Remembering Robert Mundell: a pathbreaking giant

The Nobel Prize-winning economist, Robert Mundell (1932-2021), passed away on Easter Day, April 4, 2021. Professor Pedro Videla eulogizes the man known as the "father of the euro" as well as one of the founders of the field of open economy macroeconomics.

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By Pedro Videla

To thank Robert Mundell (1932-2021), who passed away on Easter Day, for almost everything useful we know about macroeconomics is hardly an exaggerated gesture. The research he carried out early in his career provided the foundation for open economy macroeconomics. Before Mundell, the standard analysis in macroeconomics assumed a closed economy.

In 1999, Mundell was awarded the Nobel Memorial Prize in Economic Sciences for his "uncommon -- almost prophetic -- accuracy in predicting the future development of international monetary arrangements and capital markets." The Swedish Academy cited a half dozen of his seminal papers published from 1957 to 1963 when Mundell was just 25 to 31 years old, a prodigy far ahead of his time.

Born in Canada, much of Mundell's paradigm-shifting work took place at the International Monetary Fund (he joined the staff in 1961) and the Economics Department of the University of Chicago, where he was a professor from 1966 to 1971. One of his groundbreaking papers, "Capital Mobility and Stabilization Policy Under Fixed and Flexible Exchange Rates" (1963), showed that under a floating exchange rate and perfect capital mobility, monetary policy becomes effective, and fiscal policy ineffective, in affecting real output in the short-run, whereas the opposite is true when the exchange rate is fixed. He built what was arguably the most influential open-economy models of the 20th century: the Mundell-Fleming model [British economist Marcus Fleming (1911-1976) worked independently along similar lines]. His model supported the idea that economies could not simultaneously have fixed exchange rates, monetary autonomy and free capital flows -- known as "the impossible trilemma."

Mundell's model indicated that fiscal policy played an important role under a fixed exchange rate. He initially considered that increases in government spending and cuts in taxes had pretty much the same effect on the economy. But later his work began to emphasize the supply-side incentives provided by tax cuts, which gained most attention during the Reagan administration in the 1980s.

In 1981 and 1986, the Reagan administration cut the top marginal tax rate from 70% to just 28%, in two steps, while eliminating many tax exemptions. At the same time, Fed Chairman Paul Volcker tightened monetary policy to fight inflation. The United States experienced what was then its longest economic expansion in the post-war era.

Keynesian economists -- like Paul Krugman -- minimized this contribution as a political sideline unrelated to Mundell's theoretical work. But Mundell himself argued that this was not the case. He believed that monetary policy should target price stability and fiscal policy should target full employment. He proposed cuts in the marginal tax rates to reduce tax evasion, foster work and encourage risk-taking. These ideas were radical at the time and gave rise to supply-side economics as a political movement. In a 2006 interview with the

American Economic Association, Mundell said: "Supply-side economics made the argument that steeply progressive tax rates reduced the size of the pie to be distributed... The poor might be better off with a smaller share of a larger pie than with a larger share of a small pie."

His research also held particular relevance for developing countries after the demise of the Bretton Woods system of fixed exchange rates in 1973. In "Currency Areas, Exchange Rate Systems and International Monetary Reform" (2000), Mundell noted: "It is essential to make a distinction between 'pegged' and 'fixed' rates... Pegged exchange rates sooner or later always collapse."

Mundell's is also considered the "father of the euro." In a pioneering article published in the *American Economic Review* back in 1961 ("Optimum Currency Areas"), he provided the theoretical basis for a common currency. Mundell concluded that an optimum currency area requires high labor mobility and wage flexibility to maintain economic activity in the face of asymmetric external shocks.

He argued that the main benefit of a flexible exchange rate is its allowance for independent monetary policy. This benefit is significant when regions are hit by different economic shocks and when wages are not able to be adjusted or labor cannot move readily across regions. On the other hand, the principal gain from a common currency is that it facilitates transactions and makes price calculations easier. Mundell concluded that the trade-off between these two forces determines optimal currency zones.

Mundell recognized that Europe didn't meet the criteria of optimal currency zone (for reasons such as labor market flexibility and mobility). He also agreed that the euro project was in trouble without an underlying political union. But he believed that the euro would lead to closer fiscal collaboration. He argued that the European Central Bank should maintain monetary discipline and thus limit the ability of national politicians to borrow and overspend.

Despite being called the father of the euro, Mundell never forgot that the new currency was immersed in a continually changing international environment. In a 2008 interview, he said: "The euro is now one of the two top currencies in the world and that will continue to be the case for the next few decades." However, he continued, "Within 30 years, I would expect there to be a global currency that is used for international transactions." Perhaps the global currency that Mundell predicted will arise from competition between cryptocurrencies, favoring the most stable.

The Economist magazine and other financial publications portrayed Mundell as an eccentric. An example cited was his unexpected performance at the Nobel Prize banquet, singing Sinatra's "My Way." He spent much of his Nobel Prize money restoring a palazzo near Monteriggioni, which he'd bought for $20,000 back in 1969, already convinced that the demise of the Bretton Woods system (and a spike in inflation) was imminent. At that palazzo, Mundell organized conferences with sumptuous dinners and fine Tuscan wines. Krugman was among those to poke fun at the events taking place in a "crumbling half-habitable villa."

Mundell may have been perceived as an oddball even by the standards of his profession. But this is irrelevant. What matters is that at this very moment, somewhere in the world, there are students of economics musing: "Let's see, perfect capital mobility, fixed exchange rate, so monetary policy is, um... ineffective." Their minds are being furnished by a model that a pathbreaking thinker constructed 60 years ago. That thinker, a young Bob Mundell, was instrumental in improving the way we think about macroeconomic problems today.

Thanks, Bob: your legacy is truly enormous.