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Don't Sweat Central Bank FX Intervention

Summary

Since May 2020, the U.S. dollar has broadly weakened against most G10 and emerging market currencies. However, some foreign central banks and policymakers have indicated unease in the renewed strength of their respective currencies. Over the past few weeks, some central banks have also directly intervened in FX markets to weaken their currencies, while others have engaged in FX reserve management operations to rebuild external buffers. While the immediate market reaction to announced FX measures has been a sell-off in local currencies, we believe broader market forces will ultimately prevail, and central bank intervention will not be enough to halt the longer-term trend of a weaker U.S. dollar.

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FX Intervention Isn't Enough to Halt Dollar Decline

One theme that emerged amid the COVID pandemic has been a weaker U.S. dollar. As the global economic recovery began to take shape and policy turned ultra-accommodative, market participants increased exposure to riskier currencies and did not feel compelled to seek the safe haven qualities of the U.S. dollar. On a peak-to-trough basis the U.S. dollar index (DXY) index has declined 12.5%. While U.S. dollar weakness can be viewed as a signal market participants are confident in the global economic recovery, stronger foreign currencies have grabbed the attention of some foreign central banks. Toward the end of 2020, and especially over the last few weeks, we have seen policymakers express discomfort with renewed strength in their respective currencies on concerns it could lessen their economic competitiveness in the global marketplace. Given the fragile recovery in many foreign economies, policymakers have suggested a weaker exchange rate may be preferred in an effort to enhance exports.

Forms of FX intervention are more commonly seen from emerging market central banks; however, G10 central banks have become more active. For example, while ECB policymakers have not directly intervened in currency markets for a weaker euro, ECB President Christine Lagarde has expressed some concern regarding the strength of the euro and the role a stronger currency could play in disrupting the local economic recovery. In addition, at its most recent policy meeting this week Bank of Canada (BoC) Governor Paul Macklem highlighted how Canadian dollar strength "is significant" and "on the BoC's radar screen". And finally, Sweden's Riksbank announced changes to its FX reserve management policies. Over the next few years, Riksbank will self-finance FX reserves by selling Swedish krona and converting to hard currency rather than building reserves through external financing measures.

FX intervention has been more direct in the emerging markets. In Asia, the Reserve Bank of India, Bank of Thailand as well as the Central Bank of the Republic of China (Taiwan) have all intervened in currency markets in favor of a weaker local currency and have explicitly stated a preference for weaker exchange rates to support exports. EMEA region central banks have acted in similar fashion, most notably the National Bank of Poland and the Central Bank of Israel. Both central banks have taken strong action to push their respective currencies lower, with the Central Bank of Israel recently stating it will purchase US$30B of FX reserves over the course of 2020. Latin American central banks have not been as aggressive; however, the Central Bank of Chile recently stated it will look to boost FX reserves through market operations, selling pesos and purchasing U.S. dollars in an effort to rebuild liquidity buffers and defend against another possible downturn in financial markets.

Historically speaking, central bank FX intervention can be effective; however, FX intervention tends to result in more short-term market reactions rather than fundamentally changing the direction of a currency. To that point, underlying economic fundamentals as well as broader market forces typically prevail and have more influence over the medium-to-longer term direction of a currency. We can point to a few examples of where economic fundamentals and market participants have been more influential; however, the early stages of the COVID crisis may be most relevant. In early 2020, emerging market central banks stepped into markets to support their respective currencies and prevent a significant sell-off. Perhaps the most active central bank was the Brazilian Central Bank (BCB), with policymakers intervening in spot and swap FX markets consistently over the course of last year. Despite FX intervention, the Brazilian real was still one of the worst performing emerging market currencies, selling-off over 22%. However, the Brazilian currency did see short-lived strength on the back of a BCB FX action or announcement. In addition, despite Lagarde's comments regarding keeping an eye on euro appreciation, the euro has reached highs not seen since 2018.

Despite the elevated amounts of FX intervention and FX reserve management operations from foreign central banks, we still favor U.S. dollar weakness in 2021 and in the early quarters of 2022. With the global economic recovery still broadly in place and vaccine distribution likely to be more widespread later this year, we believe a period of synchronized global economic growth will materialize. Against that backdrop, the U.S. dollar should follow historical patterns and gradually weaken. In addition, the Federal Reserve is likely to keep policy rates lower for longer and unlikely to taper asset purchases anytime in the near future. Commitment to easy monetary policy should keep Treasury yields on a gradual path higher and continue to support risk sentiment. The combination of these factors should keep downward pressure on the U.S. dollar over the medium-to-long-term and foreign currencies supported.

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