



Market Letter

The Riksbank and the krona

May 14 2019

Our statistical analysis show that it is the unmotivated purchases of nearly half the existing stock of government bonds by the Riksbank that is the reason behind the significant depreciation of the currency. The purchases, which has been made in a different light than the Fed and ECB's bond purchase programs when the global financial system was at risk, seem to have created a mistrust in monetary policy, resulting in a weaker krona. The analysis also shows that the krona has been further affected negatively by the fact that professional forecasters recently have been doubting the central bank's ability to achieve the inflation target. Thus, the paradox is that the more efforts the Riksbank puts in to achieve the inflation target with unconventional methods, the less credible is the inflation target perceived by professional forecasters.

Why is the Krona weakening?

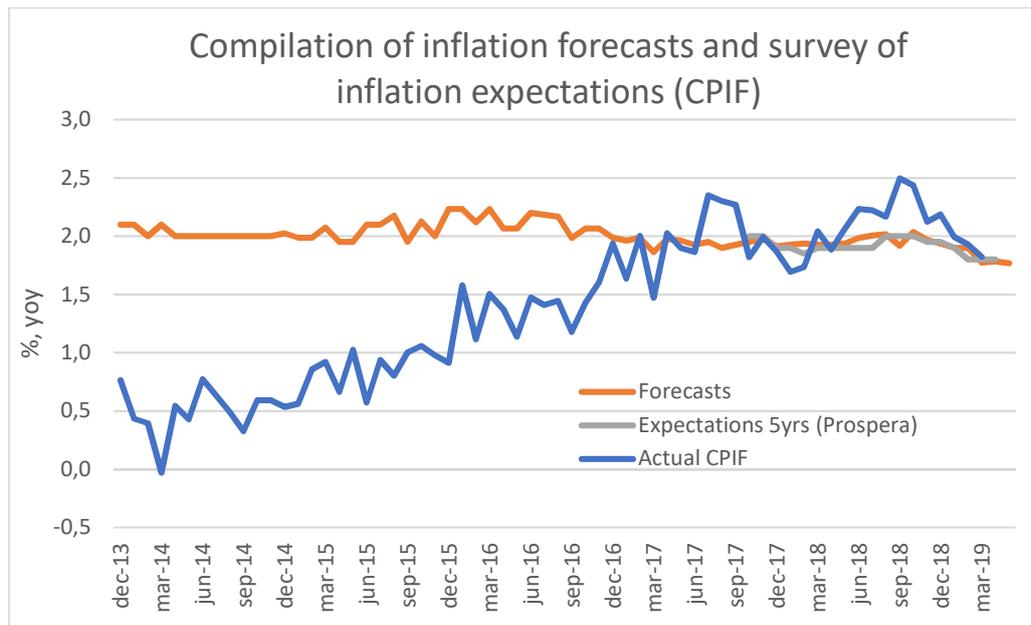
Not a day goes by without an occasional economist, business leaders, investor or even ex-prime minister complains about the weak Swedish krona. The central bank governor himself, Mr. Ingvges, expresses no worry, but has great difficulties explaining the reasons behind the weaker currency. Here is our explanation of the factors behind the depreciation of the krona.

Short to medium term, the development of the major currencies is a result of domestic monetary policy and global risk appetite on financial markets. We have written about that before and these factors explain to a large degree where currencies are and where they are going. If we run a simple statistical analysis and explain the effective SEK index (it's called KIX and is what the Riksbank focus on) with a measure of monetary policy in relation to where the economy is in the business cycle and a measure of global risk appetite, it explains a lot but not all of the krona's development. In these terms the currency is about 10% weaker than monetary policy stance and risk appetite implies.

Forecasters start to doubt the Riksbank

One often highlighted explanation for the weak krona is that confidence in the central bank has deteriorated. In academia, a common way of measuring confidence for a central bank with an inflation target is to see how well inflation expectations are aligned to the target. (See for example https://www.norges-bank.no/contentassets/3fba8b3a3432407d929ae9218db1ffc4/12_bordo_siklos_2014.pdf, for a comprehensive survey.)

We have collected every inflation forecast for the period 2018-2021 (for the target inflation variable, CPIF, which is a measure of underlying inflation, excluding the interest rate component of imputed housing costs), which is listed on the Swedish National Institute of Economic Research's homepage. This includes forecasts from more than 20 governmental institutions, banks, labour unions, employers' organisations, and international organisations. Every month, as forecasts are published, we have taken the median forecast for every year 2018 to 2021, and then averaged these four median values. This compilation starts in December 2013 and is shown in the chart below, together with a survey of inflation expectations of financial market participants, only with one and a half years history (done by Prospera), and the actual CPIF inflation rate.

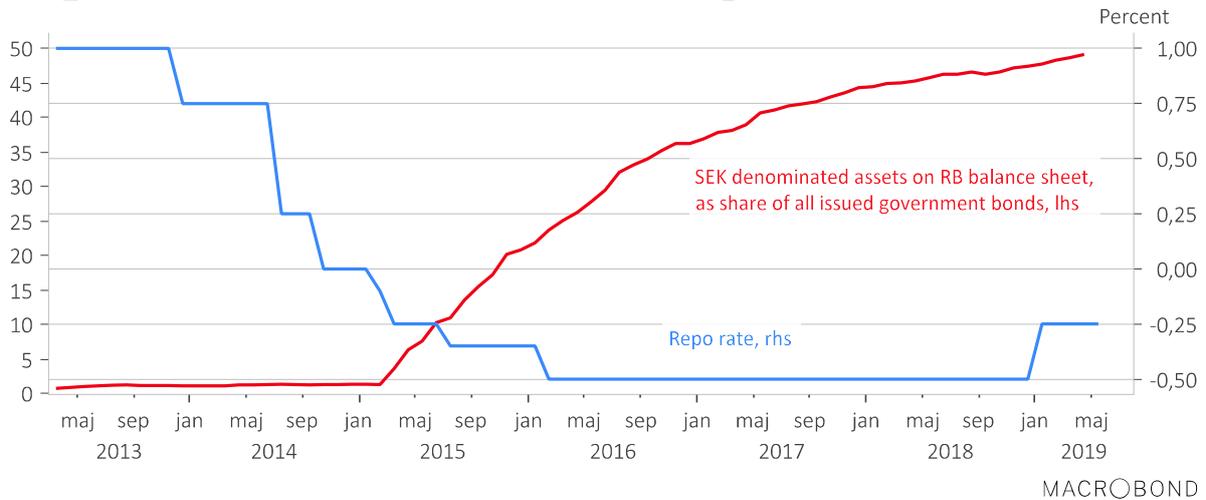


During this period, forecasters have obviously had a great confidence in the Riksbank's ability to achieve the inflation target, even in 2014-2015 when actual inflation was clearly below target. The average median forecast was even higher than 2% at the time. However, since 2017 our compilation shows that forecasts on average tends to be lower than the target of 2% and has recently exhibited a worrying tendency to decline further. The same declining trend can also be seen in the inflation expectations survey of financial market participants. We have used the compilation of forecasts as input to the explanatory model of the krona and even if the variation is small it has a statistically significant effect. When taken account of monetary policy, risk appetite and inflation forecasts, the krona is still some 7% weaker than the model can explain.

Can the Riksbank's purchases of government bonds be the culprit?

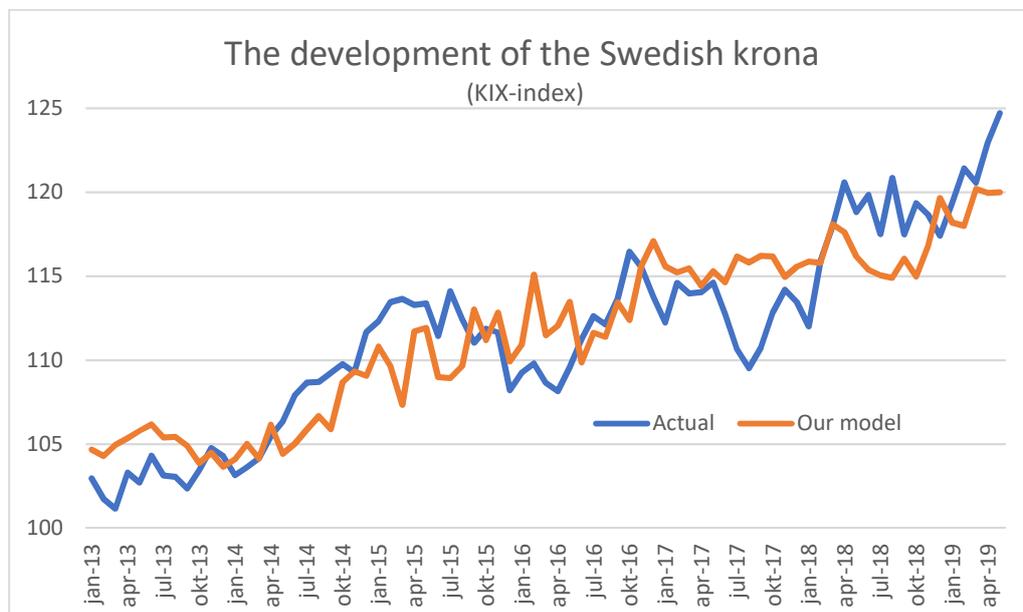
One possible explanation is that confidence, measure by the ability to reach the inflation target, can be intact but that the measures that a central bank use to achieve it can have such negative repercussions, that the overall confidence in monetary policy is falling. Consequently, the currency is weakening. Against this background we have tested if the negative repo rate and the purchases of government bonds have any statistical significance for the level of the krona. Both the negative repo rate and the bond purchases were implemented from 2015. See the chart below.

Repo rate and Riksbank's share of government bonds



We have already a variable for monetary policy, so we have used a dummy variable for the period of the negative repo rate, from February 2015 onwards. The other indicator is the share of government bond on the Riksbank's balance sheet to all outstanding government bonds denominate in SEK. This program also started in the beginning of 2015 and has been expanded several times since then. In March 2019 around half of all government bonds were owned by the central bank.

The dummy variable for the negative repo rate does not add to the explanatory power of our krona model. On the other hand, the share of government bonds turns out to have the highest significance of all variables, since 2013. If we use the four variables- monetary policy stance, risk appetite, inflation forecasts and the Riksbank's share of government bonds – to model the development of the krona, we get the orange line in the chart below. The blue line is the actual KIX index. (Note that a higher value means a weaker currency and vice versa.)



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The two series corresponds reasonably well to each other. The krona turned a bit stronger in mid-2017, which the model didn't catch, and neither the major depreciation during the first half of 2018. The latest rise of risk aversion connected to the outbreak in the trade war between USA and China, as well as the new signals from the Riksbank, in the end of April, of extending the purchase program, have not shown up in the explanatory variables yet. They probably explain why the currency in mid-May was around 4% weaker than the model suggests. Statistically speaking, the purchases of government bonds by the Riksbank "explains" 10% or half of the krona depreciation since 2013, while lower confidence among professional forecasters contribute to an additional 5%. (If you are interested in the specifics of the model and background data, please send an email to contact@reconpatrol.com.)

Fed, after the Lehman crash, and ECB, after the euro crisis in 2011, launched extensive bond purchasing programs in the capacity of lenders of last resort, as the global financial system was at risk. The massive purchases of the Riksbank, in relative terms, have not been made against the same dramatic background and are thus perceived as unmotivated and desperate. This probably explains the diminishing confidence in Swedish monetary policy, and the spectacular weakening of the currency. Probably more worrisome in the longer run, is a growing mistrust in the ability to achieve the inflation target. Thus, the paradox is that the more efforts the Riksbank puts in to achieve the inflation target with unconventional methods, the less credible is the inflation target perceived by professional forecasters.

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