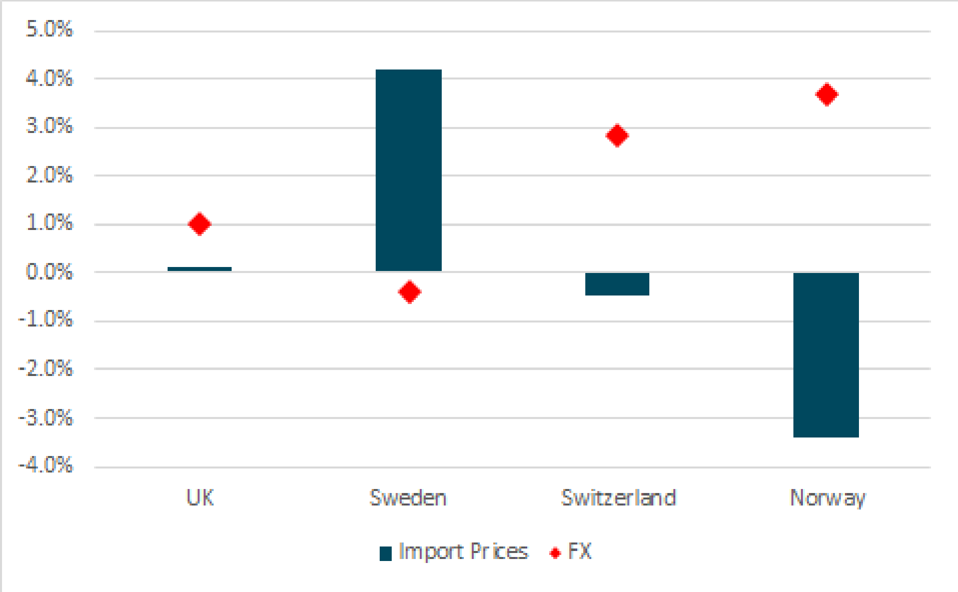
November 15, 2023

FX Pass-Through Needed In Europe

Strong inflation pressures and stubborn prices over the past 18 months called for central banks to use every instrument at their disposal to drive down prices and inflation expectations. Yet, foreign exchange pass-through is a tool that has traditionally faced strong scepticism among policymakers. For example, even now the Bank of Japan appears to be tolerating steep declines in yen valuation despite clear evidence of pass-through. Japan is highly dependent on imports for many of its goods, especially energy, so it is hard to imagine a weaker yen not having an impact on household inflation expectations. Based on many policymakers' decomposition analysis, inflation expectations are now a key contributor to headline inflation. This means open, import-dependent economies will continue to be heavily exposed to pass-through risk, not just realised but also forward-looking.

Many central banks have talked the talk on pass-through, but few have done anything about it. There have been very few examples of proactivity, such as the intra-meeting hike by the Philippines' central bank aimed at preventing inflation-generating currency depreciation. Throughout the past few rounds of rate hikes, all central banks whose countries have the Eurozone as a key trading partner have stressed the importance of anchoring their currencies against the euro to limit imported inflation. The evidence shows that this is still very much relevant, even as the euro may have peaked due to the ECB likely done hiking. The chart below shows currency moves over the past quarter on a nominal effective exchange rate (NEER) basis against import prices. Reaction functions differ between individual countries, but it shouldn't be a surprise that currencies with the best performance over the past quarter have managed to hold down import prices more assertively.

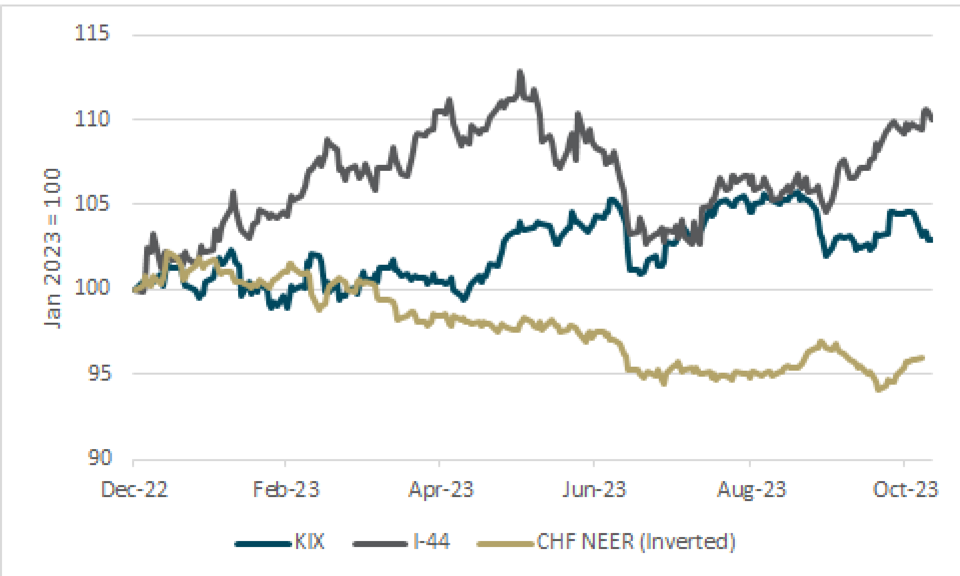
FX Gains In Q3 vs. Import Prices



Source: Bloomberg, Macrobond, BNY Mellon

Perhaps the most worrying aspect of inflation in smaller, euro-exposed economies is that it is showing signs of rebounding. The material upside surprise in Norway's inflation reported last week points to another hike this year; Norges Bank had flagged this at its last policy meeting. We would not rule out the need for additional tightening next year. Considering the state of the Eurozone economy and the need for stimulus as soon as the inflation trajectory allows, the risk of policy divergence is clear. If Norges Bank does not seek to push up debt-servicing burdens for households aggressively, then the exchange rate will need to be the primary source of tightening – and we think there is every reason to continue targeting import prices. Despite the recent improvement in NOK valuations, the I-44 import price index remains close to the year's highs and is underperforming equivalents in Sweden and Switzerland (we use the inverted BIS NEER as a proxy for an import price index as the SNB does not have an explicit import-based exchange rate index).

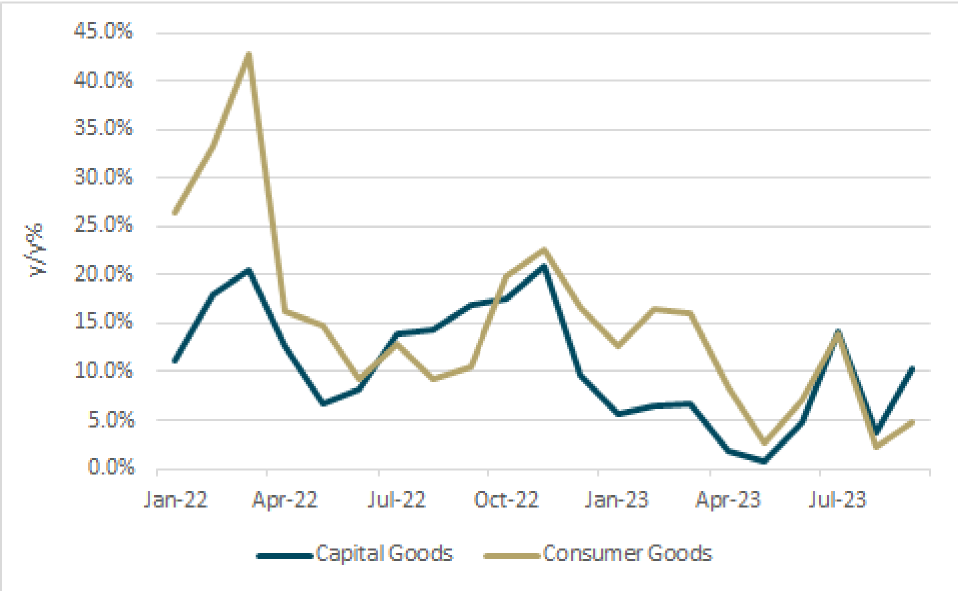
Import Indices For Sweden, Norway And Switzerland



Source: Bloomberg, Macrobond, BNY Mellon

The chart below shows three-month sequential inflation annualised in Norway for non-agricultural imported items. After big drops in H1, the recovery since July threatens to undermine the progress made through Q3 – the I-44 is now closer to 110 after having fallen below 103 in July. While pass-through transmission in agricultural goods and other primary imports' adaptivity to global pricing is faster, prices for discretionary consumer goods could prove harder to dislodge if demand remains strong. Assuming that supply issues are not driving prices on a marginal basis, forcing up the exchange rate can help with price transmission without overly damaging margins. Lower oil prices may have contributed to the I-44 rebound on the back of a terms of trade adjustment, but if Norges Bank judges that the krone has over-compensated for this and is now damaging price stability, policy steps will likely be needed. We do not expect material changes in the FX purchases framework as the mechanism is not intended a policy tool. Instead, shifting policy expectations to manage demand and complement FX strength seems the more appropriate path.

Norway Imported CPI-AT

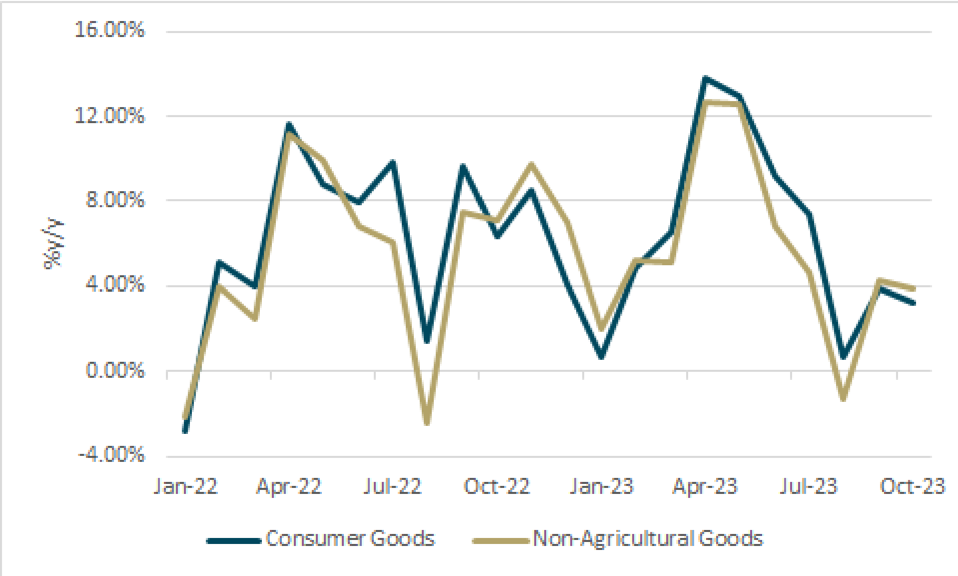


Source: Bloomberg, Macrobond, BNY Mellon

The impact of exchange-rate weakness on monetary policy in the G10 is most acute for Sweden, and the Riksbank is quite forthright about the challenges. The import price gain in Q3 was the strongest among non-Eurozone European economies, even though the decline in the krona slowed. This points to a case of expectations of pass-through driving inflation rather than inflation itself. As stated in our introduction, inflation expectations now contribute strongly to price formation. Wages and supply pressures have generally been dominant globally in driving the expectations component, rather than a falling exchange rate. Sweden and Japan are probably alone in this regard. On a sequential level, we can see below that prices for imported capital goods and consumer goods are rebounding again, with the former close to

10%. We think such numbers underscore the urgency of forcing up the exchange rate. The Riksbank's FX hedging programme is intervention in all but name. While it has been successful in driving down EURSEK recently, we think it needs to move on to expectations management. Rate hikes, a much larger hedging programme (and perhaps calling it intervention outright) should all be on the table, in our view.

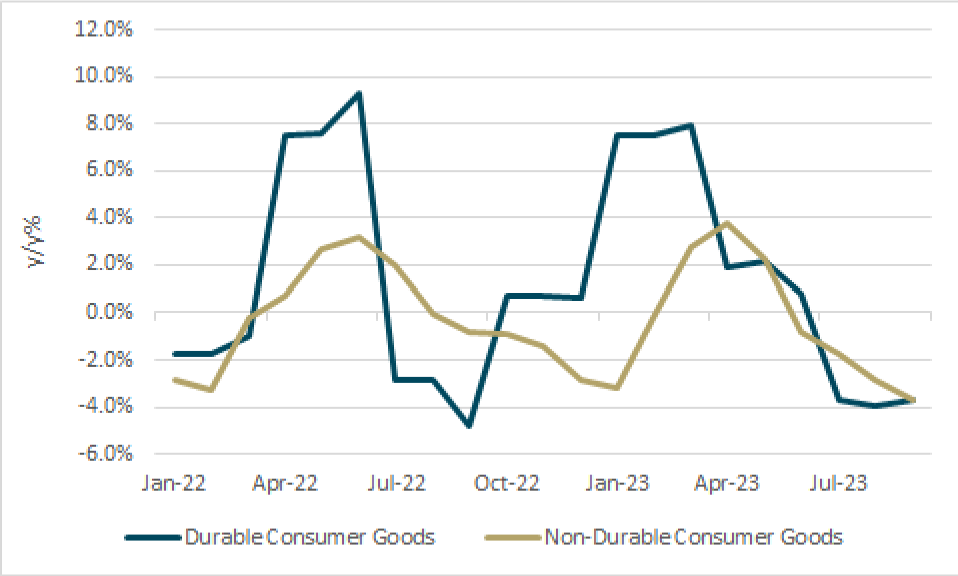
Sweden Imported Inflation



Source: Bloomberg, Macrobond, BNY Mellon

While Swiss import prices softened only marginally in Q3, the franc has continued to strengthen and inflation is comfortably heading back to target. As shown below, durable and non-durable consumer goods inflation are now contracting on a three-month annualised basis; prices for the latter are now below January 2020 levels, indicating the entire post-pandemic price surge has been fully offset. The bulk of the work was done through H1 as the CHF NEER strengthened by around 5%. While the disinflationary pass-through may have been limited on a mathematical level, the clear path of appreciation will have a demonstrable effect on inflation expectations as households expect lower consumer goods prices. Consequently, even though CHF appreciation ended in Q3 (and there are signs the SNB is now moving the other way), the inflation expectations component of CPI is likely very weak and contributing to the overall declines: corporates realise that pricing power is now more limited and have reacted accordingly.

Switzerland Imported Inflation



Source: Bloomberg, Macrobond, BNY Mellon

Using the exchange rate does work for small, open economies whose trade is tied to a large neighbour. Surplus economies' currencies such as SEK, NOK and CHF underperformed due to adverse import balances from higher input costs, but at the same time their financial accounts were also under pressure from higher external yields. Just talking about using the exchange rate as a tightening tool ultimately was not enough due to lack of tightening to complement the process. However, in the next six months we expect the ECB to shift its bias. For the Scandinavian and Central and Eastern European central banks, we think it is imperative that there isn't immediate synchronisation which would limit potential FX gains against the euro. Pass-through is understandably under-utilised as a policy tool in developed economies, but we view the upcoming window against the euro as an opportunity to anchor import-based consumer prices.

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