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Riksbank Expected to Lower Conditional Interest Rate Path

Tina Mortensen
+44-20-7986-3284
tina.mortensen@citi.com

- We expect the Riksbank to maintain the repo rate unchanged at 0.75%, but to revise its conditional interest rate path for 2015-16 lower (by about 25-30bp) when it presents the Monetary Policy Update on 9 April. In other words, the Bank is expected to maintain its near-term easing bias, while indicating initial tightening around 1/2Q next year. Very low core CPI, ongoing inflation undershoots vs. Riksbank forecast combined with genuine inflation concern among board members – the Feb minutes confirmed that the Board's focus has shifted from financial stability concerns to inflation, with several members indicating very little tolerance for additional downside inflation surprises – are expected to more than outweigh the strong 4Q GDP outcome, supporting a downward revision to the rate path in April. Although our base case remains for a stable key policy rate throughout the year, another repo rate cut cannot be entirely ruled out. Hence, we reckon the discussion on the board this year will be about whether to ease further rather than about the timing of initial tightening. Current market pricing indicates around a 40% probability of a rate cut before yearend, and a full rate hike is not discounted until 4Q-15 (indicates a 10% probability of a rate hike in 2Q-15 and 52% for 3Q-15).

- We only expect minor changes to the Riksbank's economic forecasts in April, with the most notable ones being a slightly raised GDP forecast and lower inflation projections.

- From an inflation-point-of-view, the timing (and pace) of planned tightening appears a bit pre-emptive, in our view, and we reckon that it probably leans heavily on household debt worries. Given low inflation and perhaps some awareness of the Riksbank's well-known inflation bias (tends to overestimate inflation), we expect tightening to commence slightly later (mid-2015). Awareness of the inflation bias is clearly a risk that could produce an even later rate hike – if the Riksbank extrapolate inflation forecast errors into a much more dovish forecast or a greater willingness to wait on rates until a forecast of above-target inflation 2-3 years ahead is confirmed by data going their way.

Lower Conditional Interest Rate Path

Stable key policy rate, but conditional interest rate path likely to be lowered by 25-30bp for 2015-16

At the upcoming 9 April monetary policy meeting, we expect the Riksbank board to leave the key policy rate unchanged at 0.75%, but to revise its conditional interest rate path for 2015-16 lower (by about 25-30bp). In other words, the Bank is expected to continue to signal around a 16% probability of a near-term rate cut, while indicating initial tightening around 1/2Q next year. Very low core CPI, ongoing inflation undershoots vs. Riksbank forecast combined with genuine inflation concern among board members are expected to more than outweigh the strong 4Q GDP outcome, supporting a downward revision of the rate path in April. Although our base case remains for a stable key policy rate throughout the year, another repo rate cut cannot be entirely ruled out. Hence, we reckon the discussion on the board in the near term will be about whether to ease further rather than about the timing of initial tightening. Current market pricing indicates around a 40% probability of a rate cut before yearend, and a full rate hike is not discounted until 4Q-15.

Swedish economic activity indicators have been mixed since Feb meeting, but strong 4Q GDP gain likely to fuel upward revision to Riksbank 2014 GDP forecast

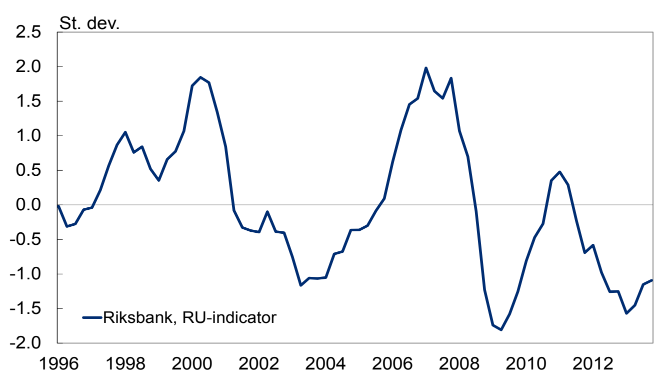
Since the 13 February meeting, Swedish economic activity indicators have been somewhat mixed, as also suggested by Citi's Economic Surprise Index, which has reverted back to zero (meaning that data, on average, have not surprised in any directions) following general upside surprises in the period around the February meeting (ESI stood at around 38). Most important for the Swedish economic outlook is the strong 4Q GDP outcome (up 1.7% Q/Q and 3.1% Y/Y), which markedly overshot the Riksbank's February forecast of a 0.6% Q/Q gain. As a large part of the gain was inventory-driven – and hence should prove temporary – we reckon that the Riksbank only will make a minor upward revision to its 2014 full-year GDP growth forecast. This is further supported by the decline in NIER sentiment in February and March (the Economic Tendency Indicator has slipped by a total of 5.6 points and is now close to its long-term average). However, we note that the 0.6pp upward surprise in full-year 2013 GDP growth also was helped along by upward revisions to 2-3Q 2013 GDP, and that although NIER sentiment indicators have fallen back in recent months, a clear majority remain at expansionary levels. Finally, the 1.8 points gain in PMI to 56.5 in March (driven by stronger orders inflow), indicates a decent recovery in the manufacturing sector, and should ease some of the concern over weak NIER readings in recent months. On balance, we expect the Riksbank to lift its full-year 2014 GDP forecast by 0.2-0.3pp to 2.6-2.7% Y/Y.

Figure 1. Riksbank's Decision on Apr Conditional Interest Rate Path

Arguments for an unchanged conditional interest rate path:
▪ 4Q GDP substantial above expectations, upward revision to 2013
▪ Signs of an improving labour market (unemployment looks set to decline)
▪ House prices in upward trend
▪ High household debt burden
▪ Household lending is gradually accelerating
Arguments for a lower conditional interest rate path:
▪ CPIF continues to undershoot Riksbank expectations, and is not only well below target, but also close to zero; inflation expectations below target
▪ Capacity utilization still very low, unemployment above Riksbank forecast
▪ Weak development for unit labour costs (ULC)
▪ Macroprudential measures soon to be implemented
▪ Rate path indicates very aggressive tightening next year (125bp in total)

Source: Citi Research

Figure 2. Sweden – Resource Use Indicator (St. Dev.), 1996-4Q 2013



Sources: Riksbank and Citi Research

International recovery continues, but with some uncertainty lingering in the US and China

The prospects for international recovery have deteriorated slightly in the US and EM (especially China), which has also been reflected in consensus global growth forecasts (have been revised slightly lower). Otherwise, international recovery seems to be developing largely in line with the Riksbank's February forecast. We note, though, that the gap between consensus growth forecasts and the Riksbank's assumptions remain substantial in the case of US GDP growth for this year (0.5pp)

and euro area GDP growth for next year (0.4pp). As we have argued previously, this supports another downgrade of the Riksbank's global growth outlook. Meanwhile, we do not expect the turbulence in Russia/Ukraine of late to have a substantial impact on the Bank's forecast, but it will most likely be mentioned as a risk factor in the accompanying statement and the Monetary Policy Update. Meanwhile, slightly lower bond yields and equities plus lower risk appetite should partly offset the positive growth indications domestically (supports a lower conditional interest rate path).

The labour market continues to show signs of stabilising, but has disappointed slightly versus Riksbank expectations

The labour market continues to show signs of stabilising, but development has been somewhat weaker than expected by the Riksbank back in February; since the outset of the year, the LFS jobless rate has overshot the Central Bank's forecast by 0.2-0.3pp (was 8.2% in Jan and 8.1% in Feb). Meanwhile, employment growth is accelerating, with short-term indicators suggesting that the upward trend in employment will continue and that unemployment likely will start to decline in the near-term. Although unemployment is slightly above the Riksbank's forecast from February and employment growth on the weak side, we only expect minor fine-tuning to the Bank's labour market forecasts in the April MPU; employment growth is likely to be lowered marginally for this year (by 0.1pp to 1.1% Y/Y), while the unemployment rate probably is seen slightly higher for 2015-16.

Inflation is currently very low, and expected to continue to undershoot target this and next year

Inflation is currently very low; CPIF inflation was confirmed at 0.4% Y/Y in February (and CPI at -0.2% Y/Y), 0.15pp below the Riksbank's forecast. The downward surprise reflected to a large extent lower-than-expected energy prices, and with energy prices having eased further in March, these will likely add further downward pressure on inflation in the near-term. Although the downside surprise versus Riksbank forecast narrowed in February (0.3pp in January), it follows a long series of undershoots in recent years. With very low actual inflation (combined with below target inflation in recent years), most measures of inflation expectations are below or well below the 2% inflation target.[1] This is clearly a concern for the Riksbank, and several board members did also make it clear in the February minutes that their tolerance for additional downside inflation surprises were very low

Strong gain in 4Q productivity increases the likelihood of profit margins being restored via higher productivity gains rather than via price hikes, questioning the Riksbank's 2015 inflation forecast

We have previously warned of an upside inflation risk if rising unit labour cost, driven by low productivity growth, turns out to have a greater impact than expected. National accounts data, meanwhile, showed a strong recovery for productivity growth in 4Q, including upward revisions to productivity growth in previous quarters. In turn, the history of ULC has been lowered and ULC turned out to be stable in annual terms in 4Q. Looking back in time on the Riksbank's forecasts, it becomes clear that expectations of a strong gain in ULC have been an important driver behind the Riksbank's forecast of an upturn in inflation to around the target level in recent years; as demand recovers, companies would be expected to raise profit margins to compensate for previously higher costs. Meanwhile, in an article in the February Monetary Policy Report the Riksbank concludes that companies have found it difficult to raise their prices at the same rate as their costs have increased due to the weak demand situation – explaining lower-than-expected inflation in 2013. Ahead, the Riksbank expects that companies will restore margins by lifting prices, which should eventually lead to a strong pick-up in inflation. In a risk scenario, meanwhile, the Bank highlights the different impact on the outlook for inflation and the repo rate if profit margins are restored through 1) price hikes (higher inflation, more aggressive tightening) vs. 2) productivity gains (weaker inflation, rate cuts). With the strong gain in productivity growth in 4Q-13, this increases somewhat the likelihood of profit margins being restored via higher productivity gains rather than through price hikes, in our view. This is also an important reason behind our lower 2015 inflation forecasts compared to the

[1] Household inflation expectations 1-year ahead stood at 0.9% in March (NIER), Prospera inflation expectations in 1Q were 1.4% on a 2-year horizon and 1.8% 5-years ahead, while BEIs stand at around 1.4%.

Riksbanks. In other words, we expect that lower-than-expected ULC eventually will lead the Riksbank to cut its 2015 inflation forecasts.

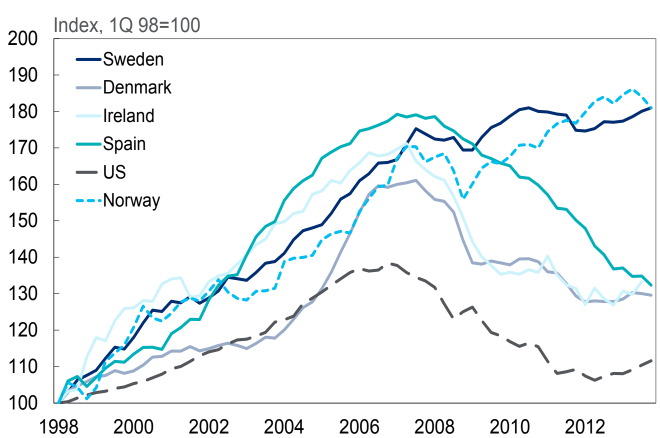
The Riksbank has faced repeated criticism for poor inflation forecasts, but is unlikely to make any adjustments for it

The Riksbank has faced repeated criticism for poor inflation forecasts; different evaluations find that the Riksbank systemically has overestimated inflation. The Riksbank has acknowledged this, but does not seem to have made any adjustments despite its repeated forecast errors – its inflation forecast remain above consensus, and it was a very reluctant board, which cut the repo rate in December. In other words, we doubt that awareness of its historic bias will prompt the Bank to pull down their inflation forecasts going forward

Although the Riksbank board has shifted its focus to inflation…

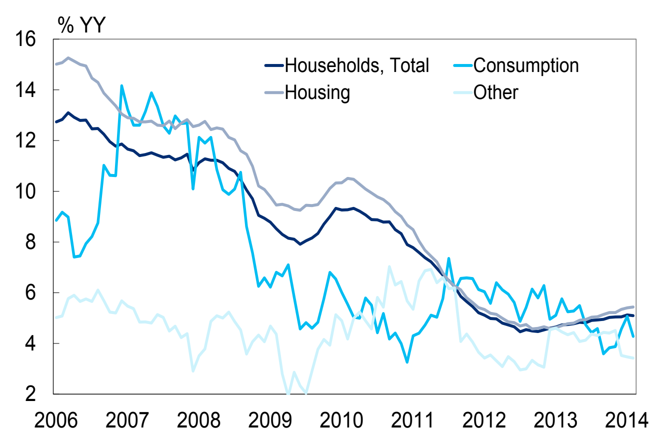
Although the February minutes confirmed a shift in focus from financial stability considerations to inflation, concern over household lending and debt likely remain; household lending growth is slowly accelerating (was stable at 5.1% Y/Y in February, but up from 4.7% Y/Y, a year earlier), and accelerating housing prices suggest that lending growth likely will pick up further this year. In other words, the Riksbank's dilemma between hitting the inflation target and longer term instability worries is unlikely to fade anytime soon. In theory, one route to address this dilemma could be to loosen monetary policy, while at the same time tighten macroprudential policy, as with the late-2013 mix of rate cut and increase in banks' risk weights for mortgages. We reckon the FSA may well tighten macroprudential policy more, and the FSA now has several tools in its kit, including a mortgage loan ceiling (of 85%), higher risk-weighting for bank mortgage loans (proposed in November to raise the ceiling further from 15% to 25%), the build-up of counter-cyclical capital buffers and principal repayment recommendations for mortgage loans. We expect various measures to be implemented in July this year. We also note that the Swedish Bankers' Association has also lowered the amortization limit from 75% to 70%.

Figure 3. Selected Countries – Real House Prices (Index, 1Q 1998=100), 1998-3Q 2013



Note: Data for Ireland only run until 3Q 2013. Sources: Ecowin, Haver and Citi Research

Figure 4. Sweden – MFI's Lending to Households by Purpose (Yr.-Yr.), 2016-Feb 2014



Sources: Statistics Sweden and Citi Research

…it is still likely to continue to take financial stability considerations into account in its interest rate deliberations

As we have argued previously, the new measures – albeit difficult to calibrate – should alleviate some of the pressure on the Riksbank, once operational. Despite ample capacity in the economy and low inflation, the majority of the monetary policy board will likely continue to take house prices, credit expansion and household debt into account in its rate decisions. Measures aimed at reducing financial stability risks may leave room for the central bank to use its policy instrument – the repo rate – more actively to get inflation back up to target. As we forecast well below-target inflation in coming years, we reckon the Riksbank should be in no rush to tighten monetary policy. Hence, we confirm our long-held view of stable rates until mid-

2015, when we see the first rate hike coming. We reckon the hiking cycle probably will be moderate over the forecast period; with continued unusually low interest rates abroad, a higher repo rate could cause the Swedish krona to appreciate, which would slow recovery and dampen inflation.

However, given inflation bias, we see risks that initial tightening could be postponed further out in time

For comparison, the Riksbank sees initial tightening in early-2015, and once the hiking cycle commences, its February conditional interest rate path indicates that monetary policy will be tightened at a relatively fast pace – the path indicates rate hikes at around every meeting by at least 25bp during 2015, and total tightening of around 125bp. We question this, given the current setting with a very expansionary monetary policy stance among international/neighboring central banks – i.e. Norges Bank signals total tightening of 38bp for 2015, and Citi has no rate hikes penciled in our forecast for the ECB next year (and for most of 2016). And although economic activity in Sweden is likely to pick up this and next year, we still see below-target core inflation. In turn, we believe this likely lean heavily on household debt worries. Given low inflation and perhaps some awareness of the Bank's inflation bias, we expect tightening to commence slightly later. Awareness of the inflation bias is clearly a risk that could produce an even later rate hike – if the Riksbank extrapolate inflation forecast errors into a much more dovish forecast or a greater willingness to wait on rates until a forecast of above-target inflation 2-3 years ahead is confirmed by data going their way.

The doves on the board are likely to vote for a cut, but will Mr Jansson change his mind?

We expect these concerns to be shared by Ms Ekholm (and possibly also Floden), who likely again will be voting for a 25bp repo rate cut and a lower conditional interest rate path at the April meeting, after abstaining from making any reservations in February. We even see a possibility that Mr Jansson could vote for a cut after he appeared surprisingly dovish in the February minutes; he made it clear that inflation will be his *"overriding priority"* in his monetary policy considerations in the year ahead, and against this background said it would be necessary to consider *"further repo-rate cuts if the expected increase in inflation fails to materialise"*. With ongoing inflation undershoot vs. Riksbank forecasts in Jan (0.3pp) and Feb (0.15pp), this could prove enough to tip the scale for him. We note, though, that he earlier this week reiterated that the Riksbank needs to consider household debt growth in its interest rate deliberations. Should Mr Jansson change his mind, we see a very high probability that the rest of the Board also will vote for a rate cut in April.

Appendix A-1

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