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ECONOMICS: EUROPEAN PERSPECTIVES

WILL JULY'S INFLATION PRINT FORCE THE RIKSBANK TO ABANDON ITS DOVISH BIAS?

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Sweden's July inflation rate surprised the market and Riksbank on the upside, moving above its 2% target and reaching its highest level since December 2009. Is this enough to cause the oldest central bank in the world to deviate from its dovish policy stance and tighten policy before the ECB?

Positive Outlook

The Swedish economy has grown more strongly than the rest of Europe over the past two years, with an average growth rate of 3.7% between 2015 and 2016 compared with the euro area's 1.7%. We expect this outperformance to continue. Indeed, following surprisingly strong second quarter growth of 1.7% and positive survey data for July, we have raised our projection for 2017 growth to 3.3% (compared with the euro area's 2.1%).

Swedish inflation has also been higher than in the euro area in recent years. Before the July data, though, inflation had been below its 2% target for more than five years (*Display 1*), leading the Riksbank to adopt a dovish policy stance. In particular, the central bank has made it clear that it doesn't want to tighten monetary policy ahead of the European Central Bank (ECB), as this might attract flows into the Swedish krona and undermine its efforts to boost inflation.

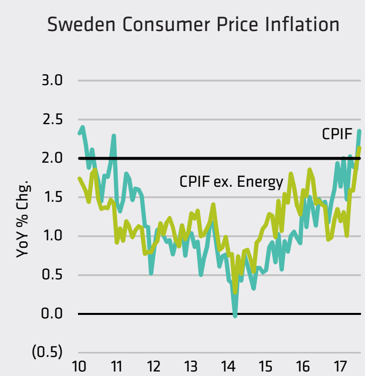
So how does the July inflation release—which saw CPIF* rise to 2.4%—change this picture? Is it sufficient for the Riksbank to abandon its dovish bias and tighten policy ahead of the ECB?

One Swallow

Although the July inflation print took markets (and us) by surprise, we don't think it's as alarming as it sounds. That's because the rise in prices was concentrated in specific items, particularly electricity and package holiday prices. The latter, which can be highly volatile, rose by 30% year-on-year in July—adding 0.4% points to headline inflation—but is expected to fall back in coming months.

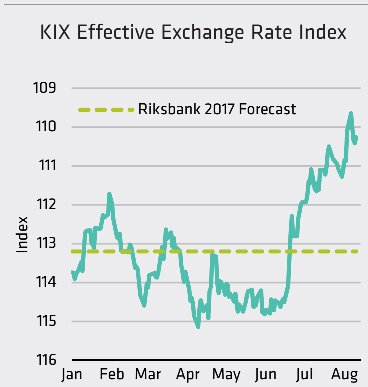
After a period in which inflation has been below target for so long (CPIF has averaged 1.0% over the last five years), during which there have been several false dawns, we doubt the Riksbank will attach too much weight to a single number. Indeed, the Executive Board has repeatedly stressed that a stabilization of inflation at the 2% target is a necessary precondition for any withdrawal of monetary stimulus—unlike the ECB, which has started to signal a future winding down of its quantitative

Display 1
Inflation Back at Target



As of July 31, 2017
Source: Haver Analytics

Display 2
Stronger than Expected



As of August 22, 2017
Source: Riksbank

*CPIF excludes mortgage interest payments and is the de facto benchmark for Swedish inflation. The Riksbank is likely to formally adopt CPIF as its operational target at its September meeting.

easing (QE) program even though inflation is still below target.

Downside Risks

In our view, there are several factors that could prevent Swedish inflation from stabilizing at the 2% mark and lead the Riksbank to maintain a dovish policy stance, at least in the near term.

One of the most important of these, and one of the Executive Board's biggest fears, is that any hint of an earlier-than-expected tightening of monetary policy could lead to a sudden and permanent appreciation of the krona. That would lower import prices and make it more difficult to stabilize inflation at 2%—especially in a small, open economy like Sweden. In this respect, it's worth noting that the krona's effective exchange rate index is already stronger than the Riksbank expected at the time of its last policy meeting (*Display 2, previous page*).

Another factor that could prevent inflation from stabilizing around the 2% mark is the low inflationary environment abroad. On the domestic front, meanwhile, sluggish wage growth could prove a significant drag on inflation. The Riksbank's inflation forecasts assume that a shortage of labor and declining unemployment will push wage growth higher, putting upward pressure on inflation. But with the industrial sector having recently agreed an annual pay rise of just 2.2%, there's very little evidence of this at present.

Hawkish Stance Unlikely For Now

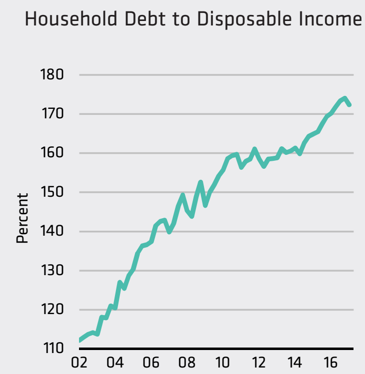
Overall, then, we think the Riksbank will maintain its dovish bias. But how could this be wrong? We see three key risks.

First, we could be wrong and inflation could stabilize at 2% more quickly than expected. In this case, the balance of risks for the Riksbank would change quickly and it could start tightening monetary policy earlier than expected.

Second, the Riksbank's dovish governor Stefan Ingves and his deputy Kerstin af Jochnick might stand down in January when their terms expire. If they were replaced by more hawkish members, it would shift the overall balance on the Executive Board in a less dovish direction.

Third, the Riksbank could start to give greater weight to household debt—over 170% of income—and house prices—up 40% in the last three years alone—in its policy deliberations (*Display 3*). For now, the Riksbank is hoping that new mortgage amortization rules will help contain this risk. But if these fail, there will be increased pressure on monetary policy to combat this looming threat to financial stability.

Display 3
Rising Threat



As of March 31, 2017
Source: Haver Analytics

September Meeting

There's little doubt that recent data releases have increased the probability of an early rate rise in Sweden. On balance, though, we still believe it's too early for the Riksbank to take a step in this direction. In our view, that will require evidence that the recent rise in inflation can be sustained together with some clarity on the ECB's future policy intentions (which is unlikely to be forthcoming before October).

At its September 6 meeting, the Riksbank is widely expected to announce changes to its inflation-targeting framework: formalizing CPIF as the inflation target (*see footnote, previous page*) and possibly introducing a +/-1 percentage point variation band around the target. We do not, though, expect any major policy signals—let alone a change of policy itself. Rather, we expect the central bank to stick largely to the recent script while it collects fresh evidence on the inflation outlook and awaits greater clarity from the ECB. We will also be monitoring incoming data and other policy drivers, to determine precisely when the Riksbank will abandon its dovish bias. ■