This year’s Nobel prize in economics has been awarded to Robert Mundell. His most celebrated work on capital flows, exchange rates and optimal currency areas is more than 30 years old, but it has never seemed more relevant than it does now.

Man of the hour

THE Nobel powers-that-be apparently make it a rule (nobody knows why) to award the economics prize only for work that is at least three decades old. This year, it seems, they have tried to apply the principle once more, honouring Robert Mundell, a professor at Columbia University in New York. Mr Mundell did his most important work, which was in international monetary economics, in the 1960s. Since then he has drifted away from what most economists would regard as the mainstream. However, somebody seems to have slipped up: the new laureate’s work, despite its age, could hardly be more topical—or more controversial—than it is now.

It is hardly an exaggeration to say that in the 1960s Mr Mundell invented open-economy macroeconomics in its modern form. The Mundell-Fleming model (a British economist, Marcus Fleming, who died in 1976, worked independently on similar lines) integrated international capital flows with the other forces driving demand and output. Back then, and for some years after, the intuitions of most American economists were guided by domestic-economy models. Perhaps that was not so unreasonable, given the size of the American economy and the fact that it was (by European standards) not much influenced by external factors. Being Canadian presumably helped Mr Mundell to break out of that mind-set.

In any event, economists’ intuitions are nowadays shaped by the standard open-economy, mobile-capital paradigm—the one that Mr Mundell established. Today, when an economist muses, “Let’s see, perfect capital mobility, fixed exchange rate, so monetary policy is, er, ineffective,” it is Mundell-Fleming that is being consulted.

At about the same time, Mr Mundell wrote another paper whose citation rate has gone through the ceiling in the past few years. It was on “optimal currency areas”—that is, on the criteria that should decide whether exchange rates among any group of countries should be fixed. Mr Mundell argued that, ideally, areas within which factors of production (notably labour) were mobile should have one currency; areas with factors that were not should have different currencies. Or at least, that is what people thought he argued. These days he tends to say he has been misunderstood about this.

Economists who have looked at Europe, asking, in the manner of Mr Mundell, whether it is an optimal currency area, usually answer No. Factors are not sufficiently mobile between countries: this makes the exchange rate a useful price-adjuster, under certain circumstances. Oddly, however, Mr Mundell very
strongly believes that Europe is, in practice if not in theory, an optimal currency area. He is an enthusiast for Europe’s single currency. Even more oddly, Mr Mundell believes that the planet as a whole is an optimal currency area. He has long argued for a return to the gold standard, as the next best thing to (and presumably a stepping-stone towards) a single currency for the world.

How can these positions be reconciled? Mr Mundell says that his point all along was really as follows. A movable exchange rate is only any use if shocks are felt across entire currency areas. In fact they tend to hit regions that lie within such areas (as when cheap oil hurts Texas and helps Massachusetts) or else straddle the borders between currency areas. If you accept the logic of the optimal currency area approach, the world requires a proliferation of currencies, so that every area subject to shocks has its own. But this is wrongheaded. Bearing in mind the instability that movable currencies can create, the idea of having “enough currencies” is ridiculous (which is why Texas, however far the price of oil drops, will never demand its own currency; likewise Yorkshire, even though the decline of the coal industry may have called for a devaluation). In the real world, as opposed to in theory, movable currencies are more trouble than they are worth. Better to be rid of them altogether.

For some time, it must be said, orthodox economists have found Mr Mundell’s arguments hard to follow. Or perhaps the trouble is that they are not trying. It annoyed them very much that Mr Mundell showed Arthur Laffer how to draw that famous curve about tax rates and tax revenues—which, with the wrong name attached to it, went on to animate writers for the editorial page of the Wall Street Journal and other supply-side zealots who, in their turn, persuaded Ronald Reagan to push through deep tax cuts in the 1980s. That was not “proper economics”, you see.

Mr Mundell continues to delight in confounding orthodox types. For a while he grew his white hair down to his shoulders—an effect that disconcerted even some admirers. And they are scornful (and perhaps jealous) that he spends much of his time in a vast palazzo near Siena that he bought 30 years ago for a modest outlay. Paul Krugman, scourge of gold-bugs and other economic oddballs, once mocked it as a “crumbling half-habitable villa” where the great eccentric organises conferences “outside the regular round of academic meetings”.

Well, that may be, but EMU is a fact: Mr Mundell was sure it would happen, which was very eccentric of him, and he was right. And now the great man, eccentric or not, has his Nobel—and a million dollars pays for a lot of new plaster.

For a list of Mr Mundell’s writings, and a bigger photograph of his little boy, see his website.