

Robert Mundell is one of the world's leading economists. He is one I have a great deal of respect for and would always listen to very closely. An article in today's Wall Street Journal, describes Mundell's speech in late March and why he's concerned that the US is headed for another recession. <http://on.wsj.com/mJNjpG>

Mundell's talk is fascinating. For one thing, it represents the first time to my knowledge that a supply-side economist (other than me) has pointed to Fed tightening prior to the financial collapse as "one of the worst mistakes in its history."

Supply-side economists tend to view gold prices as the sole determinant of monetary ease or restraint. Many capable economists refused to look at evidence that might point to monetary restraint prior to the financial collapse. Now that Mundell has opened the door, others are likely to follow.

Mundell's argument for a recession turns on the Fed ending QE2. His solution is to fix the value of the dollar to the Euro. This solution is likely to produce a far better monetary policy than whatever the Fed has in mind.

The European Central Bank (ECB) has had and is likely to continue to have a monetary superior to the US. Fixing the dollar to the Euro would mean accepting the ECB's monetary policy. Almost anything other than the Fed's policy is likely to be a significant improvement.

As for Mundell's concern over an upcoming recession, it's certainly a possibility. The big difference between Mundell's approach and mine relates to the implied cause versus effect of different policies. I view the Fed's action as the cause. The change in exchange rates is the effect. Mundell's analysis suggests that the exchange rate is the cause and monetary policy should respond to the exchange rate as opposed to the other way around.

The Fed's poor record in conducting monetary policy suggests that Mundell is correct that pressures in the foreign exchange market would provide a far better guide to policy than the Fed's convoluted approach.

As for whether the Fed will restrict liquidity when QE2 ends, I doubt it but wouldn't rule it out. The Fed has been flying blind for some time. With a blind pilot, there just isn't a high degree of confidence there will be a safe landing.