It's about time. Those of us who work on international monetary theory have been wondering for a decade when Robert Mundell would get his richly deserved Nobel Memorial Prize in Economic Sciences. Mundell's work is so central to that field, so "seminal"--an overused term that really applies here--that on many disputed issues his ideas are the basis for both sides of the debate. But a layperson might be confused about exactly what Mundell and his prize are really about.

The Wall Street Journal editorial page, rather pathetically, has declared this a "supply-side" Nobel. No surprise there: Editor Robert Bartley's attempts to claim intellectual vindication have become increasingly desperate in recent years. With eight years and counting of Clintonian expansion making Reagan's "seven fat years" look positively shabby, and with supply-side heroes such as Jude Wanniski looking loonier by the day, the Wall Street Journal will take anything it can get. (Since when does Bartley care about what some Swedes think, anyway?) For what it is worth, the citation by the Nobel committee doesn't mention anything Mundell has written since he was adopted as mascot by Bartley et al. some 25 years ago. It is the young Mundell, whose theories still dominate the textbooks, who earned the prize.
So if it isn't a supply-side Nobel, what is it? Well, how about regarding it as a Canadian Nobel?

I'm not sure why Canadian policy issues are universally regarded as being dull--why the winning entry in the old competition for most boring headline, "Worthwhile Canadian Initiative," still seems so funny (yes, I think it's funny, too). Maybe it has something to do with the way they talk, eh? But when it comes to international monetary matters, Canada has often been a very interesting case--the country that defies the trends, that demonstrates by example the hollowness of the conventional wisdom of the moment. Right now, for example, Canada's ability to thrive with an independent dollar is the best single argument I know against British europhiles who insist that their nation must join the European Monetary Union or die. And when the young Canadian economist Robert Mundell did his most influential work, in the early 1960s, it was arguably the Canadian difference that inspired him to think outside the box.

Here's what the world looked like in 1960: Almost all countries had fixed exchange rates with their currencies pegged to the U.S. dollar. International movements of capital were sharply limited, partly by government regulations, partly by the memory of defaults and expropriations in the '30s. And most economists who thought about the international monetary system took it for granted, explicitly or implicitly, that this was the way things would continue to work for the foreseeable future.
But Canada was different. Controlling the movement of capital across that long border with the United States had never been practical; and U.S. investors felt less nervous about putting their money in Canada than anywhere else. Given those uncontrolled movements of capital, Canada could not fix its exchange rate without giving up all control over its own monetary policy. Unwilling to become a monetary ward of the Federal Reserve, from 1949 to 1962 Canada made the almost unique decision to let its currency float against the U.S. dollar. These days, high capital mobility and a fluctuating exchange rate are the norm, but in those days they seemed outrageous--or would have seemed outrageous, if anyone but the Canadians had been involved.

And so perhaps it was the Canadian case that led Mundell to ask, in one of his three most famous contributions, how monetary and fiscal policy would work in an economy in which capital flowed freely in and out in response to any difference between interest rates at home and abroad. His answer was that it depended on what that country did with the exchange rate. If the country insisted on keeping the value of its currency in terms of other nations' monies constant, monetary policy would become entirely impotent. Only by letting the exchange rate float would monetary policy regain its effectiveness.
Later Mundell would broaden this initial insight by proposing the concept of the "impossible trinity"; free capital movement, a fixed exchange rate, and an effective monetary policy. The point is that you can't have it all: A country must pick two out of three. It can fix its exchange rate without emasculating its central bank, but only by maintaining controls on capital flows (like China today); it can leave capital movement free but retain monetary autonomy, but only by letting the exchange rate fluctuate (like Britain—or Canada); or it can choose to leave capital free and stabilize the currency, but only by abandoning any ability to adjust interest rates to fight inflation or recession (like Argentina today, or for that matter most of Europe).

And what choice should a country such as Canada—where capital controls were not a serious option—make? Should it explicitly or implicitly give up on having its own currency and go on a U.S. dollar standard, or were the risks of a fluctuating dollar-dollar rate a price worth paying for the ability to actively stabilize the domestic economy? The debate over how to define an "optimum currency area" is an endless one, but Mundell set its terms, suggesting in particular that a key feature of such an area would typically be high internal mobility of workers, that is, the willingness and ability of workers to move from slumping to booming regions. (This is a criterion, incidentally, that Europe—whose single-currency regime Mundell now enthusiastically supports—manifestly does not satisfy.)
It's hard to appreciate today just how novel both Mundell's statement of the issues and the way he tried to resolve them were at the time. But if you look at the international monetary literature when Mundell was in his glory days, you get the impression that he was 15 or 20 years ahead of his contemporaries. They were still thinking in terms of a controlled world, a world where money moved where and when the authorities told it to move. He was thinking in terms of a world where money moved freely and massively to wherever it could earn the highest return. At the time, only Canada, thanks to its giant neighbor, lived in anything like the world he envisaged; today we all do. And if you look at any major textbook in international economics--such as the perennial best seller by Krugman and Maurice Obstfeld--you still find that the monetary half of the book is very largely based on the papers Mundell wrote in the early 1960s.

So who is this economist that the Wall Street Journal thinks is on its side? Well, economists do change their styles and their views as they get older; Mundell changed more than most. Those seminal early papers were crisp and minimalist; they looked forward with remarkable prescience to the wild and woolly, out-of-control world of modern international macroeconomics. By contrast, Mundell's writings since the early '70s have been discursive, one might almost say rambling, and often reveal a sort of hankering for the lost certainties of the gold standard. (And yes, he has said a few things that can, with some effort, be construed as support for supply-side economics.) The precocious theorist anticipated the 1990s; the elder statesman has hearkened back to the 1890s.

So you can take your pick as to which Mundell you prefer; but the Nobel committee basically honored Mundell the younger, the economist who was iconoclastic enough to imagine that Canada, of all places, was the economy of the future--and was right.

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Mundell's major papers and Mundell-related links can be found on the Columbia University economics department home page. If you missed the international economics course in college, click here to get up to speed with Krugman and Obstfeld's textbook. The Nobel Foundation provides information on its prizes and recent winners. To learn 129 facts about Canada and its international leadership, visit the government's Privy Council page. And stop by the Canada Club Web site to post or read responses to the question "What's so great about Canada?" For a more skeptical view, see the South Park movie, which explored the darker side of Canada's cutting edge culture.

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This reader thinks Krugman is deluding himself about the health of the modern Canadian economy:

Is Paul Krugman kidding? He appears to hold up the Canadian economy as a role model. I live in Buffalo right across from the Canadian border--and even though our economy is so sick that the entire metro area is losing population, Canadians come HERE for jobs instead of vice versa. Canada's unemployment rate is comparable to that of European social democracies (i.e. bad, floating around 10% in recent years). Socially, Canada may be a role model--but certainly not economically.

(Michael Brus, 10/19)

Paul Krugman is a professor of economics at MIT and the author, most recently, of The Return of Depression Economics (click here to buy the book). His home page contains links to many of his other articles and essays.

Illustrations by Robert Neubecker.
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