FX Intervention: Back in fashion

The last 24 hours have seen central banks in Sweden, Chile and now Israel pre-announce FX intervention programmes. The incentives to do this are all slightly different, yet they have all been afforded opportunities by the weak dollar environment

A weak krona remains a concerns as the Riksbank prepares to cut rates

Riksbank: Saving money

Following the somewhat surprising FX intervention from the National Bank of Poland back in December (buying EUR/PLN under 4.50), the last 24 hours have seen three central banks pre-announce FX buying programmes.

Of the three, we would say Israel's FX intervention plan is partly driven by similar considerations to Poland (to prevent the negative effect of the strong currency on the economy – though the inflation outlooks are vastly different in both countries), Sweden's has been justified on the budgetary side, while Chile's is macro-prudential.

The Riksbank yesterday announced a three-year plan to buy SEK 5bn worth of FX per month for the next three years, as an alternate means of funding its FX reserves. The move serves to pay down SEK 178bn worth of FX loans which had been issued by the National Debt Office as a means to bolster FX reserves. Replacing FX debt-funded reserves with FX openly acquired in the market serves two main purposes: i) they are cheaper to fund and ii) the Riksbank may hope this programme slows the EUR/SEK decline, recently pressing 10.00.

As the Riksbank widely acknowledges though, SEK 5bn per month is just a drop in the ocean compared to daily EUR/SEK and USD/SEK volumes of SEK 160bn and SEK 150bn, respectively, and is unlikely to make a dent on overall trends – where we see EUR/SEK ending the year at 9.75. One final point here – nearly 70% of the FX debt the Riksbank wishes to pay down is in USD, perhaps lending a slight bias to the nature of the intervention of subsequent portfolio re-allocation.

Central Bank of Chile: Macro-prudential

Chile's announcement of an FX reserve accumulation programme, totalling USD 12bn, which compares with current holdings of USD 39bn, should not be seen as an attempt to alter the Chilean peso's trajectory. Instead, we view the decision as part of a broader macro-prudential effort, to enhance the country's credit metrics, ahead of what is likely to be a challenging couple of years for the country's credit rating outlook.

Chile, Mexico and Colombia are the three LATAM majors that have suffered a credit rating downgrade since March 2020. And the outlook for these three credits is likely to be under severe stress in the coming years, following the sharp deterioration in macro indicators seen following the Covid-19 pandemic.

In the case of Chile, the task of rebuilding its macro indicators is going to be especially difficult in light of the heavy political calendar scheduled for 2021. After experiencing tremendous political tumult for a few years already, Chileans are expected to elect a constitutional convention to rewrite the country's constitution in April, which will be followed by general elections in November. All told, these events are likely to alter materially the outlook for Chile's macro indicators for years to come.

For a central bank, one of the most effective initiatives to boost the country's credit metrics would be to boost FX reserves. Chile has historically resisted embarking on the reserve-building initiatives that were so prevalent among LATAM commodity-exporters over the past two decades. Given the country's high credit rating and robust macro-indicators, that effort was arguably less necessary than for countries with otherwise fragile macro indicators like Brazil. As a result, Chile now has considerably less reserves than its regional peers (including Colombia and Peru).

Overall, faced with a challenging macro outlook, we see the Central Bank of Chile's (BCCh) decision as an effective preventative step to bolster Chile's external credit metrics by accumulating FX reserves, facilitated by what we expect to be a supportive period for emerging market FX in general and, in particular, a supportive environment for Chile's terms of trade, amid high copper prices.

Regarding FX forecasts, the intervention will alter the short-term trajectory, i.e. make it difficult for the USD/CLP to break below 700 as we had expected in the short term, but should not alter the longer term (as it enhances credit indicators etc). We remain comfortable with our year-end 700 forecast - as that will come after the elections and assumes a rather benign risk appetite/copper trajectory.

Bank Of Israel: Macro-inspired

The Bank of Israel (BoI) has long been one of the most interventionist central banks and last year spent US$21bn trying to slow the decline in the USD/ILS. This did not stop USD/ILS dropping to a recent low of 3.11 versus pre-Covid levels of 3.45. Driving the shekel stronger has been a healthy current surplus in excess of 3.5% of GDP, aided by debt portfolio flows on the back of Israel's sovereign bonds last year being included in the WGBI global bond index.

Following recent ILS strength, the BoI has today pre-announced a $30bn FX intervention programme for 2021 and it sounds like it will do the same again for 2022 at the end of this year. The incentives are macro-economic – to support the economy at a time of low inflation.

Will $30bn, or $2.5bn per month, be enough to turn the USD/ILS bear trend? The BoI bought $4.4bn in December alone, without much impact, and we suspect that if we are correct with our broadly bearish dollar scenario, BoI action will not prevent USD/ILS hitting our year-end target of 3.00.

Dollar implications: Shouldn't interfere with bear trend

News of increased dollar buying, especially from Israel and Chile, may point to a little more dollar demand, but the amounts involved here look small relative to the activity of the large Asian central banks of China, Korea, and Taiwan. FX reserves among this community have been commonly rising by US$10bn+ each over recent months – in moves to slow, not reverse the dollar downtrend.

As the Bank of Israel found in December, FX intervention is easily swamped by global portfolio flows and if, as we expect, a synchronised 2H21 global recovery comes through and the Fed stays on hold, the dollar could be falling anywhere between 5 and 10% across the board.

This also raises the question of whether the European Central Bank or the Bank of Japan announce a programme to increase the size of their FX reserves? This looks highly unlikely. The US has experienced a strong dollar for a long while now and Washington's currency manipulator report was borne out of US frustration that the rest of the world had not allowed their currencies to correct higher during a dollar bear trend.

We expect US scrutiny to remain fierce this year and if we are correct with our bearish dollar call, we suspect the ECB and the BoJ will just have to grin and bear it.

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