People in Economics

Ahead of His Time

Laura Wallace interviews economist Robert Mundell

When Robert Mundell received the Nobel Prize in economics in 1999, the Royal Swedish Academy of Sciences cited his "uncommon—almost prophetic—accuracy in predicting the future development of international monetary arrangements and capital markets" back in the 1960s. He's widely regarded as a pioneer of modern international economics. In the same field, he's the economist who developed the modern theory of optimal currency areas, and many observers include him among the fathers of the euro.

Mundell's Nobel Prize had long been expected and was welcomed by his peers. Maurice Obstfeld commented at a 2000 IMF conference honoring the former IMF economist that, had Mundell's achievement been entirely technical, it might have had little impact. "Instead, through a rare combination of analytical power and Schumpeterian 'vision,' Mundell distilled from his mathematical formulations important lessons that permanently changed the way we think about the open economy." Michael Mussa—a student of Mundell's at the University of Chicago and later IMF Economic Counsellor and head of research—tells F&D that Mundell's enormous impact on the field came about "not because of any single idea but because of the approach he took to thinking about international economics." He notes that Mundell was "in the forefront of the analysis of the importance of international capital movements and its role in international economic interactions."

Although the Canadian-born economist's work during the 1960s has now become mainstream, a number of policies that he's advocated at various times have not been embraced by the vast majority of his peers. These include his call for a return to a gold standard when U.S. inflation hit double digits in 1980; a return to the post–World War II (1946–71) Bretton Woods fixed exchange rate system, modified to
correct its defects; and the creation of a global currency. Even his championing of "supply side" tax cuts, which gained most attention during the Reagan administration and made him a hero of U.S. political conservatives, has puzzled many economists. Most recently, his outspoken advice to China on its exchange rate regime is causing unease among policymakers in the major industrial countries and their advisors at international organizations like the IMF.

Is there an inconsistency between pioneering modern international macroeconomics and supporting so many non-mainstream notions? Mussa says no. "Bob has always been an enormously stimulating and unorthodox thinker. So there has been a consistency. His contributions were related partly to his willingness to think outside the box." Actually, Mundell doesn't see himself as a maverick economist, insisting that his work has stayed steadfastly in the tradition of the great economists from Adam Smith through the founders of the IMF, including Keynes, who believed in fixed exchange rates based either on gold or on a world currency. As for the issues on which he doesn't garner much peer support, he doesn't mind being in the minority. And he doesn't object to The Economist magazine's portrayal of him as "the great eccentric." Little surprise that he serenaded his Nobel Prize banquet guests in 1999 with the fourth verse of Frank Sinatra's signature song "My Way."

A stint at the IMF

Mundell was born in 1932 in Kingston, Ontario, where he started his academic life in a one-room schoolhouse. He received his bachelor's degree in 1953 from the University of British Columbia in Vancouver, with a joint major in economics and Slavonic studies. For his graduate work, he did a year at the University of Washington in Seattle, then a year at the Massachusetts Institute of Technology (MIT), where he was influenced by Paul Samuelson and Charles Kindleberger. Then he spent a year at the London School of Economics (attracted by the work of Lionel Robbins and James Meade), where he finished his Ph.D. thesis for MIT in 1956 on international capital movements under the supervision of James Meade—who had recently published his classic, pioneering books on the theory of international economic policy (which won him a joint Nobel Prize in 1977)—and with advice from fellow Canadian Harry Johnson. After that, he was a postdoctoral fellow for a year at the University of Chicago.

Over the next few years, Mundell taught at the University of British Columbia, Stanford University, and the Johns Hopkins Bologna Center of Advanced International Studies in Italy (where his lifelong love affair with Italy first took root). He lectured and published papers on international trade, optimum currency areas, and monetary and fiscal policy trade-offs under fixed and floating exchange rates—attracting the attention of the IMF's Research Department, then headed by Jacques Polak. Polak recalls going to great lengths to
recruit Mundell, whom he considered "courageous" for studying floating exchange rates at a time when the topic was "taboo."

One of Mundell's first assignments during his two-year stay (1961–63) at the IMF was to address the problem of the appropriate mix of fiscal and monetary policy, a subject that was being debated with respect to the United States. The result was the paper "Appropriate Use of Monetary and Fiscal Policy for Internal and External Stability," which refuted the prevailing U.S. doctrine of easy money to lower long-term interest rates and a budget surplus to siphon off inflationary pressure. "I argued that, under fixed exchange rates, monetary policy had to be devoted to the balance of payments and fiscal policy to stimulating the economy," he explains. "This caused a revolution in thinking about the policy mix," he says, leading to the reversal of the U.S. economic policy mix and the 1964 tax cuts. He says that it was a critique of this paper by economists at the U.S. Federal Reserve Board that led him to an even stronger assumption of perfect capital mobility.

Mundell also worked on the theory of inflation, showing that, contrary to the theories of Irving Fisher and Abba Lerner, an increase in expected inflation would raise interest rates, but by less—later known as the Mundell-Tobin effect. And he worked on the monetary approach to the balance of payments, a subject that Polak had pioneered. Mundell says he developed a theoretical framework that was the foundation of an alternative to the Keynesian framework for balance of payments equilibrium. He notes that it was further developed by his University of Chicago students, including the late Rudi Dornbush, Jacob Frenkel, and Mussa, all of whom later influenced the IMF.

Mundell considers his major breakthrough to be his 1960 journal article that introduced a model of an economy dominated by two markets: one for goods and services and one for foreign exchange. Before that, he says, there weren't any models of what today we call international macroeconomics. Many spin-offs followed, including the Mundell-Fleming framework (also named after his IMF colleague, Marcus Fleming, a British citizen, who had been working along similar lines independently). The model shows that under a floating rate and perfect capital mobility, monetary policy becomes powerful, and fiscal policy powerless, in affecting output, whereas the opposite is true when the exchange rate is fixed. It also shows that if a country has a fixed exchange rate, it cannot in the long run have an independent monetary policy, and that if it has an independent monetary policy, it cannot have fixed exchange rates. This result holds whether or not there is capital mobility. Indeed, he considers that the "impossible trinity," which implies that a country can have a fixed exchange rate and an independent monetary policy if it also has capital controls, is erroneous. And making matters worse, in his view, the trinity's "irrelevant focus on capital movements has been the spurious raison d'etre of the shift in the 1970s to flexible exchange
In Mundell's Nobel citation, the academy praised him for establishing "the foundation for the theory which dominates practical policy considerations of monetary and fiscal policy in open economies." It said that his work on monetary dynamics and optimum currency areas had inspired generations of researchers. His analysis of the appropriate policy mix anticipated the idea that the central bank should be given decentralized responsibility for price stability—the case now in most countries. On exchange rates, he posed a new and fundamental question: in what circumstances is it advantageous for a number of countries to relinquish an independent monetary policy or even their monetary sovereignty to join a monetary union or a fixed exchange rate international monetary system?

Europe's currency area

Mundell's insights into currency area formation were later used to create a common currency in Europe. Did Europe fit the definition of an optimum currency area? For him, the answer turned on factor mobility, modified by the need to utilize as fully as possible the convenience of money as a unit of account and a medium of exchange. Although Europe didn't meet all of his stated criteria (such as high labor mobility), he has been a stalwart supporter (see box). And he insists that the monetary union has been a great success. "Some say that Europe has performed badly compared with the U.S. over the past 10 years, but they forget that Europe has zero population growth and that European per capita income growth isn't much below the U.S. figure."

He also stresses that the euro was never expected to be a panacea. Like many others, he believes that much of Europe has overindulged in its social model, relying on high, steeply progressive tax rates and protective labor laws. Does he think part of the euro area's problem hinges on its lack of labor mobility? "Labor mobility is an important escape valve," he says, "but it isn't the end-all of the theory of optimum currency areas. Even if every European were completely immobile, rooted in one place, it wouldn't mean that Europe should have 300 million currencies, one currency for each person!"

But he does acknowledge that the European Union (EU) has suffered a setback as a result of the recent French and Dutch votes against the proposed new constitution, although he sees this as a signal to develop a better political model—not a disaster. "Maybe it isn't possible to create a European government that is modeled after an existing government. Academic political scientists, including well-wishers for Europe all over the world, may have to invent something new, a new political structure for Europe." As the EU absorbs its 10 new members, with lower-than-average per capita incomes, he says, there will be growing pains and a need for an interim system of government for a colossus of 25 nations. "But it will be achieved because, for Europe, it isn't just the best game in
town, it's the only game."

**More monetary unions**

How about the rest of the world? Actually, if Mundell could have his way, the entire world would be one big optimum currency area, sharing a global currency. But he admits that political rivalries make it difficult for this to happen because a necessary condition for the creation of a monetary union—global or otherwise—is the creation of a security area. He believes that, in a world where war is a possibility, an international monetary system based on a fiat world currency wouldn't work unless it were backed by one or more of the precious metals. Gold could still be used as a reserve asset in a reformed international monetary system in the 21st century, but it would be a far cry from the international gold standard that prevailed before World War I.

So where does that leave us? Mundell would be thrilled if the governors of the IMF would give more thought to finding an arrangement to get back to the goals of Bretton Woods. "There was nothing fundamentally wrong with the kind of monetary system we had in the postwar world." It was a system in which other countries fixed their currencies to the dollar, while the U.S. fixed the price of gold. Gold was convertible but only for foreign monetary authorities. Mundell regards it as having been an ingenious accommodation to the reality of the United States as an economic superpower. In that regard, he quotes Joan Robinson as having once called the IMF an "episode in the history of the dollar." Mundell argues that the system broke down in the early 1970s because the U.S. rejected the idea of increasing the price of gold—and thus made gold's relationship with the dollar untenable—not because fixed exchange rates were wrong. In fact, had the U.S. revalued gold, the system could have sailed along for another two or three decades. Mundell believes the best way for a smaller country to achieve monetary stability is to fix its currency to a large and stable currency area. He also feels that the IMF is playing a "divisive role" by encouraging countries to move to flexible exchange rates, "balkanizing the monetary world into a ridiculously large number of tiny currency areas."

Mundell argues that the best system for both small and large countries would be a stable international monetary system based on fixed exchange rates. A second-best, interim, arrangement would be for the smaller countries to fix credibly to the dollar or the euro, in this way participating in the stability of the larger currency area. However, the solution would be even better if a basket of the dollar, the euro, and the yen—what he calls the DEY—were to become the nucleus of a new global currency issued by a revamped IMF.

He also supports a strong multilateral surveillance role for the IMF—particularly, closely monitoring global economic developments to spot potential crises and to try to fend them off. But he doesn't want surveillance to become a code for giving the IMF
power to determine exchange rates in a world without an international monetary system. And he disagrees strongly with what he regards as global pressure to force China to appreciate its currency—insisting that a large yuan appreciation wouldn't help resolve global current account imbalances, but would devastate China, causing drastic deflation, impoverishing the rural sector, and cutting its growth rate by as much as half. Mundell hopes China will keep its exchange rate fixed to the dollar while continuing to move toward currency convertibility. And he hopes it will turn its attention to huge challenges in health, education, the environment, and agriculture. As for reducing the income divergence between rural and urban China, he says, the best plan would be "to give the farm people the same rights to own property that city people have."

The Palazzo Mundell

What is Mundell up to these days? Given his fascination with China—its people and the pivotal role that the giant economy has begun to play in the global economy—he has recently become a "citizen" of the Municipality of Beijing, a legal nicety (no visa needed to enter and exit China) that facilitates his considerable involvement in the country's economics, education, and even business. He's an honorary professor at 30 universities in China and an honorary dean, president, or chairman of several research institutes. He has set up some scholarships for students, founded the "Best Young Economist" award, and turned over the royalties from his six-volume *Collected Works* in Chinese to fund a literature award. A new university has just been named after him (the Mundell International University of Entrepreneurship) in Beijing's Zhongguancun area, known as the "Silicon Valley of China."

A defense of the euro

Despite recent troubles in the euro area on a number of economic policy fronts and questions about whether the creation of the currency has been worthwhile, Mundell fiercely defends its track record. "In all the aspects in which it was expected economically to make an improvement, it has performed spectacularly."

He argues that every citizen in the euro area has a better currency than before, one that vies with the dollar in its prestige and stability. Every firm now has access to a capital market that is continental in scope. With the elimination of exchange rate uncertainty between members of the euro area, there aren't any more speculative capital movements within the euro area, and interest rates have become equalized. (Note that instead of double-digit interest rates for many of the countries, they are now at or below 5 percent.) Every country in the euro area has a better monetary and fiscal policy mix than before. The possibility of a surprise inflation-cum-devaluation has been ruled out, and hedge funds can't make a dime between euro
countries. And information and transaction costs have plummeted, Mundell says, clearing a path for a vast increase in the most beneficial type of intra-area trade and payments.

He also stays strongly rooted in academia, much beloved by generations of students who have deeply valued how much he has been willing to give of himself to help them grow. He was a professor at the University of Chicago (where he was also Editor of the Journal of Political Economy) from 1966 to 1971—a time famous for its economic talents, including several other future Nobel Prize winners. "As a teacher, he was both stimulating and irritating," says Mussa, explaining that Mundell liked to tease his students with "intelligent questions that weren't entirely well structured and therefore didn't have clear answers." Since 1974, he has been a professor at Columbia University.

David Bloom, Harvard professor of economics and demography and a former Columbia colleague, recalls that the most interesting conversation he ever had with Mundell was about the effect of cross-country demographic imbalances (in age) on international capital flows—a topic that Mundell isn't normally associated with but finds enormously important for macroeconomic performance. In fact, Mundell developed a four-generation model that shows that if one country has a demographic shock, it creates a wave of interest rate changes that bring on, in an open economy, compensating capital movements. The model also highlights the role that the U.S. baby boom has played in U.S. balance of payments and budget deficits, as there was high demand for resources (some of which were internally generated and some of which flowed in from abroad) associated with investing in children.

Plus, he continues to do research. Mundell says finding a way to stop inflation without bringing on a crisis tops his list. As he explains it: "Disinflation under inflation targeting works by monetary restriction, higher interest rates, returning confidence, capital inflows, current account deficits, and an appreciating currency. The appreciating currency then fosters more disinflation and helps the country to meet its new inflation targets. But after the new low-inflation equilibrium has been reached, the currency is overvalued and recognition of this brings on a speculative crisis."

When Mundell isn't in Manhattan or Beijing—or traveling around the world lecturing and advising policymakers or international institutions—he and his family (wife Valerie, 8-year-old son Nicholas, and three children from a previous marriage) find refuge in the 12th-century castle in Siena, Italy, that he bought in 1969 for only $20,000 as a hedge against inflation. It is here, at the "Palazzo Mundell," that he organizes yearly academic conferences—begun in the early 1970s—on the burning economic issues of the day. And it is here that he can relax and enjoy the finer things in life, like art and
music (especially opera).

When Mundell received $975,000 for the Nobel, he announced that most of it would go to restoring his Italian villa, which initially lacked running water and electricity. He estimates that the restoration is 75 percent finished. "That's enough. We have to leave something for the next generation to do," he says, and he hopes that, besides finishing the restoration project, his children will make their mark in life "their way." But just to make sure little Nicholas gets a head start, he's being tutored in Chinese.

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