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Article

## Riksbank preview: Still waiting for Godot

We expect the Swedish central bank to keep the monetary policy stance unchanged at its July meeting. That may provide some short-term support for the krona and short-term rates, though we would never exclude a dovish surprise from the Riksbank

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The outlook for the Riksbank remains broadly similar to the last meeting in April. We expect only limited changes to its economic forecasts, and the interest rate path to be left unchanged (indicating the first hike at the end of 2018).

The Riksbank has a well-known dovish bias and has delivered a de facto softer policy stance at each of its past three meetings. So even an unchanged stance at this meeting, reiterating its forecast that interest rates will rise by the end of the year, might provide some short-term support for the krona and short rates.

In the longer term, our view remains that weak domestic inflation pressure and the very gradual tightening of ECB policy means the Swedish central bank is unlikely to deliver its first rate hike until mid-2019. We believe the Riksbank's policy stance will start to shift slowly in that direction as the year goes on.

Below is a more detailed analysis of the key factors driving the Riksbank's policy.

### Inflation: Headline strength masks underlying weakness

In April, the Riksbank put significant emphasis on core inflation (which remains subdued at around 1.5%) as opposed to the headline inflation measure (which is at the 2% target). The message was that the Riksbank would look through temporary effects on the inflation rate and focus on the underlying trend.

That divergence between core and headline inflation continued in April and May and will increase further over the summer. Higher energy prices will push up the headline figure above 2% while base effects (related to last year's change to the measurement of airfares) hold back core inflation around current levels or even lower. Service price inflation, the best gauge of domestic inflation, has fallen materially over the past few months and looks likely to remain moderate.

We expect only minor changes to the Riksbank's inflation outlook. Headline inflation will likely be revised up in the near term to reflect higher energy prices and a weaker krona, while core may be revised down a little, yet again. But we will have to wait until autumn for clarity on the inflation outlook.

## Growth: Still solid but risks are increasing

First quarter GDP came in pretty strong at 0.7% quarter on quarter, but near-term indicators suggest momentum is slowing down. The second quarter is likely to see slightly slower growth at 0.5%QoQ, and momentum could slow down further during the second half of the year.

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**Our view remains that the majority of Riksbank MPC members are reluctant to raise rates much before the ECB does. At most, we see a 10bps hike in December or February 2019 as plausible, bringing the Riksbank's policy rate in line with the ECB's - 40bps deposit rate**

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Two key factors drag on Swedish growth: the slowing housing market and the 'soft patch' in European growth seen in the first half of 2018. Other central banks, e.g. the ECB and the Bank of England have expressed confidence that fundamentals remain solid and global growth momentum will pick up again. The Riksbank will probably make a similar assessment of the global outlook and argue that it has already factored in a slower domestic housing market and therefore not changing its forecast significantly.

But the risks to their forecast are clearly to the downside. A global slowdown would be particularly problematic for Sweden in the current situation where domestic demand is already slowing down.

Also, tensions around US trade policy have escalated and pose a major risk to Sweden's export-dependent economy. Sweden is particularly exposed to the US' threat to impose tariffs on car imports. Trade with the US accounts for about 2% of Swedish GDP (of which around a fifth is car exports). Indirect links via the auto parts supply chains into Europe are also at risk.

## Housing: Not out of the woods yet

Swedish house prices have stabilised over the spring, but the troubles in the housing market are far from over just yet. The supply of unsold homes is at record highs, with lots of newly built-apartments coming onto the market. To clear the overhang of unsold properties, we suspect further price falls, perhaps 5-10%, may be necessary this autumn.

This week, the Swedish premium property developer Axxonen filed for bankruptcy, becoming the first corporate victim of the housing slowdown - and it won't be surprising if it were the first of many. Several developers have scaled back construction plans over the past months. While lower construction is factored into the Riksbank's forecast, it is always hard to judge how bad things can get. The housing market remains the key domestic risk in Sweden, and the Riksbank is unlikely to raise rates until it can be sure the situation has stabilised.

## Exchange rate: Better too weak than too strong

The krona exchange rate steadied over the past couple of months after the rapid depreciation from February to April. But it remains around 2% weaker than factored into the Riksbank's April forecast, and 4% below the expected average for Q3. This will mechanically push up on the inflation and GDP forecasts and at the margin supports a somewhat more hawkish stance.

But we don't think the Riksbank particularly minds a weak krona. Policy-makers have long fought to keep the exchange rate from appreciating too rapidly and will continue to prefer currency weakness to strength.

## ECB: Later hikes from Frankfurt means later hikes in Stockholm

Finally, the ECB's policy announcement at its June meeting is arguably the most significant news for the Riksbank since its last meeting. The firm guidance that the ECB does not intend to raise interest rates "through summer 2019" gives the Riksbank more clarity on a key determinant for its policy stance.

Our view remains that the majority of Riksbank monetary policy committee members are reluctant to raise rates much before the ECB does. As Governor Ingves pointed out in the minutes of the April meeting, the current Riksbank stance "is very much due to the highly expansionary monetary policy conducted in the euro area in recent years. In this respect, the Riksbank is in approximately the same situation as the central banks in Denmark and Switzerland."

Given that neither the Danish nor the Swiss central bank are expected to raise interest rates until after the ECB does, this is a fairly clear signal that the Riksbank is unlikely to raise rates this year and will wait until nearer the time the ECB is likely to raise rates. While the Riksbank is less constrained by the ECB than the DNB or SNB, it is still difficult to see them raising rates more than nine months ahead of the first date (September 2019) that the ECB might move. A more likely scenario is that the Riksbank waits until July or even September 2019.

At most, we see a 10bps hike in December or February 2019 as plausible, bringing the Riksbank's policy rate in line with the ECB's - 40bps deposit rate.

