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European Minors' Activist Monetary Policy

Central Banks Prefer Mann's Definition of Activist Policy to Bailey's

- SNB and BoC indicate that "going big" after cuts start can shorten the cycle
- Riksbank this week will likely follow this approach
- Europe will need to look past lack of risk constraints from the Fed

Despite growth challenges, policy confidence is solid in Europe

The Fed decision this week will dominate proceedings amid over a dozen key central bank decisions around the world, as policymakers attempt to tidy things up ahead of year-end and fireworks in January as a new US administration arrives. For some economies, most of them in emerging markets, US monetary and trade policy could represent almost a "dual tightening" of financial conditions. A stronger dollar threatens to push up imported inflation, while tariffs on a trade partner is imposing an effective rise in the real effective exchange rate, but only through export prices. Any form of offset would require further declines in nominal exchange rates and aggravate price risks from dollar strength.

Even so, many central banks have set out their stall on this and will focus on demand risks from loss of exports. Meanwhile, we have also observed that for some economies with material trade exposures to the US, it appears that central banks are doing what they can on rates as quickly as possible as long as inflation expectations are well-anchored and the economy is already slowing. In such an environment, there is certainly greater justification in worrying less about positive pass-through. Last week, the Bank of Canada (BoC) and Swiss National Bank (SNB) both cut rates by 50bp. While these two decisions shouldn't be considered total surprises and the scale of the cuts underscore the weak outlook in these economies, there was a rather positive twist as well in their policy conclusions. The BoC felt that it was apt to “anticipate a more gradual approach” to easing, while SNB President Schlegel stated that the “the likelihood of negative rates had become smaller,” as underscored by the uplift in the central bank’s inflation forecasts towards the end of their forecast horizon.

In short, both central banks have subscribed to (Bank of England Monetary Policy Committee Member) Catherine Mann’s definition of “activist policy.” In November, she challenged BoE Governor Bailey’s supposed interpretation that “activist policy” simply implied more aggressive rate cuts (and the governor has since backed away from that stance); rather, the known BoE hawk favoured gradually moving away from restrictive rates but “move big…when it is clear that the inflation persistence which has been embedded in the process has been purged.” In Canada and Switzerland, the purge is complete whereas this is not the case in the Eurozone and the United Kingdom. It is telling that even after the ECB and SNB decisions last week, end-2025 rate expectations for the ECB remain close to where they were at the beginning of the year, which does correspond to ECB President Lagarde’s determination to maintain some balance in the ECB’s approach. In contrast, pricing for SNB rates at the same point has fallen by close to 150bp between the June and December meetings, but last week’s decision generated no additional reaction (Exhibit #1), suggesting the market deems the SNB’s new outlook for some green shoots of reflation as totally credible.

Exhibit #1: End-2025 Rate Expectations Stabilising in Europe

Source: Bloomberg, BNY

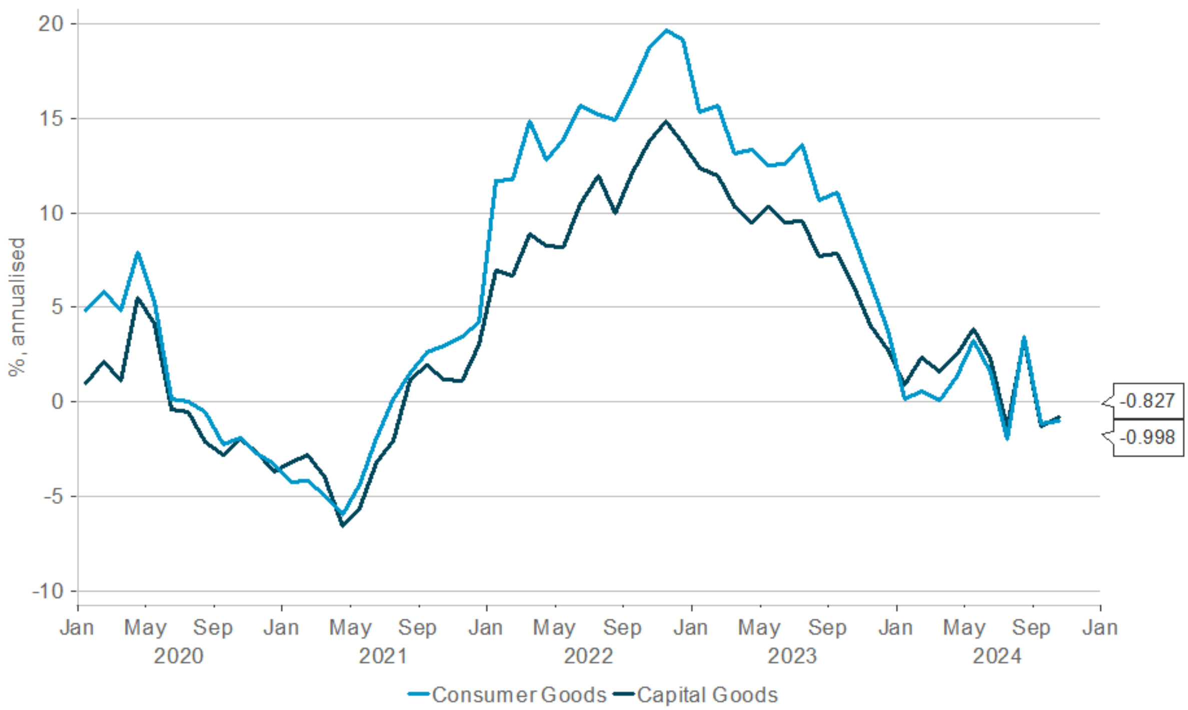
Looking ahead to the three Western European central bank decisions this week, we believe the Riksbank is clearly in the "Mann school" of activism and will "go big" again with a 50bp cut. However, notwithstanding current market positioning, it appears that there is also significant reluctance to price in terminal rates significantly below neutral. The three-month forward rate agreement (FRA) for Q4 2025 stands at just below 2%, and pricing has not changed much over the past quarter (Exhibit #2). We fully expect the Riksbank to adopt communication similar to the SNB and indicate some confidence that inflation will move back to target towards the end of their forecast horizon, with a chance of a lift in the repo rate outlook as well.

Exhibit #2: Additional Cuts Not Expected in Nordics

Source: Bloomberg, BNY

Even on the economic front, despite the persistent risk of direct and indirect export weakness due to soft Eurozone manufacturing and US tariff risk, Sweden's own Purchasing Manager Index (PMI) has largely stayed in expansion territory since Q2 this year and has totally diverged from Germany and the Eurozone aggregate. Meanwhile, there are even signs of domestic demand stabilising. However, when measured in terms of price index changes (Exhibit #3), there is no room for complacency as consumer and capital goods prices appear to have simply stopped falling and just about hanging at around zero growth. Disinflation is clearly present and warrants additional easing, but the Riksbank has some initial data support that deflation can be avoided.

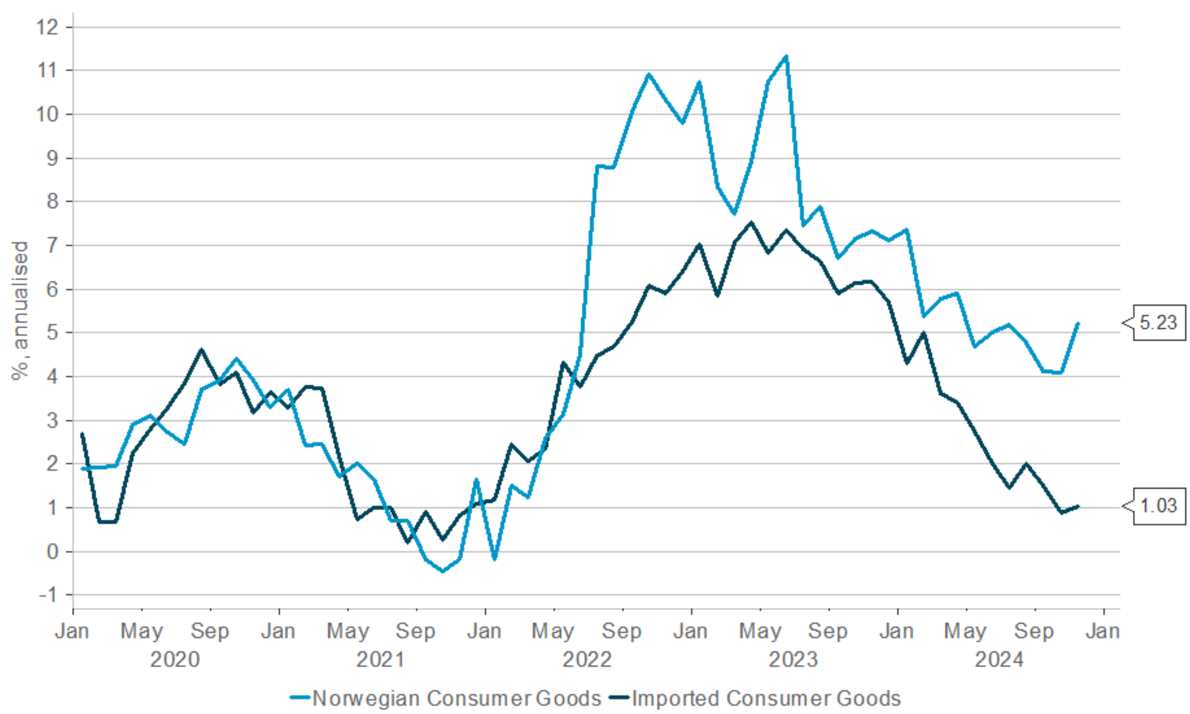
Exhibit #3: Swedish Demand Stabilising at Lows



Source: Macrobond, BNY

In contrast to Riksbank terminal rate pricing for next year, the same Q4 2025 FRA for Norges Bank rates has moved higher by 100bp over the same period and is approaching 4%, indicating 50bp in cuts for next year. Even with the country's considerable financial resources, we believe the risk to such pricing is only to the downside. Norway's automatic stabilisers means that declines in domestic demand will always be limited, but the general trend in consumer goods' prices indicates Norges Bank will need to make a firm judgement on domestic resilience in an increasingly adverse external environment. Imported consumer goods price inflation has fallen to 1%y/y (Exhibit #4), despite Norges Bank's I-44 import price index looks set to end the year up an additional 4%. This suggests that weak demand has offset any potential price increase in imported consumer goods attributable to exchange rate adjustments. A demand component is clearly affecting prices, while domestic consumer goods inflation remains high, indicating wage persistence which could yet justify rates staying higher for longer. This appears to be a similar conundrum to the European Central Bank. Even so, given the outlook for oil prices and that small open economies face faster price adjustments to demand shocks, which in turn requires a commensurate response, Norges Bank probably needs to clearly signal entry into the "Mann school" of activist policy and warn the market that it will be ready to cut soon, and it will go big when cuts begin. Given the current state of NOK valuations, a better way to reflect such policy is for significant repricing in FRA curves for next year – 50bp is nowhere near enough, even if the rest of Europe stabilises. We suspect Catherine Mann herself would like to see the Bank of England also enter this position soon, but the lack of credible labour market data and fiscal loosening means there is a lot more "price purging" to go in the UK.

Exhibit #4: Norwegian Consumer Demand Divergent



Source: Macrobond, BNY

Please direct questions or comments to: iflow@bny.com

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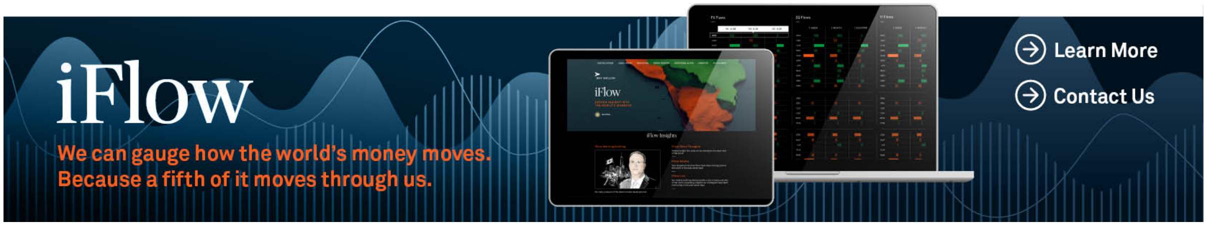

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