Liquid Insight

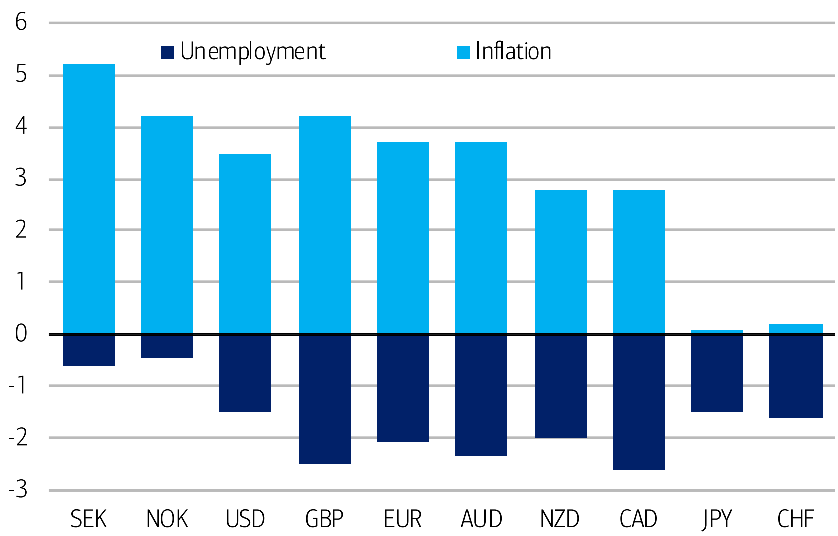
Les Misérables: A year later

Key takeaways

- We update our modified Misery Index, suggesting more work for G10 central banks to reduce inflation vs. optimistic consensus.
- We also discuss how high inflation has proved FAIT and MMT policy frameworks as being ineffective.
- FX implications are far from straightforward, and depend on how G10 CBs deal with still difficult policy challenges ahead.

By Athanasios Vamvakidis

Exhibit 1: Modified Misery Index (deviation of inflation from 2% and unemployment from NAIRU)
Except for the BoJ and the SNB, all other G10 central banks still have a lot of work to do to fight inflation



Source: BofA Global Research and Bloomberg.

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The pursuit of macroeconomic happiness

A year ago, as inflation started to surge, we calculated a modified Misery Index for G10 economies, which we update in this report. Our key takeaway is that the mission to fight inflation seems far from over, while tight labor markets offer no excuse, and the consensus appears too optimistic. We also discuss how high inflation has now proved the FAIT and the MMT policy frameworks as being ineffective. The FX implications are not straightforward, but tighter monetary policies for longer and the impact on the economy are likely to drive FX markets above and beyond, at least for the rest of this year, in our view.

12 April 2023

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Timestamp: 12 April 2023 01:32AM EDT

A modified Misery Index for G10 economies: A year later

All G10 central banks effectively target a combination of inflation and unemployment. Even the ones that in theory target only inflation have to take labor market conditions into account to assess inflation risks.

So far this year, central banks continue to focus on inflation rather than employment. Inflation rates have peaked in G10 economies this year, but from multi-decade highs and from multiple times above their target—which is still the case. To a large extent, headline inflation rates have dropped this year because energy prices have dropped. However, core inflation rates have yet to peak in most G10 economies. Moreover, unemployment rates have dropped to multi-decade lows and have yet to bottom in all G10 economies. It seems that G10 central banks are still far from their inflation targets, but have overshot their employment goals. It therefore makes sense for inflation to still dominate the reaction function of central banks today.

In this context, our modified Misery Index can provide some guidance on how G10 central banks have been doing so far and how much they still need to catch up, with potentially important market implications. The literature defines the Misery Index as the sum of inflation and unemployment rate. High inflation and high unemployment suggest that the central bank does a poor job of striking the right balance in the inflation-unemployment trade-off. A low Misery Index is better than a high Misery Index.

A year ago, as inflation started to surge, we made some adjustments to calculate a modified Misery Index for G10 economies, which we update in this report (see Les Misérables 28 March 2022):

- We use core instead of headline inflation rate. As part of the sharp increase in inflation last year and its drop this year has to do with volatile commodity prices, core inflation provides a better measure of sustained price pressures, in our view.

- We take the absolute value of the deviation of core inflation from 2%, instead of just looking at the level of core inflation. Therefore, we assume that inflation above 2% is as bad as inflation below 2%. There is no theoretical justification for this, but we assume that this is a better way to access what G10 central banks are doing, as 2% is their target. In any case, core inflation is above the 2% target in all G10 economies today, which was not the case when we first calculated this modified Misery Index a year ago.

- We take the deviation of the unemployment rate from NAIRU--last year, we took the deviation of unemployment from its pre-pandemic level, but the results are similar. We, therefore, assume that unemployment is bad, but only if it is higher than NAIRU—otherwise, it is a good thing. This also addresses a potential bias if structural unemployment in some countries is higher, for reasons that have nothing to do with monetary policy—structural unemployment in Europe is higher than in the US because of structural rigidities.

What central banks need to do to eventually make us "happy" may make us "sad" in the meantime

The results in Exhibit 1 suggest that except for the BoJ and the SNB, all other G10 central banks still have a lot of work to do. Very high core inflation rates remain a problem in all G10 economies, except for Japan and Switzerland. And unemployment is below NAIRU in all G10 economies, in most of them well below.

This is despite more than a year of policy tightening. It could be that we are yet to see the full impact of the policy tightening that has already taken place, but even in this case, it is too early to discuss when central banks will actually pivot to policy easing.

Although the ranking suggests that the Riksbank and the Norges Bank are the ones further behind in G10, the differences are relatively small, again except for the SNB and the BoJ. We could also argue that the BoE has the most to do, because of high core inflation and one of the tightest labor markets.

The key takeaway for us is that the mission to fight inflation is far from over, while tight labor markets offer no excuse. Although tighter policies are needed to reduce the Misery Index, the economy will not likely be "happy" in the process, as higher unemployment will be inevitable. The question is, by how much must unemployment increase in each case to bring inflation back to the target, and whether when balanced the Misery Index will end up lower or even higher—such as in a stagflation scenario.

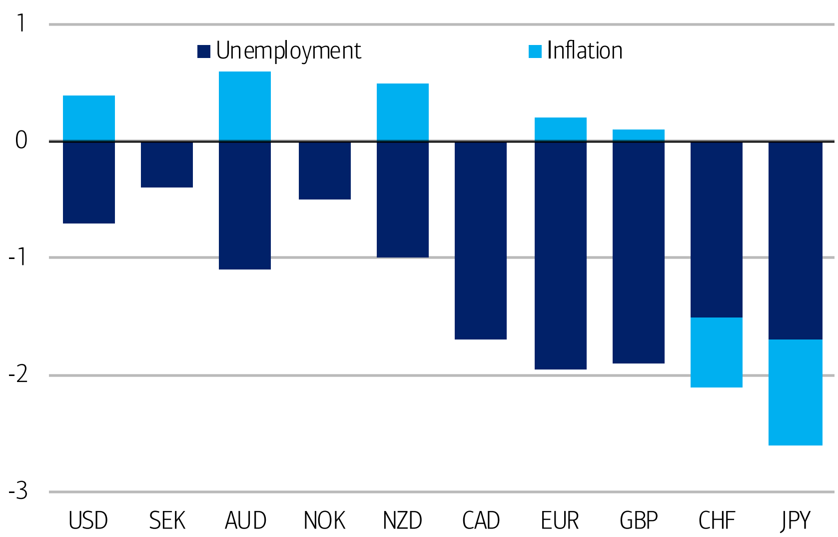
The very optimistic consensus

We calculate our modified Misery Index for the consensus forecasts in 2025. Using a similar approach, we take the deviation of inflation consensus forecasts from the 2% target and the deviation of the unemployment rate from NAIRU. In this case, we use headline inflation forecasts, as core inflation forecasts are not always available—in any case, the two tend to converge in the medium term. We don't take the absolute value of the inflation deviation from 2%, because we want to focus on what the consensus expects from the drop in inflation, assuming that the more inflation drops, the better.

The results in Exhibit 2 suggest a very optimistic consensus. Our modified Misery Index shifts from very positive in all G10 economies, except for Japan and Switzerland, to negative across the board. This is because the consensus expects inflation to drop to around 2% or even lower, with unemployment rates remaining well below NAIRU in all G10 economies. We continue to believe this is far too optimistic, even for a soft landing.

Exhibit 2: Modified Misery Index, consensus forecasts for 2025 (deviation of inflation from 2% and unemployment from NAIRU)

A very optimistic consensus expects negative misery indices in all G10 economies by 2025



Source: BofA Global Research and Bloomberg.

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Remember FAIT?

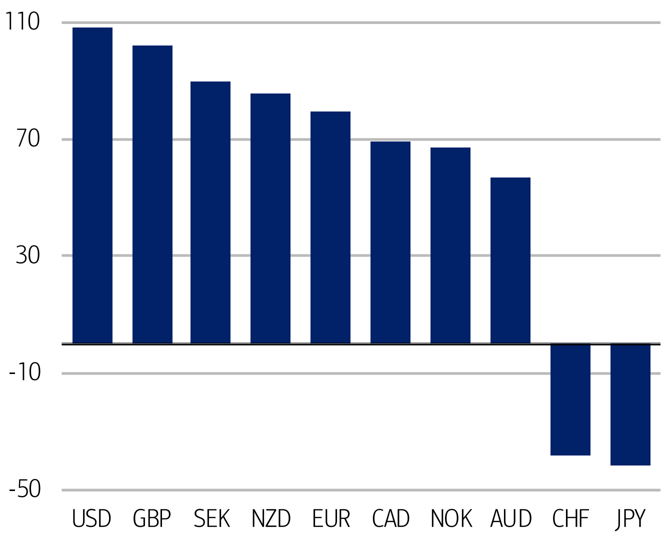
The Fed adopted a so-called Flexible Average Inflation Targeting (FAIT), following its 2019–20 framework review in August 2020. We raised concerns over FAIT then (see the report Our concerns about AIT 01 September 2020). We had argued that average inflation targeting was more like price-level targeting, which would call for unrealistic monetary policies, given how long most central banks had spent below the target, de-anchoring inflation expectations. We had also argued that FAIT made no sense from a macroeconomic point of view consistent with an ideal inflation rate, and could lead to a recession after inflation reached above target, overestimated the ability of central banks to meet the inflation target, and could lead to asset price bubbles.

High inflation now exposes to us the problems with any FAIT, AIT, or symmetric inflation targeting policy framework. Given how much inflation has increased and how persistent it has been, such policy frameworks would now suggest that central banks should not stop once they reach their 2% inflation target, but should continue tightening to bring inflation well below 2%, to offset higher inflation in the last two years, negatively impacting the economy in the process. If intentionally undershooting the inflation target following an unintentional overshooting of the inflation target is not advisable, then intentionally overshooting the inflation target following an unintentional undershooting of the inflation target would not be advisable either—otherwise, this would be asymmetric inflation targeting, with a clear inflationary bias.

Indeed, FAIT would have called for much tighter monetary policies today, to bring inflation to well below 2% and keep it there for a long time, in most G10 economies—which obviously would have been very negative for the economy. Looking at how much central banks have missed their inflation target since the pandemic started, monetary policies should be much tighter and for much longer in all G10 economies, except in Switzerland and Japan, where they should be much looser (Exhibit 3). The same calculation but starting in 2007, just before the global financial crisis, would have called for much tighter monetary policies in the case of the UK, Australia, Norway, US and New Zealand, and again much looser policies in Switzerland and Japan (Exhibit 4).

Exhibit 3: Accumulated percentage points of monthly inflation above 2% since 2019

Average inflation targeting would have called for much more tightening when considering the years since the pandemic, except for Japan and Switzerland.



Source: BofA Global Research and Bloomberg.

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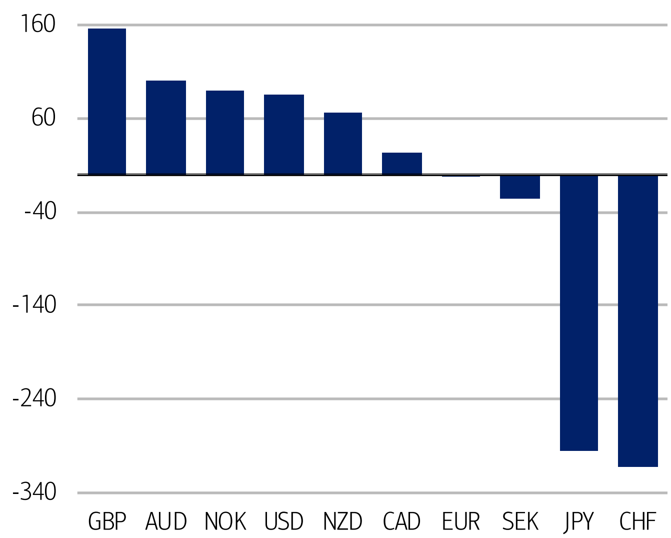
Exhibit 4: Accumulated percentage points of monthly inflation above 2% since 2007

Average inflation targeting would have called for much more tightening in most of G10, when considering the years since the global financial crisis



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Remember MMT?

We were also critical of the so-called Modern Monetary Theory (MMT) during the low inflation era, arguing that it would be proven wrong if inflation were to increase (see the report Why is FX telling us that monetary policy will not work? 30 July 2019 and Free lunch economics 08 April 2019). According to MMT, fiscal policy should be loose when inflation is low and tight when inflation is high, while central banks should just keep interest rates low in both cases. The problem is that while it is easy to loosen fiscal policies when inflation is low, it is very difficult to tighten fiscal policies when inflation is high. Moreover, without the support from monetary policy to help meet the inflation target, we may put too much burden on fiscal policy, expecting unrealistic shifts in the fiscal policy stance.

As inflation reached a 40-year high in G10 economies last year and has now proven to be sticky on the way down, the problems related to MMT should be obvious, in our view. Not only fiscal policies have not tightened in response, but governments have even been spending the revenue windfall from high inflation. The IMF Fiscal Monitor has just raised a red flag on this, calling for tighter fiscal policies. We have also been expressing concerns about loose fiscal policies since our year ahead report (see the reports Year Ahead 2023: Pivot ≠ Peak 20 November 2022 and Seven reasons why the central bank pivot may come later than you may expect 08 February 2023). The IMF estimates suggest that reducing government spending by 1 percentage point of GDP lowers inflation by half a percentage point. Focusing on core inflation, with G10 average at 5%, government spending would have to drop by 6% of GDP—most likely even higher, because the IMF estimates do not assume that interest rates would remain low in the meantime—if we were to apply MMT. Such aggressive fiscal policy tightening would have been politically and practically impossible, in our view.

FX implications are far from straightforward

A year ago, we had argued that our modified Misery Index suggested upside potential for USD, GBP and CAD vs. JPY, and for EURCHF, AUDNZD and NOKSEK. These results turned out to be mostly right. However, at that time central banks were catching up with tightening from well behind.

The question today is different, as it has to do with the economic pain that central banks would be willing to cause to meet their inflation target, while the FX implications are far less straightforward. All central banks appear committed to their inflation targets today, but they could be tested once unemployment starts to increase, particularly if it has to increase above NAIRU to bring inflation all the way down to the target. Moreover, the positive correlation between rates and FX may shift if "something breaks" in the process.

We can say that our analysis strictly speaking is negative for JPY and CHF, but with the caveat that this could change in a risk-off scenario caused by monetary policy tightening. We could also say that our analysis is bearish CHFJPY, as the SNB has been much more hawkish than the BoJ despite our modified Misery Index being almost the same for both, but such divergence can continue during this year. Our analysis does suggest that the strong consensus for a weak USD may be proven wrong and/or could take longer to materialize.

The only thing we can say with certainty is that central bank Misery Indices remain too high in most cases and that markets appear too optimistic. Tighter monetary policies for longer and the impact on the economy will likely drive FX markets above and beyond, at least for the rest of this year.

Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023 – Year Ahead 2023: Pivot ≠ Peak**, 20 Nov 2022
- After the storm, **Global FX Weekly**, 31 Mar 2023
- Budding stability **Global Rates Weekly**, 31 Mar 2023
- As the market dust settles, **Liquid Cross Border Flows**, 3 Apr 2023

Rates, FX & EM trades for 2023

For a complete list of our open trade recommendations, as well as our trade recommendations closed over the past 12 months, see the reports below:

Global FX Weekly: After the storm 31 March 2023

Global Rates Weekly: Budding stability 31 March 2023

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