Cautious Riksbank may add pressure to krona

We expect Sweden's Riksbank to hike rates from late 2023, though policymakers are likely to remain reluctant to endorse much - if any - tightening when the Bank meets this Thursday. Despite the recent rally, EUR/SEK is not overvalued in the short-term, and a cautious Riksbank announcement may generate more SEK weakness this week

The Swedish krona has appreciated over 5% against the dollar and around 3.5% against the euro since the end of January

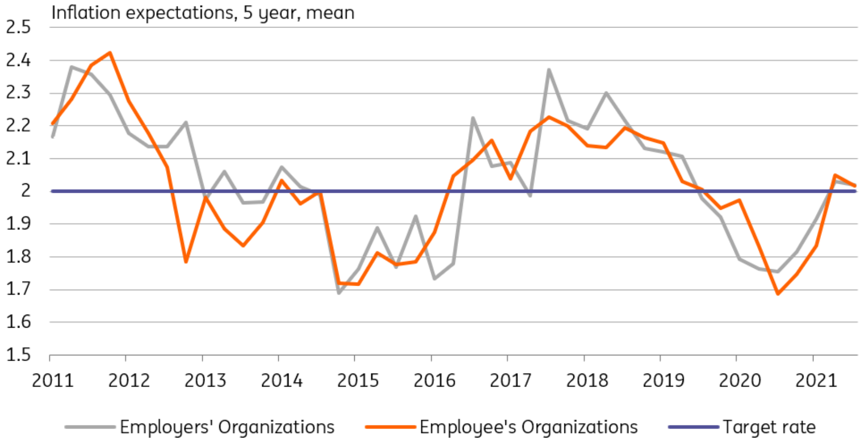
Riksbank to stay cautious, despite solid economic backdrop

This week's Riksbank meeting has the potential to be more interesting than most. This is not because policymakers are likely to do anything – indeed they have made it pretty clear they won't be joining the club of central banks hiking interest rates in the next couple of years – instead, the focus will be on the central bank's intentions in 2024.

That's clearly a long way off, though our own view is that the Riksbank is likely to have hiked, potentially more than once, by the end of that year. Our forecast for the first rate hike in late-2023 tallies with what our team is expecting from the European Central Bank.

So far, the Riksbank has been resistant to include a rate hike in its published rate projection, which as of September went out as far as 3Q 2024. That might change this week, with the inclusion of a notional rate rise for the final quarter of 2024, though even that isn't totally guaranteed.

The economic backdrop would justify hints of very modest tightening. Indeed, by one measure of unemployment from the Public Employment Service (PES), the rate is not far off pre-virus levels. Labour demand indicators and business confidence is high, and the backdrop for a better negotiated wage outcome in 2023 is reasonable.



Source: Macrobond, ING

That's not to say that the Riksbank faces any imminent threat of a serious wage spiral – and that's fairly clear when looking at long-term inflation expectations. Both employer and employee organisations involved in wage setting see five-year inflation rates around target.

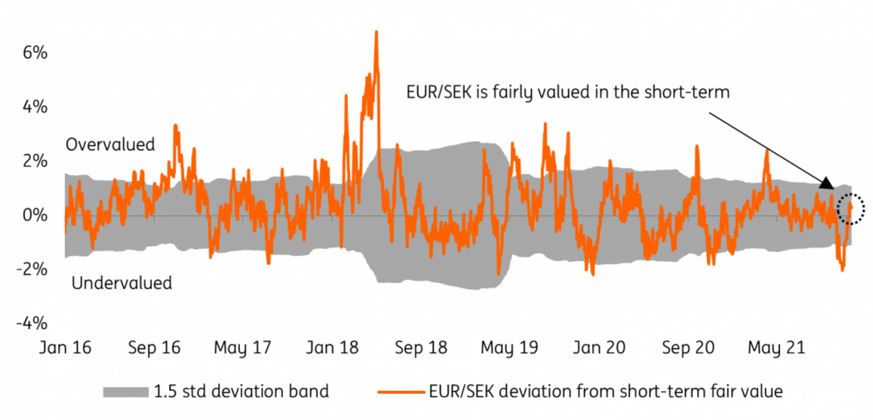
The challenge for the Riksbank, like many other central banks, is that markets have begun to price in rate hikes much earlier than policymakers are hinting. Investors are looking for at least one rate rise next year, and policymakers will no doubt be wary that including a rate hike in its projections – even one as far away as 2024 – could reinforce some of these expectations. The latest rise in Covid-19 cases across Europe adds another potential reason for caution this week.

That caution probably means it is also too early to hear about the Bank's balance sheet plans beyond next year. The Riksbank has said it will reinvest to keep the size of its bond holdings unchanged in 2022, after the QE programme wraps up this quarter. We suspect policymakers will allow a gradual reduction in bond holdings thereafter. But this is probably a story for a later meeting.

FX: Riksbank unlikely to rescue the krona

Scandies have been the worst performing currencies in the G10 over the past month, and despite the recent EUR weakness, EUR/SEK has recovered almost all of the October losses and is now trading around 10.12. The recent rise in Covid cases in Europe and fresh restrictions being imposed in Austria and Germany are likely worsening the already choppy environment for SEK, which has an historically high beta to EU-related sentiment (Sweden's economy highly relies on intra-EU trade).

Despite the recent rally in EUR/SEK, the pair is not showing signs of overvaluation, according to our short-term fair value model (chart below). That is due to the fact that the October rally in SEK was not justified by equal moves in its short-term drivers (front-end rates, shape of the yield curve, equity performance, risk sentiment), so SEK moved into expensive territory against the EUR. The recent SEK underperformance was simply a re-alignment to its equilibrium level, and there's little to suggest the EUR/SEK rally is overstretched.



Source: ING, Refinitiv

As discussed above, we expect the Riksbank to push back against market speculation that the tightening cycle will start as early as 2022. Despite our view that policymakers won't be able to delay tightening beyond 2023, the Riksbank is likely aware that adding a 2023 rate hike to their current forecasts will be a de-facto confirmation that hawkish bets are warranted and would likely cause a hawkish re-pricing in the SEK money market.

Given the non-alarming inflation outlook and recent CPIF expectations remaining relatively anchored, we think the Riksbank will disappoint hawkish expectations this week, and we expect some dovish re-pricing of rate expectations. In FX, this should translate into more SEK weakness in our view, although losses should be more marked against the USD than against the EUR. Still, EUR/SEK may approach the 10.20 level this week.

Looking beyond the short-term, a quite strong negative seasonality for EUR/SEK in December suggests the pair could gradually converge to the 10.00 level again by year-end. That is, however, conditional on the ability of EU countries to face the new Covid wave without strict containment measures.

Author

James Smith
Developed Markets Economist, UK
james.smith@ing.com

Francesco Pesole
FX Strategist
francesco.pesole@ing.com

Disclaimer