April 5, 2021

103 Murphy Court
Nashville, TN 37203
Ph. (615) 460-0100
Fx. (615) 460-0097

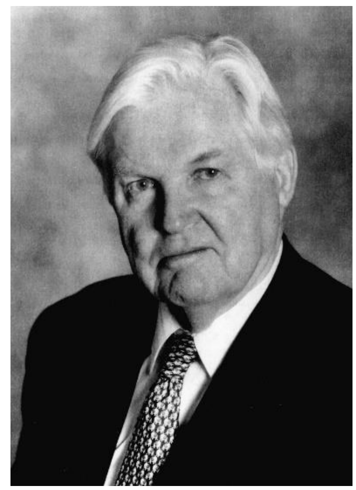
ROBERT MUNDELL: THE ZEUS OF ECONOMICS HAS DIED

By Brian Domitrovic, Ph.D.[1,2]

I spent all weekend thinking about Bob Mundell. I had just gotten the hard copy of my own book released several weeks ago, and I was reading it, beginning with the dedication: *To Bob Mundell*. Robert A. Mundell, the 1999 Nobel Prizewinner in economics and in an easy argument the greatest economist of the last several generations, died April 4 in his beloved Italy at the age of 88.

The book I wrote is *The Emergence of Arthur Laffer: The Foundations of Supply-Side Economics in Chicago and Washington, 1966-1976*. Subject 1A of the book is that mentioned in the title. 1B is Arthur Laffer's best friend in economics, Mundell, ever since the two became the fastest of chums on the economics faculties of the University of Chicago in the latter 1960s.

Mundell was an impossible amalgam of theoretical genius, algebraic and especially geometrical lucidity, cultural sensibility, and unmeasurable practical influence. His articles in the journals in the 1950s and 1960s were Zeus-like, on a wholly different plane from any in the field. They were reprints of the chapters of his 1956 MIT dissertation. Drip by drip they came out, and it was clear to everyone as George Stigler would put it later: "Mundell dominated international trade theory in the 1960s."



Robert A. Mundell, 1932-2021
SCANPIX SWEDEN/AFP VIA GETTY IMAGES

The Nobel citation noted two articles, one on his "Theory of Optimum Currency Areas" (as the article was called) from 1961 and the other on the monetary-fiscal policy mix from 1963. These were simplified brief restatements of the forbidding articles of 1960 on which they were based. When his boss at the International Monetary Fund (IMF) in 1961 asked him to write about such topics, Mundell said that he already had, and the ever-droll fellow began rewriting by quoting Bizet composing *Carmen*: "If it's trash they want, I'll give it to them."

The vista of Mundell's economics may be apprehended in his two 1960 articles, "The Pure Theory of International Trade" in the *American Economic Review* and "The Monetary Dynamics of International Adjustment Under Fixed and Flexible Exchange Rates" in the *Quarterly Journal of Economics*. In the former article, Mundell's analysis of "the transfer problem," as he called it, elaborated in extensiveness the economics of taxation. In the representative example he chose, when a country pays reparations to another, the funds gained by taxation, there is a cumulative series of effects over the global economy. The paying country produces at greater cost and less income; the receiving country gains in income but not productivity and there is less to buy, including after-tax investment paper from the foreigner; and crucially, capital flows adjust to a comparatively slower-growing world economy. The characteristic Mundell graph shows the spiraling in on a point after a series of processes like these.

Such arguments blew Keynesianism out of the water. Extrapolating from the transfer problem, if a government tries to manage its domestic economy by adjusting taxes or spending, the effects in the realm of international capital movements are immense. The classic case is of a budget deficit. While "aggregate demand" in the home country conceivably could increase with a budget deficit, its financing instruments are internationally marketed bonds. The only thing foreign purchasers of bonds care about is the real rate of return in a currency that holds value. Therefore any Keynesian tax cut had best be marginal, enhancing

[1] Brian Domitrovic is the Richard S. Strong Scholar at The Laffer Center.
[2] This article was originally published by Forbes on April 4th, 2021 https://www.forbes.com/sites/briandomitrovic/2021/04/04/the-zeus-of-economics-has-died/?sh=6a473d635baa

the rate of return, and spending implying future taxation dampens the global demand for securities in the home country's currency. Perpetual borrowing without currency devaluation is the prerogative only of a solitary global economic hegemon. Such could be taken from the monetary dynamics article, reprised brilliantly in a textbook chapter Mundell produced in 1968 on "Growth and the Balance of Payments." As he wrote in that piece, "no theory advanced in the postwar era has been more greatly in conflict with the facts," as he addressed the common view, in economics at the time and in no small measure today, that devaluation of national currencies can be productive of economic growth.

Mundell's Chicago graduate student Rudiger Dornbusch said that Mundell's economics illustrated the "tyranny of capital mobility." Typically one thinks of tyranny as applied by governments against people. Here was tyranny applied by people against governments. No matter how sovereign governments try to be in their economic policy, if their countries are integrated with the world at all, international capital movements will "vote" on domestic policy changes without regard to anything but the pure economics of the matter.

Somehow Keynesianism—and monetarism—limped into the 1970s, saying you can manage domestic demand and supply, and therefore growth and employment, by adjusting taxes and spending and the money stock in a country, even though Mundell's field-defining articles of the previous two decades had shown that capital movements will overwhelm all efforts at domestic authorities to fine-tune their way to a desired result. After-tax return in a currency that holds its value—that is the siren that attracts investment from the sole capital market, namely the world's.

In a remarkable second phase of his career, Mundell faced down Keynesianism and monetarism not only theoretically, but practically. His Chicago buddy Laffer hauled him into the discussions Laffer was having with the Gerald Ford administration and the editorial page leadership of the *Wall Street Journal*. The *Journal* people in particular were greatly intrigued by what they heard. Editor Robert L. Bartley dropped his concern over "crowding out"—a budget deficit coming from a marginal tax cut that worrywarts said pressured the private capital markets—because as Mundell told him, "the Saudis will finance that." Bartley's deputy Jude Wanniski even moved Mundell back toward a greater advocacy of the gold standard than he had displayed in the 1960s, when Mundell was toying with the advisability of world money on the order of the IMF's Special Drawing Rights.

The "Mundell-Laffer hypothesis," as Wanniski termed it in 1975, in several years' time went by the new moniker "supply-side economics." It advanced the "policy mix" (as derived from Mundell's 1963 Nobel-gaining article) of tax cuts that increase the investment rate of return, namely marginal tax cuts, coupled with monetary policy that guarantees the means of exchange. With Laffer, Mundell was suspicious of the ability of any national monetary authority to influence the actual supply of money or its value. The world of capital movements did these things. And money came into a country and stabilized the currency when that country made its investment environment attractive by ensuring good after-tax returns within its borders.

This was the intellectual adumbration of the Reagan Revolution in economic policy—and conveyed now not principally in the journals but directly to representatives of the power elite. The epochal minimally inflationary growth of the 1980s and 1990s, after the pathetic and infuriating stagflationary 1970s, came as directly out of Mundell's (and Laffer's) economics as we ever see in the academic-policy nexus. The amazing thing in Mundell's case—and for Laffer on this score do consult the book—is that Mundell unambiguously was the best at what he did in his field in his preparatory decades, the 1950s and 1960s, to his calling on the stage of affairs in the 1970s and 1980s.

Personally, Mundell came alive among friends who indulged his economics, who wanted to see where all the intriguing leads went. I myself was swept into it, beginning in 2002 when I first watched his remarkable Nobel Prize lecture, "A Reconsideration of the Twentieth Century." Like an epigone Bob loved to cultivate, I there and then reoriented my research agenda as a cub historian toward what he had to say. My 2009 history of supply-side economics *Econoclasts* is perhaps best understood as an illustration of that lecture.

I have come to move away from the Charles Kindleberger (Mundell's adviser)-induced contention of "A Reconsideration of the Twentieth Century" that there was a structural problem with the gold standard in the 1920s, the inattention to which brought the Great Depression. Reading in Wanniski and the public-purse sources from those days, and in conversation with Nathan Lewis and Steve Forbes, I have focused in on that "transfer-problem" argument of Mundell's. Marginal tax increases were a huge rage in the advanced world of the 1920s, as the Piketty/Saez team will be quick to tell you. That is what killed the world economy—and enhanced the demand for gold at the expense of real investment, the best exposition ever of the theoretical issue appearing in Mundell's 1971 book on *Monetary Theory*.

In *The Emergence of Arthur Laffer*—and again, Mundell is the big #2 subject of this book—I try to recapture some of the historiographical motivation I had before I encountered Mundell, before 2002 when my work was in the political economy of Hegelianism. I argue that these guys did not of course change history. Rather, they were prepared for the urgent role that history assigned to them—so very well prepared. By the 1960s, the American economy, and an ever-growing part of the globe, was a society of expanding mass affluence. No people under such conditions are going to take something like the extended stagflation nonsense of the long 1970s and be resigned, saying that times were good while they lasted. The collective consciousness of society will demand a reversion to the old great trend. It was the "aspirational structure of a complex society accustomed to affluence," as I put it in this book, that "shoved" Mundell (and Laffer) to the fore as the time of that affluence flagged. That Bob Mundell, very much with the assistance of his friends in the supply-side movement, transmitted his amazing journal economics to the realm of real affairs, as the world suffered with its confidence and prosperity in the 1970s only to win again in the decades after, is an accomplishment the likes of which few in history have ever had the privilege of reflecting on as their own.