

FX: Intervention, rebalancing and EUR/USD

Weakness in emerging market currencies is being resisted through FX intervention. The rebalancing of FX reserves, after that intervention, is probably one factor pressuring EUR/USD



EM portfolio outflows hit local currency markets, policy makers resist

The Covid-19 shock has hit asset markets hard, especially those in emerging markets. Investors are aggressively shifting back along the credit curve, favouring core fixed income markets (Treasuries and Bunds) over say EM equities. That is quite understandable.

But the speed of departure from EM markets has been staggering. The IIF reported this week that based on their calculations US\$83bn of portfolio capital left EM in March. That eclipsed the previous record of around US\$60bn in October 2008. Data suggests since late February some US\$60bn left from the equity markets of India, Taiwan, China, Korea and Brazil. On the debt side, Indonesia, India, South Africa and Mexico saw some of the biggest outflows.

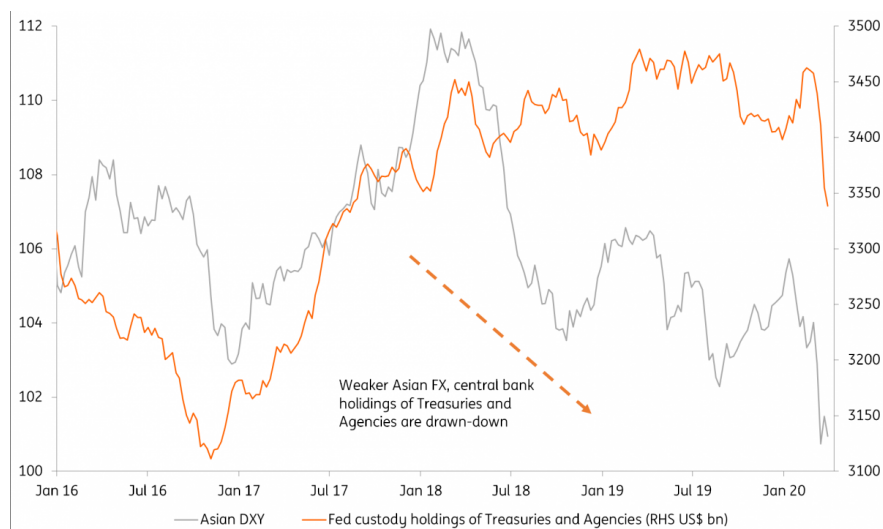
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Those countries with large FX reserves have probably been trying to resist the local currency depreciation – or smooth liquidity – with FX intervention. Transparency on FX intervention is still poor but given FX reserves are largely held in US government and agency debt any changes in those holdings can provide some insights.

The Federal Reserve provides weekly data on US Treasury and Agency securities it holds in custody for foreign central banks around the world. This is only a snap-shot, since some central banks keep their holdings elsewhere, e.g. through Euroclear. Yet the Fed data shows a net decline of US\$124bn in these holdings since the third week in February.

Below we overlay a chart of these holdings with the Asian DXY. Like many in EM, Asian currencies have come under heavy pressure and similar to events in 2016, when the CNY was under pressure and the PBOC was intervening heavily, central bank holdings of US Treasuries and Agencies are under pressure.

Asian FX under pressure against the dollar, central bank holdings of US Treasuries & Agencies decline



Source: Bloomberg, ING

The EUR/USD connection

What's this got to do with EUR/USD? EM countries intervening to support their currencies will typically sell USD from their FX reserve portfolios given the USD based nature of their economies (trade flows, debt etc). This activity is typically undertaken by the intervention desk at the central bank.

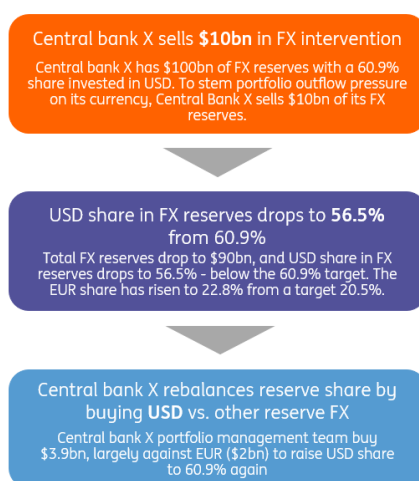
The intervention to sell USD has implications for the share of currencies in FX reserve portfolios. For example, in the graphic below, we demonstrate that – using the latest IMF statistics for FX reserve

shares – a sale of 10% of FX reserves (exclusively USD sales) would see the USD share in reserves fall from 60.9% to 56.5%.

A different desk at the central bank – usually the portfolio management team – would subsequently go into the market to re-balance the USD share back to the 60.9% benchmark. Given that the EUR is the second-largest share in FX reserve portfolios, this will lead to some sizable EUR/USD selling.

The reserve management re-balancing process

Stylised graphic of FX intervention and FX reserve portfolio re-balancing



Source: ING

Of course, there are a myriad of factors driving EUR/\$ right now, but some stability in EM asset markets, some stability in Asian currencies in particular and signs that central bank holdings of US Treasuries and Agencies are steadying (suggesting lower draw-downs) might provide greater evidence that EUR/\$ is finding a base.

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