Riksbank hikes by 50bp amid concerns about weak krona

Policymakers are trying to stem currency weakness but a housing market correction and weaker economic activity suggest there are limits to the number of future rate hikes. The positive reaction by the krona is encouraging, but it will now be up to data to support a further SEK recovery. Short-term turmoil is still a possibility

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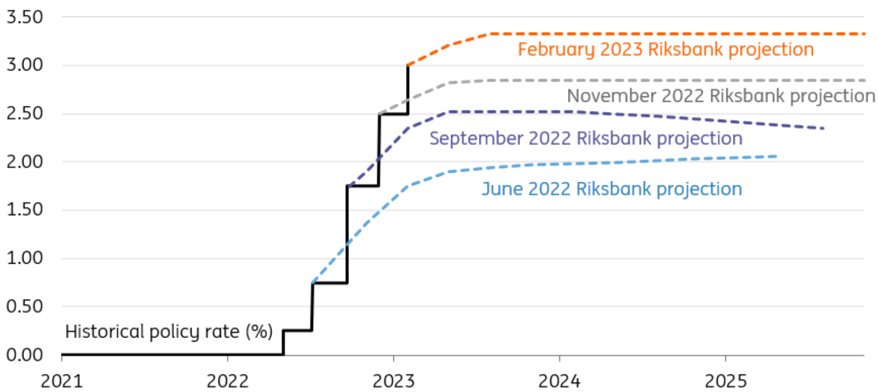
Sweden's Riksbank has hiked its policy rate by another 50 basis points, and has made it abundantly clear that it's worried about the ongoing weakness in the krona.

Yet the reality is the Riksbank will need to tread more carefully on rate hikes from now on. That's clear from its new interest rate projection which points to another 25bp hike in April, and implies there's a chance it could do the same in July, but that this is likely to be it. The impact of past policy tightening is becoming increasingly evident, in particular in the housing market. Prices are down 15%, and we know Sweden has a comparatively high proportion of households that have a mortgage, and on top of that, the majority are on variable rates. Growth is suffering too, and we're likely to see a wider impact of the housing problems in consumption and construction as the year goes on. Sweden is likely to be an economic underperformer within Europe.

For now, policymakers have half an eye on wage negotiations, which are likely to settle on a higher settlement than in the past. And the near-term policy outlook undoubtedly hinges on the krona, as well as what the European Central Bank decides to do beyond its March meeting. For now, we're pencilling in one final 25bp hike in March, but wouldn't totally rule out another over the summer.

Riksbank interest rate projections over time



Source: Riksbank

SEK reaction is encouraging

We argued in recent commentaries how a hawkish hike was a necessary step by the Riksbank to help restore confidence in SEK-denominated assets and halt the slump in the krona. The initial market reaction seems to be rewarding today's rate decision, as EUR/SEK dropped nearly 1% to the 11.25 mark. If those levels hold, we'd be looking at a 40+ big-figure cushion to those March 2009 record highs, which would probably mark a fully-fledged currency crisis in Sweden.

Now, the data needs to play its part. We have reasons to believe inflation will start easing in the coming months, although the outcome of wage negotiations could see the jobs market working against a deflationary path. This, and the soft patch of growth data, argues against a straight-line recovery in SEK and short-term turmoil for the krona is still a possibility. We think the Riksbank can be satisfied with EUR/SEK staying around 11.20-11.40 for now.

A sustainable reappreciation of SEK beyond the 11.00 mark against the euro remains the base case for this year, although the path for the Riksbank to fight inflation without triggering an uncontrolled property and economic slump has got narrower, and downside risks remain meaningful.

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