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Investment Institute Macroeconomics

Macrocast

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European Convergence

- The Riksbank's cut will not prevent some inflation undershooting in Sweden. The undershooting risk is also clearly on the mind on the Bank of England's policymakers as they get ready to cut more than the market expects.
- The minutes of the April meeting strengthen the case of a June cut by the ECB – the doves are also pointing to the undershooting risk.

The Riksbank was the second central bank, after the Swiss National Bank, to cut rates in Western Europe. The Bank of England's message last week was dovish, consistent in our view with a rate cut in June, or August at the latest, and Bailey' warning that the BoE may have to cut more than what the market currently expects strengthens our call for a total of three 25bp cuts this year. The minutes of the ECB's April meeting were even more explicit than Lagarde in her press conference in telegraphing a rate cut in June, qualified as "plausible". The scenario of a general "European wave" of monetary easing before the summer, in contrast with a more hesitant Fed, is now stronger.

The risk of undershooting the inflation target and inadvertently bring about an excessive cost to output and employment is creeping up in European policymakers' minds. While the Riksbank may now be lauded for daring to cut earlier than the ECB despite the weakness of the Krona, the Swedish central bank may have in fact waited for too long before starting to reverse its stance. In a context of recession and significant rise in unemployment, the Riksbank is now forecasting that inflation will fall below 2%. A key dovish message from the Bank of England last week was its new forecast in which inflation would fall significantly below 2% towards the end of the projection horizon if the market's expected path for monetary policy materialises. The undershooting risk was also one of the arguments used by the doves at the ECB when they called for a cut in April already.

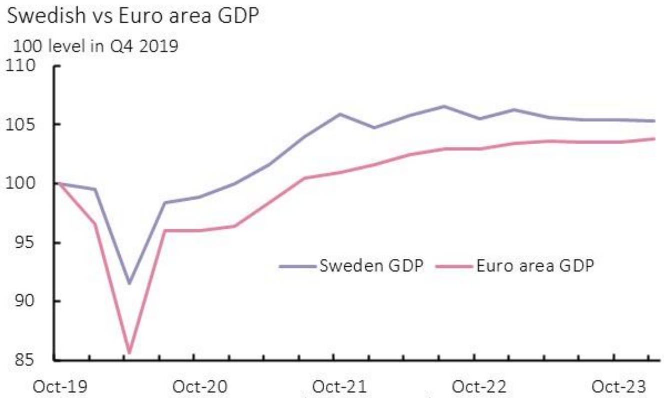
The ECB minutes however pointed to much concern about what the Fed could do in the face of resilient inflation in the US. Given the dominance of the US market, it is natural that European policymakers carefully monitor the macro and policy developments there. But we have been arguing since the beginning of the year that the risks are asymmetric across the Atlantic, with inflation undershooting a potential risk in Europe, against a sizable overshooting risk in the US. Reading Europe with American lenses could lead to costly policy mistakes.

Lessons from Sweden: don't wait too long!

We regularly look at Sweden as a "predictive laboratory" for the rest of Western Europe. The very straightforward communication style of the Riksbank helps. No need there to invest in pernickety textual interpretation worthy of medieval scholasticism. The Swedish central bank was the first to exit negative rates, and the justification they gave at the time ("*people find negative rates weird*") was in our view one of the best, if short. Their candour was also refreshing as they embarked on rate cuts last week. The first paragraph of the policy statement starts with: *"inflation is approaching target while economic activity is weak. The Riksbank can therefore ease monetary policy".* Simplicity wins! The same applies to forward guidance: if the outlook holds, two more 25bp cut will come this year. No need to read between the lines.

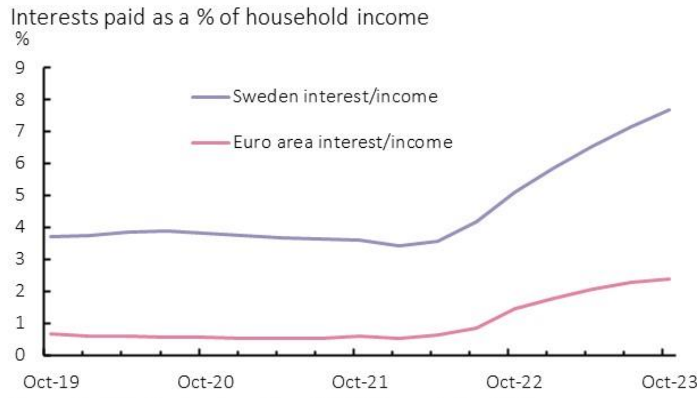
Now, beyond the fact that Sweden is not exactly leading the way this time since the Swiss National Bank was the first to cut last month, we would argue that Sweden is finding itself in a very different position than the Euro area and most other Western countries. Indeed, **what is unique about Sweden is that the entire economic narrative fully conforms to textbook economics**: the monetary policy tightening begat an economic slowdown which is triggering a rise in the unemployment rate which in turn puts a lid on inflationary pressure. Some of these ingredients are missing for now in the Euro area – and even more clearly so in the US.

Exhibit 1 – The Swedish outperformance is gone



Source: Statistics Sweden, Eurostat and AXA IM Research, May 2024

Exhibit 2 – Monetary policy hurt a lot, and quickly

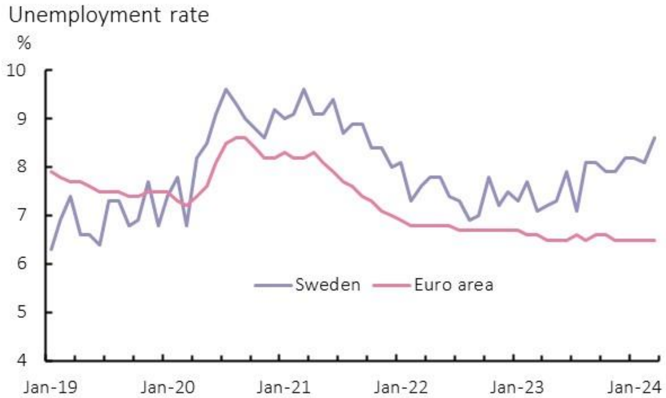


Source: Statistics Sweden, Eurostat and AXA IM Research, May 2024

Recent real economy developments in Sweden have indeed been more problematic than in the Euro area. True, when compared with the pre-Covid GDP level, as of Q1 2024 Sweden still outperforms (see Exhibit 1). Yet, beyond the fact that the pandemic had less of an impact on Sweden given its specific choice of health policy, more recently GDP has been falling in quarter-on-quarter (qoq) terms every quarter since early 2023. From a recent peak in Q3 2022 GDP has declined by 1.2%. This contrasts with the Euro area's very mediocre but still generally positive readings. **Monetary policy has played a significant role in this deterioration in macro conditions**. Transmission is particularly quick in Sweden, given the dominance of variable rates in mortgages combined with a high leveraging in the household sector. As a percentage of disposable income, interest payments rose massively, and much more quickly than in the Euro area (see Exhibit 2).

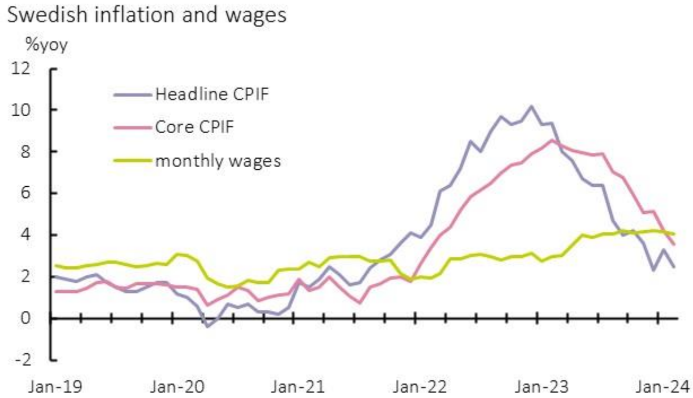
The labour market has been another area of divergence. While in the Euro area, the best news we have had on the macro front was the stability of the unemployment rate, despite GDP growth rates falling for more than a year under their potential, **unemployment has jumped in Sweden, now significantly exceeding the pre-Covid level** (see Exhibit 3). The magnitude of the monetary policy impact, together with the steep reaction of the labour market, can explain why the Swedish central bank chose to cut rates while core inflation was still relatively elevated, and wages were still rising at a fairly fast clip (see Exhibit 4).

Exhibit 3 – Massive labour market pain in Sweden



Source: Statistics Sweden, Eurostat and AXA IM Research, May 2024

Exhibit 4 – Inflation now correcting fast



Source: Statistics Sweden and AXA IM Research, May 2024

So, at first glance, given these differences in their respective macro situations, it seems that the Swedish central bank has little to offer in terms of lessons for the European Central Bank (ECB). **We think however that Sweden offers a good example of "policy overshooting",** driven in this instance by the country's specific sensitivity to exchange rate developments, and hence could be seen as a cautionary tale for other central banks.

Indeed, it may be brave now for the Riksbank to cut policy rates without waiting for its larger counterparts in the West and hence take the risk of triggering another significant depreciation of the krona and a bout of imported inflation. But **we would argue that precisely because of its concern about the exchange rate channel the Riksbank waited too long to start reversing its stance**. Last year, the Riksbank followed the ECB step by step, hiking again in September while the Federal Reserve (Fed) peaked in July. Yet by the end of last summer, it was already crystal clear that the Swedish economy was seriously hit – the unemployment rate had already moved up and GDP had declined significantly in Q2 – while consumer prices were decelerating. **The Swedish central bank warned last week upon cutting its policy rate that inflation may *"temporarily undershoot the target slightly this year".*** The Riksbank has also decided not to change its long-term forecasts for inflation which do not return to a steady 2% before 2026. Policy overshooting ends up with inflation undershooting.

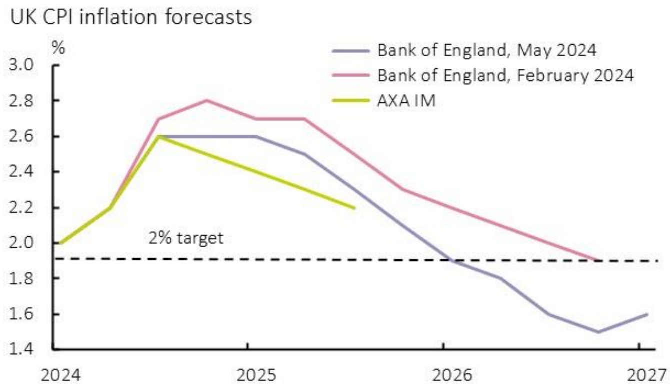
A popular view among the hawks at the ECB Governing Council is to only believe "actual data", excessively focusing on getting observed inflation numbers in line to the detriment of "working the pipeline" and taking on board the lags with which monetary operates. Waiting until inflation is effectively bang on target – which by the way is still not exactly the case even in Sweden – means imposing a completely unnecessary cost in terms of lost output and employment. Note that **since monetary policy transmission is slower in the Euro area, anticipating the lagged effect of its stance is even more essential for the ECB than for the Riksbank**. Another interesting takeaway from the recent Swedish experience is that one should not overstate the inflationary impact of a currency depreciation. If a small open economy such as Sweden has managed to send inflation back on track despite a depreciation of 22% against the dollar and 12% against the euro in 2 years, a much bigger economy such as the Euro area should be able to manage the imported inflation effect which another dose of currency weakness could trigger should the divergence with the Fed persists.

Bank of England prepares for cuts

The risk of undershooting the inflation target seems to be also on the minds of the Bank of England (BoE)'s policymakers. Habitual readers of Macrocast may remember that we had expressed our conviction that the British central bank would be forced to significantly revised down its – very hawkish – inflation forecasts from February. This materialised in a spectacular fashion in the monetary policy report released last week (see Exhibit 5). Inflation conditional on the market's then expected trajectory for the BoE stood above 2% until Q1 2027 in the February batch. **Inflation is now seen by the central bank as falling below 2% from Q2 2026 onward and significantly undershoot the central bank's target after that, falling as low as 1.5%yoy in Q1 2027.** The change reflects to some extent the mechanical impact on the forecasts of the shift in the market's expected trajectory for policy rates. Relative to February, the market has revised up its central expectations by 60bps for the end of 2024 and 90bps by the end of 2025). Yet, beyond this effect, the BoE explained during the press conference last week that they were now expecting less persistence in consumer prices.

Given the magnitude of the inflation undershooting, Governor Bailey explicitly warned that the BoE could have to ease more than the market currently expects: 55bps by the end of this year according to the pricing of the forward contracts, with surprisingly little change after the generally dovish press conference. For our part, we expect three 25bp cuts in total this year. Bailey did not elaborate much on when the easing phase could start. June is "*neither ruled out nor a fait accompli*" to quote him verbatim, and the market is currently agonizing on whether June or August would be the starting point. June is our baseline, as we anticipate some effect from low inflation readings in the coming months, starting with the April reading out next week, thanks to the combination of favourable base effects and the decline in energy prices triggered by the lower cap announced by the regulator Office of Gas and Electricity Markets (OFGEM) for April-June.

Exhibit 5 – Drastic revision



Source: Bank of England and AXA IM Research, May 2024

True, **the higher-than-expected print for GDP in Q1 (+0.6%qoq), as consumer spending was boosted by wage growth exceeding headline inflation, which was released after the BoE meeting, may weigh on the Monetary Policy Committee (MPC) opinion**, but we think the impact of low consumer price readings will supersede the sense of comfort which the recovery could provide to the policymakers. The fact that two MPC members, one more than in March, and among them an "internal" member (David Ramsden, Deputy Governor), dissented to push for a cut last week already suggests that the conversation is now quite advanced at the BoE, even if of course "data dependence" will ultimately drive the timeline.

The MPC will have two more inflation prints to chew on by its 20 June meeting. Since the bulk of the impact of the change in the energy price cap will show up in the April data, the May print may be more interesting to read through the properly "macro" forces at work in the British inflation process, but it will come up only one day before the MPC meeting, which will add to the suspense. In the meantime, labour market data will be key. This week on Tuesday, the materialisation of the further deceleration in weekly earnings expected by the market for March would help move the dial towards a June move.

The ECB's getting explicit

Christine Lagarde had been pretty straightforward at her press conference last month, strengthening the market's (and ours) expectation of a rate cut in June irrespective of what the Fed would do, but the minutes of the Governing Council meeting released last week pushed things by another notch: *"It was seen as plausible that the Governing Council would be in a position to start easing monetary policy restriction at the June meeting if additional evidence received by then confirmed the medium-term inflation outlook embedded in the March projections*". Of course, this does not constitute a commitment, and data dependence is still very here, but the message is clear. We also find it quite telling that the Council chose to comment directly on market expectations to implicitly endorse them*: "members felt that markets had understood the ECB's communication and reaction function and were prepared for the possibility of a rate cut at the June meeting"*.

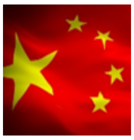
What we also found interesting in the minutes was the elaboration on the position defended by "*a few members*" in favour of an immediate cut. They argued that, given the decline in expected inflation since the last ECB hike in September, the monetary stance had become even more restrictive, especially when combined with the ongoing reduction of the central bank's balance sheet. **The balance of risk may thus have changed, with the odds of inflation ultimately undershooting the target rising**. While a "*broad consensus*" emerged on waiting until June to get a better picture, we find it interesting that the minutes did not point to a bitter debate, with no mention of strong rebuttals of the doves' position. The hawks are clearly already reconciled with – or resigned to – a cut in June. The new battle lines have probably moved to the speed of the subsequent easing and the level of the terminal rate. Virtually no one at the Council seems to consider that the current level of restriction needs to be maintained for much longer, but we note that the minutes' nod to the market expected trajectory for the policy path did not extend beyond June.

The minutes helped us to understand better why Fabio Panetta, one of the leaders of the doves on the Council, found it necessary to write a rebuttal of the position of those on the Council who seem very sensitive to the likely movements of the Fed. Indeed, even a cursory reading of the minutes would show that US inflation – and what the Fed may do about it – was clearly one of the key topics on the table. We find the summary in the minutes very one-sided: *"The depreciation of the euro following the release of the US inflation data pointed to a need for close monitoring of the impact of the exchange rate on euro area inflation. Spillovers from the United States through a sustained exchange rate effect would likely slow the disinflationary process in the euro area".* There was no mention of the adverse effect of tight financial conditions in the US – the result of a "high for longer" Fed – spilling to Europe, adding to the already restrictive monetary stance. The latter point was at the centre of Panetta's speech.

We are also struck by the one-sided nature of the comments on fiscal developments. The discussion according to the minutes did not stray far from the usual message from the ECB to national governments: *"The need for fiscal prudence and consolidation across the euro area had to be clearly spelled out… it was widely considered good news from a monetary policy perspective that there would soon be a new framework in place, providing guiding principles and enhancing prospects for more credible implementation*". This reads as if more fiscal restriction would interfere less with what monetary policy is trying to achieve. We would argue that in the current circumstances, given the overall fiscal tightening already in the pipeline, the ECB has more reasons to ease quickly. This is another key difference with the US.

So all in all, while the June cut is not at risk in our view, unless a truly massive surprise crops up in the dataflow in the next few weeks – the minutes made it plain that they were expecting, and would thus implicitly tolerate, some "bumps" on the road – **the majority of the Governing Council is still erring on the side of a very prudent pace of easing in the second half of 2024, with probably very little forward guidance and volatility-inducing data dependence.**

Given the past surprises with persistent inflation, such prudence by the ECB – which is likely to be extended to all the other central banks in Europe after the beginning of their respective easing – is fully comprehensible. We are however concerned about the risk of a form of "intellectual contagion" from the debates in the US. Given the dominance of the US market, it is natural that European policymakers carefully monitor the macro and policy developments there. But we have been arguing since the beginning of the year that the risks are asymmetric across the Atlantic, with inflation undershooting a potential risk in Europe, against a sizable overshooting risk in the US**. Reading Europe with American lenses could lead to costly policy mistakes.**

Country/Region	What we focused on last week	What we will focus on in next weeks
	• Snr Loan Officers Survey (May) showed business conditions continue to tighten, household loosening • Consumer credit (Mar) eased back consistent with some softening in demand • Weekly jobless claims jumped to 231k – a 9mth high. Start of May often sees seasonal jump but will monitor for persistence	• CPI inflation (Apr), headline and core expected to ease, but focus on services ex-shelter • PPI inflation (Apr) expected broadly stable and watched for implications for PCE inflation • Retail sales (Apr) stagnation expected after stronger March, watch for signs of weakness • Empire and Philadelphia Fed (May)
	• Industrial output (Mar) in Germany and Italy were weak at -0.4%mom and -0.5% respectively. • Final Composite PMIs (Apr) was better at 51.7 boosted by Svcs • EMU retail sales rose by 0.8% m/m in Mar, with solid rebound in food and fuel consumption. • EMU Sentix index rose to -3.6 in May (from -5.9)	• Final HICP (Apr) • EMU employment data and 2nd estimate for GDP growth (Q1) • EMU industrial production (Mar) • ZEW surveys (Ger, May)
	• BRC total sales points to softer retail sales in Apr. • RICS house price balance held steady at -5% in Apr. • MPC kept Bank Rate unchanged at 5.25% (0-7-2 in favour of cut). June remains our base case. • GDP up by stronger-than-expected 0.6% in Q1, we revised up our year forecast to 0.6%, from 0.4%.	• Labour market data to show the unemployment rate held broadly steady at 4.2% in Mar. • AWE ex. bonuses likely ticked down to 5.9% in Mar, from 6.0% in Feb.
	• USDJPY has held broadly steady at around 155, following intervention • Cash earnings up 0.6%mom in Mar., below expectations • HH spending rose by 1.2% in Mar. (consensus -0.3%) • Eco Watchers Survey outlook fell to 47.4 in Apr, from 49.8	• Money stock looks set to rise by around 2.5% in April, the same as in March • Corporate goods price index looks set to rise by 0.8%yoy in Apr, unchanged from Mar. • GDP likely edged down by 0.3% in Q1, following a small 0.1% rise in Q4
	• Caixin Service (Apr): 52.5, edged down from 52.7 in March • FX reserves (Apr): USD3.201tn (Mar: USD3.246tn) • Exports in USD grew by 1.5%yoy (Mar: -7.5%); imports grew by 8.4%, up from -1.9% in March	• 10-17 May: Credit data (Apr) including total social financing, M2 money supply, new loans, and FDI • 11 May: CPI and PPI (Apr) • 17 May: April monthly output data retail sales, fixed asset investment and industrial production
	• CB: Poland on hold (5.75%), Malaysia on hold (3%), Mexico on hold (11%), Brazil -25bps (to 10.5%), Peru -25bps (to 5.75%) • Q1 GDP Indonesia (5.1%yoy), Philippines (5.7%yoy) • April inflation (%yoy) Philippines (3.8%), Taiwan (1.95%), Hungary (3.7%), Chile (4.0%), Colombia (7.2%), Mexico (4.7%), Brazil (10.8%)	• CB: Romania, Philippines • Q1 GDP: Poland, Malaysia • April inflation: Romania, Poland, Czech Rep

Upcoming events	US:	Tue: PPI (Apr), Fed Chair Powell speaks at event organised by Netherland's Foreign Bankers' Association; Wed: CPI (Apr), Empire state mfg survey (May), Retail sales (Apr), Business inventories (Mar), NAHB housing market index (May), Long term investment flows – TIC data (Mar); Thu: Building permits (Apr), Housing starts (Apr), Philadelphia Fed index (May), Weekly jobless claims (11 May), Industrial production (Apr); Fri: Leading index (Apr)
	Euro Area:	Mon: Ge Current account (Mar); Tue: Ge&Sp HICP (Apr), Ge CPI (Apr), Ge ZEW Survey: current situation & economic expectations (May); Wed: Ez GDP (Q1, p), Ez Industrial production (Mar), Fr HICP (Apr); Thu: ECB releases semi annual Financial Stability Review, It HICP (Apr); Fri: Ez CPI (Apr), Fr ILO Unemployment rate (Q1), Fitch to review Spain's credit rating
	UK:	Tue: ILO Unemp (Mar), Average earnings (Mar), BoE Chief Economist Huw Pill speaks at the Institute of Chartered Accountants Economic summit; Thu: MPC member Megan Greene speaks at Make UK about the labour market; Fri: MPC member Catherine Mann speaks at the Economic Statistic Centre of Excellence conference
	Japan:	Thu: GDP (Q1, p), Industrial production (Mar)
	China:	Wed: PBoc 1y MLF announcement; Fri: Fixed asset investment (Apr), Industrial production (Apr), Retail sales (Apr)

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