MUNDELL AND FRIEDMAN: FOUR KEY DISAGREEMENTS

Richard G. Harris

Despite agreement on the broad theoretical framework common to modern macroeconomists, Professors Mundell and Friedman appear to disagree on four key issues: the efficiency and stability of foreign exchange markets, the flexibility of prices and wages, the significance of national economic size, and the importance of political constraints on monetary arrangements. Consideration of these questions for Canada suggests a credibly fixed exchange rate with the US dollar would be the best policy.

Bien qu'ils s'entendent sur le cadre théorique commun aux spécialistes de la macroéconomie moderne, les professeurs Robert Mundell et Milton Friedman semblent s'opposer sur quatre questions clés : le rendement et la stabilité des marchés des changes, la flexibilité des prix et des salaires, le sens à donner à la dimension des économies nationales et l'incidence des contraintes politiques sur les arrangements monétaires. Considérant ces questions du point du vue du Canada, la meilleure politique consisterait à adopter un taux de change fixe et crédible par rapport au dollar américain.

The debate that appears on pages 10 and 30 between Milton Friedman and Robert Mundell, two of the greatest monetary economists of the 20th century, is a pleasure to read, and should be mandatory reading for all students of international macroeconomics and finance. With the exception of a few simple propositions that follow from elementary monetary theory, most students and all policy makers find questions of international monetary reform to be extremely complex, if not completely confounding. In their discussion, Professors Friedman and Mundell cover the whole range of issues that form the core of the modern debate on fixed versus flexible exchange rates, monetary integration, and the architecture of the global financial system. Their carefully stated arguments should help focus debate in the economics profession on the core analytical and empirical issues.

To a non-economist, it may be surprising that two eminent economists who share the same analytical framework, and who both have an astounding range of knowledge on world monetary history should come to such divergent views on a number of important policy issues. It illustrates quite well, I believe, the general state of affairs in international monetary economics—despite the voluminous amount of research which has done on these issues in the last four decades. I will restrict my comments to four areas where there is at least some analytical disagreement between Mundell and Friedman and then comment briefly on the future of the Canadian dollar.

Despite agreement on the broad theoretical framework common to modern macroeconomists, Professors Mundell and Friedman appear to disagree on four key issues: the efficiency and stability of foreign exchange markets, the flexibility of prices and wages, the significance of national economic size, and the importance of political constraints on monetary arrangements.

- The Friedman view has always been that foreign exchange markets are generally stabilizing and that foreign exchange market speculation performs a useful social function. In principle, differences in inflation rates or unsustainable fiscal policies are assumed to result in appropriate adjustments in both the nominal and real exchange rate. (The real exchange rate measures the exchange rate net of differences in national inflation rates.) The Mundell view is

that speculation in foreign exchange markets often but not always leads to inefficient and destabilizing exchange rate movements that are unaccounted for by real economic factors. These two opposing views carry important implications for the Nobelists' respective positions on almost all the issues they discuss. Friedman supports flexible rates and believes they provide important insulation of one country against another's monetary policy. Mundell believes that credible fixed exchange rates are the only sensible alternative for small countries, and furthermore that larger currency areas serve to reduce the risk and volatility that smaller currency areas linked by flexible exchange rates would otherwise induce.

- On the relative efficacy of goods and factor markets the two professors' views are reversed. Friedman puts great importance on wage and price inflexibility. For these reasons he believes it is far better to adjust an exchange rate in the face of a given economic shock than to adjust individual prices. Mundell, on the other hand, has greater faith in the ability of prices and wages to adjust in the face of shocks, and more generally in the ability of goods and factor markets to adjust to external shocks. Mundell is also quite sceptical about the ability of an exchange rate adjustment to provide the changes in relative prices that on-going real changes in the economy require. It's interesting that the Friedman position is much closer to the original 1960's Mundell argument for optimal currency areas, at least as taught in the textbooks. The Friedman-Mundell discussion of the Irish "inflation" is extremely insightful and illustrates a number of the central questions in this debate, including how one needs to be more precise in defining inflation when discussing this set of issues.

- Most if not all of Friedman's positions take as their starting point a sovereign nation state with a given set of political institutions, including those which govern monetary policy. Country size and the size distribution of nations play virtually no role in his analysis and economic integration only a tangential one. Mundell, on the other hand, continually makes distinctions between large and small countries, emphasizes the role of asymmetries in countries' sizes, and views the monetary integration of regions as a fundamental policy choice. To simplify severely, the Friedman view is typically American and the Mundell view typically Canadian. Friedman comes to the conclusion that both small and large countries can prosper under flexible exchange rates, and sees the proliferation of currencies and central banks as a natural and useful consequence of the growth in the number of nation states. Mundell, by contrast, views the proliferation of "junk" currencies as detrimental to world growth and certainly detrimental to small countries on flexible exchange rate regimes. Professor Mundell poses the question of size provocatively by asking "Should California have its own exchange rate?" Professor Friedman's view is that this question is uninteresting since the choice of a monetary area is essentially a political question, and his views on the Euro substantially confirm this. Mundell, on the other hand, views the question of the size of the currency area as absolutely essential, and generally believes that larger currency areas promote greater volumes of trade and economic growth. Despite Mundell's original theoretical contributions on this question, it is an important question that still lacks an accepted theoretical treatment.

- While there is much that Robert Mundell and Milton Friedman do agree about, ultimately there is clearly a difference of views on the relationship between monetary affairs and the nation state. Friedman sees monetary union as equivalent to political union. Instability in one leads to instability in the other. Mundell views a country's monetary regime and monetary policy as largely endogenous, with a range of outcomes being possible, from a permanently fixed exchange rate regime, such as official dollarization, to complete monetary independence. He does not view political integration as a necessary condition for monetary integration. Both Friedman and Mundell offer impressive examples to support their respective positions and their differing points of view on Bretton Woods and the Euro reflect these differences. My own reading of history is that Mundell is correct on this. It is clear the success or otherwise of the Euro is a major test case for these positions. If Friedman is correct, the Euro should be shortlived. The success or demise of the majority of the world's junk currencies provide equally important test cases. If many of these nations retain political independence while discarding their currencies, the Mundell view will have been proven correct.

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Let me close with some brief comments on the Canadian currency issue. Should Canada have a credibly fixed exchange rate with the United States, or even a NAMU (a North American Monetary Union)? Friedman and Mundell differ on the relative performance of

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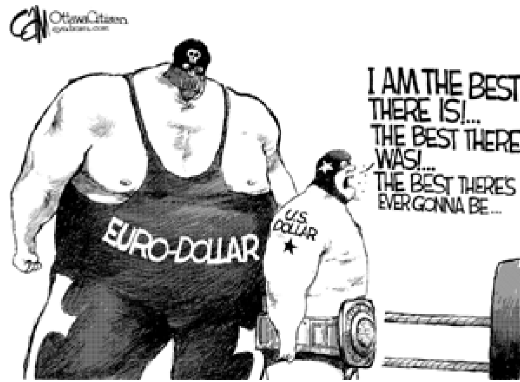

Cartoon: Cam Cardow

Sometimes size matters

Canada and the United States' monetary authorities over the last several decades, which is interesting. My own view, however, is that whether the Fed has done better than the Bank of Canada is somewhat tangential to Canada's interest in a credible fix with the US Even if US monetary authorities do make mistakes, which they almost certainly will, there is little that Canada can do about that no matter what exchange regime we choose. More importantly, even far-sighted Canadian monetary authorities cannot offset the transmission of a US recession or monetary boom to Canada. With increasing goods and factor market integration across the Canada-US border, the volatility in the real exchange rate due to differences in monetary policies results in high adjustment costs to Canada with few offsetting benefits. There has yet to be a convincing demonstration that an independent monetary policy has resulted in any major macroeconomic benefits for Canada, and there have been several instances where it has probably caused important harm.

It is true that under a credibly fixed Canada-US exchange rate policy, mistakes by the Federal Reserve will result in larger Canadian business cycles than might have been otherwise achievable in a perfect world. But the world is not perfect. The Bank of Canada's credibility problem is compounded by the fact that most Canadians see a large depreciation of their currency as a policy "mistake" even if, while the currency has been depreciating, the Bank has hit its inflation targets, as it has done for most of the last decade. In a globalized world, and under our current floating exchange rate regime, a series of such mistakes by an "independent" Bank of Canada will simply accelerate the rate at which the Canadian dollar achieves Mundell's "junk" status.

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The opposite view There is no currency regime that is superior at all times and in all places. The dissimilarity between the structure of the US and Canadian economies, and particularly their asymmetric response to swings in commodity prices, suggests that a fixed exchange rate regime would be costly at this time. However, were Canada to become less dependent upon the production of commodities in the years and decades ahead—and there is good reason to expect that it will—the cost of abandoning our flexible exchange rate regime may not be as onerous 10-20 years down the road. As a result, the issue may be worth revisiting at that time.

While the case for abandoning Canada's flexible exchange rate system is far from airtight, the options narrow once we consider what is feasible, and not just what is desirable. And, paradoxically, what may appear to be the simplest solution—a pegged exchange rate—is perhaps the least sustainable of all the options that are being proposed. It shouldn't come as any surprise, then, that very few industrialized countries actually adhere to a pegged exchange rate. And many of those that do allow their currencies to fluctuate within bands...

If a simple peg is not feasible, the idea of a common North American currency is a pure and simple no-go. North America is not Europe. The US alone accounts for more than 80 per cent of continental GDP (including Mexico), which would make for a lopsided union. It is illusory to believe that the United States would be willing to abandon the almighty US dollar, and subject its monetary policy decisions to the interests of a North American Union. Even in the event where a sufficient number of countries were to adopt the US dollar outright—which could lead US authorities to take a closer look at entertaining a monetary union—it is still unlikely that the US would be willing to relinquish its monetary sovereignty. ... The bottom line is that, from the standpoint of the United States, a monetary union does not come even close to passing the "what's in it for me?" test.

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