FX Watch

02 December 2016

Divergence among European FX

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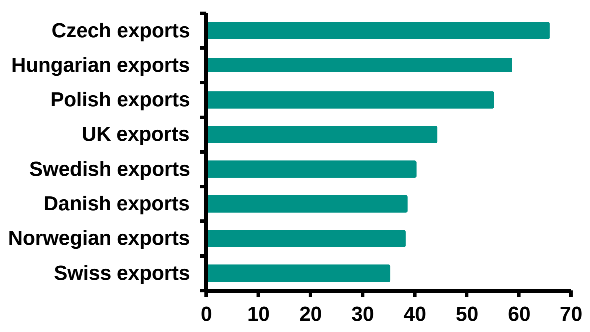
- **We expect the Norwegian krone and the Swedish krona to appreciate…**
- **…because of tighter monetary policy and higher oil prices (krone)**
- **We also see upside in the Hungarian forint and the Polish zloty vs euro…**
- **…as their central banks are likely to tighten before the ECB**
- **FX interventions should keep the Swiss franc and Czech Koruna in check**
- **We expect sterling to be resilient versus the euro**
- **The Turkish lira will remain under pressure due to weak fundamentals**

Exports to the eurozone are an important driver for growth…

The economies of Sweden, Switzerland, Norway, Denmark, Czech Republic, Poland and Hungary are highly dependent on the growth outlook for the eurozone. This is because a substantial share of their exports are directed to the eurozone and net exports are an important contributor to GDP growth (see graphs below). We expect the eurozone economy to grow slightly above trend in 2017 and 2018. However, this is in line expectations in financial markets so the impact is likely to be neutral. Therefore, the contribution of net exports to GDP is unlikely to see substantial surprises unless there are large currency swings.

Exports to the eurozone (July 2016)

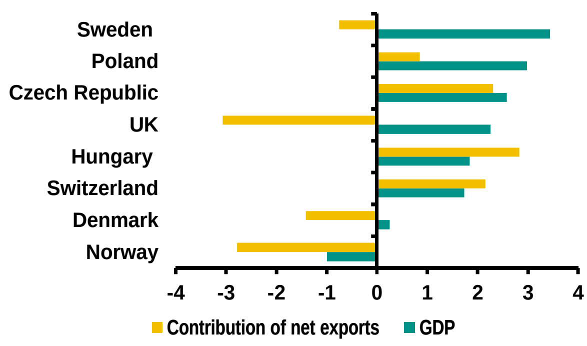
% of total exports



Source: IMF Dots

GDP and net exports (Q2 2016), UK & Norway Q3

Pps yoy



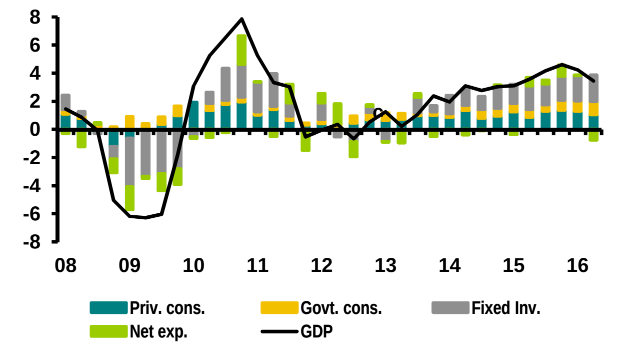
Source: Thomson Reuters Datastream, ABN AMRO Group Economics

…but domestic demand has also been a driver in Scandinavia

For Norway, Sweden and Denmark, final domestic demand is an even more important driver for growth than net exports. This is because low interest rates have boosted private consumption and fiscal policy has been supportive.

Net-exports a drag on growth in Sweden…

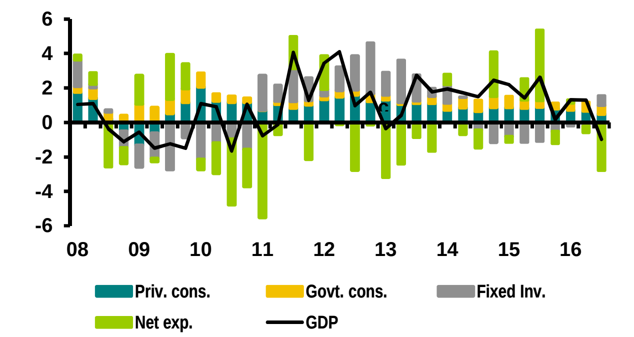
% of total exports



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

…as well as in Norway

% yoy



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

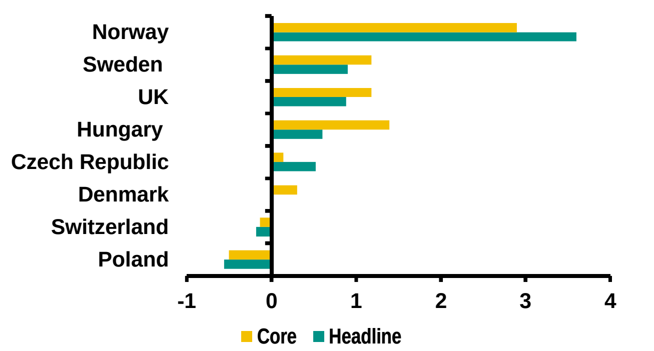
In Sweden, the communication that monetary policy will remain loose for longer has resulted in a substantial weakness in the Swedish krona. It is likely that this weakness will result in higher inflationary pressures and a positive contribution of net exports to GDP growth. In Norway, the recovery of the oil price should ultimately lead to a positive contribution of fixed investment to GDP growth. As a result, GDP growth is likely to improve further.

Central banks follow ECB and economy

The central banks of the countries mentioned in the first graph have been closely following the outlook for their economies, the strength in their currencies and the behaviour of the ECB. In general, these central banks have designed various methods of monetary policy easing, as some have intervened in currency markets while others have tried indirectly to influence currency valuations by cutting interest rates and/or by quantitative easing. However, we expect the monetary policy stance for most central banks in these countries to change.

CPI

In %



Source: Thomson Reuters Datastream

The central banks mentioned below have inflation targets (with the exception of the central bank of Denmark). In addition, they aim to dampen the negative impact on their economies of currency strengthening (Switzerland, Czech Republic) or oil price declines (Norway).

Monetary policy target and our view

	Monetary policy	2017	2018
Norway	Inflation target: CPI close to 2.5%	+50bp	+50bp
Sweden	Inflation target: CPI 2%	On hold	+50bp
Bank of England	Inflation target CPI 2%	On hold	On hold
Hungary	Price stability: 3% +/- 1%	On hold	On hold
Czech Republic	Inflation target: Headline CPI 2% +/- 1%, floor EUR/CZK at 27	Exit floor EUR/CZK H2	On hold
Denmark	Fixed exchange rate policy: EUR/DKK 7.46038 +/- 2.25	On hold	On hold
Switzerland	Price stability: CPI < 2%	FX interventions	On hold
Poland	Inflation target: CPI close to 2.5% +/- 1%	On hold	On hold
Turkey	Price stability: 5% +/- 2%	+25bp	On hold

Source: ABN AMRO Group Economics, central banks

Norwegian krone and Swedish krona to appreciate…

Norway is the only country where inflation has reached the target of the central bank. This means that the rise in growth that we expect due to stronger fixed investment and pick-up in net exports, will result in relatively quick policy tightening by the Norges Bank. We expect the Norges Bank to hike interest rates by a total of 50bp in 2017 and 50bp in 2018. In addition, our energy analyst expects higher oil prices. Both forces should result in an appreciation of the Norwegian krone in 2017 and 2018. Political uncertainty in the eurozone will probably also favour the Norwegian krone and the Swedish krona versus euro.

In the case of Sweden, domestic growth has been strong but net exports contracted, while inflationary pressure has diminished. We think that the current monetary policy stance is too accommodative for the Swedish economy especially considering the overheating housing market. The Riksbank has communicated that it will keep its accommodative policy in place in 2017 and that it will start tightening monetary policy in 2018. We think this point will probably come earlier than the Riksbank now envisages, but it is unlikely to be before July 2017. We expect the Riksbank to change its communication in the second half of 2017, resulting in a substantially stronger Swedish krona. We expect a total of 50bp rate hikes in 2018.

…as well as sterling versus euro in 2017…

We expect sterling to weaken versus the US dollar in 2017 but to strengthen versus the euro. This is because eurozone political uncertainty will weigh on the euro across the board. Moreover, as the focus in financial markets has shifted from Brexit to Trump and now to the eurozone political uncertainty, sterling is likely to be relatively resilient.

Despite the weak outlook for the UK economy, we expect the Bank of England to stay on hold because of higher inflationary pressures. Moreover, fiscal policy will probably be designed in such way that inflationary pressures do not build. The government would like to avoid a situation in which the Bank of England would need to start hiking interest rates. Modest fiscal stimulus in 2017 combined with an absence of rate hikes by the Bank of

England is likely to result in the economy muddling through. All in all, we think that most of the negative investor sentiment has abated and this will probably result in investors closing their short positions if sterling weakens somewhat. Therefore, we judge that a new sharp depreciation of sterling is unlikely.

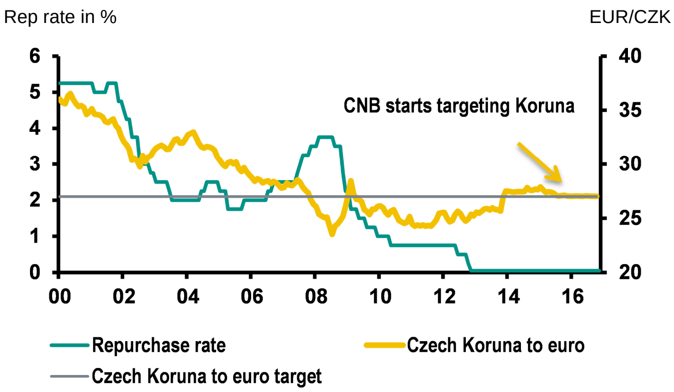
…and as Hungarian forint and Polish zloty versus euro

The macro-economic fundamentals of Hungary and Poland have improved considerably. Hungary in particular has become far more resilient to external shocks. Moreover, the recent upgrade of Hungary by rating agency Moody's means that it is now investment grade according to the three rating agencies. Although the labour market is tight and could result in inflationary pressures, inflation is still far below the central bank's target. A combination of a relatively strong economy and inflation slowly picking up will probably result in the Hungarian central bank tightening monetary policy before the ECB. However, it is unlikely to tighten policy quickly monetary policy as it will take some time before inflation reaches the inflation target. Even though political tensions between Hungary/Poland and the eurozone remain, this is unlikely to weigh heavily on the currency. In the case of the zloty though, FX mortgage relief could continue to weigh on the currency. Overall, expect the Hungarian forint and the Polish zloty to outperform the euro in 2017 and 2018.

FX interventions to cap the upside in Swiss franc and Czech Koruna…

The central bank of the Czech Republic has prepared financial markets for the idea that the floor in EUR/CZK will probably be abandoned in the second half of 2017. To avoid a sharp appreciation of the Koruna it will probably intervene in FX markets to dampen the move. It has much more room to manoeuvre than the Swiss National Bank as FX reserves in the Czech Republic are relatively small as a percentage of GDP compared to Switzerland. After the abandoning of the floor in EUR/CZK, the central bank is unlikely to tighten monetary policy as inflation is far below its target.

Monetary and FX policy Czech Republic

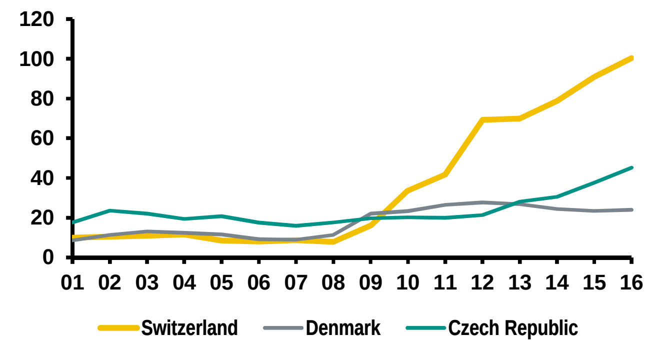


Source: Thomson Reuters Datastream

The Swiss National Bank will probably continue its foreign exchange interventions in 2017 because eurozone political uncertainty is weighing on the euro versus the Swiss franc in 2017 and deflation pressures will remain present in Switzerland. In our forecasting horizon, inflation is unlikely to move towards the central bank's target of a maximum of 2%. Market expectations of tapering by the ECB should support the euro in 2018 in an environment of constructive investor sentiment. Therefore, we expect EUR/CHF to rise in 2018. We expect the Swiss National Bank to lag behind the ECB unless inflation rises sharply which is unlikely in our view.

FX reserves as % of GDP

In %, 2016 is our forecast based on recent data



Source: Thomson Reuters Datastream, central banks of countries above

…and central bank of Turkey to tighten

The situation in Turkey is quite different than the other countries mentioned earlier in this report. First of all, the macro-economic picture is weakening with lower economic growth, lower industrial production and weak tourism. In addition, the external financial position is still vulnerable. Turkey has a significant current account deficit and it is highly dependent on portfolio flows to finance this. Moreover, FX reserves are relatively low. What is more, the political situation is uncertain, which is scaring off potential investors. Against this background the Turkish lira has dropped to a new all-time low. This could result in higher inflationary pressures and therefore limit the firepower of the central bank to cut interest rates to support the economy. Recently, the central bank tightened monetary policy but this was seen as too little to arrest the slide in the lira. It is likely that the central bank will continue to tighten monetary policy as long as the lira remains under pressure.

ABN AMRO European FX

Changes in red/bold

	02-Dec	Q4 2016	Q1 2017	Q2 2017	Q3 2017	Q4 2017	Q1 2018	Q2 2018	Q3 2018	Q4 2018
EUR/USD	1.0662	1.07	1.05	0.95	0.95	0.95	1.00	1.03	1.06	1.10
GBP/USD	1.2614	1.25	1.24	1.23	1.22	1.20	1.22	1.24	1.28	1.30
EUR/GBP	0.8452	0.86	0.85	0.77	0.78	0.79	0.82	0.83	0.83	0.85
USD/CHF	1.0103	1.01	1.03	1.15	1.16	1.17	1.12	1.10	1.08	1.05
EUR/CHF	1.0772	1.08	1.08	1.09	1.10	1.11	1.12	1.13	1.14	1.15
USD/SEK	9.2091	9.11	9.29	10.21	10.11	10.00	9.25	8.74	8.49	7.95
EUR/SEK	9.8185	9.75	9.75	9.70	9.60	9.50	9.25	9.00	9.00	8.75
EUR/NOK	8.9791	9.25	9.00	9.00	8.75	8.50	8.50	8.25	8.25	8.00
USD/NOK	8.4217	8.64	8.57	9.47	9.21	8.95	8.50	8.01	7.78	7.27
EUR/DKK	7.4398	7.46	7.46	7.46	7.46	7.46	7.46	7.46	7.46	7.46
USD/TRY	3.51	3.30	3.35	3.40	3.45	3.50	3.50	3.30	3.20	3.20
EUR/PLN	4.49	4.45	4.40	4.35	4.30	4.30	4.30	4.30	4.25	4.25
EUR/CZK	27.06	27.10	27.10	27.10	27.00	26.50	26.50	26.50	26.00	26.00
EUR/HUF	314.52	310	310	305	300	300	300	300	300	300

Source: ABN AMRO Group Economics

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