Sweden’s Riksbank cements dovish stance with no rate hikes forecast

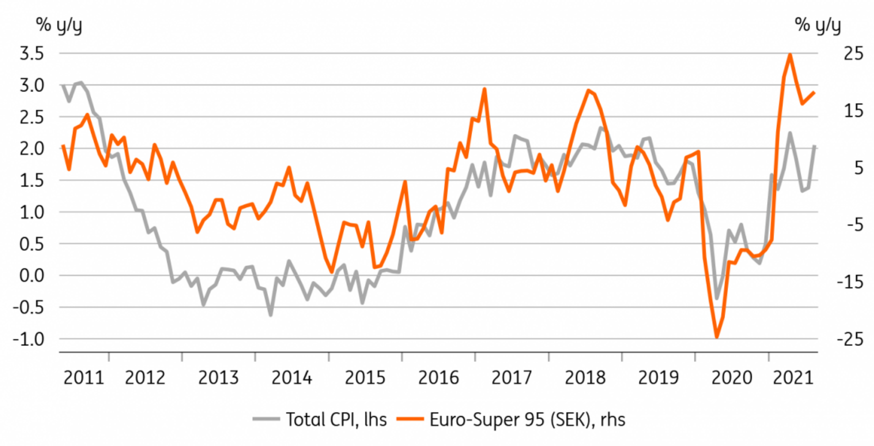
Despite some excitement around recent inflation data, Sweden's central bank has again signalled it doesn't intend to hike the repo rate in the next three years. With the krona's rate profile likely to remain unattractive in the medium-term, we expect it to lag pro-cyclicals backed by domestic tightening cycles in periods of supportive risk sentiment

Source: Shutterstock

At a time when global central banks are inching towards reducing the level of stimulus, the Swedish Riksbank remains firmly at the back of the pack when it comes to tightening policy. Policymakers unsurprisingly kept the repo rate on hold this month, although a surprise burst in inflation during August had raised the possibility that the central bank could introduce some hikes into its published interest rate projection.

In reality, any changes to this profile were only ever likely be small and focused on 2024 at the earliest, given that the rise in inflation can be largely explained by energy, food and like everywhere else, supply chain disruptions. But in the event, the Riksbank opted against signalling any rate hikes at all. The result is that the central bank is forecasting no changes in its repo rate for at least the next three years.

Energy costs have helped lift Swedish inflation



Source: Macrobond

Whether or not that changes will inevitably boil down to wages. Here, the Riksbank is modestly optimistic, noting some recent acceleration in pay growth. Sweden is facing a jobs mismatch, which is no doubt putting pressure on wages in some areas. But ultimately the direction of pay settlements is largely determined by multi-year negotiations, the next of which won't come until 2023. Hikes in the repo rate will rely on these resulting in rate of wage growth noticeably above 2%, which was the product of talks held in 2020. For now, it's worth noting that inflation expectations over the medium-term - a key aspect of any negotiations - are reasonably stable.

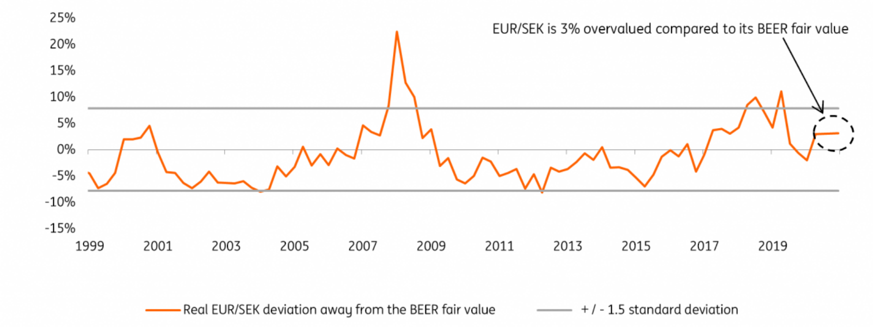
The more pressing question is what will happen to the central bank's bond holdings accumulated under the recent QE programme – in particular covered, or mortgage bonds. The Riksbank will complete its planned balance sheet expansion later this year and has committed to maintaining the size of these bond holdings through 2022 – albeit there'll be some volatility due to the irregular and sizable nature of maturities.

In all likelihood, the central bank will stop (or reduce) reinvestments of some maturing bonds from 2023, which will act as an initial form of policy tightening.

SEK: Rate profile to remain unattractive

SEK's reaction to the Riksbank rate announcement was very muted, likely indicating markets have remained quite reluctant to price in any hawkish turn just yet. From a forward-looking perspective, the reiteration of the Riksbank's dovish policy continues to cloud the outlook for SEK, as any periods of sustained recovery in risk sentiment should – in our view – see the krona lag other procyclical currencies (like Norway's krone) which can count on a domestic tightening story.

That said, SEK's medium-term outlook remains tied to the prospects of the global and, in particular, European recovery. For now, we are still inclined to think that countries with high vaccination rates – like the European ones – will be able to weather the coldest months without having to resort to strict containment measures, as third doses of the vaccine are rolled out. We think such prospects leave room for EUR/SEK – which is around 3% overvalued, according to our medium-term BEER fair value model (chart below) - to gently trend lower into the middle of next year, moving sustainably below 10.00 in 1Q22.



Source: ING, Refinitiv

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