



Rec Amisite²

Rec 6
12/7

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Prime Minister

mb

You will be interested in the
enclosed letter from Professor Willem
Buxter ^(29 June) — one of the two best young (45)
neo-Keynesians — where he expresses
unequivocal and surprising agreement with
me on the arguments about the EMS
He is an important ally

mb

Dear Alan,

79/6

This may amuse you,
Wille-

The Editor,
Sunday Times

27 June 1989

LSE

01-405 7686, x 3177

Sir:

The argument in the Sunday Times of June 25, 1989 by Professor David Currie and Mr. Geoffrey Dicks in support of full British participation in the exchange rate arrangements of the EMS contains an interesting contradiction.

In their view, entry at a rate of DM 3.10 - DM 3.20 will cut inflation to 3.5 % in 1992 as opposed to 5.5% under a continuation of existing policies. The mechanism that produces this anti-inflationary gain is, in the words of Currie and Dicks, that "... EMS entry links our inflation performance to that of West Germany, which has been much better over the past decade. It offers a clear, non-discretionary rule for monetary policy, and it cannot easily be overthrown."

This argument is correct only if there is complete credibility that, once the UK enters the exchange rate arrangements of the EMS, it will stay in indefinitely. The experience of the USA, where after seventy years of Federal government it took a hefty civil war to stop the Southern states from seceding, shows clearly that integration need not be irreversible. Even if the participation of the UK in the exchange rate arrangements of the EMS were to be permanent, the possibility remains of realignments (i.e. devaluations) of Sterling within the EMS. If realignments that are de facto at the discretion of the UK government continue to be possible, then any inflation differential between the UK and West Germany will be consistent with UK membership in the EMS.

In their analysis of the anti-inflationary gains from joining the EMS, Currie and Dicks therefore assume permanent UK membership at a constant exchange rate. With the very high degree of financial capital mobility that exists already between the UK and many of the EMS members (and a-fortiori with the even higher degree of capital mobility we can expect after 1990), the implication of a permanently fixed Sterling/D-Mark exchange rate is that interest rates in the UK and Germany will be equalized. The level at which they are

equalized will be the low German one if domestic credit expansion (dce) in the UK adjusts passively to an unchanged German dce. It will be the high UK level in the unlikely event that the Bundesbank passively validates British dce.

Unused as I am to finding myself in agreement with Professor Alan Walters, I must nevertheless conclude that his analysis of UK interest rate behaviour is consistent with the maintenance of a credible fixed exchange rate when the degree of international capital mobility is as high as it is between the UK and Germany. The statement by Currie and Dicks that there must be "some initial rise in U.K. interest rates to enable Sterling to appreciate" is not consistent with the rest of their analysis. These kind of interest rate differentials would emerge only if, after the UK joined the EMS, the market still perceived some threat of a future devaluation of the Pound. In that case, however, the anti-inflationary benefits of joining would not be realized. One cannot have it both ways. My guess is that the future paths of inflation and employment will not be much affected either way by whether Britain joins the exchange rate arrangements of the EMS or remains on the sidelines.

The economic importance of full UK participation in the EMS and of eventual monetary unification is in any case rather minor, and is dwarfed by its political and symbolic significance as a further step towards West European political unification and towards centralization in Brussels of key economic and social decision making powers.

While I am a long-standing European Federalist, I consider such centralization desirable if and only if the decision makers in Brussels are accountable, i.e. subject to effective parliamentary control. Neither the national parliaments nor the Council of Ministers currently fulfill this role, nor can they be made to do so. Until the institutional democratic vacuum created by a still largely toothless European parliament is filled by granting it a true legislative function, full budgetary powers and the ability to dismiss the Commission, further political integration and centralization seem a dangerous road to travel.

Yours sincerely,

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