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Sharp downturn awaits Sweden in 2023

Multiple headwinds will push Sweden into recession in 2023. But with inflationary pressures still not abating, we expect the Riksbank to hike rates by an additional 50 basis points (bps) at this week's meeting.

Key Takeaways

- Our forecast is for the Riksbank to remain laser-focused on inflation and to announce another 50bp hike on Thursday.
- This could be the final one of the cycle, but risks are skewed in the direction of another hike in April.
- We expect the recent Q4 GDP estimates to mark the beginning of a pattern of recessionary activity data. Our forecast is for 2023 GDP growth -0.9%.
- Swedish households are particularly vulnerable to the effects of higher rates due to the structure of the housing market.
- Firms are among the most highly leveraged in Europe, and thus also susceptible.
- The combined effects of recession and higher interest rates will see real incomes squeezed. This will take inflation on a path back towards target over the course of 2023.
- Our base case is for the severity of the recession, and the associated unwinding of inflationary pressure, to prompt easing by the Riksbank by the end of the year.

Pressing on with hikes

Despite having made a cumulative 250bps in hikes in 2022, the Riksbank executive board enters its first meeting of 2023 with an ongoing inflation problem. To complicate matters, the Bank must now also contend with slowing activity, reinforced by multiple headwinds.

We expect it to press on with its hiking cycle, raising rates by another 50bps to 3.0% at this week's meeting.

There is good reason to believe last year's hikes are already taking their toll on activity. Admittedly, activity data for October and November were resilient. But Sweden's momentum ran out at the end of the year, with the preliminary Q4 GDP report showing a 0.6% contraction.

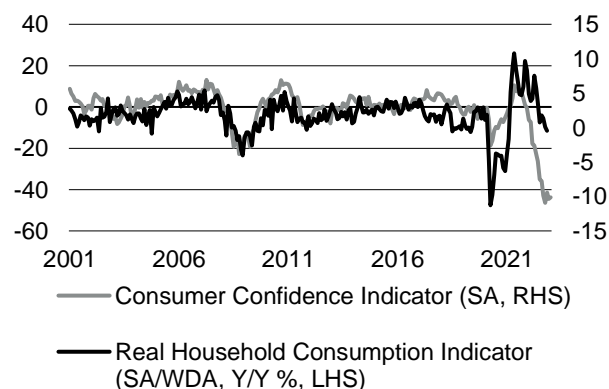
We think the souring of the data flow marks the beginning of a downturn that will push Sweden's 2023 growth rate below zero. Indeed, a closer look at the data reveals a number of weaknesses.

Recession is hard to avoid

Factors hampering activity growth include supply disruptions, the real disposable income hit from high inflation, and tighter monetary policy.

These drivers will be familiar to those watching similar dynamics in the UK, US and Eurozone. However, Sweden differs from its peers in the relative contribution of these factors, and the exact channels through which each will act.

Figure 1: Depressed consumer confidence suggests spending will fall



Source: Haver, February 2023

Consumer confidence has been exceptionally weak in recent months, remaining near an all-time low in December (see Figure 1). Household consumption looks remarkably resilient by contrast, but we think the collapse in confidence predicts a significant weakening in spending.

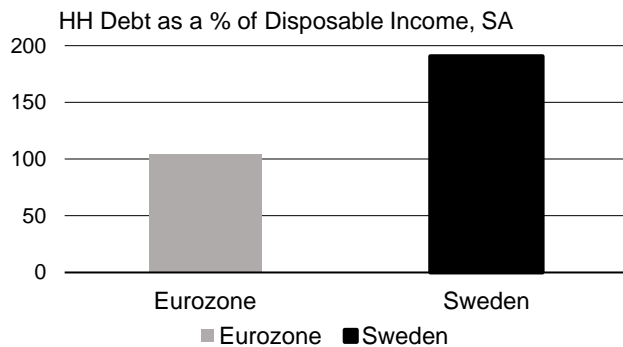
This downturn will be reinforced by the full pass-through of higher rates. Swedish households are more leveraged, especially via housing, than comparable economies (see Figure 2).

Higher interest rates have passed through to mortgages quickly, with the latter rising over 200bps in 2022 and set to increase further given our expectation of a rate hike. Around 50% of Swedish mortgages are on variable rates, and must be refinanced this year. This is in stark contrast to other European countries, where longer terms are the norm.

Moreover, the impact of higher rates on housing prices — which have fallen by 15% since the start of 2022 — has been particularly strong in Sweden. With interest rates still on the rise and incomes squeezed tighter, this correction might have further to go.

All this has negative implications for household consumption via lower disposable income, wealth effects, and lower confidence.

Figure 2: Swedish households are considerably more indebted than their counterparts in the Eurozone



Source: Haver, February 2023

Other parts of the Swedish private sector are also highly leveraged. Firms allocate over 20% of their income to debt servicing, and have the highest debt ratio in Europe. We therefore expect a strong slowdown in new investment and capital expenditure as the full effect of higher rates is felt, deepening the expected contraction.

All told, our expectation is that Sweden entered a recession with the Q4 2022 GDP contraction, and we are forecasting full-year 2023 GDP growth of -0.9%.

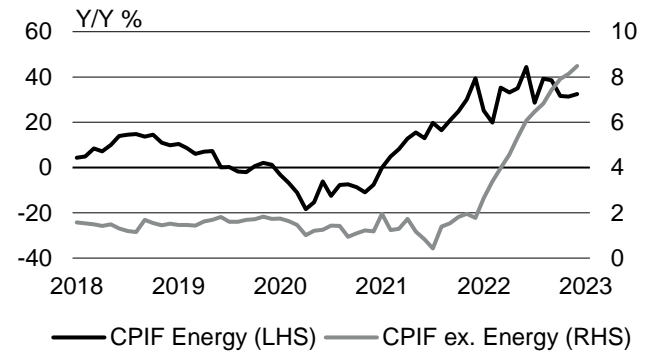
Inflation still not abating

Sweden's inflation problem has followed a similar path to that of its peers: an energy price shock drove up volatile

components, before higher input costs transmitted higher prices across the economy.

At the present juncture, core inflation remains elevated, and 85% of the inflation basket is above target. Meanwhile, headline inflation sits at a 30-year high (see Figure 3).

Figure 3: Inflation broadened over 2022

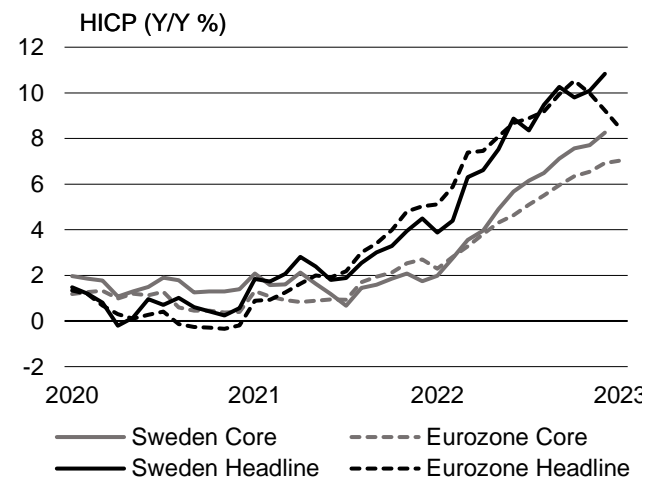


Source: Haver, February 2023

However, Sweden's inflation story does contain a few key differences from peers. First among these is its breadth and persistence. While headline inflation appears to have peaked in the Eurozone and in the UK, it has yet to turn a corner in Sweden (see Figure 4).

Core inflation also remains comparatively high.

Figure 4: Sweden's inflation problem looks particularly severe in its regional context



Source: Haver, February 2023

In addition, energy exposures differ from those faced by other European countries. Across the European Union, natural gas makes up 24% of the energy mix, whereas in Sweden the share is just 2%.

This means that Sweden's growth prospects saw a relatively small improvement from recent natural gas price dynamics compared to much of the rest of Europe.

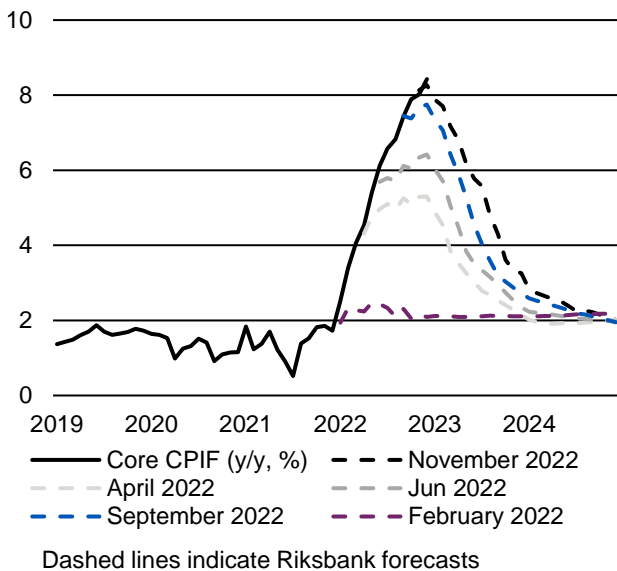


More work for the Riksbank

The Riksbank consistently underestimated inflationary pressures in 2022, and with headline inflation north of 10%, there is plenty of pressure on the Bank to impose even tighter financial conditions to contain underlying inflation pressures.

Indeed, the detail of recent consumer price reports provide little solace. The Riksbank's repeated underestimation of price pressures extends to core CPI (CPI-F excluding energy), which sits above its most recent forecast rate (see Figure 5). Likewise, services inflation, which is usually stickier than goods inflation, has shown no sign of abating.

Figure 5: The Riksbank is once again entering a meeting with core inflation higher than anticipated



Source: Haver, February 2023

Sweden's monetary problems are compounded by the weakening of the Krona, which has driven up the price of imported goods. The currency is down 14% against the dollar since the beginning of 2022.

The Krona is also down against the Euro, sitting at €11.44 as of Monday, its weakest level since the global financial crisis.

A few positives

Even though the economy is at a difficult juncture, there are some tailwinds that could plausibly soften the 2023 recession. For a start, supply side pressures globally are easing. Evidence for this can be found in Swedish survey

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data: the proportion of companies recording input and equipment shortages as a key factor limiting output fell from 62% in Q3 to 50% in Q4 last year, while the proportion recording labour shortages fell from 24% to 14%.

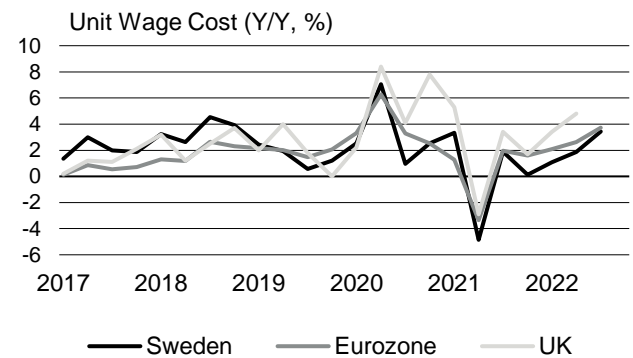
Meanwhile, the Riksbank arguably has fewer worries than the Federal Reserve or the Bank of England regarding labour market dynamics.

While Sweden has experienced similar labour market strength in 2022, recent wage growth prints have come in lower than those of its peers. If economic activity weakens as we expect, this could provide the conditions for a fall in underlying inflation.

The Riksbank's job is also made easier by the prospect of unions accepting a 4% pay rise in the next round of collective bargaining.

The large real-terms pay cut implied by such rates of wage growth will weigh on disposable incomes, further assisting the Riksbank in its efforts to bring inflation back to target.

Figure 6: Unit labour costs are contained



Source: Haver, February 2023

After the hiking cycle

Though not our base case, it is entirely possible that Thursday's hike is not the last of this cycle. The Riksbank proved willing to surprise markets and forecasters with larger-than-expected hikes in 2022. This risk may rise if core inflation does not decline meaningfully before Q2.

However, it is our central expectation that the Riksbank will react to recession by ending the rate hiking cycle. The drivers of recession are essentially deflationary, and even though we anticipate some price stickiness, the combination of the contraction and restrictive policy will bring year-over-year inflation rates down slowly in 2023.

Indeed, some rate cuts before the end of the year are possible.



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