

FX Pilot

SEK outlook – short, medium and long term

- In the short term, the krona is in the hands of the Fed, which needs to start its rate cuts
- In the medium term, the krona should benefit from better functioning markets...
- ... a more expansionary fiscal policy and a tighter monetary policy compared with the period 2013-2019
- In the long term, several factors point to the krona being undervalued



Summary

This FX pilot is based on the theme article on the krona published in our latest Konjunkturprognos in May 2024 (link [here](#), in Swedish). Here we summarise the most important conclusions and add a few new insights.

The krona is at weak levels, but there are a number of factors that indicate that it will strengthen in the future. In the short term, the Fed needs to initiate interest rate cuts in order for the risk appetite to return in the foreign exchange markets.

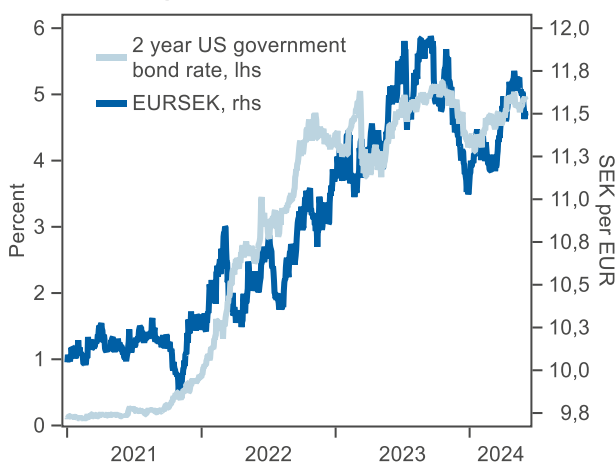
In the medium term – two to five years – we believe that the Riksbank's monetary policy will be somewhat tighter than it was in 2013-19, when the krona weakened. This is largely driven by the side effects seen from the extremely expansionary monetary policy pursued during that period. Strong public finances pave the way for an expansionary fiscal policy going forward, which should benefit the krona since many other countries have significantly more strained public finances. Increased government borrowing coupled with the Riksbank reducing its bond holdings are helping to bring life to the Swedish government bond market, and the resulting improved liquidity should attract foreign investors and lead to a stronger krona. Households' and funds' savings in foreign assets have probably contributed to weakening the krona over the past ten years, and there is a risk that this effect will persist.

In the long term, there are several structural, economic factors that indicate that the krona is undervalued and should therefore strengthen. We conclude that the appreciation of the krona will be somewhat slower than we previously had in our forecasts. This is partly motivated by the fact that it may take time for investors to change their fundamental view of the Riksbank's monetary policy and thus the krona.

Short-term – SEK in the hands of the Fed

This theme has characterised the FX market, and the krona in particular, since the central banks realised just over two years ago that inflation needs to be combated with higher interest rates. Since then, the krona has weakened as a result of rising global interest rates and the increased concern about the global – and not least the Swedish – economy. In this environment, risk appetite in the foreign exchange markets has been low, and this has further fuelled the depreciation of the krona.

SEK exchange rate and US interest rate

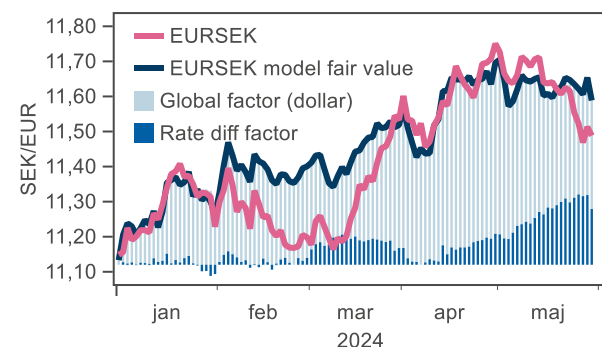


Sources: Macrobond and Handelsbanken

Since the beginning of the year, the krona has weakened by about 3 percent against the euro and 5 percent against the dollar. During the first few months, the weakening was driven by global factors, i.e. that interest rates in the US, Europe and Sweden

rose as a result of the market delaying the expected interest rate cuts. For most of the past two months, these global factors have reversed slightly, and the dollar has weakened. However, the krona still struggled as the appreciation was counteracted by domestic factors, in the form of decreasing Swedish interest rates as the market priced in more interest rate cuts from the Riksbank.

Global factors and rate differentials have weakened the krona since the start of the year



Note: The model takes as input a dollar index as proxy for the global factor (light blue), and rate differentials as a proxy for SEK- and/or EUR-specific factors (dark blue).

Sources: Macrobond and Handelsbanken

The process is captured well in the model above. It also shows that, despite headwinds from both global and domestic factors, the krona has strengthened somewhat over the past week; a strengthening which the model fails to capture. Instead, the model suggests the krona is stronger than its short-term fair value, and there is thus some risk of a rebound towards weaker levels again in the near future.

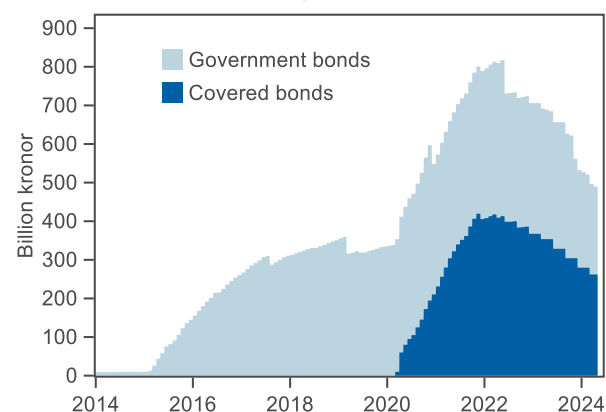
As we already concluded above, in the short term, a lot is about the Fed. When it feels confident enough to initiate interest rate cuts, the krona and other cyclical currencies will strengthen.

Several factors point to a stronger krona in the medium term

If we look beyond the shortest term and instead think about the medium term, say two to five years ahead, there are a number of factors that speak in favour of a stronger krona and, at the same time, a few factors that counteract the appreciation.

During the period 2013-20, the krona weakened significantly, as the exchange rate against the euro went from 8.50 to 10.50, and the exchange rate against the dollar went from 6.50 to 9.50. There are several explanations for the weakening, but one of the most important is probably monetary policy. During this period, the Riksbank had problems with inflation that was below the target of two percent, and in response it conducted a very expansionary monetary policy. The policy rate was lowered to negative levels, large volumes of government bonds were purchased, and a mandate was acquired that gave the Riksbank board the ability to intervene quickly in the foreign exchange market if the krona were to appreciate. A weakening of the krona was one of the sub-objectives of the monetary policy strategy, since a weaker krona could lead to higher inflation. A weaker krona was obtained, and possibly it also led to slightly higher inflation, although this is difficult to determine.

The Riksbank's holdings of bonds



Note: The Riksbank also holds municipal and corporate bonds, but these are relatively small.

Source: Macrobond and Handelsbanken

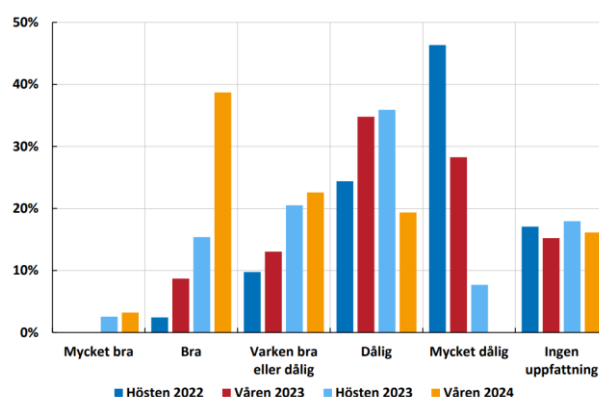
In recent years, the side effects of the ultra-expansionary monetary policy have become increasingly visible. The negative interest rate received great criticism from the public, who wondered why, in the years before the pandemic, the Riksbank had a "crisis rate" when the economy was actually doing well. It was then abandoned, and despite relatively low inflationary pressures, it managed to raise the policy rate to zero in two steps in 2018 and 2019.

When policy rates rose sharply in 2022 and 2023, the next major side effect was exposed, namely the losses that the Riksbank made when the bonds it had bought fell in value. But that's not the only side effect of the purchases. Even before that, it was clear that the market for government bonds, in particular, was functioning increasingly poorly, in the wake of the Riksbank buying bonds and thus removing them from the market.

Looking ahead, we believe that the Riksbank will avoid this type of extremely soft monetary policy. Partly of its own volition, partly because the new Sveriges Riksbank Act makes it more difficult to use, for example, bond purchases to drive up inflation. As the Riksbank's QT programme progresses, and the balance sheet normalises, the volume of outstanding bonds (the "free float") in the market increases. This will make the market work better, which in turn will attract foreign investors back to the krona. We have already seen examples of this, in the Riksbank's own financial market survey. In the chart below, you can see how market participants now have a much more positive view of the functioning of the government bond market.

Diagram 13. Hur bedömer ni för närvarande marknadslikviditeten på sekundärmarknaden för nominella statsobligationer?

Andel av antal svar i procent



Anm. Antalet svar för våren 2024 var totalt 31.

Source: Riksbank financial market survey 2024:1

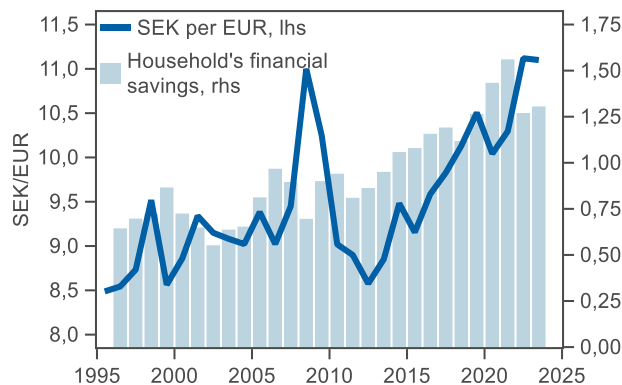
Our view is therefore that the Riksbank will stick to a somewhat tighter monetary policy going forward, and that it can thus tolerate a situation where inflation deviates by a few tenths from the target, on either the upside or the downside. In that case, the Riksbank's communication will be important in order to be able to achieve that strategy. Perhaps we can already see some signs of that kind of strategy. In the latest minutes, after the meeting in May, Erik Thedéen spoke about inflation and that it may deviate from the target by a few tenths, and then concluded with:

"In this regard, it is important that we and other actors have realistic expectations of what monetary policy can achieve."

- Erik Thedéen, Minutes of May 2024

Another factor that has driven the krona depreciation over the past ten years is that Swedish households and funds, to a large extent, have saved in foreign assets, which has meant a steady sale of kronor. This is not just a factor that is specific to Sweden. The IMF has shown that there is increasing global interest in investing in US assets, which of course has given support to the dollar. Interest in US assets will most likely not decrease going forward, given the development of tech and AI. Hence, there is a risk that the flows from Swedish households and funds, will persist and weigh against the krona.

Households' financial savings



Note: Households' financial savings is the sum of bank deposits, ownership of stocks, bonds and funds. Divided by nominal GDP.

Sources: Macrobond and SCB (Sparbarometern)

On the other hand, one factor that should be able to support the krona in the next few years is the scope for an expansionary fiscal policy. Sweden has a very low national debt compared to most other countries.

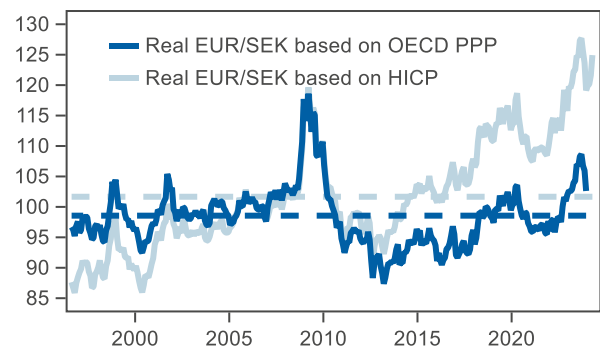
The krona undervalued in the long term

In the long term, say ten years ahead, we usually talk about so-called "equilibrium rates". This is a level at which the exchange rate tends to be drawn in the long term, given that all cyclical and temporary shocks in the system subside. We will never have such a reality – there will be new shocks/disturbances, and new economic fluctuations – but it is nevertheless useful to think in terms of equilibrium exchange rates when forecasting exchange rates.

A common approach is to use models to estimate an equilibrium exchange rate. There are a number of different models, and each has its strengths and weaknesses. A fairly simple one is purchasing power parity, which is based on the real exchange rate returning to its long-term value, which is often estimated as the historical average. Then the question arises as to which price index to use to calculate the real exchange rate, and depending on which one you choose, you can get very different answers. The figure below shows two examples, where the OECD price index gives an equilibrium rate of SEK 10.80 per euro, while the HICP gives an equilibrium rate of SEK 9.40 per euro. In both cases,

the krona is currently undervalued, but the difference between the equilibrium exchange rates is large.

Large difference between different measures of the real exchange rate

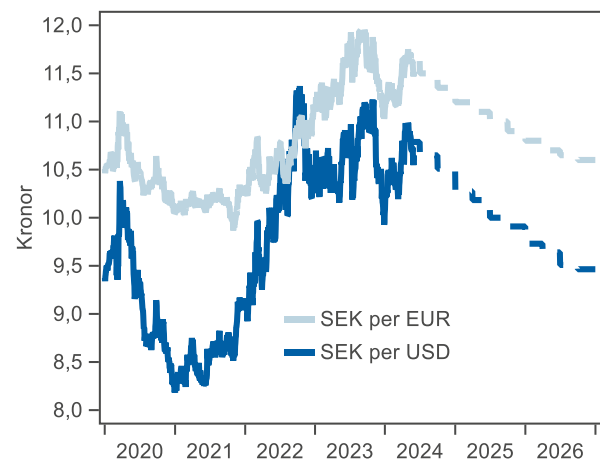


Note: Dashed lines indicate the averages over 2000-2024, and these are our estimated long run equilibrium exchange rates according to the PPP theory.

Sources: Macrobond, OECD and Handelsbanken

Some other models instead take the balance of payments as a starting point, and then it is common to look at the current account, the terms of trade, and, for example, the relative productivity of the different countries. Even in this type of model, the krona is undervalued. For example, it can be stated that Sweden has had a stronger productivity growth than the eurozone, which should have contributed to a stronger krona.

Forecasts on SEK exchange rates



Sources: Macrobond and Handelsbanken

In light of both the models and the other longer-term factors, we conclude that the long-term equilibrium exchange rate of the krona against the euro is about SEK 10, and against the dollar about SEK 8.50. There is, of course, great uncertainty about these estimates, but what one can at least feel reasonably confident about is that the krona is undervalued and should therefore move towards stronger levels, in both the short and long term. An important factor, as we have discussed, is that foreign investors are changing their view of the Riksbank and thus also the krona. This transition may take time, and this is reflected in our forecasts in that the appreciation of

the krona is relatively slow. Even within our forecast horizon – the end of 2026 – the krona will not reach its long-term equilibrium exchange rates.

Handelsbanken FX forecast

Forecasts are based on Handelsbanken's Global Macro Forecast, which is published three times per year, in January, May and September. Depending on the market situation financial forecast revisions are made in between publications.

	Latest	Q2 2024	Q3 2024	End 2024 (Q4)	Q1 2025	Q2 2025
EUR/SEK	11.49	11.65	11.50	11.35	11.20	11.10
USD/SEK	10.60	10.79	10.65	10.51	10.28	10.18
GBP/SEK	13.50	13.71	13.53	13.35	13.18	13.06
NOK/SEK	1.01	1.00	0.99	0.99	0.98	0.98
CHF/SEK	11.72	11.89	11.73	11.35	11.09	10.99
JPY/SEK	6.77	7.10	7.24	7.35	7.29	7.33
CNY/SEK	1.46	1.49	1.47	1.46	1.47	1.45
EUR/USD	1.08	1.08	1.08	1.08	1.09	1.09
USD/JPY	156.63	152.00	147.00	143.00	141.00	139.00
EUR/GBP	0.85	0.85	0.85	0.85	0.85	0.85
GBP/USD	1.27	1.27	1.27	1.27	1.28	1.28
EUR/CHF	0.98	0.98	0.98	1.00	1.01	1.01
USD/CNY	7.25	7.25	7.25	7.20	7.00	7.00
EUR/NOK	11.42	11.70	11.60	11.50	11.40	11.30
SEK/NOK	0.99	1.00	1.01	1.01	1.02	1.02
USD/NOK	10.53	10.83	10.74	10.65	10.46	10.37
GBP/NOK	13.41	13.76	13.65	13.53	13.41	13.29
CHF/NOK	11.65	11.94	11.84	11.50	11.29	11.19
JPY/NOK	6.72	7.13	7.31	7.45	7.42	7.46
CNY/NOK	1.45	1.49	1.48	1.48	1.49	1.48

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