

## In case you missed it: Over-reaction and under-performance

The Bank of England doesn't move, but did markets over-react? We tell you why we've changed our Malaysian ringgit and Swedish krona forecast. And don't get carried away by the Eurozone's recent strength; our new report asks whether it can ever escape its productivity rut.

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As the Eurozone recovery matures, a more permanent pickup is not yet assured. In this major report, we note that major structural reforms have yet to take...

By Peter Vanden Houte and Bert Colijn



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Report | 11 May 2018

# Can it last? The long awaited pickup in Eurozone productivity

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Source: istock

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## Bank of England stays on hold, but have markets overreacted?

As the Bank of England points to a possible rebound in economic growth and further wage rises, we think markets may have been too quick to write off a...



Source: Bank of England

In light of the dreadful first quarter growth reading, the Bank of England has opted to keep rates on hold this month. Unsurprisingly, two of the more hawkish committee members have again gone against the pack and voted for an immediate rate rise. But markets have interpreted the overall tone of the meeting as more dovish than anticipated – money markets have priced out a 2018 rate hike.

Reading through the statement, we suspect this is a bit of an overreaction. The Bank is keen to emphasise that it thinks the weaker growth will prove to be temporary – and interestingly, that the initial estimate of 1Q GDP has been wildly underestimated. The latest forecasts assume an upward revision from 0.1% to 0.3% QoQ.

It also remains upbeat on the outlook for wage growth. Although it has nudged down its forecast to 2.75% for this year, it appears satisfied that the tight jobs market is translating into higher pay. Remember that Bank Agents have been highlighting that 2018 could be the best year for wage settlements since the crisis.

Importantly, the Bank still feels that further “ongoing” tightening would be “appropriate”, and all of this makes us think that policymakers still have a preference to hike in August if the data allows

them to.

That's not to say there aren't risks – the biggest of which lies in the consumer sector. By some measures, the first quarter was the worst three-month period for retailers since the crisis. At the same time, consumer credit growth appears to have collapsed in recent months with surveys indicating that banks have significantly tightened lending standards. It's unclear exactly how this will play out, but this could prove to be bad news for near-term growth. We suspect that this will have been a key reason why policymakers opted to keep rates unchanged today.

Then there's Brexit. If the lead-up to the December and March EU summits are any guide, the months ahead of the October leader's meeting could see talks become increasingly noisy. Throw in the fact that core inflation is set to return to target within the next three to four months, and it could become increasingly complicated for the Bank to tighten policy as we move through the year.

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## Swedish krona: A forecast revision

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Source: Shutterstock

### ING's revised EUR/SEK forecasts

	2018	2018	2018	2019	2019	2019	2019
EUR/SEK	Q2	Q3	Q4	Q1	Q2	Q3	Q4
<b>New</b>	<b>10.80</b>	<b>11.00</b>	<b>11.00</b>	<b>10.90</b>	<b>10.70</b>	<b>10.60</b>	<b>10.50</b>
<i>Previous*</i>	10.20	10.00	10.10	10.00	9.90	9.80	9.80

Source: ING. \* As per 'Swedish Krona: Swimming Naked?' 7<sup>th</sup> March 2018

## Trade war risk premium to rise again

We see further upside risks to EUR/SEK and revise our previous EUR/SEK forecast higher. We look for EUR/SEK to reach the 11.00 level in the next three months and stay there for the remainder of the year.

As per [USD: Curb Your Enthusiasm](#), we expect the theme of protectionism to return in June following the recent calm after the US administration recorded some quick wins, with trade negotiations with Mexico, Canada and South Korea being a good example. As Chris Turner points out, the focus will now turn to China and the EU, as both are preparing retaliatory tariffs should the

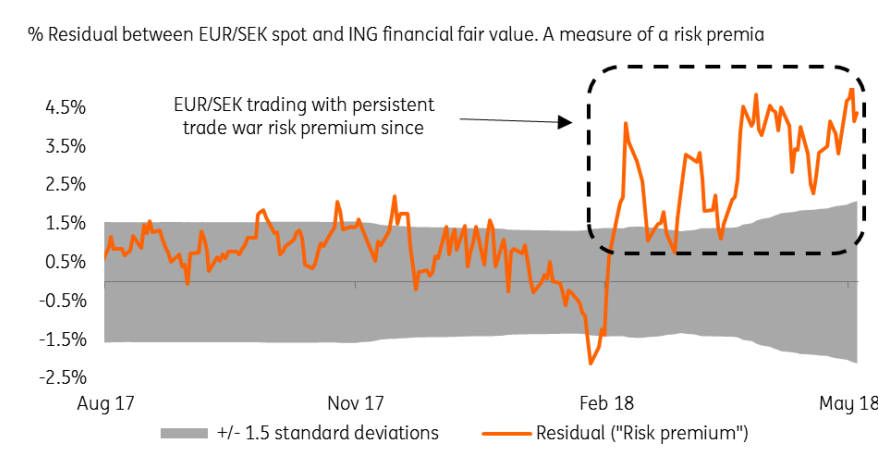
US go through and implement its threats.

On the Chinese side, it will be late May/early June when President Trump decides which of the proposed tariffs on China will stick. We doubt Beijing can offer enough in early May to significantly water down these tariffs. Instead, we look for a residual of those US tariffs to be implemented in June and the Chinese to reciprocate. These concerns about a global trade war should be negative for the krona.

As per [SEK: Swimming naked?](#), we see SEK as one of the G10 currencies most vulnerable to escalating trade tensions due to the openness of its economy (one of the highest in the G10 FX space) and its high beta to global growth. This is depicted in **Figure 1** which shows a material rise in the SEK risk premium (against EUR), with the trade war risk premium now being at around 4%.

While extreme, we don't rule out a further rise in the risk premium given the SEK's high vulnerability and its cheap funding costs (SEK being the second cheapest G10 currency to short). SEK vulnerability to the global trade tensions was one of the main reasons why we turned bearish on the currency earlier in the year and why we now revise our EUR/SEK forecast even higher.

## Persistent risk premium evident in SEK

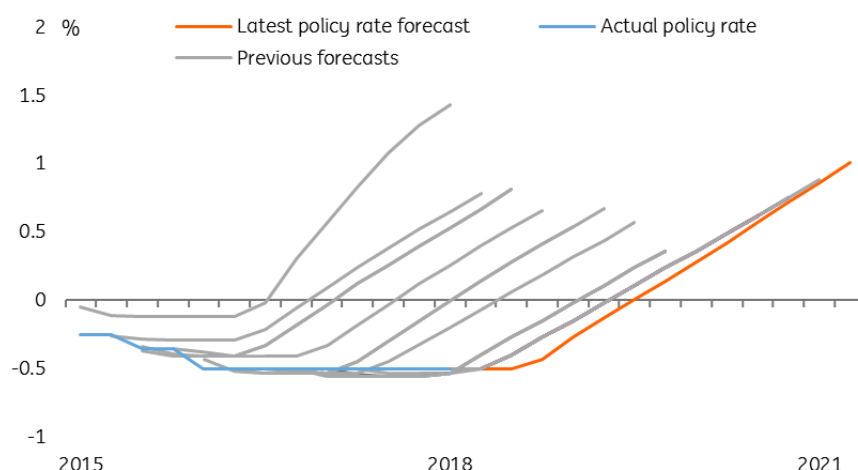


## Dovish Riksbank to remain dovish

On the Riksbank side, history teaches us that one should assume a dovish stance as a base case. The Swedish central bank has repeatedly pushed back the date for its first rate hike. Its April decision to push the projected first rate hike into December was the eighth revision to the policy rate forecast since negative rates were first introduced in 2015 (**Figure 2**).

So we have to ask ourselves, what would it take for the Riksbank to change its behaviour and actually deliver a rate hike in 4Q 2018? In our view, it's hard to see why this time will prove any different. The Riksbank's dovish bias remains intact and there is little sign of domestic price pressure accelerating to push inflation above 2%.

## Rate hike continuously postponed



## The bar for a Riksbank response is set very high

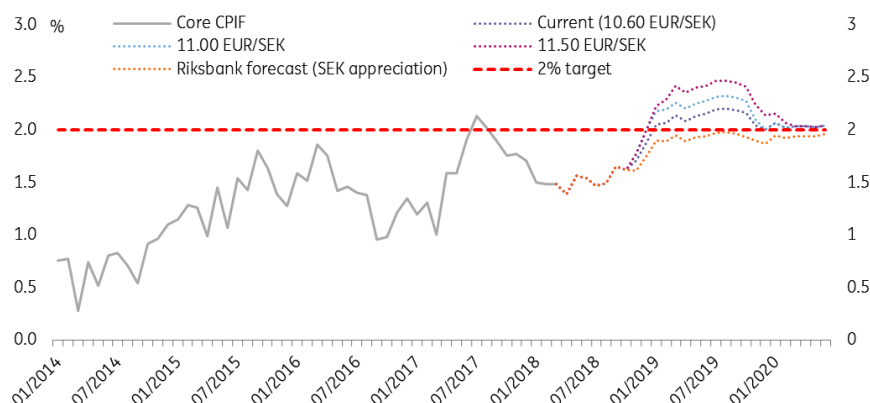
The krona's latest depreciation could lead to inflation printing above the 2% target towards the end of 2018 and early 2019. However, as we show in **Figure 3**, a simple projection based on the Riksbank's latest forecast and different scenarios for the currency suggests that even a further depreciation (i.e. EUR/SEK at or above 11.00) would not necessarily lead to a significant overshoot in core inflation.

Even with EUR/SEK at 11.50, the core inflation would still remain within the +/- 1% tolerance band around the 2% inflation target.

Importantly, as seen in the chart below, this is likely to be a temporary effect and the Riksbank can probably look through above-target inflation were that to be driven by external factors. Hence, we see the EUR/SEK 11.00 as achievable and the journey towards it not necessarily drastic enough to trigger an actual Riksbank response via rate hikes (bar some occasional verbal interventions).

Given its inherent dovish bias, we no longer expect the Riksbank to hike this year (provided SEK does not experience an extreme sell off well above our target of EUR/SEK 11.00) and will only hike next year in line with the ECB in the middle of 2019.

## Inflation overshoot limited





## Economy to slow down

While the main reason for the Riksbank's dovish shift this year has been the weaker-than-expected inflation figures in 1Q, the wider Swedish economy also looks a bit softer. Forward-looking indicators have come off and household spending weakened at the start of the year. This is in large part due to the housing market slowdown that started in the second half of 2017. Though house prices have stabilised over the past couple of months, construction is set to slow materially in 2018 and 2019. This will drag overall economic growth down from the 3% average of the past five years.

Though the Riksbank has factored this housing slowdown into its forecasts, we see downside risks to its expectation of 2.6% in 2018 and 2.0% in 2019. The housing market turmoil could easily end up doing more damage to household consumption than anticipated.

And the global growth story, a key support for Sweden's export-oriented economy, looks a bit less solid than a few months ago. We see a material probability that the Swedish economy slows more abruptly than expected, which would become another reason for the Riksbank to delay rate hikes.

## Domestic politics

Another factor that could weigh on SEK over coming months is the upcoming Swedish election in September. The rise of the far-right Swedish Democrats means that neither of the traditional centre-right and centre-left party groupings are likely to win a majority in parliament. That means we are likely to see a repeat of the 2014 stalemate situation, resulting eventually in a weak minority government.

While Sweden benefits from strong institutions and an underlying consensus on key issues among the mainstream parties, political uncertainty could nevertheless provide an additional negative factor for SEK in an environment where investors are looking for any negative headline news to sell the battered SEK.

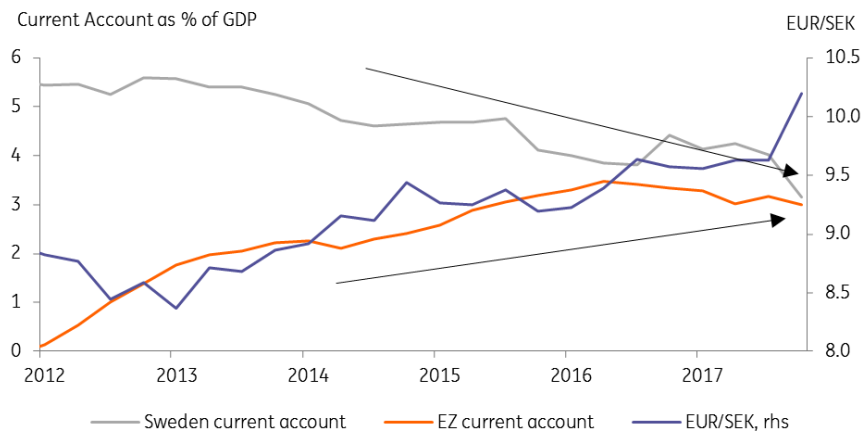
## Current account surplus shrinking

As noted [SEK: Swimming naked?](#), the SEK has all but lost the relative current account surplus advantage vs the EUR. The deteriorating Swedish current account surplus (from 4% of GDP early last year to a projected 2.5% by end 2018) contrasts with the Eurozone current account dynamics which remain stable at around 3% of GDP (**Figure 4**).

As the relative current account positions converge, the krona's cushion vs the euro fades away, making the currency more vulnerable to the direct effect of global risk sentiment or the relative monetary policy position.

We thus see further upside risks to EUR/SEK and **we revise our previous EUR/SEK forecast higher**. We look for EUR/SEK to reach the 11.00 level in the next three months and stay there for the remainder of the year.

## SEK losing the tailwind of the current account advantage



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## Malaysia: Mahathir returns, uncertainty lingers

The lingering political and economic uncertainty ahead leads us to revise our end-2018 USD/MYR forecast to 4.05 from 3.84 previously



# 4.05

ING forecast of USD/MYR at end-2018

Revised up from 3.84

### The best of MYR appreciation may be over

The markets were counting on the return of the former government of Najib Razak for continued economic and political stability. So, an initial negative market reaction to the surprising election results seems probable, though that will not be until Monday, 14 May when the market opens after the election holiday. But that's not all.

The lingering political and economic risks as we outline below will weigh on investor confidence and performance of local markets, especially the Malaysian ringgit (MYR) for some time, probably through the end of this year. The MYR has lost 2.2% of its value against the US dollar since early April. Besides the increase in political noise since the announcement of elections in early April, the return of the USD's strength was also responsible as reflected in across-the-board weakness in Asian currencies since. We now see USD/MYR breaching the 4.00 level within the next three months and ending the year above

that level. Accordingly, our end-2018 USD/MYR forecast is revised to 4.05 from 3.84 earlier (spot 3.95, consensus 3.81, market forward 4.00).

# 113

## Parliamentary seats for Pakatan Harapan coalition

Out of total 222, a clear win

Better than expected

### A clear victory but muddled future

A decisive victory by the Pakatan Harapan (PH) coalition led by Mahathir Mohamad may not mean an end to election-related political uncertainty. On the contrary, we can think of more political jitters, if the former ruling coalition Barisan Nasional (BN) and their supporters fail to digest the election defeat that ended over six decades of BN rule. An absence of any untoward incidences in coming days and a smooth transition of power from BN to PH may be positive for markets in the near term. But it doesn't end there.

This election result was one of the three possible scenarios we painted in our election preview note, where we also noted that a new government of Mahathir inherits a strong economy, which he will use to consolidate his power for the future, possibly paving the way for his son, Mukhriz Mahathir, to be his successor.

Having ruled the country for two decades under the BN banner, Mahathir may provide strong leadership, to begin with. However, Mahathir's old age (92 years) and potential political cracks with key allies, especially his former foe Anwar Ibrahim, whose Peoples Justice Party (PKR) is the dominant member of the PH coalition, could cast a shadow on the stability of the Mahathir administration. The test of this will be as early as June, when Anwar is expected to be released from jail on a royal amnesty.

### And more economic risks ahead

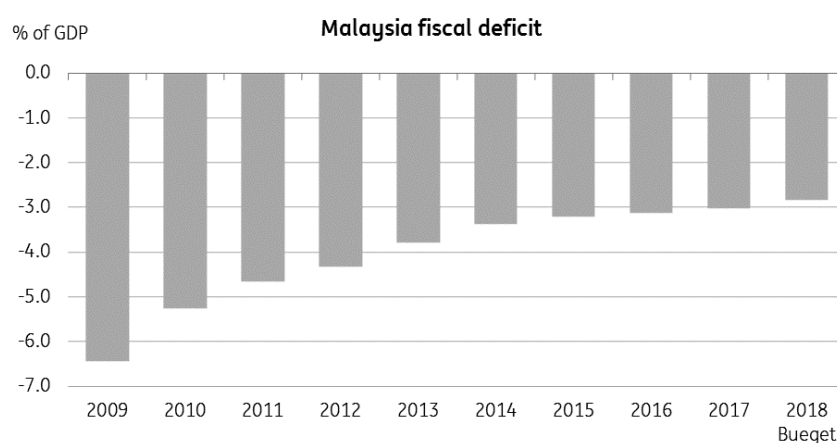
The Malaysian economy has been doing well and local financial markets have been outperforming their emerging market counterparts since last year. The sustainability of these trends hinges on the continuity of current economic policies under the new administration.

Among Mahathir's main elections promises were a scrapping of the 6% Goods and Services Tax introduced by the previous administration in April 2015. The fiscal reforms including the launch of GST and dismantling of fuel subsidies were instrumental in the consolidation of Malaysia's public finances, evident in a more than halving of the budget deficit from over 6% of GDP in 2009 to about 3% in the last year (see chart). Any reversal of these reforms by the new administration will be a setback for investors. No wonder, Moody's was quick to react to the election outcome by painting a credit negative scenario. Moody's rates sovereign at A3, on par with S&P and Fitch, with stable outlook.

*Some campaign promises, if implemented without any other adjustments, would be credit negative for Malaysia's sovereign bonds. –Moody's statement.*

Among other economic risks, one could anticipate Mahathir reassessing a multitude of foreign investment projects launched by the previous administration, as well as reopening the investigation of the 1MDB corruption scandal in which former PM Najib was allegedly involved. Moreover, the previous Mahathir regime was known for restrictive economic policies, prohibiting free flow of capital to and from Malaysia in the aftermath of the 1997 Asian crisis.

## Steady fiscal consolidation



Source: CEIC, Malaysia Ministry of Finance forecast

## But some positives

The economy has been doing well since last year and local financial markets have outperformed relative to their emerging market counterparts, for which we credit a positive terms of trade shock from rising global commodity prices, particularly the price of oil. Considering recent geopolitical developments, the upward oil price trend is your friend.

Barring any unfriendly policy shifts, Malaysia's sound economic fundamentals should sustain as the main positive for investors and markets. We reiterate our forecast of only a modest slowdown in Malaysia's GDP growth this year to 5.5% from 5.9% in 2017 (consensus 5.4%, government 5.5-6.0%). The test of this will be the release of GDP data for the first quarter next week (17 May), for which our forecast is 5.6% year-on-year growth.

However, likely negative sentiment toward the MYR strengthens our conviction that the Malaysian central bank (BNM) will continue on the normalisation path for monetary policy with one more 25bp hike in the overnight policy rate in the third quarter.



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# Hong Kong: Upgrading GDP growth for 2018

The extremely strong growth of the Hong Kong economy in 1Q18 surprised us. The growth mainly came from consumption created by the wealth effect from...



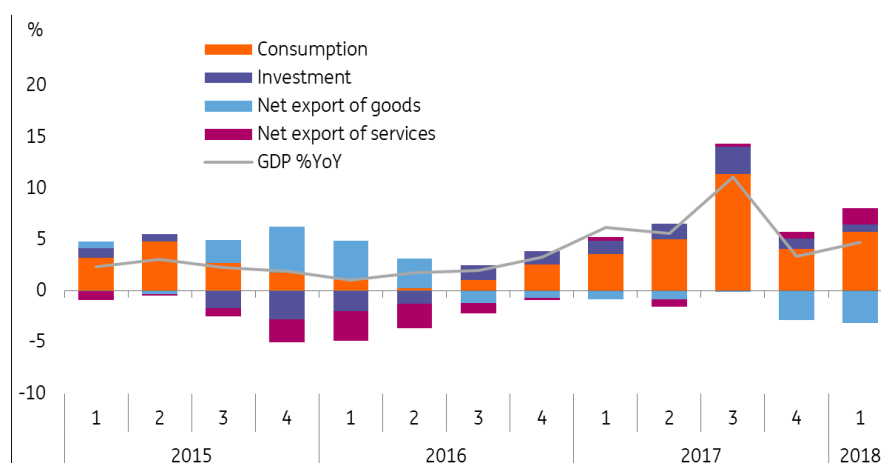
Source: Shutterstock

## Surprisingly strong GDP driven by consumption

Hong Kong GDP grew 4.7% year-on-year in 1Q18, which is strong but consumption is even stronger at 8.6%YoY. We underestimated growth at 3.4%YoY in 1Q, the same as consensus.

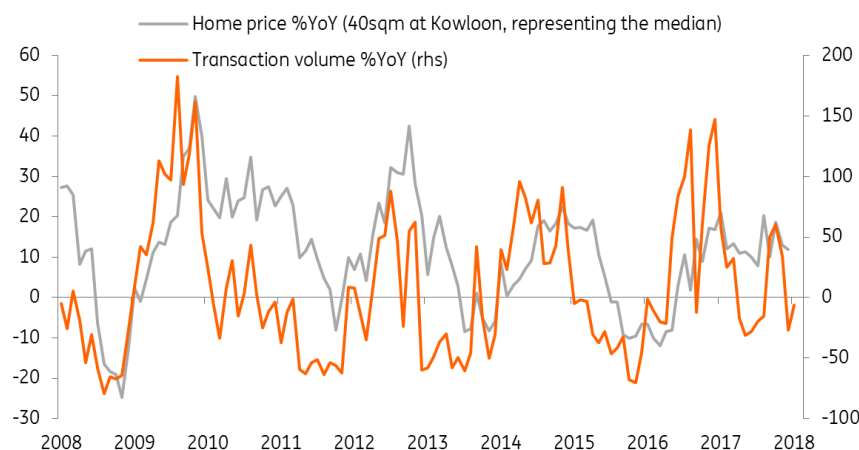
Consumption growth could be due to the wealth effect of rising home prices, which have increased more than 20% for most housing units in 12 months. Though other components also grew at a decent rate, we argue that those were mainly due to the base effect from 1Q17.

## Hong Kong strong growth driven by spending



Source: ING, Bloomberg

## Housing prices keep rising



Source: ING, Bloomberg

## Home prices will continue to rise albeit at a slower pace in 2H18

Home prices are not likely to stop rising unless there is a big negative unexpected event in the market. Rising interest rates from more Federal Reserve rate hikes would certainly increase the burden of mortgage borrowers, so home prices would rise at a slower pace. But we do not expect a fall in property prices. With new flats becoming smaller, property developers are able to keep new homes affordable to young people with wealthy parents.

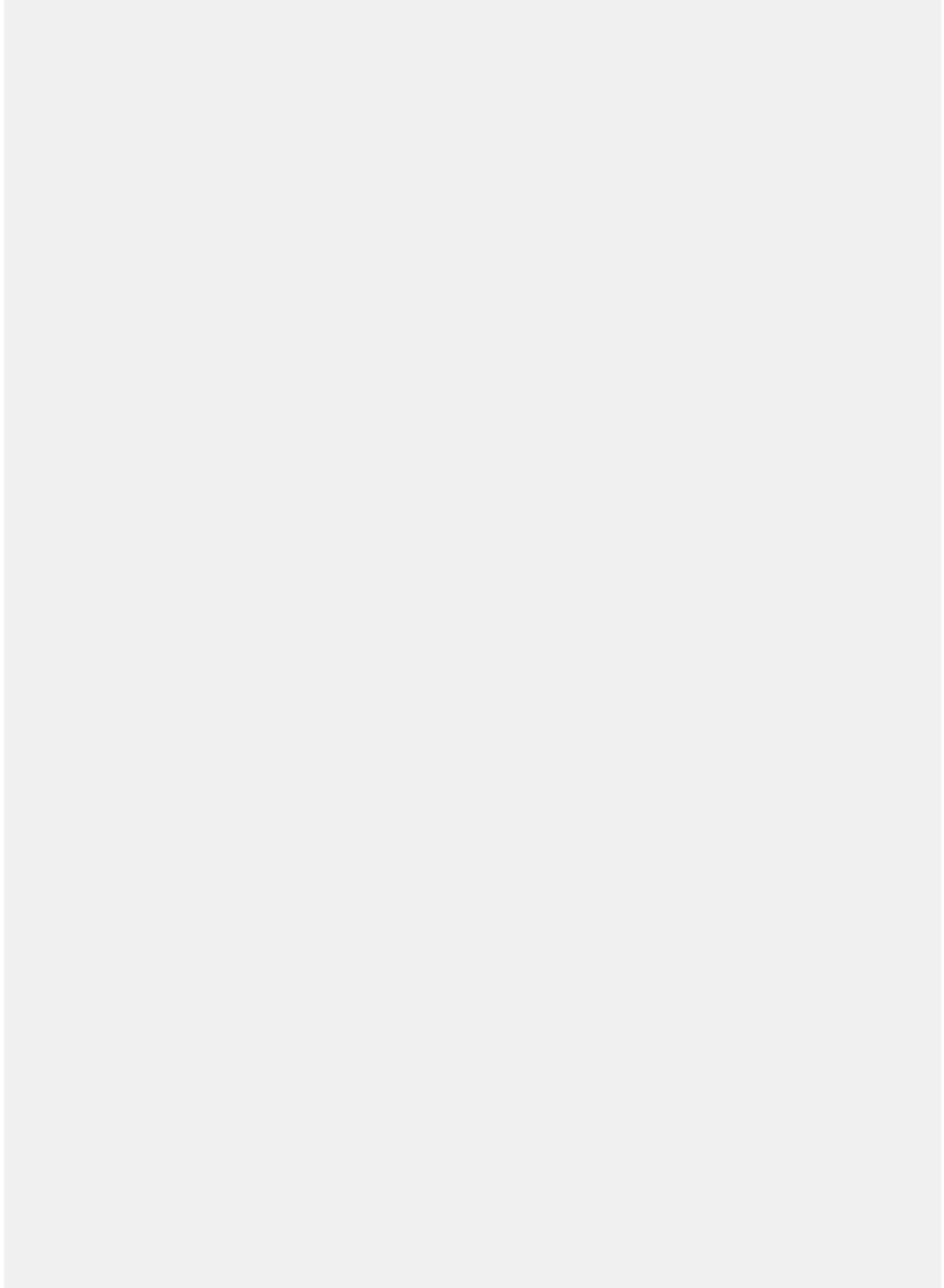
In addition, rising home price expectations would also induce existing home owners to refinance their mortgages, even at high interest rates, to invest in an additional property, hoping for some capital gains in the longer term. In other words, the wealth effect would continue to exist for a few more quarters.

## Uncertainties mount from trade tensions

On the other hand, we believe that the escalating trade tensions could disrupt Hong Kong's re-export businesses. Those activities would be mainly shipping, port, logistics and trading businesses.

## We revise Hong Kong GDP upward to 3.8% in 2018

We maintain our GDP forecasts for the remaining months of 2018, as good growth from consumption will be offset by trade-related service activities. But the strong growth in the first quarter is sufficient for us to revise our GDP forecast for 2018 to 3.8% from 3.4%.



## SNB rallies against “Vollgeld initiative”

The Swiss will vote on the “Vollgeld initiative” next month but according to polls, public opinion is still wavering and the central bank...



Source: Pexels

On 10 June, Swiss citizens will be asked to give their opinion on an initiative which may reform the monetary system.

Those who promote it want to withdraw bank's ability to create money by giving the Swiss National Bank (SNB) the sole responsibility to create both bank notes and electronic money. The complexity of the topic makes it hard for supporters and opponents to explain the arguments to the general public. In this context, the SNB which, like the Federal Council and Parliament, is strongly against the initiative, is putting efforts to share clear arguments about the possible impact of a “yes” vote.

### For the central bank, it is a “no”...

In a speech on 3 May, the SNB President Thomas Jordan said “the initiative raises unrealistic expectations” and its adoption “would have serious consequences for Switzerland”. According to President Jordan, a sovereign money system would make lending more difficult and complicated. This would indeed be the case as banks would no longer be permitted to use customers' sight deposits to finance loans and instead would have to rely on investors solely, borrowing would become more costly. In turn, it would harm investment, consumption and

ultimately GDP.

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*We believe abstention will be the major winner of the referendum and our baseline scenario is the monetary system won't change any time soon*

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In addition to negative consequences for the real economy, Jordan believes it would impact the effectiveness of monetary policies negatively. The sovereign money initiative requires going back to a system where central bank controls the money supply directly and not rates as is the case nowadays. But, as highlighted by Jordan, interest rate targeting is more efficient than monetary targeting and guarantees a flexible supply of liquidity to the economy, particularly during times of crisis.

Promoters of the initiative believe Switzerland will be able to benefit from seigniorage on scriptural money creation, which is an unused resource in today's system. These additional resources could then be used to reduce the burden on citizens through 'debt-free' payments by the SNB to the Confederation, the cantons or the people. But according to Thomas Jordan, these resources would only replace today's SNB revenues brought by yield profit on foreign currency purchases, investments, or on banks loans granted. "Under established practice today, the SNB distributes the interest on its capital, while under a sovereign money system it would be selling off the capital," says Jordan. He thus thinks that 'debt-free' payments would not make the country any richer."

The initiative's authors also believe it would avoid bank runs, which is highly debatable and "too big to fail" problems as well as prevent the creation of financial bubbles. But Thomas Jordan thinks sovereign money would not help to eliminate the risk of instability. He explained that "even without recourse to sight deposits, banks can grant loans which are too risky, hold too few provisions for times of crisis and become insolvent if a bubble bursts". Moreover, a sovereign money system would not eliminate the risk of having banks too reliant on short-term financing from the money market.

Jordan also insists on the fact that a sovereign money system would impose unnecessary burden of responsibility on the SNB which would have to assume tasks that exceed its mandate. Indeed, the initiative imposes the SNB to make 'debt-free' payments, as well as to guarantee the supply of credit to the Swiss economy. According to Jordan, "the latter is problematic because it could lead to a conflict of interest between price stability and credit supply". Moreover, the SNB would be directly involved in the debate on distribution issues, which could politicise the SNB.

## **For public opinion, it is more a "don't know yet" mood**

Will the initiative get enough public support to be enforced?

Nothing is certain right now, but this week we received some indications about the result of the popular vote. According to a survey conducted by the Research Institute gfs.bern on behalf of the public broadcaster SSR<sup>[1]</sup>, only 35% of those polled said they would slip a yes in the ballot box on June 10, against 49% who would vote no. The remaining 16% is still undecided.



In theory, this is far from a done deal yet as the electorate still seems fairly undecided. The proportion of those who are already sure of their choice is only 53%. But in practice, it seems difficult for the supporters of the initiative to catch up. Indeed, support for popular initiatives usually tends to diminish as the voting date approaches.

According to another poll published earlier this week, 45% of respondents would vote no, and 42% are in favour of the initiative. The results of this survey are however to be taken with more caution because it was conducted online on the websites of various newspapers of the Tamedia group.

[1] A representative sample of 1,200 citizens between 16 April and 26 April. The margin of error is +/- 2.9%.

## Our baseline scenario

We believe abstention will be the major winner of the referendum, but a majority will still reject the proposal. Our baseline scenario is the monetary system won't change any time soon.

However, the risk is still worth flagging. Indeed, a "yes" for the reform would require a complete overhaul of the current monetary system. It would cause insecurity and could harm the financial center and, thus, Switzerland as a whole. It is almost impossible to anticipate the consequences on the Swiss economy for now, but in a first instance, it would probably lead to a further weakening of the CHF.

[The Swiss vote on the monetary system](#)

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