ROBERT MUNDELL'S NOBEL PRIZE

A creative theorist who ultimately disregards his own theory

when advocating policy choice

by Jean-Jacques Rosa

Although macroeconomists have always admired Robert Mundell’s work, they nevertheless have always had second thought reservation. Indeed, no one can fail to appreciate the range and breadth of his views. Mundell's well-known model of an open national economy was well ahead of its time during the 60’s when tariff barriers and controlled exchange rates prevailed. The theory considerably expanded current thinking at a time when the effects of monetary and budgetary policies were studied without taking into account imports and exports of goods, services and capital. Mundell initially reasoned that a closed economy model is valid only for a global economy. He thus derived innovative conclusions on inflation which, according to him, cannot be linked to a single country’s money supply but must result from changes in the global money supply.

Global monetarists

He thus found himself both in complete agreement with and total opposition to Milton Friedman, an elder colleague at the University of Chicago. Friedman held national governments responsible for inflation within their own countries and advocated a fundamental principle: the efficiency of floating exchange rates in dissociating the national economy, as well as internal inflation, from international activity and inflation in other countries. Mundell, however, arrived at the logical conclusion that exchange rates between nations must be fixed, because all national economies taken together make up a homogenous entity in a state of perfect intercommunication. The controversy between Mundellian "global monetarists" and "national" monetarists raged for several years, but eventually died down, leaving monetarist theory primarily "national" in focus but including a more complete understanding of exchange rate phenomena and their consequences.

Who was right? It would appear, in retrospect, that American inflation at the end of the 60’s and during the 70’s was driven, at least partially, and unquestionably, by the cost of financing the Vietnam War. But it is also certain that the 1971 abrogation of the Bretton Wood system of fixed exchange rates engendered more expansive monetary policies formerly held in check in certain countries by fixed exchange rates. Previously, a head of state or minister of Finance had the unpleasant duty of requesting approval from IMF when he needed permission to devalue currency in order to obtain needed international financing from Washington following overly liberal money creation.

Thus, two-digit inflation in the 70’s may have been a result of learning to manage the new freedom to create money. Many governments, elated by these new facilities, were unable to immediately regulate situations arising when flexible determination of the currency exchange rates is possible on an open exchange market. Increased rigidity of monetarist doctrine as it evolved into a dogmatic creed was yet another indirect result of this newly gained freedom. Central bank governors internalized the theory as a rigid anti-inflationist doctrine substituting for external controls previously enforced by a fixed exchange rate system managed by the International Monetary Fund.

However, time has proven Friedman correct, with Mundell's thinking flawed because excessive and therefore deeply contradictory. Friedman believed that exchange rates, like other prices, would change over time to integrate fluctuating and often divergent conditions in productivity and prices between countries. Subsequent developments, including an increasingly widespread tendency to adopt flexible exchange rate systems in many countries, confirmed his theories. And curiously enough, this development paradoxically vindicates Mundell’s famous theory of optimal monetary zones, cited by the Nobel jury.

Mundell extended his analysis of fixed exchange rates further in an attempt to determine the precise conditions that allow fixation of this type of relative price without generating negative economic consequences. And his conclusions are hardly surprising. If two economies are intricately connected by intensive trade, if labor and capital can circulate freely -- if, in other words, they constitute a single, homogenous entity, one economy in fact, then currency and exchange rate variations serve no purpose. They only complicate the tasks facing businesses and consumers by scrambling pricing signals and artificially increasing the cost of market transactions. It is thus preferable to use a single currency in a unified economy.

Benign neglect

But although this brilliant analysis is perfectly correct, Mundell's insistent application of the theory to contrary realities reveals the extremism typical of the pure theorist. He now supports fixed exchange rates under any and all circumstance, and recommends a gold standard that would, along with fixed parity, constitute a single, worldwide currency as the ideal solution. However, this concept totally contradicts the analysis of optimal monetary areas developed by Mundell himself. It is absurd to believe that all the world's nations form a single, perfectly homogenous economy that meets the precise requirements of an advantageous monetary union as described in the classic article by this latest Nobel prize winner.

Even countries geographically and developmentally close and linked by trade and a single market, such as the recently created euroland, do not constitute an optimal monetary zone as defined by Mundell. This fact is recognized by increasing numbers of economists who have completed accurate, sophisticated studies, some of which are cited in my recent book (1). There are still imperfections that prevent complete mobility of people and capital, and structural economic differences engender a variety of reactions to identical economic factors in diverse national economies, as can be currently observed in the euro zone where divergent economic conditions are common.

However, Mundell does not take such facts to heart, and remains convinced that the world may be seen as a single economy with perfectly fair arbitration processes. A world where the gold standard represents the only suitable monetary regime, and where a country's prices and activity are dependent on random discoveries of new gold mines in South Africa, Russia, or elsewhere.

This irrational conviction, this benign neglect of economic realities, is what has made Robert Mundell both a brilliant visionary, ahead of his time, and a zealot of the "gold bug" school. This eccentric personality's contradictory facets go a long way to explain the reserves expressed in discussions on a thinker who patently dominated analysis of "monetary and fiscal policies in different exchange rate systems", according to the Nobel jury, and authored the theory of optimal monetary zones. An exceptional theorist deserves an exceptional distinction. But theorists are not always best placed to recommend pragmatic economic policies, even when such policies derive directly from their own theories.

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1. *L'Erreur Européenne*, Grasset, 1998.

Le Figaro, October 22, 1999