

## In case you missed it: The surprising and predictable

Central banks in Turkey and Russia surprised investors this week with bolder policy action than many expected while the ECB remained on autopilot and the Bank of England did nothing to change our view that rates will stay on hold until after Brexit. Elsewhere, the US-China trade spat continued to rumble on while punishment beckons for Hungary...

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# Turkey: Central bank strikes with a strong rate hike

At the September MPC, the Central Bank of Turkey hiked the policy rate to 24% with a recalibration of monetary policy in a response to weakness in the currency and a further deterioration in the inflation outlook. It also maintained its commitment to take more action, if needed



Source: Shutterstock

## 625bp

Higher than expected

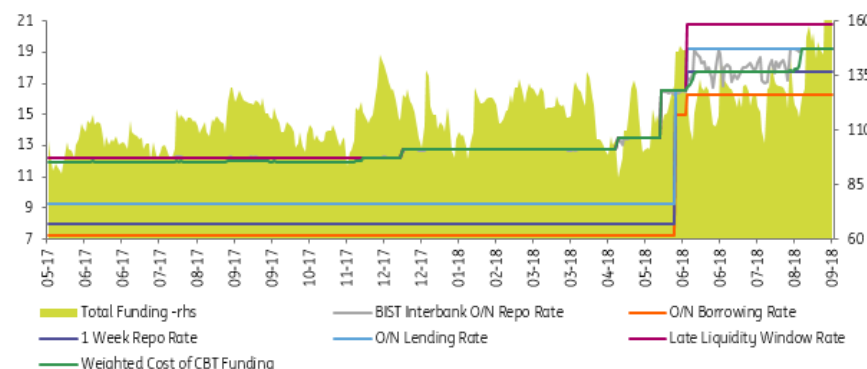
### CBT hike

(in 1-week repo rate to 24%)

At the September rate-setting meeting, the CBT firmly delivered and hiked the policy rate (one-week repo rate) by 625bp to 24%, well above the Bloomberg median consensus and our call at 21%, while also returning to full funding from weekly repo auctions, starting from 14 September (with a one-week transition period). The decision translates into 475 basis points of effective tightening from the current funding cost level of 19.25%. The move also pulled the overnight

lending rate and late liquidity window (LLW) rate to 25.5% and 27%, respectively. Markets have reacted positively to the move. Before the decision, the Turkish lira was around 6.4 against the USD. It then plunged to 6.01, currently floating around 6.15.

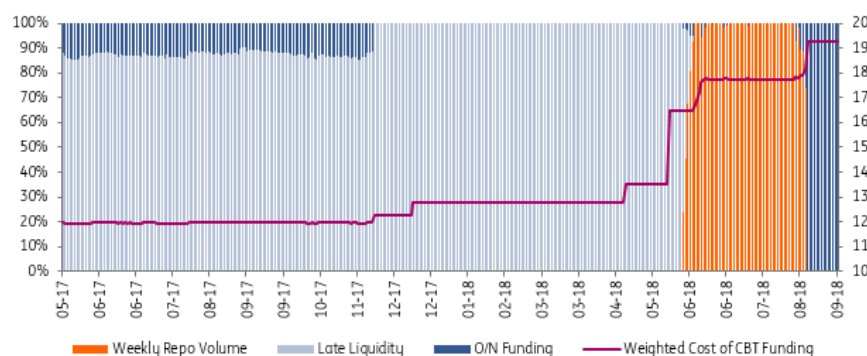
## Key CBT rates (%)



Prior to the MPC meeting, we discussed the CBT potentially matching the market pricing implied by the swap curve and/or exceeding expectations, though this was not the base case. We also thought the bank could come up with relatively measured actions to pull the ex-post real policy rate towards positive territory. Despite the spike in lending rates and growing concerns about growth prospects in the near time, the bank delivered a strong message to restore confidence.

## Funding Comp. & Cost of Funding

(5d-MA, %)



In the statement, the CBT's growth assessment acknowledged the growing negative signals from early indicators, stating that the "slowdown in domestic demand is accelerating". In the July statement, the Bank said "signs of deceleration in domestic demand (were) becoming more visible".

But, most importantly, the CBT seemed to be vocal about price stability risks given price increases which have shown a "generalized pattern across sub-sectors, reflecting the movements in

exchange rates". Recall that despite relatively benign food inflation mostly on the back of unprocessed foods, the latest August data showed a bleak picture, with general upward pressure across various sub-components, exacerbated by a sharp depreciation in the Turkish lira as well as administrative price adjustments. Given that inflation will likely increase towards the 20% handle as FX effects continue to feed through to prices in the coming months, the CBT delivered a stronger hike than expected.

The CBT kept the main policy guidance unchanged while highlighting the determination to tighten further, if needed. The bank will continue to monitor 1) the lagged impact of recent monetary policy decisions and 2) the contribution of fiscal policy to the rebalancing process in addition to 3) inflation expectations, pricing behaviour and other factors affecting inflation. This implies that the CBT is relying on an adjustment in fiscal policy to support disinflation efforts, as frequently mentioned by policymakers in recent months.

All in all, the CBT has sent a strong message with its September decision in response to rising risks around price and financial stability. The bank once again reiterated that its priority is inflation despite the recent worsening in sentiment, which will have a significant impact on domestic demand while volatility in financial markets is likely to make consumers & investors more cautious. The CBT move could contribute to stabilisation in the currency while the release of the Medium-Term Economic Plan detailing the policy reaction of the government to recent volatility, will be key for markets in the near term.

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## Russia surprises with a 25bp rate hike

The Central Bank of Russia (CBR) surprised markets by raising its key rate by 25bp to 7.50% today. Future rate hikes will depend on how inflation and economic growth perform compared to the CBR's expectations and also on the external environment.



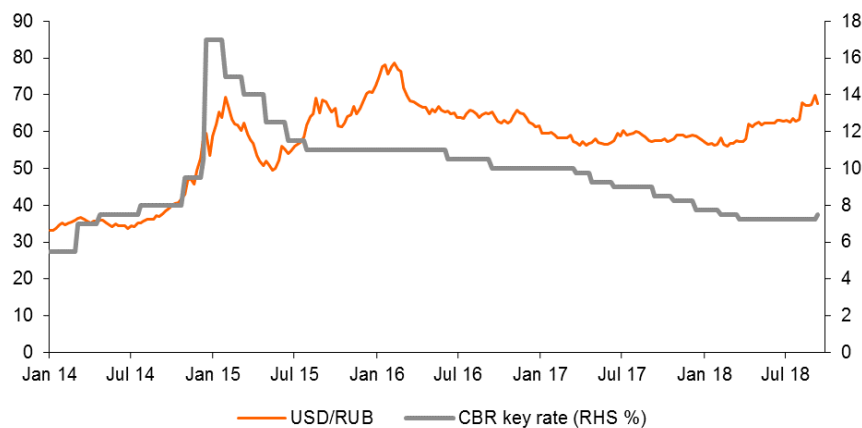
The Head of Russia's Central Bank, Elvira Nabiulina

### Inflation risks prompt action from the CBR

The key reasons for the CBR's rate hike today included higher inflation risks based on the high degree of external uncertainty and its impact on financial markets. According to the CBR, a further rise in yields in developed markets, capital outflows from emerging markets and geopolitical risks could contribute to continued high financial market volatility – so influencing Rouble and inflation expectations.

The necessity of further increases in the key rate will depend on inflation and economic growth performance compared to the CBR's expectations and also to external risks and the reaction of financial markets.

## CBR hikes rates for the first time since 2014



Source: Bloomberg

## Revised growth and inflation forecasts

At the same time the CBR published revised forecasts, with annual inflation to reach 5-5.5% by the end of 2019 (from 4-4.5% previously), FY18 GDP growth remaining at 1.5-2.0%, and FY19 growth cut to 1.2-1.7% (previously 1.5-2.0%).

The CBR now expects to see annual CPI at 3.8-4.2% (vs. 3.5-4.0% in previous forecasts) by the end of 2018 with inflation peaking in 1H19 and reaching 5.-5.5% by the end of 2019. Close to the end of 2019 quarterly inflation is expected to reach 4.0%, with annual inflation to reach the 4.0% target in 2020 (in line with previous expectations). The CBR's forecasts take account of the ban on FX purchases by the Minfin, the expected VAT rate hike and the impact of recent financial market volatility. These factors will have the biggest impact on inflation in the first half of 2019. When it comes to GDP forecast changes, increased state infrastructure spending near end-2019 and in 2020 is expected to lead to increased GDP growth.

## Ministry of Finance FX purchases also suspended until year end

In another move to support the RUB, the CBR also suspended FX buying under the Finance Ministry's Fiscal Rule until year-end. This activity would normally be worth around US\$6bn of FX buying against the RUB each month and thus an extension of the suspension is consistent with the view that Russian authorities are concerned about the external environment and pressure on the Rouble into year-end. As the CBR noted today the current account surplus is enough to service external debt. Thus the suspension of FX purchases could be enough to offset any capital outflows driven by negative external risks.

## A surprise move

Our view. The decision to hike rates was unexpected for us and for the market, where "no action" was the consensus. Together with the ban on FX purchases, this will add stability to the local FX market. USD/RUB dropped by 1.5% to 67.50 and OFZ yields pared 10-11bp gains ahead of the decision and are now flat to the close.

Inflation pressure has certainly worsened due to the external environment (with EM capital outflows, DM yield growth, and geopolitical risks), with this and the VAT tax hike at the beginning of

2019 the key drivers behind the decision. What is more important is that the CBR has kept the option to make further rate hikes if needed to stabilize Russian financial markets on the back of higher uncertainty. The words "sanctions" and "potential sanctions" were substituted with references to the "negative external environment" and "geopolitical risks" - this does not change key message from the CBR that it is ready to take measures (not only rate hikes) if required.

## Rouble outlook

Consistent with a better EM environment this week on the back of a Turkey rate hike and soft US CPI, today's move could see some further modest gains in the RUB to the 67.00/67.30 area.

However, we doubt investors will want to chase the RUB too much firmer. More aggressive sanctions against Russia will be debated in the US Congress into and after US mid-term elections and, given a backdrop of rising US rates and unresolved trade issues, we maintain a view that USD/RUB will be trading back above 70 over coming weeks and months.

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## The ECB's taper autopilot is still on

The European Central Bank delivers the first step towards exiting QE; the autopilot's still on and forward guidance on rates remains in place



Source: Shutterstock

### When you know you're doing an immaculate job

When does a central banker know that he (or she) has done an immaculate job? When QE is brought to an end and financial markets could hardly care less. According to this definition, the ECB should be extremely satisfied with the outcome of today's meeting. The ECB decided to reduce the monthly net asset purchases to 15bn euro, from currently 30bn euro, starting in October. All other parameters of the ECB's monetary policy stance were left unchanged: interest rates, the wording of an anticipated end of QE by year-end and the forward guidance on rates (*"expect interest rates to remain at their present levels at least through the summer of 2019..."*).

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*The ECB doesn't see any reason to change the balance of risks to the growth outlook*

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Today's decision does not come as a surprise. Not only had it de facto been announced since the June meeting but also has the macroeconomic situation has hardly changed. According to the latest ECB staff projections, the Eurozone recovery remains intact. ECB president Mario Draghi even pointed to the fact that the Eurozone has already been growing above potential for some time.

And even though the GDP growth forecasts for 2018 and 2019 were slightly revised downwards (2.0%, 1.8% and 1.7% for 2018, 2019 and 2020, from 2.1%, 1.9% and 1.7% in the June projections), the ECB doesn't see any reason to change the balance of risks to the growth outlook. The inflation outlook remained entirely unchanged with 1.7% annual inflation in every year until 2020.

## Stand and deliver

The only subtle change in the ECB's macro assessment could be found in the wording on downside risks. Two changes: emerging markets were a new explicit downside risk and uncertainty related to global factors (protectionism, financial market volatility and emerging markets) had "*gained more prominence*" from "*remain prominent*" at the last meeting. We wouldn't read too much into these changes but rather see them as evidence the ECB is very well aware of what is happening and feels the duty to flag all possible risks.

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### *The ECB now only has to deliver*

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Looking ahead, the ECB looks set to stick to the current autopilot. The advantage of this – set in place at the June meeting – is that every step until the end of the year has already been sketched. The ECB now only has to deliver. There is no need for new hints or premature announcements. Unless there's a huge accident in growth or inflation, the ECB will simply do what it has been anticipating. The next step should be the announcement of the end of net asset purchases at the December meeting. This might not be a very exciting but highly effective strategy.

## Enjoy your flight

Even though Draghi repeatedly remarked that QE has become a permanent part of the ECB's toolbox, it is obvious that the ECB is determined to return at least the net asset purchases into this toolbox as quickly as possible (the reinvestments will stay on for longer). Smaller risks will not stop the ECB. In our view, the ECB will use the policy rate to respond to any unexpected events, be it a growth slowdown or core inflation stubbornly sticking at around 1% and not accelerating. Any of these could easily delay a first rate hike farther than the end of the summer 2019. However, this is obviously still very hypothetical.

For now, and until the end of 2018, the ECB will happily stay on taper autopilot.

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## BoE: Steady course in stormy waters

After hiking rates in August, the Bank of England kept its policy stance unchanged at its September meeting. We continue to expect that the BoE will remain in a holding pattern until after Brexit



Source: Source: Bank of England

As widely expected, the Bank of England left its policy stance unchanged at its September meeting. After a series of dissenting votes at previous meetings, the MPC voted unanimously to keep rates on hold this time. The statement reads largely unchanged from August, with the committee anticipating "an ongoing tightening of monetary policy over the forecast period would be appropriate" and that "further increases in Bank Rate are likely to be at a gradual pace and to a limited extent".

The statement and minutes suggest the MPC judges recent data to have been largely in line with its August forecast. If anything, the latest month has seen the UK data come in a touch stronger than anticipated. The solid wage growth (2.9% year-on-year) reported for the three months to July will have been particularly positive for the MPC, given the importance policy-makers have long attached to UK wages picking up. With the labour market showing more and more signs of tightening, one source of concern for the Bank appears to be gradually fading.

More importantly, the committee's language on Brexit also appears to signal an increase in concern, noting that since the August meeting there have been signs of greater uncertainty around the withdrawal process, especially in financial markets. With Governor Mark Carney having extended his term again in order to see out the period of likely peak uncertainty around Brexit (and Deputy Governor Jon Cunliffe, the Bank's point person on Brexit, also extending his term), there is little doubt that this issue remains the key to the BoE's outlook over the coming months.

The minutes also convey some worries about turmoil in some emerging markets this summer and the increasing trade tensions between the US and China. While not yet rising to a level that would materially affect the BoE's policy stance, the MPC hardly needs another source of external uncertainty to make its job harder. The continued strong performance of the US economy provides limited comfort.

Overall, we see little news in today's policy announcement, and nothing to change our view that the BoE is likely to remain in a holding pattern until Brexit uncertainty passes. That means a rate hike is unlikely until May 2019, at the earliest. The BoE outlook continues to depend in large part on the UK and EU achieving a smooth withdrawal process.

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# China: Downgrading GDP growth rate

China is once again using infrastructure investment to avoid an economic slowdown. Sound familiar? It doesn't matter. We're still downgrading our GDP growth rate for this year and next



Source: Shutterstock

## Fixed asset investment comes to the rescue

The term "trade war" appears almost everyday in economists' analyses, blogs, tweets and on social media in China. It is something we are squarely focused on as well. But we would like to be a little bit more forward-looking.

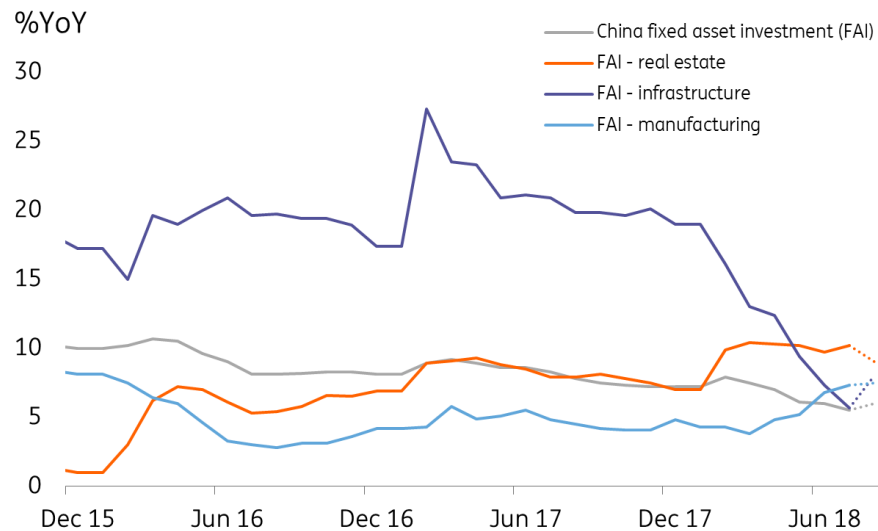
We know that a trade war is upon us and is going to escalate. The uncertainty is timing, with one wave of tariffs after another.

The Chinese government is trying to offset the damage, relying once again on infrastructure investment.

We expect fixed asset investment will rise to 6.0% year-on-year in August from 5.5% YoY in July. Infrastructure investment could rise from 5.7% YoY to 8.0% YoY, while real estate investment could decelerate from 10.2% YoY to 9.0% YoY.



## Infrastructure investment could accelerate



Source: ING, Bloomberg

## Industrial production to rise along with infrastructure

With more infrastructure projects, industrial production in general should improve. We expect industrial production to rise 6.2% YoY in August from 6.0% YoY in July.

The manufacturing story is slightly more complicated than the investment story. There are two opposing factors: One is negative as the trade war dampens export-related manufacturing activities while the other is positive as infrastructure projects boost manufacturing activity. We expect the overall growth trend to be stable. There is no need to over-borrow to boost manufacturing to a growth rate that is much higher than a no-trade-war scenario.

## Retail sales should hold up well but the future is worrying

We expect retail sales growth to rise to 8.9% YoY in August from 8.8% YoY in the previous month. The rise reflects stable growth in the spending power of the rising middle-income class, especially in the summer holidays.

However, if a trade war escalates, we expect that some Small and Medium-sized Enterprise exporters could be forced to close down. Some workers would be made redundant, and while some of those could be absorbed by State-Owned Enterprises, not everyone would. The rest would likely try to find a low-skilled job in the service sector. The redundant labour force would drive low-skilled wages lower, which could, in turn, lower basic consumption. This could create a negative feedback loop to other industries in China, affecting spending power there, too.

However, these would come at a later stage, as we expect a lagged effect on unemployment.

Infrastructure investment could provide additional job vacancies for redundant workers but we are not completely optimistic on the outlook.

## GDP growth downgrade in 2018 and 2019

Even with fiscal stimulus supporting infrastructure investment and monetary easing at the

same time, we worry about the outlook for the Chinese economy in light of the trade war.

We are lowering our GDP growth rate in 2018 from 6.7% to 6.6% and from 6.5% to 6.3% in 2019.

More stimulus would support the 2019 growth rate, but there is still a limit to what the government can do.

## Fiscal stimulus likely to create overcapacity and over-borrowing

Once again, infrastructure projects will be at the heart of fiscal stimulus. This will come from credit expansion because some of the fiscal stimulus comes from SOEs or local government financial vehicles. This also means that we will see overcapacity both this year and next.

The side-effect of over-leveraged corporates or local government would probably be seen only after a couple of years when interest costs rise after the effects of the trade war fade. By that time, we may need to analyse overcapacity and financial deleveraging for a second time.

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## Changes in the automobile sector in China – an effect of the trade war?

China has hiked tariffs on US imported vehicles but simultaneously lowered tariffs on automobiles from other countries alongside promoting foreign ownership in the industry. We think this is a response to the intensifying trade dispute and will change both the production and consumption of China's automobile industry

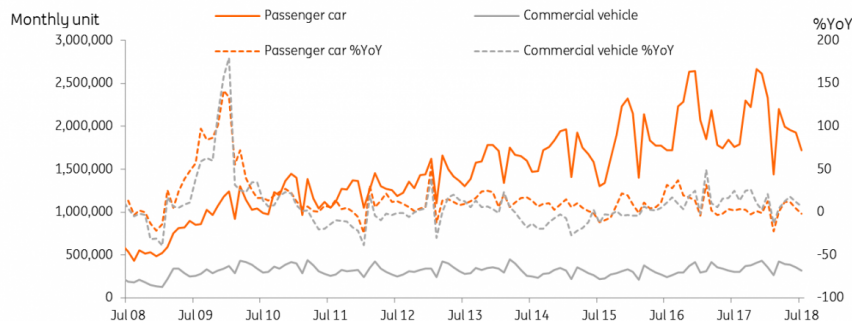


Source: Shutterstock

Most of China's automobile production are passenger cars. Commercial vehicles make up less than 20% of the auto production market, though, in terms of growth rates, commercial vehicle production has grown more quickly than passenger cars since early 2017. But we don't think China is about to make significant changes to the market share of this industry.

## China automobile production

As passenger cars constitute the bulk of automobile production in China, we will focus on their production and sales and how tariffs and changes in foreign ownership could affect this market.



Source: ING, Bloomberg

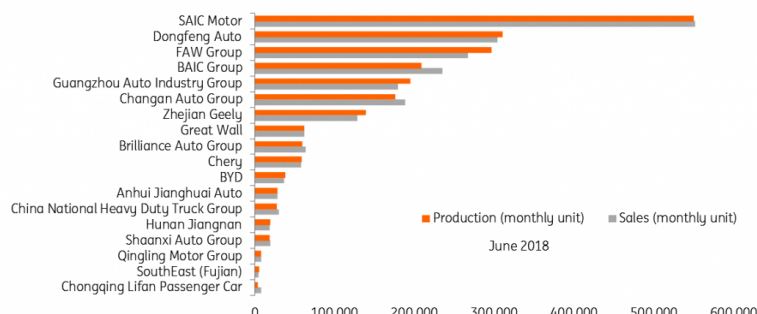
## Chinese car market is mostly a joint venture market

The Chinese automobile market is mainly a joint venture market with both domestic and foreign auto producers producing joint venture brands. This is a legacy of the first auto manufacturing in China, which started with joint ventures. Local brands did not have a chance to develop. There might also be a “consumption bias” on JV brands, since early on, there may have been little trust in local brands, even if the foreign joint venture brands were manufactured in China. Most automobile companies in China have joint ventures with European and Japanese manufacturers. There are only a few Korean and American joint ventures.

According to [media reports](#), foreign players have around 60% of sales in the Chinese automobile market which includes joint ventures. The chart below shows the Chinese passenger market, and then how this translates into better known JV brands.

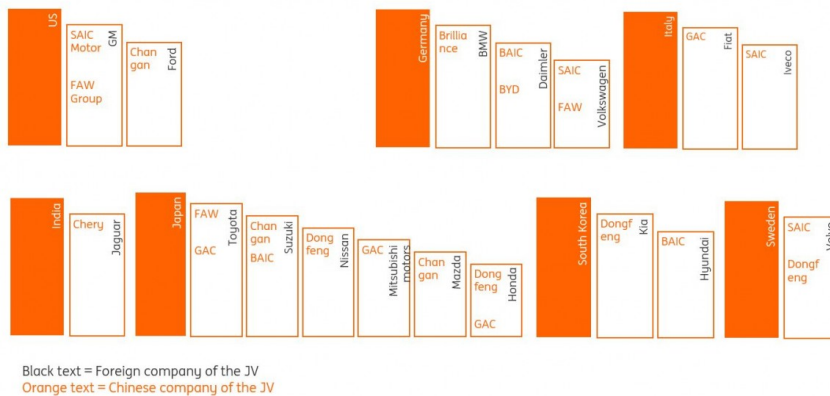
However, one caveat to this are the new “energy cars” that are being built from scratch recently. One consequence of this is that some local brands are becoming more popular in the electric car arena than established JVs of traditional combustion cars, e.g. BYD.

## Production and sales of passenger cars by brand in China



Source: ING, Bloomberg

## Foreign JVs in China and their domestic partners

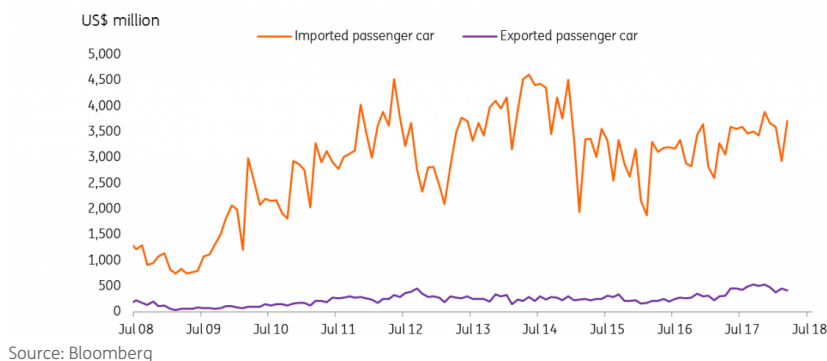


## Imports are growing, but still account for a very small share

In the 12 months to June 2018, domestic passenger car production, including joint ventures, didn't match the volume of domestic car sales even with production volume running at more than a million units per month, which is why imports filled the difference.

Currently, auto-import volumes are still only about 5% of domestic production, but the import trend has picked up from around 43,000 in early 2015 to about 76,000 units now.

Imports have been much larger than exports in terms of passenger cars (around 30,000 units per month) and also in terms of the dollar value (see chart). The rise in imports from 2016 indicates there is room for more imports in the Chinese passenger car market.



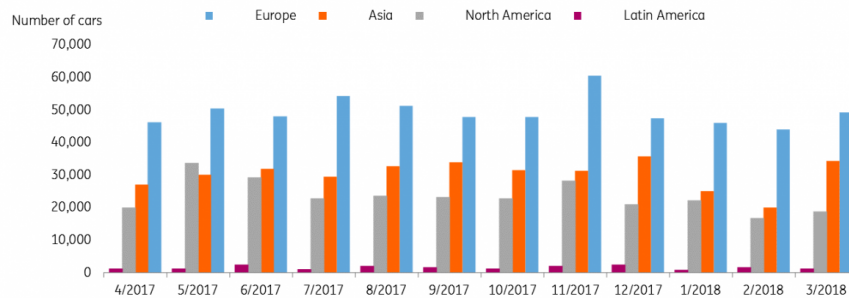
We believe the market is changing as consumers will prefer foreign brands after tariffs have been cut for most imported cars. We expect local production to fall as imports increase after the tariff changes.

The fall in imports of passenger cars in 2015, which didn't pick up until 2017 could be a phenomenon related to the loss of wealth during the 2015-2016 crisis driven by the sudden depreciation of the yuan against the dollar, which triggered fall in prices of the A-share stock market and the Chinese housing market.

## The trade war impact

Most of China's passenger car imports come from Europe (48%) and Asia (33%). Imports from North America make up only 18% of China's car imports.

### Number of China's imported passenger cars

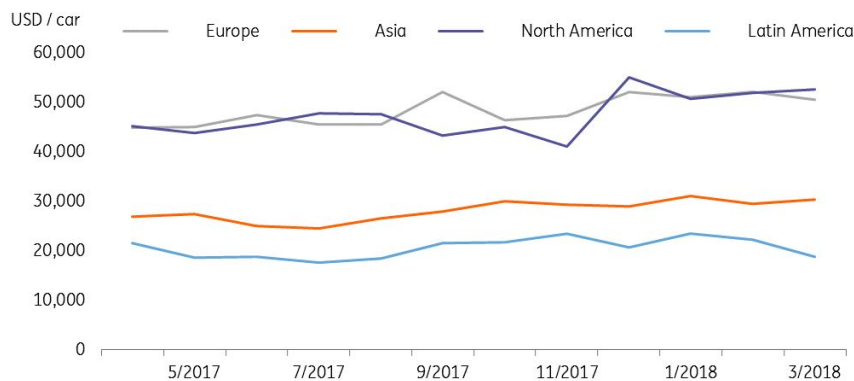


Source: Bloomberg

One possible reason is that there are not as many US brands as European brands in the global automobile market. Another reason could be prices. American cars are not cheap with higher transportation costs. They have either been as expensive as European made cars or even more expensive in the last nine months.

Or it simply could be a matter of consumer preference or perception, with European cars having a greater cache than their US counterparts.

### Unit price of China's imported passenger cars



Source: Bloomberg



## Policy change on tariffs of imported automobiles



Source: ING

## Tariffs make US car exports to China even more difficult

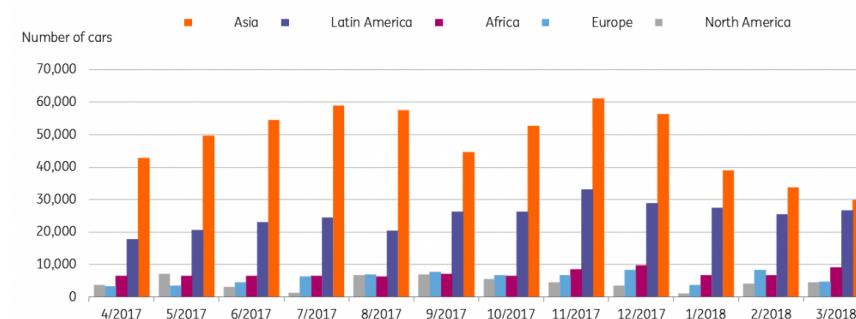
Looking ahead, prices of automobiles imported into China from the US will become even higher compared to other import origins. US car imports will attract an additional 25% of tariffs under the \$16 billion goods tariff list effective on 23rd August, which delivers a total tariffs rate on imported American cars to 40%. What's worse for US imports, is that China has lowered tariffs for automobiles which aren't American to 15% from 25%,

The net effect will be a price cut for cars imported to China except, for the cars imported from the US. Unsurprisingly, we expect Chinese consumers to favour purchases of European cars.

Though the changes in tariffs will benefit European imports and hurt US ones, they could also have some substitution effects on European joint venture brands produced in China, which may grow more slowly as a result.

The US export market for China's passenger cars is very small. China's main export market is Asia and Latin America, so tariffs imposed by the US shouldn't affect China's passenger car exports in general.

## Number of China's exported passenger cars



Source: Bloomberg

## Impact of changes in foreign ownership

Opening up the market for more foreign ownership will affect new energy cars immediately. More global brands producing new energy vehicles will start production in China, as they can now have full ownership of the brand in China. This is a break from the long-lasting tradition of joint ventures in the sector.

## Policy change on foreign ownership

It is well known that the automobile manufacturing industry in China has a lot of joint ventures between domestic and foreign brands. The practice is that foreign manufacturers could only set up a joint venture up to a 50% stake. The National Development and Reform Commission (NDRC) announced opening up the industry to foreigners on 17th April 2018.

## Relaxing foreign ownership in China's automobile industry

**By 2018:** Removal of shareholding cap with regards to OEMs manufacturing new energy vehicles (NEV) and special purpose vehicles (SPV)

**By 2020:** Removal of shareholding cap with regards to OEMs manufacturing commercial vehicles

**By 2022:** Removal of shareholding cap with regards to OEMs manufacturing of passenger vehicles and the 2+2 restriction  
(one foreign investors can invest in no more than two JVs manufacturing passenger cars and no more than two JVs manufacturing commercial vehicles; in practice one foreign OEM normally may be permitted to engage at maximum two Chinese OEMs as JV partners)

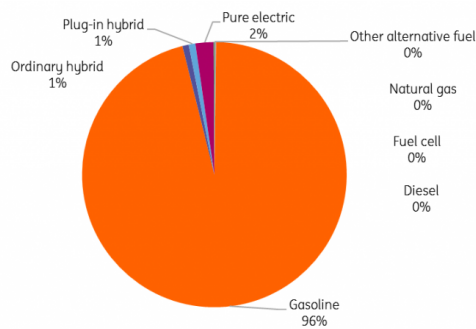
Source: ING

96% of Chinese auto production is of conventional gasoline engine vehicles. Only around 3% are either hybrid or pure electric cars.

By relaxing the rules around foreign ownership, we expect more foreign brand new energy vehicles to be produced in China. Tesla has already set up a production factory in China. In the future, foreign wholly-owned automobile production in China may not only serve the domestic market but also help increase exports.

This could bring competition to local brands that focus on new energy car production. But as we expect the pie of new energy vehicles to expand, the competition that local new energy vehicle brands may face may not be as fierce as competition in the traditional car market.

## Production of passenger car by energy type June 2018 YTD

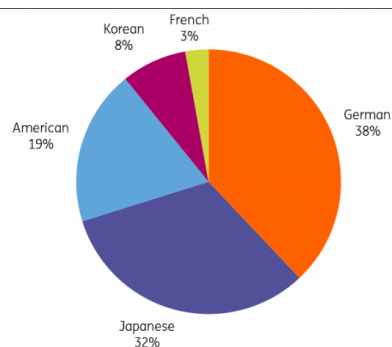


Source: CEIC

The change in foreign ownership policy will not benefit all global passenger car producers equally. If they do not manufacture new energy cars, i.e., traditional combustion cars, then they need to wait until 2022 to have the joint venture restrictions removed.

Nowadays, American brands make up 11% of total production in China. If tariffs on US imported automobiles continue to be in place into 2022 then US brands may choose to increase production lines in China to circumvent the tariffs.

## Foreign brands market share in China



Source: CEIC

In short, changes in policies in the automobile sector, namely on tariffs and foreign ownership, will induce Chinese consumers to buy more imported cars from the rest of the world (except the US) and to buy fewer imported cars from the US. US automobile producers, which are also new energy car producers, can build a production line in China now without ownership restrictions.

Other US car manufacturers might also move their production lines to China if tariffs continue into 2022. We do not expect tariffs to affect China automobile and parts producers as fall in exports to the US could be sold to the domestic market, which is growing.

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# The EU moves to punish Hungary

Punishment beckons for Hungary for allegedly breaching core European values. Economic reaction has so far been muted, but reputational damage could hit investment



Viktor Orban, Hungary's Prime Minister at the European Parliament, September 2018

## The decision

Hungary is closer to facing censure by Europe for allegedly flouting EU rules. Although we don't see any short-term direct economic consequences from the move, the reputational damage to Hungary and its Prime Minister, Viktor Orban (pictured), could affect investment and rating decisions.

On Wednesday, the European Parliament (EP), approved the Sargentini Report which 'comprehensively lists' a series of issues said to breach the values of the European Union, not least the functioning of the constitutional and electoral system, freedom of expression and interference in academia.

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*A prolonged investigation period now starts*

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A total of 448 MEPs voted in favour of the report with 197 against and 48 abstaining, translating into a 69% majority, above the two-thirds needed to trigger the Article 7 procedure. Poland, which

says it will block any sanctions against its near-neighbour, went through a similar process in January this year.

We need to highlight that this is still only the preventive phase of the whole Article 7 process; the talking is only now about to start and the European authorities will want to avoid any possible sanctions. The parliamentary vote now pushes the issue in front of the European Council and a proposal will be sent to the EU member states. A prolonged investigation period now starts, where the Council will hear the views of the Hungarian authorities. They'll attempt to assess whether there is a clear risk of serious breaches of the rule of law in Hungary or not. If it feels the concerns are grounded, the Council will vote to push the issue into the next phase. That's where Poland is right now.

## Economic and reputational consequences

The recent decision does not have direct consequences as far as the 2014-2020 EU programming period is concerned, but it can put additional pressure on the Council to adopt a more cautious approach regarding the investigation and audit on Hungary's usage of EU funds. In a worse case scenario, it could jeopardise the expected inflow from the EU in 4Q18 with a prolonged discussion on the issues. Even then, we don't see it as a real game changer, as the Ministry of Finance and the Debt Management Agency seems to be prepared for that and it's clear that Hungary will meet with all the fiscal rules including the one-twentieth rule on debt reduction and the 3% of GDP deficit rule.

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*Market reaction has so far been muted*

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The market reaction was rather muted with HUF, bond yields and the local stock market being relatively stable. Reputationally, the whole process could have a negative effect on investment and ratings decisions. At this stage, however, it's difficult to calculate the effect on the real economy. The highest long-term risk comes from talks regarding the common European budget for 2021-2027, where the EU funds might be tied to a 'rule of law' clause. However, the new ruling must pass unanimously and secondly Hungary has to go through an 11-step process, which we'll detail below, and any eventual sanctions have to be passed unanimously by the European Council so don't hold your breath.

## How close is Hungary to get a real punishment?

That's because Hungary is still far away from there; the vote on the Sargentini report was just the **first step** of the 11-step process. In the **second step** – so from now on – the European Council will start its hearings and can pass a proposal by vote to initiate Article 7 proceedings. The Council may pass this proposal by a qualified majority vote, meaning at least 22 of the 28 member states must support the decision. If six member states vote against it, the procedure could be blocked.

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*The process will drag on*

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The **third step** is where the European Council initiates Article 7 proceedings and the Council and the Commission together start a thorough investigation regarding which points of the rule of law has been violated. The **fourth step** sees consultations held between the counterparties and the concerned country. The **fifth step** contains a formulated opinion by the European Commission about the alleged violation of the rule of law. Hungary can go pro-active here, taking corrective measures itself, or can refuse the EC's opinion. As a **sixth step** (if Hungary refuses to react to the fifth), the Commission will make recommendations to which Hungary may respond by either respecting these recommendations or by ignoring them. Obviously, if Hungary refuses to change anything, we go to the **seventh step** where the Council officially activates the next steps in the Article 7 process. The **eighth step** is where the preventive mechanism starts, where the Council will need to vote with a four-fifths majority that there is a clear risk of a serious breach by Hungary.

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*Any eventual sanctions will require unanimous backing*

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**Step nine** comes when the EP or the Council proposes the opening of the sanctioning mechanism, but with this, we quickly reach **step ten**, where the Council must decide *unanimously* that there is a serious and persistent breach by the accused country. Then, a qualified majority is needed in the Council to in practice suspend rights of the accused country, including voting rights. With this, we reach **step eleven**, the official closure of the proceedings.

It is unlikely we'll get to that point, not least because of Poland's support for Hungary, which has said it will oppose any sanctions that may be imposed on the country. And it's not clear when the next steps will be taken or what the eventual consequences will be.

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## Swedish elections: Winner takes nothing

A very tight vote leads to a deadlocked parliament. Lengthy negotiations likely lie ahead, with little prospect of a strong government. The economy (and the krona) will probably remain in no man's land



Source: Shutterstock

### A dead heat

The Swedish election result could hardly have been closer. On current projections, two major political blocks are separated by a single parliamentary seat (144 vs 143). The margins are so close that votes from Swedes living abroad, which will be counted by Wednesday, could shift the outcome (based on previous results, the centre-right are likely to gain a little).

But the rise of the far-right Sweden Democrats means that neither the current centre-left government nor the centre-right 'Alliance' is anywhere near a majority in parliament.

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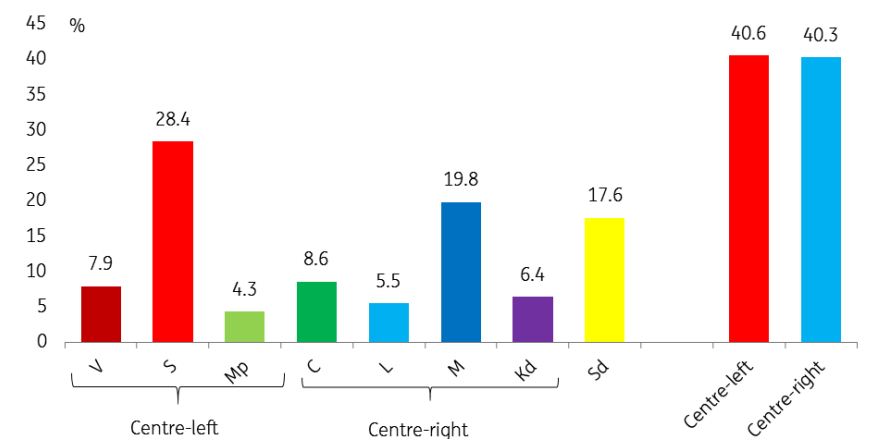
*The two centrist parties are in the (potentially unenviable) position of kingmakers. If they were to accept either a centre-right government or a Social Democrat government supported by the Greens and the Left, that would end the impasse*

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Going by the statements each party made ahead of the election, there is no feasible majority based on the current parliamentary arithmetic, which means compromises will be necessary. Negotiations have already started, but it will take some time for the parties to work out where they stand.

Relative to the previous election, the extremes have gained: the Sweden Democrats have increased support from 12.9% to 17.6% and the Left from 5.7% to 7.9%. The government parties lost support, in particular, the Greens (down from 6.7% to 4.3%). The alliance parties have seen votes redistributed from the Conservatives to the Centre and Christian Democrats, but have gained little overall.

## Preliminary result



Source: SVT

## What happens now?

Prime Minister Stefan Lofven has announced he will stay in office and seek renewed support for a government led by the Social Democrats. The opposition parties have called on him to resign, and want to form a centre-right government. So, ahead of what looks likely to be long and tough negotiations, this will amount to little more than political theatre.

In reality, the parliamentary situation is exceptionally complicated. Neither of the traditional political blocks can form a government without consent from either the other side or from the Swedish Democrats. Even combinations such as a centrist government (S+Mp+C+L) or a right-wing government (M+Kd+Sd) are short of 50 %, which means some cross-block solution is necessary.

Arguably, the two centrist parties (C and L) are in the (potentially unenviable) position of kingmakers. If they were to accept either a centre-right government supported by the Sweden Democrats or a Social Democrat government supported by the Greens and the Left, that would end the impasse.

However, both of those options go against their election manifestos and would risk them losing support in future elections. The centrists have said they would prefer a centre-right government, but if that proves impossible, they are open to a deal among the mainstream parties (aimed at excluding the Sweden Democrats and the Left from influence).

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*In the medium term, the worry is that another weak government means another four years without meaningful economic reforms, and if Sweden suffers an economic downturn or financial turbulence a minority government could prove unable to take decisive action*

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Indeed, they may spot an opportunity in that if both the Social Democrats and the Conservatives refuse to accept a government led by the other, a possible compromise could be for the two largest parties to step aside and support a centrist minority government. There is some precedent for such a solution, though previous centrist governments in the 70s and early 80s proved unstable and short-lived.

Whatever compromise the mainstream parties work out, the new government is likely to struggle with either a weak parliamentary position or internal divisions. It is hard to see a constellation that will last long once it starts governing. And a government forced into constant compromises could prove a poisoned chalice for the parties involved, accelerating the draining of voter support from the mainstream towards the Sweden Democrats and the Left. New elections (the first since 1958) could prove the only way out of what looks like a political cul-de-sac.

## Key dates

**12 September:** All votes counted and the final result confirmed

**24 September:** New parliament is seated, and elections for a new speaker and deputy speaker take place. If the current government doesn't voluntarily step down, a vote of confidence must take place within 14 days.

**15 November:** Final deadline for a new government to pass a budget for 2019. If no budget is passed current spending plans are likely rolled forward.

**25 December:** Earliest date that a new election can be called. The new vote would most likely take place in **mid-March next year**.

## What does all this mean for the economy?

The political stalemate has limited near-term implications for the Swedish economy. With a stable institutional framework, Sweden can probably operate on auto-pilot for some time. There is no obvious need to change the budget for next year, nor does the government face genuinely urgent economic decisions.

In the medium term, the worry is that another weak government means another four years without meaningful economic reforms and that if Sweden suffers an economic downturn or financial turbulence, a minority government might be unable to take decisive action.

Having said that, Sweden has a long tradition of the mainstream parties acting together on both long-term issues (e.g. pensions and defence) and in crisis situations (in 2008 and the early 90s crisis). A key question in the months ahead is to what extent the acrimonious election campaign (and the potentially fraught aftermath) has eroded the capacity for such consensus solutions.

## And the krona?

With EUR/SEK already down from 10.70 to 10.45, it looks like most of the 'it could have been worse' relief rally is probably in the past. The krona is in limbo until there is more clarity on what happens next on the political front. If the parliamentary deadlock cannot be broken and new elections are announced some of the political risk premium seen in the run-up to the vote could easily return.

Until there is new information on the political front, attention will start to shift back to the economy and central bank outlook. The immediate focus is on inflation data this Friday and the Riksbank minutes next Monday. We continue to see the underlying story as SEK negative: the domestic economy is slowing, the Riksbank remains among the most dovish central banks, and Sweden is highly exposed to the impact on global trade of the Trump administration's aggressive tariff policies.

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# When 'nudging' becomes 'sludging'

Are the choices we make ours alone or have we subconsciously been 'nudged' into them by clever marketing? And is this a good thing for society? We reflect on the concept of 'nudging' 10 years after Richard Thaler brought the theory to prominence



## What's a 'nudge'?

This year, we celebrate the 10th birthday of 'Nudge', the best-selling book by Richard Thaler and Cass Sunstein. In [Nudge: Improving decisions about health, wealth and happiness \(2008\)](#), the American professors introduced the powerful idea of nudging. A nudge is a subtle change in the 'choice architecture' (the way choices are presented to consumers) to encourage shifts in behaviour. Simply put, it can help people and societies make wiser choices (or avoid mistakes) without restricting their freedom.

To understand how nudges can help us make better decisions, it's important to consider why we often make bad choices in the first place.

## Tricks of the Mind

The ability to choose seems to us to be a very powerful tool. However, we humans have developed various psychological quirks and mental shortcuts (so-called [heuristics and cognitive biases](#)) to make our decision-making time on earth more bearable. Sometimes, these shortcuts lead to good

decisions more quickly, but frequently they trick our minds to make unconscious mistakes.

Remember Barack Obama and his suits? He only wore grey or blue suits to limit his choices about what to wear. Limiting choice formed a smart mental shortcut that let him spend his time on other – far more relevant – decisions, [he said](#).

But many of us are also subject to the [status quo bias](#). This is based on another common psychological quirk: we like sticking to the default choices because inertia makes us resistant to change. Just think of your health insurance or your mobile subscription: how often do you switch deals? Because of our tendency to leave things as they are, the use of pre-selected options is then one of the most subtle but powerful nudges that companies may use to influence people's decisions.

And here's one more popular nudge involving a third option. Say you sell shirts and have two products, a cheap one (€30) and an expensive one (€70). Just adding a third ultra-expensive product (€250) next to the other two will make more people buy the shirt that costs €70, because now they think €70 is a bargain. By carefully architecting people's choices, you can 'nudge' them to pick the most beneficial option for themselves. Or, you can tempt them to follow someone else's interest.

Are consumers aware of such subtle 'choice architecture' design changes? And should we welcome commercial nudging? Only if it benefits the individual or if it promotes the public good, Thaler and Sunstein recommend. That is called *nudging for good*.

## From nudging to sludging

If you think about it, it all comes down to ethics. So which ethical principles should 'nudges for good' be built upon? Thaler and Sunstein propose the following principles:

1. The nudge should be transparent and never misleading.
2. The original set of choices should remain available.
3. It should be easy to opt out of the nudge (for example, in a single click).
4. The behaviour being encouraged should improve the welfare of those being nudged.

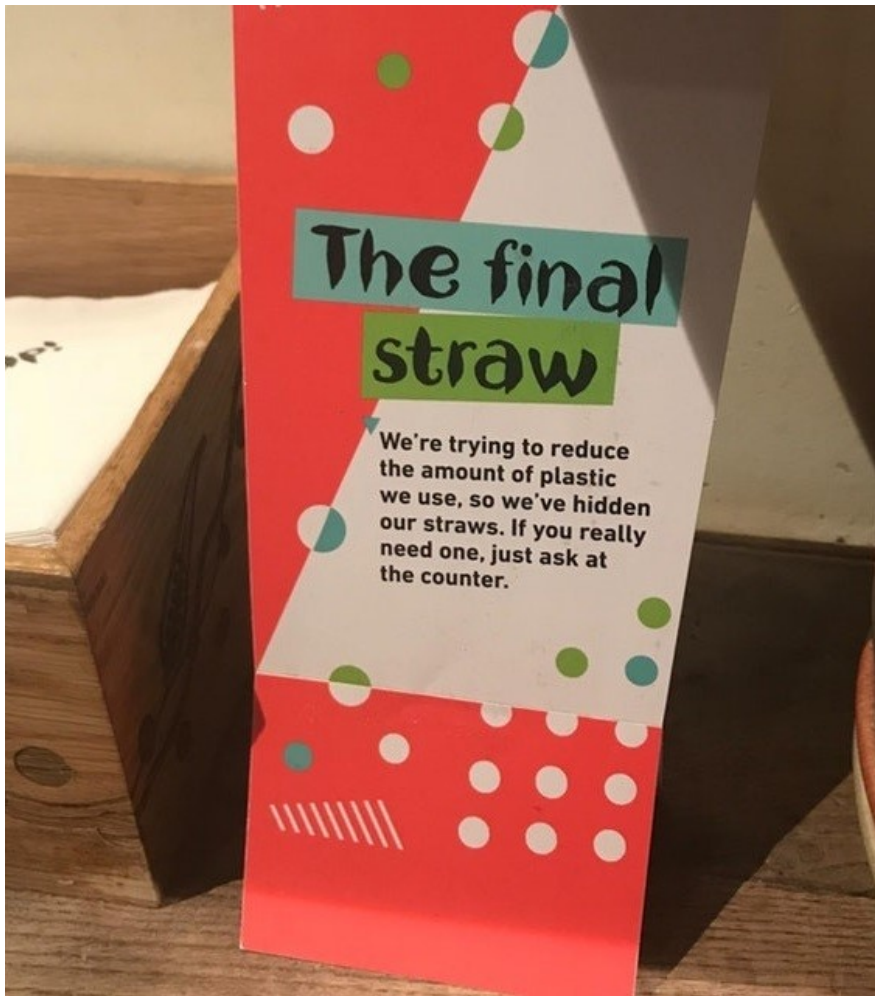
If a nudge is built on all of the above principles, we're dealing with a 'nudge for good'. If any of the four principles is violated, particularly the last one, [Thaler himself](#) calls it a 'sludge' – 'a nudge for bad'. Sludging takes advantage of cognitive biases and choice architecture. People are sludged towards behaviours that are not in their best interests but may benefit a company or government instead.

According to [Sunstein](#), sludges usually lead people to waste time and/or money, resulting in future regrets. Think of an unhelpful pre-selected option that persuades people to purchase excessive insurance or make foolish investments. This is exactly the stuff that complex subprime mortgages were made of. [Evidence shows that these](#) were marketed to the less-educated and less-wealthy customers who would never be able to pay their mortgage if a real-estate crisis hit.

## Nudging for good, better, best

Nudges for good could relieve concerns about the ethics of (covert) manipulation of behaviour. One simple and powerful example of a good nudge is the 'Final Straw' campaign, which boosts

awareness about the impact of consumer choice.



The key here is transparency. The [British House of Lords \(2011\)](#) suggested two criteria to determine whether a nudging intervention is ethically acceptable. 'Choice architects' should either (1) tell people about the nudge directly or (2) ensure that perceptive consumers can discern the implementation of a nudge. Indeed, disclosing the intention behind a nudge encourages people to evaluate more sceptically the potential effect of choice architecture, and to actively identify whether the steered option is actually in their interest.

But does nudging still work when people are aware they're being nudged? Recent studies conducted in [Germany](#), [the Netherlands](#) and the [US](#) have confirmed that nudges can indeed be made transparent without reducing their effectiveness. This has been shown to work in various contexts (from saving money or energy to eating healthy food) and in various forms (e.g. default options, opt-ins/outs, or reminders). [Research](#) also shows that disclosing information on *the potential behavioural influence and/or purpose of the nudge does not trigger psychological reluctance*.

The lesson from these [studies](#) is that, overall, [consumers appreciate transparency](#). They are likely to favour a certain choice architecture if they believe that it has a legitimate goal and if it fits with their interest and values. This support evaporates when people suspect a sludge. Upfront disclosure improves their perceptions of the fairness and ethicality of the nudge, and their willingness to cooperate again in the future.

## Cleaning up the sludge

It is clear that companies should not – and don't need to sludge their (potential) customers. But the way to a sludge-free world also depends on *how we behave as consumers*: we must resist the sludges that are still in effect. The more often we turn down questionable offers, the less incentive we give companies to turn to such schemes. If, instead, we reward companies that act in our best interests, nudges for good will survive and flourish, and the options available to us will improve.

And how about policymakers and other consumer advocates? Should they not be encouraging consumers to stop and pause when facing a nudge... or a sludge? Yes. This would probably diminish the biasing effect of nudging, enabling consumers to make choices they themselves deem to be in their best interests. As personally pleaded by Thaler in a recent [article](#): "Less sludge will make the world a better place."

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