OFF THE NEWS

The Clarida Rule

The original idea behind the so-called Taylor Rule, named after the esteemed economist and friend of this publication John B. Taylor, suggests that the Federal Reserve, in its conduct of monetary policy, avoid a shoot-from-the-hip approach. Instead, the central bank should set the Fed funds rate based on the gap between its targeted inflation rate and the actual rate—and the output gap between actual employment versus the natural level of employment.

From a practical standpoint, in a situation of rising inflation rates, nominal interest rates should be raised by an amount higher than the inflation rate rather than on a one-for-one basis.

According to recent papers prepared by the Fed staff, for example, following the Taylor Rule they suggest a 1 percent overshoot in inflation would mean that 50 basis points should be added to the recommended Fed funds rate.

While the Taylor Rule provides a highly useful explanation for the Volcker and Greenspan years, because of the complex geopolitical and other turmoil of recent economic times, the rule has from time to time been adjusted.

Recently, Federal Reserve Vice Chair Richard Clarida, a respected academic economist with hands-on experience in financial markets, has initiated important modifications to the Taylor Rule. Some central bank insiders are referring to the culmination of these changes as the making of the new Clarida Rule.

Clarida calls for a new "inertial Taylor-type rule" once the conditions for lift-off specified in the FOMC statement have been satisfied. He would have a coefficient of zero on the unemployment gap (meaning the Fed only responds to weakness, not tightness, in the labor market). He calls for a coefficient of 1.5 on the gap between core PCE and the 2 percent longer-run target. In other words, if inflation overshoots by 1 percent, under the Clarida Rule the Fed would add 150 basis points to its recommended Fed funds rate.

Fed Vice Chair **Richard Clarida** *combines his top theoretical and practical market experience as he modifies the Taylor Rule.*

Lagarde "The Reader"

Both in the hallways at the European Central Bank and in ECB-watching circles, ECB President Christine Lagarde has developed a new nickname, "The Reader." The nickname has grown over recent months as observers have begun to question the ECB chief's grasp of the nuances of monetary policy. "If you notice in her public comments, including those offered after ECB Council meetings, Lagarde talks openly and freely about her views on climate change and income inequality, both political subjects. There is a spontaneity and sophistication to her comments. But not when discussing monetary policy," an insider said, no doubt to avoid making mistakes.

Others suggest the president of Europe's central bank reads strictly from a prepared text that on monetary policy only addresses the most basic questions. "There are no signals, very little the markets can grab onto when she offers her public thoughts," a market strategist added.

ECB President
Christine Lagarde

Published with permission of Hedgeye Risk Management.

THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
220 I Street, N.E., Suite 200
Washington, D.C. 20002
Phone: 202-861-0791 • Fax: 202-861-0790
www.international-economy.com
editor@international-economy.com

Merkel's Obsession With Avoiding Nationalism

Throughout the early stages of the global pandemic, German Chancellor Angela Merkel was determined that any measures taken, including the vaccination of the German people, be done under the leadership of the European Commission. Merkel told colleagues she was intent on avoiding the "nationalization" of responses to the pandemic.

The problem is that the European Commission seriously mismanaged the European vaccination rollout. At a time when the United States was reaching a first-dose vaccination rate of over 50 percent, Germany was achieving less than half that rate.

The chancellor's blunder has produced an immediate political fallout—a 5–6 percent drop in support for Germany's conservative parties, down to 27–28 percent support by late April. Worse, Germany's Liberal Party leaders, who are normally quite willing to join in ruling coalitions with the conservatives, now because of the conservative parties' pandemic incompetence are not so sure. They are toying with the opposition.

German Chancellor **Angela Merkel**

Note: By far the most vibrant political party in Germany today are the Greens. Their level of public support has jumped to 22 percent compared to that of the Social Democrats, who have dropped to below 16 percent as of late April. What would be needed to produce a Greens-Social Democratic ruling coalition? A third member with at least 10 percent support. The Liberals would definitely fill that role, but would be unlikely to have much influence.

New Treasury chief **Janet Yellen.** *Has she changed her tune on the significance of deficits and surpluses, or have the economic times changed?*

Changed Her Tune?

"One factor which accounts for part of the productivity surge is the investment boom which has driven the latter part of the expansion, the consequence of an historic shift in the stance of fiscal policy. The switch from chronic and growing deficits in the federal budget to surpluses has boosted national saving, cut interest rates, and spurred private investment. …

"Only time will tell if recent productivity trends can sustained. We can improve the odds by maintaining the fiscal discipline which is responsible for our investment boom."

—Janet Yellen,
"Is America's Productivity Uptick the Real Thing?"
(TIE, *September/October 1999)*

The Passing of Three Friends

The world has lost several giants in the field of international economic policy. Robert Mundell, Richard Cooper, and John Williamson all helped shape the modern global economy with their thinking on exchange rates, international economic policy, and global development. And not coincidentally, all were valued contributors to *TIE.*

Nobel laureate **Robert Mundell,** *1932–2021, studied how cross-border capital flows could affect interest and exchange rates, and advised on the creation of the euro. He also helped bring about a major fiscal stimulus in the early 1980s as a counter when Fed Chair Paul Volcker courageously broke the back of double-digit inflation with aggressive interest rate hikes.*

John Williamson, *1937–2021, a founding senior fellow at the Peterson Institute for International Economics, created the "crawling peg" exchange rate system and coined the term "Washington Consensus" for a set of policy reform recommendations for developing countries. He was known for his pragmatic common sense when addressing policy questions.*

Harvard University's **Richard N. Cooper,** *1934–2020, was a strong advocate of international policy coordination. He held senior policy positions under four presidents.*

Due to an editing error, an important word was left out of the bio for legendary investor Stanley Druckenmiller's article—the word "never." The bio should have read, "Stanley Druckenmiller has never had a down year."