Take cover – the Riksbank loads the big currency bazooka

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The Governor of the Swedish Riksbank has renewed and intensified his threat of currency interventions. The voice of reason says no. However, the Riksbank is under intense pressure and subject to provocation, and its focus is short term. That the new threats caused only marginal effects on the krona despite low market liquidity around the turn of the year is troubling for the governor. It is reasonable to assume that monetary policy effectiveness (transmission) has weakened overall due to globalisation and financial integration. In contrast, the transmission effect from exchange rates may have improved. However, currency interventions are a double-edged sword, with unpredictable results that will quite certainly lead to major currency losses for the Riksbank. Nevertheless, then faced with two evils - i.e. the risk of causing new imbalances at a rising economic price currency - interventions may be preferable. How far is the Riksbank prepared to go? For all intents and purposes, is low inflation not a luxury problem, compared to what other countries have to contend with?

Sweden ended 2015 in an indisputable state of economic boom. GDP growth has a broad base, and household credit growth is on the rise (at an annual rate of 7.3 per cent in November). Nevertheless, both currency and financial policies are conducted in an even more expansionary direction through the Riksbank's continued purchasing of government securities and the Swedish government's handling of the refugee crisis. On top of that, the country's total financial savings surplus – the current account – amounts to a sizeable SEK 250 billion (5 per cent of GDP). This surplus confirms that the krona is already significantly undervalued.

Currency exchange rates and SEB's assessment of equilibrium real exchange rates

	4 January 2016	4 January 2015	Equilibrium real exchange rate according to SEB
EUR/SEK	**9.18**	9.45	**8.50**
USD/SEK	**8.45**	7.95	**7.20**
EUR/USD	**1.09**	1.19	**1.18**

The Riksbank's policy is undeniably **powerful** and **unique**, but also **controversial**. The Riksbank broke into unknown policy territory about a year ago, when it introduced a negative key interest rate. We may be about to see another new, unique and controversial step: currency interventions, i.e. forced sales of the krona. The background is a comment by Ingves, Governor of the Riksbank, on 30 December, where he stated that an unwelcome **appreciation in the krona may cause the Riksbank to intervene**.

When hundredths matter to the Riksbank

The currency policy is uncomfortably short-sighted. Individual monthly inflation figures greatly influence the Riksbank's decision. The fact that the Executive Board discusses the inflation outcome in terms of hundredths confirms that the Swedish central bank is under pressure.

There are several conceivable explanations to this short-sightedness. Firstly, **the immediate future is "critical" to the Riksbank**. New wage agreements are to be concluded; if inflation is forced downwards by global factors while export companies become less profitable due to the stronger krona, the parties' differences may grow stronger regarding the value of the inflation target as an anchor to the labour market and wage formation. Also, potential criticism of the Riksbank's target flexibility and forecasting ability in the upcoming Riksbank evaluation (King & Co, due on 19 January) adds new power to an already intense Riksbank discussion.

Secondly, a low **inflation outcome** in recent years is an uncomfortable condition, underpinning the Riksbank's low tolerance to new inflation-related disappointments. The rate of inflation will increase in the beginning of 2016 due to increased taxes. Nonetheless, we have come to the conclusion that the Riksbank will be forced to make new uncomfortable downward revisions to its inflation outlook, perhaps as early as in February – during ongoing wage negotiations no less.

Thirdly, the Riksbank is affected by the **monetary policies of central banks in Europe and the US**. In recent months, the Riksbank was forced to consider the ECB's increasingly expansionary monetary policy and the Fed's increased interest rate. Uncertainty surrounding the policies of these central banks also creates uncertainty about what the Riksbank ought to do.

Policy must take following 3 issues into account:

❶ *How strong is the transmission between the Riksbank's various policy measures and inflation?*
❷ *Is it reasonable to do "whatever it takes" to achieve a higher rate of inflation?*
❸ *If the answer to the question above is yes – which is the*

most reasonable tool to reach the inflation target of 2 per cent?

Foreign influences unusually strong in Sweden

Compared to many other countries, Sweden has an unusual economic and financial dependency on the surrounding world. This dependence limits the Riksbank's ability to influence economic and financial developments and **weakens the transmission between monetary policy tools and inflation**.

The ongoing globalisation of national labour markets lessens the ability to set wages that deviate from the surrounding world. The global commodity cycle is in a process of adaptation, where supply and demand in several areas remain in a price-reducing imbalance. These forces are beyond the Riksbank's control.

Until now, the Riksbank's monetary policy strategy has involved influencing both the **price of money** (interest rate of -0.35 per cent) and the **liquidity volume** (by purchasing government securities for SEK 200 billion). The aim is to reduce both short-term and long-term interest rates and keep the Swedish "note printing press" operating at full speed in the hope that this will weaken the krona and boost corporate loans.

Transmission is reduced here, as well, as **both Swedish liquidity and the price of money must be viewed from a global perspective**; global policy rates are low, and by a rough estimate, the central banks' contribution of additional liquidity in recent years has been in the range of SEK 127,500 billion. This means that the Riksbank's SEK 200 billion is a major step for Sweden, but it is still a small one from a global perspective.

Global financial integration also challenges the Riksbank's – and other central banks' – ability to control long-term interest rates. A global balance between savings and investments affects the development of interest rates, including Swedish interest rates. High savings in the last decade, not least among EM countries, also affect us.

On the one hand, financial integration has most likely made central banks less able to use interest rate and liquidity channels to influence domestic economic and financial developments. On the other hand, globalisation may have improved their abilities with regard to currency exchange rates. This change may explain why several central banks increasingly focus on exchange rates in their monetary policies. However, exchange rate fluctuations are a zero-sum game.

Sweden's response to "whatever it takes"

If we assume that monetary policy tools are efficient and transmission works — is it reasonable to do whatever it takes to reach the inflation target? In principle, the Riksbank is right to consider currency interventions. They are more appropriate today than they were in 2001 when the Riksbank last intervened in the currency market. In a situation where the interest rate cannot be reduced any further (the Zero Lower Bound) - which, it should be noted, is not the case yet, according to the Riksbank - **selling kronor is an** "**emergency measure.**" But it would be undertaken at the expense of other countries — our inflation problem would be exported to countries that, in several cases, also suffer from major deflationary pressure. Also, short-term currency exchange rate variations play a minor role in the medium- and long-term development of inflation. **All in all, the low Swedish inflation can so far be viewed as a** "**luxury problem.**"

If a central bank intervenes in the interest and currency exchange rate markets, price mechanisms are disabled. This may have a negative impact on the economy's long-term production capacity, by setting too low a price of money for too many players and granting competitive advantages to certain companies that should not normally enjoy such advantages.

Analysis and research indicate that **currency interventions are a tool associated with a highly uncertain outcome**. As the krona is seriously undervalued already at the outset, the Riksbank will try to force the krona **even further away from its fair value** (in 2001, the situation was the opposite). This means that the Riksbank cannot expect market participants to join them in selling kronor — they must undertake this task all by themselves, which may require major intervention amounts to achieve the desired effect.

There are two conditions under which the Riksbank should take action and sell kronor in the currency market:
❶ If Sweden were suddenly to experience major **structural inflows of capital**, like Switzerland and Denmark. However, the conclusion is that while Sweden has capital inflows, these are primarily connected to the current account surplus.
❷ If the Riksbank would need to **send stronger signals** about a durable expansionary financial policy. However, the conclusion is that market prices and the Riksbank's repo interest rate forecast are well aligned over the next couple of years.

The krona's appreciation in recent weeks, after the latest interest rate decision (on 15 December), **should not surprise the Riksbank**. Fundamentals support a stronger krona, and the currency market is in a holding position to buy kronor. Even so, the risk of inflation is pushed in the wrong direction.

The Governor of the Riksbank's latest and clearest warning of currency interventions fits a pattern of recognition from 2001. At the time, the Riksbank reached an impasse, and threats had to be turned into action (actual currency interventions and a change in interest rates). **It should be noted — and this should be a warning sign for the Riksbank — that the krona weakened only marginally after Ingves' last currency threat.**

Better one loss for the Riksbank than...

For all practical purposes, the Riksbank has unlimited resources — and the muscle required — **to sell kronor for foreign currency**. This is highly likely to mean that there is acceptance for a significant currency loss, as the krona is currently undervalued and should be strengthened in the future (also according to the Riksbank's forecast). There is, of course, some room for the Riksbank to reduce interest rates even further, but Ingves' move suggests that the Riksbank realises that the lowest possible interest rate level will soon be reached. In the choice between an even lower price of money - and keeping the note printing press operating, without fuelling rising asset prices any further - currency interventions may be a suitable tool. Ingves' move means (a) that we have come closer to selling kronor, but it is uncertain how much support this has in the Executive Board; and (b) that the Riksbank sends a clear signal that interest rates will not be raised any time soon. If the Riksbank wants to go through with this, it must be prepared to invest major volumes and accept logical criticism from the rest of the world. The question is: is it prepared to do so, or will it stop at words? A definite conclusion can be repeated: **The Riksbank needs a longer period of adjustment to reach the 2 per cent inflation target. This also supports a reintroduction of the tolerance interval.**

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