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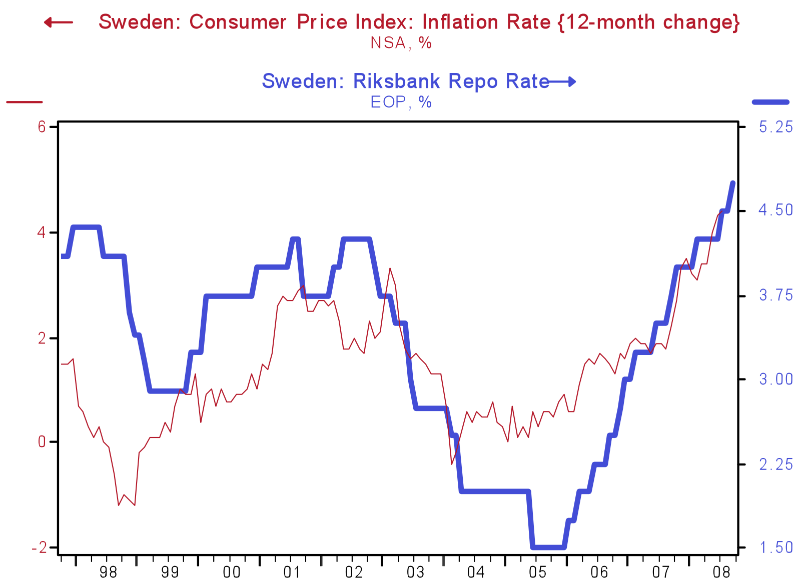
Sweden's Riksbank Hikes One More Time

With the economy slowing rapidly but headline inflation well above the upper limit of the central bank's target in recent months, it was a close call whether Sweden's Riksbank (central bank) would raise its repo rate again this month. In the event, the bank opted for one more bout of tightening, taking the rate up 25bps to 4.75%, while also making it clear that this is likely to be the last rate hike for this cycle.

The Riksbank targets headline inflation of 2.0% over a two-year forecast horizon, and has now raised its repo rate a total of thirteen times since early 2006. The bank said this morning that this final move was needed to prevent the high inflation of recent months from becoming entrenched – but in the next breath said that lower prices of oil and other commodities, along with weaker growth forecasts for Sweden and overseas, warrant a looser policy going forward than previously forecast. Back in July, the central bank had anticipated a quarterly-average repo rate of 4.8% in Q4 2008, rising to 4.9% in Q3 2009. Today's projection foresees an average Q4 rate of 4.7%, easing to 4.6% in July-September 2009. In other words, the next policy shift is likely to be a rate cut sometime after the middle of next year.

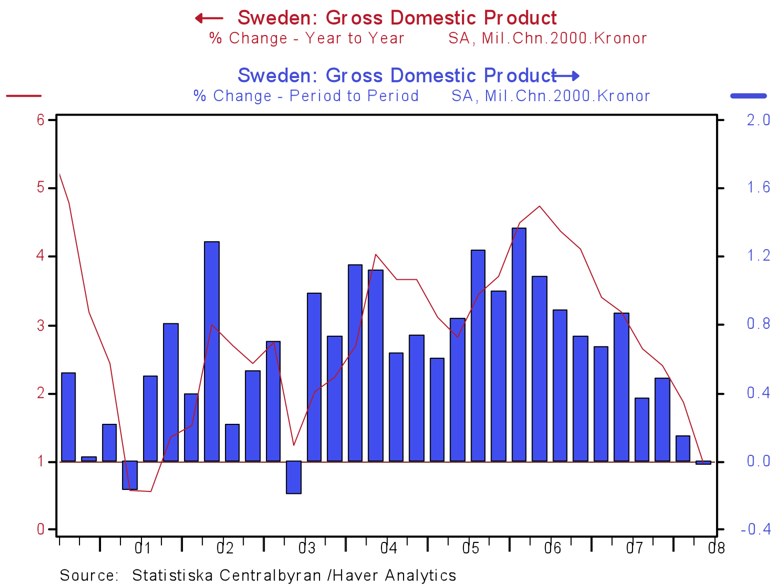


Sources: Statistiska Centralbyran, Sveriges Riksbank /Haver Analytics

Headline inflation hit an annual 4.4% in July, its highest level in nearly 15 years, but may have peaked. The August reading of household inflation expectations from the National Institute of Economic Research (NIER) – reportedly closely watched by the Riksbank – came down nearly one full percentage point to 2.9%.

Meanwhile, the economy does show every indication of a rapid cooling. Real GDP growth was essentially flat on the quarter in Q2 and rose just 1.0% y-o-y – its weakest showing since

2001. This morning, the Riksbank slashed its growth forecasts, anticipating real GDP of 1.4% this year and 0.8% in 2009, down from the July forecasts of 2.1% and 1.2%, respectively. This is even gloomier than the NIER, which last month lowered its growth forecast for this year to 1.7% (previously 2.4%) and for 2009 to 1.4% (previously 2.0%). The NIER noted "a rapid economic slowdown in the OECD area, which receives 80% of Swedish exports" as well as lower domestic demand.



Last week, the NIER reported that its index of economic sentiment fell to 85.5 points in August from 88.5 in July. The consumer confidence index remained well into negative territory at a seasonally-adjusted -19.6 (-18.4 in July) and the manufacturing confidence index slid further downward, to -12 (-10 in July).

Earlier this week came the news that the Sif-Swedbank purchasing managers' index dropped further below the growth-contraction mark of 50.0 in August, coming in at a seasonally-adjusted 46.4 (48.6 in July), as production, orders, and employment all fell. The weak PMI report makes it highly likely that the NIER manufacturing confidence indicator for September will decline yet again.

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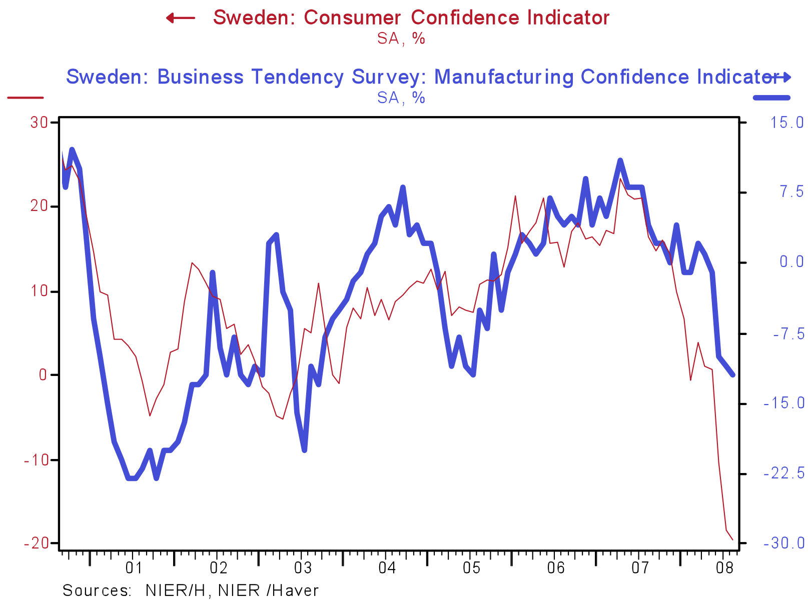

The government has said it is working on a stimulus package, with details to be included in the 2009 budget release sometime in the next few weeks. August inflation is due on September 9. The minutes from this week's policy meeting will be published September 17, while the next policy decision from the Riksbank is due October 23.

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ECB On Hold But Still Worried About Inflation

As expected, the European Central Bank (ECB) left its refi rate at 4.25% again this month. Of more interest was the post-meeting press conference from Governor Trichet. He noted that there are downside risks to growth but also said there is reason to hope that global growth will remain resilient. The Governor spent more time discussing the ECB's concerns about "broad-based second round effects." He emphasized that the ECB is "determined" to keep medium-term inflation expectations in line with its price stability goal of consumer price inflation below but close to 2 percent, and that the current monetary policy stance "will contribute to achieving our objective." In a signal that the ECB is unlikely to change interest rates for some time, he added that the Governing Council had no bias.

Alongside today's policy meeting, the ECB staff economic projections were released. As expected, the inflation forecast was revised up while the growth forecast was revised down. The annual rate of EU-harmonized inflation is now expected to average 3.4-3.6% this year, slightly up from the June outlook of 3.2-3.6%, with 2009 inflation at 2.3-2.9% (1.8-3.0% previously). Real GDP for this year has been revised down to just 1.1-1.7% (1.5-2.1% in June), and 0.6-1.8% next year (down from the earlier 1.0-2.0%).

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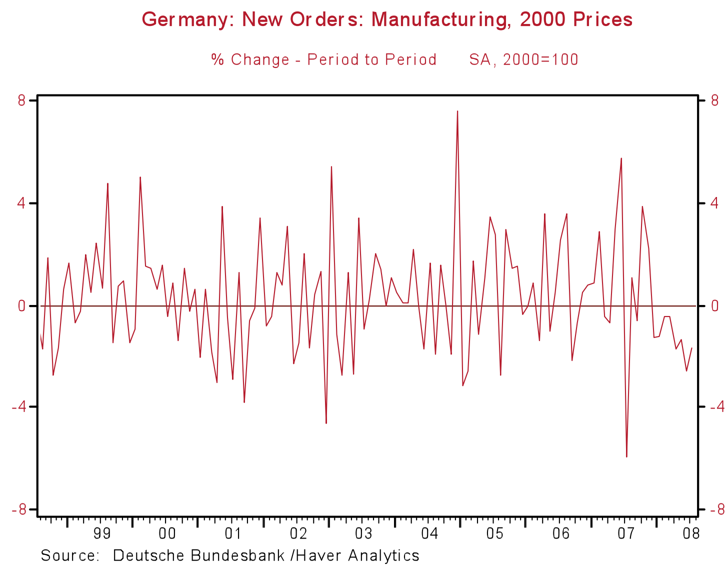
German Manufacturing Orders Drop Again

German manufacturing orders fell a seasonally-adjusted 1.7% on the month in July, the eighth consecutive monthly contraction, adding to fears that the largest economy in the Euro-zone is headed for a recession.



While orders tend to be volatile month-to-month, not since 2002 has Germany seen more than two consecutive quarters of negative growth. Although foreign orders overall did not fare quite as badly, eking out growth of 0.3% on the month (-4.5% in June), that was thanks to an up-tick in Euro-zone orders. Outside the Euro-zone, however, orders dropped 5.7% on the month. Interestingly, the other significant source of contraction was non-Euro-zone capital goods orders. While overall capital goods orders slipped 2.4% (-3.3% in June), non-Euro-zone orders plunged -10.6%.

On a two-month comparison, which smoothes out some of the volatility, June-July manufacturing orders overall were down 4.0% on April-May, with non-Euro-zone foreign orders falling 6.5% and overall capital goods orders dropping 5.9%. Could it be that capital goods demand from some of the powerhouse emerging markets is finally starting to ease back? Either way, the prognosis for German Q3 GDP growth is looking softer by the day.

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