Riksbank preview: Currency weakness in focus

The policy rate is expected to remain unchanged at -0.50% and the first rate hike is likely to be pushed out a bit further. The key question on Thursday is how the Riksbank responds to the recent krona weakness

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Weaker outlook reinforces dovish bias

As we've argued previously, 2018 so far hasn't been a great year for the Swedish economy. Growth is slowing, inflation keeps disappointing, house prices remain under pressure, and the krona has fallen sharply. This is a challenging environment for a central bank seeking to withdraw monetary stimulus and normalise policy.

Given the Riksbank's track record over the past couple of years, when it has consistently delayed each step of the normalisation process, the current situation looks ripe for another 'let's wait a bit longer' from the Swedish central bank.

Policymakers already took a step in that direction at the February meeting, when the Riksbank revised down its inflation forecast and signaled an increased likelihood that it would delay hiking rates.

Since then, inflation for the first three months of the year has come in below the Riksbank's forecast. In particular, core inflation excluding volatile energy prices has been stuck at 1.5%. This suggests domestic price pressure is weaker than the central bank thought, and means Thursday could easily see another downward revision.

Near-term indicators of GDP growth have also softened, both in Sweden and the Eurozone. Though the Riksbank's growth forecast already expects some slowing in the growth rate, the fairly abrupt fall in PMIs combined with ongoing uncertainty around US trade policy means that though the Riksbank's GDP forecast is unlikely to shift too much, the downside risks to growth have increased.

Krona depreciation raises difficult questions

The one factor that makes Thursday's meeting a bit tricky to predict is the fairly sharp depreciation of the Swedish krona over the past two-and-a-half months. The trade-weighted KIX index is down around 6% since the end of January. If the currency weakness persists, that should push inflation up in the second half of the year and will also help Swedish exporters, boosting GDP.

For the Riksbank, currency weakness offsets some of the bad news on inflation since February, and means that the downward revision to inflation should be fairly modest and concentrated on the shorter term (2Q and 3Q this year).

The more fundamental question for the central bank is what has caused the krona to weaken and whether this trend will persist. Typically, the Riksbank takes short-term currency moves in stride, anticipating a reversal towards the trend for a gradual SEK appreciation over the medium term.

Most likely, the Riksbank will stick to this approach for now. After all, it's key concern over recent years has been that excessive krona strength could undermine inflation and so it has tended to see depreciation as helpful.

But at some point, a sustained depreciation would become too much of a good thing and could signal something more troubling is afoot in the Swedish economy. We aren't there yet. But the Riksbank will be watching the krona closely, and for once it might actually prefer to see a bit of appreciation over coming months.

Policy rate delay likely

Overall, it seems probable that the Riksbank will push its interest rate path back again. We see a one-quarter move as the most likely at this point, putting the first rate hike at the end of this year. The shape of the interest rate path is already very gradual, with one hike every six months, and is likely to remain unchanged.

Deputy Governor Ohlsson will probably dissent in favour of an earlier hike, as he did in February, though it is possible that the weak inflation data since then has changed his mind.

Markets are already pricing a 4Q18 hike as the most likely outcome, with 16bp of tightening expected by December. That suggests investors are far from sure that the Riksbank will make the first hike this year, and are expecting in a dovish Riksbank on Thursday.

Our view remains that a 10bp hike in December is the most likely scenario. But whereas a couple of months ago the risks around that forecast looked roughly balanced, we now see the risk as clearly skewed towards a later rate hike.

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