

Economics

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Sweden

First Cut Likely, More to Come

- The Riksbank is likely to cut rates sharply in coming months in response to the deterioration in growth prospects. Our base case is that the Riksbank will cut by 100bp in the next six months (i.e. from 2% now to 1%). The speed, at which it will get there is uncertain. We expect it will start with a 50bp cut at the upcoming meeting, although there is a chance it will do just 25bp. Either way, rates are likely to fall further in subsequent months.
- Sweden is extremely vulnerable to the European economic cycle as 70% of its exports are channeled there and its focus on cyclically-sensitive intermediate and capital goods makes the country even more exposed to the weakening global outlook. To limit the potential negative repercussions on the Swedish economy, we are convinced that monetary policy will be eased near term.
- We see many compelling reasons for the Riksbank to deviate from its baseline scenario in its October MPR and cut rates at next week's policy meeting; the European and international economic outlook is deteriorating rapidly, the unrest on financial markets has intensified, policy rates have been cut abroad, domestic core inflation is low and well below target and rising mortgage rates in Sweden imply that monetary policy is tighter than suggested by the steering rate.
- We do, however, also see a risk that the Central Bank may prefer to await clearer signs of a turn in the domestic business cycle (i.e. that unemployment is actually starting to climb) before altering its monetary stance. GDP growth was surprisingly strong in 3Q, limiting the Bank's possibility of lowering its growth forecast for next year and the Bank was intent on hiking rates in the October Monetary Policy Report (MPR). Such an outcome would be in line with the Bank's historical reaction pattern (historical evidence, though, is very short). However, the current situation is unique in the sense that the consensus downgrades to GDP growth next year in Sweden have not only been among the largest on record, but have also taken place within a very short period of time.

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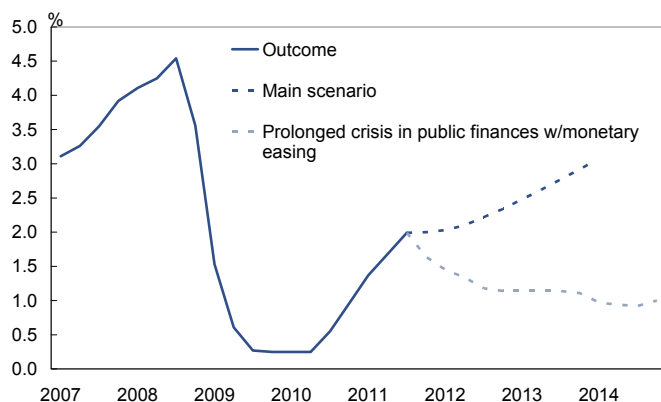
Sweden: First Cut Likely, More to Come

The Riksbank gathers for its final two-day policy meeting of the year on Monday, and will announce its interest rate decision on the following day. The Bank has lifted its steering rate seven times (25bp each time) in this tightening cycle (most recently in July) and was still content on hiking rates next year in its baseline scenario in the October Monetary Policy Report (MPR). However, the cocktail of a weaker than expected global economic outlook, continued unrest on financial markets, interest rate cuts abroad, and low domestic core inflation clearly opens the case for near-term policy easing. The Bank's low-interest rate scenario "*Prolonged crisis in public finances with more expansionary monetary policy*" also supports this (see chart 1). In addition, higher mortgage rates imply that monetary policy is tighter than suggested by the key policy rate. Hence, there is little doubt that rates are set to go lower. Our base case is that the Riksbank will cut by 100bp in the next six months (i.e. from 2% now to 1%). However, the speed at which we will get there is uncertain.

At this stage, we see many compelling reasons for the Riksbank to deviate from its baseline scenario in its October MPR and cut rates already at next week's policy meeting. The size of the cut – 25bp or 50bp – however, is a close call, as also indicated by the Central Bank's low-rate scenario "*Prolonged crisis in public finances*" (is split between 25bp and 50bp). Given the ever-gloomier outlook for Sweden's most important trading partner, the euro area, (accounts for about 70% of Swedish exports), and the country's cyclically-sensitive composition of exports, suggesting an even larger exposure to the global growth downturn, we expect the Riksbank to cut rates by 50bp to 1.50%.

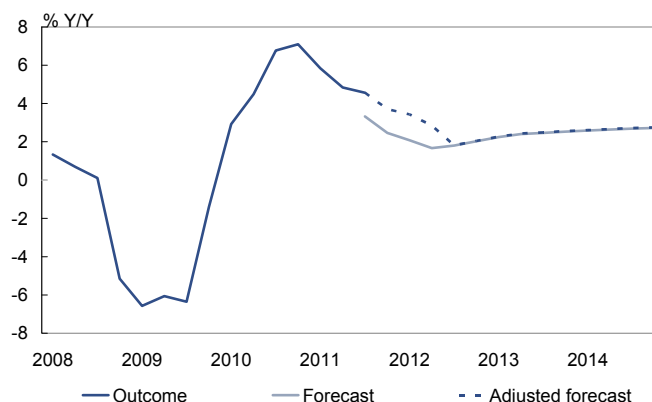
At the latest monetary policy meeting in October, a split Riksbank Board left the repo rate unchanged at 2.0% for a second consecutive meeting, arguing that: "*The difficulties in resolving the public finance crisis in Europe has led to increased uncertainty regarding the future. In Sweden, growth is expected to be slightly weaker in the coming period. At the same time, inflationary pressure is low. The Executive Board of the Riksbank has therefore decided to hold the repo rate unchanged at 2 per cent and to wait to increase it until sometime next year*". The updated conditional interest rate path suggests stable rates near-term with a 25% probability of a rate hike at the February meeting and a policy rate at 2.41% by end-2012.

Figure 1. Sweden: Actual Repo Rate and Low-Rate Riksbank Scenario (Pct.), 2007-4Q 2014



Sources: Riksbank and Citi Investment Research and Analysis

Figure 2. Sweden: Actual GDP and Riksbank Forecast (Pct. Yr.-Yr.), 2008-4Q 2014



Sources: Riksbank, Ecowin and Citi Investment Research and Analysis

The two doves on the six-member Board, Deputy Governor Svensson and Karolina Ekholm, both entered a reservation against the decision to hold the repo rate unchanged and against the repo-rate path in the MPR, arguing that that the forecasts of foreign policy rates and Swedish resource use were both too high. They wanted to lower the repo rate to 1.75% and preferred a lower rate path with the repo rate at 1.5% in the period 1Q 2012-1Q 2013 for thereafter to rise gradually to just above 3% by late-2014 (i.e. a more optimistic rate profile than in the Bank's low-rate scenario, see below). Hence, the unanimous decision to keep rates steady at the September meeting proved to be temporary.

Since the October MPR, developments internationally, though, have been more in line with the Bank's low-interest rate scenario "*Prolonged crisis in public finances with more expansionary monetary policy*", which assumes a continued deterioration in financial markets leading to a credit crunch in the euro area with a clear possibility of sovereign debt defaults, a deeper and longer downturn in global growth (recession in the euro area) and rate hikes from global central banks being postponed further in time. In this scenario, the key policy rate in Sweden would be lowered by 25-50bp already at the December meeting, and is seen around 1.0-1.25% in 2Q/3Q next year (see chart 1). Since the October meeting, the sovereign debt crisis has intensified with the focus now having shifted to Italy and Spain. As a response, the ECB has not only eased monetary policy by a total of 50bp, it has also introduced additional supporting measures, and is widely expected to ease monetary policy further next year. In an attempt to limit potential negative repercussions on the Norwegian economy, the Norges Bank earlier this week cut by a larger-than-expected 50bp, but refrained from introducing additional liquidity support measures.

Economic developments in Sweden since the October meeting have been mixed, and do not provide a clear-cut picture in terms of the policy outlook. GDP growth markedly outperformed expectations in the third quarter, rising by a hefty 1.6% Q/Q, more than 1pp above the Riksbank's forecast. This was in large part owing to very strong inventories. Although boosted by temporary factors, the outcome confirms that growth remained strong in 3Q and probably will cap the extent to which the Riksbank lower its GDP growth forecast for next year. Adding the 3Q outcome to the Bank's GDP forecast profile would suggest full-year growth of 4.7% this year and 2.5% in 2012, i.e. 0.5pp and 0.6pp above the Bank's October forecasts, respectively (see chart 2). For comparison, the December consensus forecast for GDP growth in 2012 is 1.2% Y/Y. That said, monthly growth indicators have subsequently worsened rapidly. At the same time, core inflation has undershot expectations for two consecutive months in November, while the labour market broadly has evolved in line with expectations; albeit weakening, lead indicators continue to point to rising employment in the short term. That said, lower growth is likely to lift the jobless rate next year.

Although economic data releases in Sweden have been mixed of late, it does not change the overall assessment of a weakening economy amid the international slowdown, especially within Europe. Sweden is extremely vulnerable to the European economic cycle as 70% of its exports are channeled there and its focus on cyclically-sensitive intermediate and capital goods makes the country even more exposed to the weakening global outlook. As our baseline scenario for the global economy is broadly in line with the Riksbank's low-rate scenario, we expect marked downward revisions to the Bank's baseline scenario, including its rate path, in coming months.

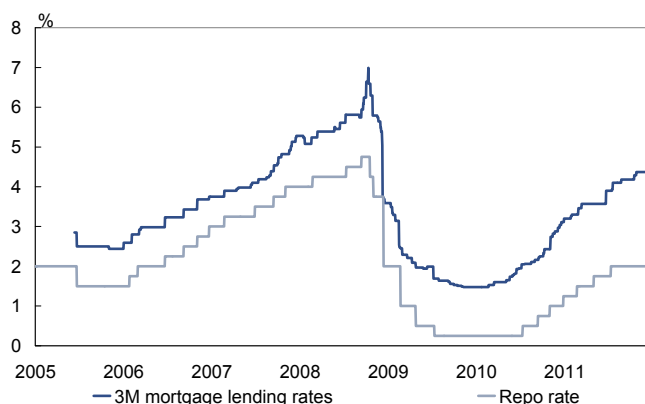
In addition, rising funding costs have exerted upward pressure on mortgage rates, suggesting that monetary policy is de facto tighter than indicated by the key policy rate. 3-month mortgage rates currently stand round 4.6%. Last time mortgage rates were at this level was back in 2007 where the key policy rate was at 3.25-3.5% (see chart 3). Although part of the rise in mortgage rates reflects new rules and recommendations from the Riksbank and the Swedish FSA, this is another piece of evidence supporting monetary easing already next week.

In sum, we see many compelling reasons for the Riksbank to embark on the easing cycle near term. We expect a series of rate cuts over the next six months and forecast a key policy rate at 1% around mid-2012. The size of easing and, hence, the pace at which we will get there is uncertain, though. Given Sweden's large exposure to the international economic cycle, especially the euro area, combined with other Central Banks' responses to the crisis, so far, we expect the Riksbank to act preemptively, cutting rates by 50bp to 1.50% already next week, to limit potential negative repercussions on the Swedish economy.

An alternative approach could be to cut more gradually, but then to supplement such a move with alternative supportive measures as the ECB did last week. Although the stress level among Swedish banks is rather limited compared to that of euro area banks, the rise in interbank spreads and, hence, the upward pressure on mortgage rates is no doubt becoming a headache for the Riksbank. With this in mind, we view it highly likely that the Riksbank at some point will need to reintroduce liquidity support and possibly also swaplines for Swedish banks if the unrest on financial markets does not settle.

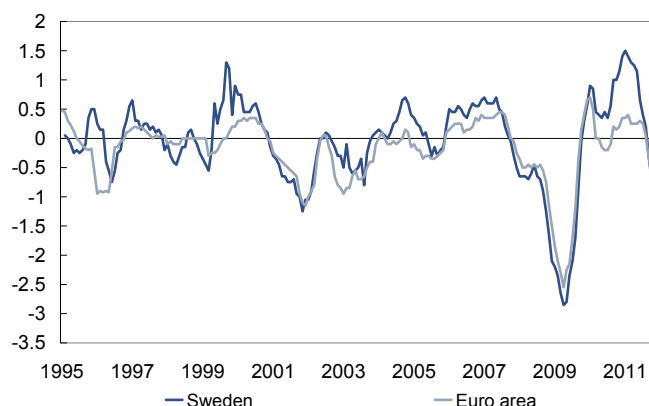
Finally, given the Riksbank's historical reaction pattern (historical evidence is very short, though), we see a clear risk that the Riksbank may prefer to await clearer signs of a turn in the domestic business cycle (i.e. clearer signs that unemployment is actually starting to climb) before altering its monetary stance. If this is the case and given that we do not see a market improvement of the global economic outlook, then a rate cut at the February meeting should be a done deal. We note, however, that the current situation is unique in the sense that the consensus downgrades to GDP growth next year in Sweden have not only been among the largest on record, but have also taken place within a very short period of time (see chart 4).

Figure 3. Sweden: 3M Mortgage Rates and Repo Rate (Pct.), 2005-12 Dec 2011



Note: The series for mortgage rates starts 13 June 2005. Sources: Ecwin and Citi Investment Research and Analysis.

Figure 4. Sweden and Euro Area: Changes in Consensus GDP Forecasts for Current and Following Year (6-month avg.), 1995-2011



Sources: Consensus Economics and Citi Investment Research and Analysis

Appendix A-1

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