the centre of the announced target range and inflation within the 2 percent target, the Bundesbank has recently raised the short-term repo rate from 3.0 percent to 3.3 percent, a clear signal that it is concerned about the compatibility of either government fiscal policy or union wage policy with the objective of price stability. This seems to confirm the link between nominal wage growth and inflation, producing falling unit wage costs determined by productivity growth. The official explanation is to insure that the new common currency starts its life without any incipient inflationary pressures. An alternative explanation is that it has reduced its inflation target for the beginning of EMU to zero.
7. It is also necessary to consider the global context. German exports to Asia expanded by more than 10 percent in 1997, up from 6 percent in 1996, and exports to Eastern Europe rose by a quarter in 1997, largely due to growth in developing countries, rather than any change in German competitiveness. 1998 will bring falling demand, along with falling prices of imported goods from developing countries and primary commodities, adding to the risk of deflation in the EU. Thus, from the global point of view, the current policy may be self-defeating and thus unsustainable. Given that nearly every country in the European Union has a positive external balance, the risk is not only for internal deflationary instability, but for global instability.

8. This simply reflects what in fact occurred under the gold standard, where individual governments fixed only the rate of conversion between gold bullion and the standard units of domestic coinage. It was left to the free market to determine international rates of exchange and to keep them stable. Under the gold standard no government gave a guarantee as to the value of its own currency in terms of foreign currency. Yet, the private international gold market produced the stability of exchange rates via international arbitrage.

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