



NORTH-HOLLAND

EDITORIAL

Robert Mundell—Three Brilliant Ideas, One Nobel

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The Nobel Prize in Economics Science, awarded to Robert Mundell in 1999, is most deserved and long overdue. Although most economists make no major original contribution during their lifetime, Bob Mundell has made at least three—each of which deserving a Nobel. These are the theory of optimal currency areas, the Mundell-Fleming model, and supply-side economics. This allowed different economic newspapers and magazines to stress the contribution closest to their political, economic, or regional interest as the principal reason for the Nobel. Thus, the conservative *Wall Street Journal* stressed Mundell's contribution to supply-side economics, the liberal *New York Times* concentrated on the Mundell-Fleming model, while European-based *The Economist* considered Mundell's contribution to the theory of optimal currency area as his most significant contribution, calling him “the father of the euro.” In fact, each of these brilliant contributions is deserving of a Nobel.

Mundell's theory of optimal currency areas spells out the conditions required for the benefits to exceed the costs for a nation belonging to an optimal currency area. The most important among these is an “adequate” labor mobility. Without sufficient labor mobility, a member nation affected by an asymmetric shock will find itself powerless to deal with the shock, because the nation can use neither monetary policy nor exchange rate policy (limited as they might be

in their effectiveness in today's world of highly integrated international capital markets), and fiscal policy is likely to be highly constrained by the fiscal discipline that would inevitably be imposed on members (the Maastricht Treaty in the case of the European Union). In the absence of adequate labor mobility, the nation affected by an asymmetric shock can then only wait for the imbalance (say a recession) to be corrected gradually on its own. Serious political problems can also arise if the nation experiences a growth rate much lower than that of the other members of the optimal currency area over the course of many years.

With adequate labor mobility, on the other hand, a nation that is a member of an optimal currency area and faces a recession will experience an outflow of labor and other factors that would eliminate its high unemployment, quickly reestablish economic equilibrium, and return to a rate of growth similar to that of the other participating countries. This is, in fact, exactly what happens when a region of the United States falls into a recession in relation to other regions, thus allowing the common currency (the dollar) to work well. In Europe, on the other hand, labor mobility is notoriously low, and so the problem of how to deal with asymmetric shocks and widely different growth rates remain. This is one reason that Italy and Germany have been growing at a much slower rate than Ireland and The Netherlands. It is easy to see why, if this situation were to persist for many years, it could create serious political problems for the lag-gard nations.

In fact, a problem is likely to arise for a country that is a member of an optimal currency area even without the country being affected by an asymmetric shock, if the country (such as Italy in the European Union today) is much less prepared and capable of rapidly restructuring its economy and keeping pace with the other member nations in taking advantage of the benefits from the expansion of the scale of operation that economic integration brings. This shows how

simple-minded those economists have been who believed that the euro would stimulate growth and quickly resolve Europe's unemployment problem.

More sober economists understood that the introduction of the euro would stimulate economic restructuring in the European Union, which *eventually* would lead to much higher growth. But they failed to comprehend that this would take time, and in the meantime, some countries (such as Italy) would face even more serious short-run problems in the form of high unemployment, and much slower growth than the other countries participating in the optimal currency area. It is not difficult to anticipate that if growth remains significantly lower and unemployment significantly higher in the next few years than in other member countries, Italy might face serious political problems. All of this type of fundamental analysis follows directly from Mundell's brilliant contribution, which remains as valid today as 40 years ago when he made it.

The second brilliant contribution made by Mundell was the open-economy macromodel that carries his and Fleming's names. This was justly called and remains the "work-horse" of international finance nearly 40 years after its introduction. Despite some recent attempts to push this model aside (as evidenced by some authors of international textbooks dropping it from their books), the Mundell-Fleming model remains without doubt the best tool for examining the working of the international economy and evaluating the effectiveness of monetary and fiscal policies under fixed and flexible exchange rate systems. The model elegantly shows why, in a world of high capital mobility, monetary policy is very effective while fiscal policy is completely ineffective under a flexible exchange rate system (like the one we have today), while the opposite is the case under a fixed exchange rate system (which Mundell prefers).

Here, Mundell's contribution is the model and not necessarily his personal preferences. To his credit, Mundell has

remained consistent in his preference for a fixed as opposed to a flexible exchange rate system. On the other hand, many economists who preferred a flexible exchange rate system during the Bretton Woods period (1945–1971) subsequently switched back to preferring a fixed exchange rate system. It seems that the grass is always greener in the neighbor's yard. When we had fixed rates, these economists concentrated on the theoretical benefits of a flexible exchange rate system, while complaining about the all-too-obvious real disadvantages of the fixed exchange rate system operating at the time. After the collapse of the Bretton Woods system, aware of the unexpected large exchange rate volatility and misalignments that have accompanied flexible rates, they are now calling for the reestablishment of some form of fixed exchange rates, remembering the advantages but forgetting the disadvantages of such a system.

We must remember that the present flexible system was not established by an agreement of international monetary authorities but was forced on the world by the collapse of a the fixed exchange rate system for lack of an adequate adjustment mechanism. All the heroic attempts to reestablish a fixed exchange rate system from 1971 to 1973 failed, and the world was pushed onto the present flexible exchange rate system by default. No fixed exchange rate system could probably have survived the two petroleum crises, the double-digit inflation that resulted from them, and the subsequent deep recession created to stop the inflationary spiral during the 1970s and early 1980s. Be that as it may, it would hardly be possible to conduct this type of analysis without Mundell's brilliant contribution.

The third of Mundell's contributions is his role in the development of in supply-side economics. Although highly controversial, no one can deny the importance and relevance of this idea over the past 2 decades the world over. Supply-side economics was the inspiration behind the deregulation movement, which started in the United States in the 1980s

and was subsequently adopted by Thatcher's Britain and embraced by most other countries of the world. To some extent, the return of the United States to being the most competitive economy in the world and its rapid and continued growth since the early 1990s is the direct result of the deregulation movement, which was inspired by supply-side economics. Indeed, there are few aspects of the international economy today that cannot be profitably analyzed by one of Mundell's contributions.

The high honor conferred by the Swedish Academy of Sciences to Mundell in 1999 is amply deserved and too long delayed. Mundell is certainly the most original economist of the 20th century. Forty years ago, he talked about things that were not even at the horizon of the economics profession. As one of his now-famous former students remarked, "He might as well been from Mars then." And it did not take the Nobel Prize for most of us to recognize and appreciate Mundell's brilliant contributions—and on a more personal level, to treasure his friendship and wisdom.