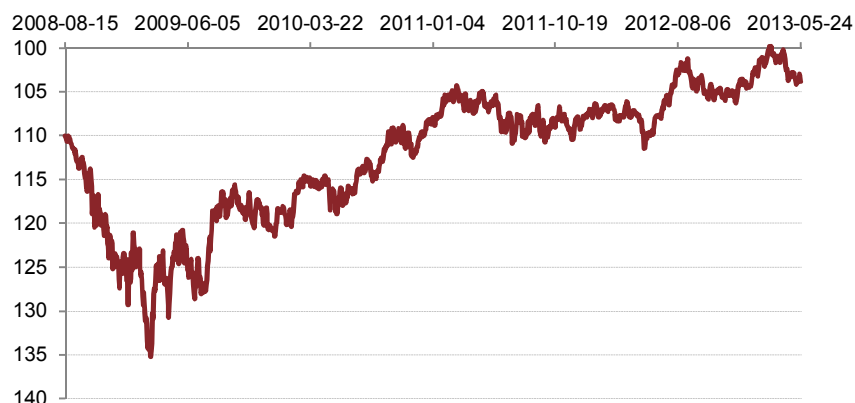


A Riksbank dilemma

- **Swedish economic outlook is weakening**
- **Riksbank is turning more dovish and likely to cut rates**
- **Household debt situation is temporarily stable but remains a major risk**

The outlook for the Swedish economy has deteriorated somewhat in recent weeks. Business and consumer confidence fell in May and Statistics Sweden's latest survey of investment in manufacturing forecasts a 10% fall in 2013 after three years of increases averaging 5-6%. Although Sweden's prospects are still better than those of most of continental Europe, the weaker outlook is also fraying Swedish nerves: after a clear hands-off policy towards the exchange rate, the authorities (not least Finance Minister Anders Borg) have begun to worry about the strength of the krona, which in March and April reached post-crisis highs. The Riksbank has kept its repo rate unchanged since last December. However, while the departure of Deputy Governor Lars E O Svensson removed a forceful dove from the Riksbank board, this was to some extent balanced by the departure of the hawkish Barbro Wickman-Parak and the two new Deputy Governors are both perceived to be leaning towards easing. Consumer prices fell by 0.5% in the year to April, their tenth consecutive month below the Riksbank's 2%±1% target. Add to this an unemployment rate rising towards 9% and it seems likely that the Riksbank will cut interest rates again. This represents a change from my previous view that the next move – probably not until the end of next year – would be a hike.

Swedish krona, KIX-index (trade-weighted effective exchange rate)



Whether 25 or even 50 basis points lower on the repo rate would matter particularly much is highly doubtful. Moreover, there are other reasons why cutting interest rates would be a bad idea. This goes

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back to the main dark cloud having over the Swedish economy, namely household debt. In spite of the unchanged policy rate, some of the larger banks (Nordea and Länsförsäkringar) are cutting their mortgage lending rates in order to gain market share. Other banks are likely to follow suit. For the Riksbank to cut the repo rate would, as it were, give a seal of approval to these moves and encourage a further build-up of household debt.

This is the more worrying in that the Swedish housing market according to a report published last week by the Fiscal Policy Council is at best fair value, at worst 15-20% overvalued. The Council does not expect a sudden and large correction in house prices. However, continued housing market strength and mortgage borrowing growth that has levelled out at just below 5% per annum, mean that imbalances continue to grow. As it is Sweden has the fourth highest relative household debt in the EU (around 170% of personal disposable income); and is one of only two countries (the other being Norway) not to have experienced a house price fall in recent years. The Swedish monetary and fiscal authorities, while well aware of the risks surrounding household debt and the housing market – Riksbank Governor Stefan Ingves has been banging on about this for years – seem to be floundering with little or no idea of what to do about it. There has been talk of mandating amortisation of loans, but nothing has happened. The Finance Minister has warned that the government may have to impose direct or indirect credit restrictions (indirect could involve taxing banks' foreign currency funding) to dampen lending.

As it happens, Swedish households are still maintaining a sizeable savings buffer; in fact, while household debt rose by 30 billion kronor in Q1, financial wealth rose by 36 billion (excluding value increases). There does also seem to have been a change in household behaviour, with the trend towards higher loan-to-value ratios changing. Nevertheless, this is at best an unstable equilibrium.

Arguably, by raising interest rates the Riksbank could do more to dampen the rise in household debt instead of encouraging it by cutting them. Just as 25 or 50bps lower would be unlikely to improve the Swedish outlook, so 25 or 50bps higher would do little or nothing to impair it. Except on two points: It would strengthen the krona; and it would extend the period before inflation returns to within target.

The Riksbank is caught between a rock and a hard place. The best policy would be to do nothing now and prepare to raise interest rates next year, at the same time trying to dampen household borrowing further. The worst would be to cut interest rates this summer; it is also the most likely next move.

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