

Theme: The krona and flows

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The weakness of the krona is unwelcome and is a headache for both the Swedish economy and the Riksbank. Our calculations show that the krona is 10-15 per cent undervalued in the long term and should thus appreciate. Based on our analytical framework for capital flows, we identify six explanations for the SEK's weakness over the past decade. Several flows are of a structural nature. Key rate hikes are a blunt tool for strengthening the krona and have undesirable side effects. Instead, we see that the krona can be strengthened by such actions as political decisions that make it more attractive to invest pension assets, for example, in Sweden instead of abroad.

This summer the krona reached a new record low against the euro: SEK 11.96 per EUR. According to our models, it was then around 20 per cent undervalued against the euro. Yet the problem is not a weak krona as such, but that the SEK has shown a weakening trend against both the euro and US dollar in the past decade, even though Sweden's economy has been relatively stronger than the rest of the world. The Riksbank's KIX exchange rate index has previously been equally weak, but during two crises: "dotcom" in 2001 and the global financial crisis in 2008.

The Riksbank cites two main reasons why the SEK has lost value recently: the krona's smallness in a troubled world and an unfavourable short-term interest rate spread. But these more short-term factors are not enough to explain its long-term downturn. We also need an analysis of possible changes in the krona's real exchange rate, as well as an analysis of capital flows. A stronger krona will boost the potential for reducing costs to companies and thus lowering inflation.

Real exchange rate – long-term equilibrium?

One of the most common ways to estimate the long-term equilibrium level of an exchange rate is to study real exchange rates. The idea is that foreign trade eventually helps real exchange rates to move towards equilibrium.

Real exchange rates can be calculated in many ways. The most common way is to use the consumer price index, but unit labour costs as well as export and import prices — which reflect a country's cost and competitive position — are also common. Real exchange rate metrics often differ greatly. According to the chart below, based on three different estimates, today's real exchange rate is 15-25 per cent weaker than the average over the past 30 years. Several real exchange rate metrics show a downward trend over the past decade, which may indicate that a comparison with the historical average exaggerates the deviation from equilibrium, at least in the medium term.

Our is thus that the real exchange rate is currently 10-15 per cent weaker than its long-term equilibrium. Several factors point in this direction. Sweden's large current account surplus indicates that the krona is undervalued. For a long time, Swedish prices rose more slowly than international prices, which — all else being equal — tends to result in an even weaker real exchange rate in the long run (assuming that the nominal exchange rate does not appreciate). In recent years, Swedish wages and salaries have also risen more slowly than international ones, reinforcing this picture. Since prices and wages move slowly, it is more likely that any adjustment in real exchange rates will take place through stronger nominal exchange rates. Real exchange rates are important in SEB's model estimates of long-term bilateral

exchange rates. According to the models, the long-term exchange rate is 9.50 per EUR and 8.00 per USD: 20 and 27 per cent stronger, respectively, than today's rates.

Large trade and current account surpluses

Estimates of real exchange rates are uncertain, and differences in how prices and wages are measured can probably explain some of the trend in the krona's real exchange rate. However, large and persistent trade and current account (C/A) surpluses support the thesis that the krona is weaker than its long-term equilibrium. Over the past 30 years, the C/A surplus has averaged 5.5 per cent of GDP, a level surpassed by only a few countries in the world. Sweden's external position — total assets minus foreign claims on Sweden — currently totals more than 40 per cent of GDP (70 per cent if direct investments are stated at market value). The fact that much of Sweden's large savings has been channelled abroad is one important reason why the real exchange rate has been weak for a long time. A growing proportion of currency transactions are driven by investments and savings rather than by trade in goods and services, which is probably an important reason why real exchange rates have increasingly diverged from trend.

Framework for capital flow analysis

Exchange rate analysis of capital flows in the balance of payments (BoP) is easier if flows are divided into autonomous and accommodating flows. The idea behind this classification is that autonomous flows occur independently of other balance-of-payment flows, for example due to changing expectations or various structural factors. But accommodating flows arise solely because autonomous flows need to be offset.

One common classification of the BoP involves viewing the C/A balance as an autonomous flow and the financial balance as an accommodating one. As mentioned above, countries like Sweden with a C/A surplus are expected to show an appreciating currency against deficit-ridden countries. The price of foreign currency in relation to the krona needs to fall — and the krona to strengthen — in order to stimulate increased purchases of foreign assets, which is a factor that complicates the flow analysis.

Another way to analyse the connections between balance-of-payments flows and exchange rate movements is to look at changes in the foreign currency exposure of different sectors. Such exposure arises when a sector has an asset or liability in foreign currency. Unfortunately, balance-of-payments statistics cannot explain changes in currency risk and thus do not provide a fully accurate picture of what has actually affected the krona. A transfer of exposure can lead to a change in the krona exchange rate. The degree of price impact is determined by how interested participants are in changing their SEK exposure krona under various conditions. For example, if the 7th AP Fund (a Swedish pension fund) decides to currency-hedge some of its foreign assets, this would — all else being equal — lead to an inflow of SEK 300-400bn and thus a stronger krona. Identifying six explanations for flows Let us observe six different capital flows that may explain why the krona is 10-15 per cent weaker than normal. The explanations vary in strength over time but are related to the following (no ranking):

The US dollar's ten-year appreciation trend. The dollar normally moves in long cycles. The volume of US fixed income and equity markets has attracted both private and public capital to the USD. The European debt crisis of 2010-12 also seriously challenged the role of the euro as a reserve currency compared to the USD.

Trend-following foreign model funds. These funds can amplify and prolong currency movements that are initially driven by other factors. In various ways, we note the presence of these funds in the SEK market and see that their importance has increased in recent years.

Demographics and public finances generate savings surpluses. An ageing population is a global phenomenon. Sweden's structural financial savings surplus is an expression of both large private institutional pension savings and large public savings. The Swedish pension fund industry has expressed concern about the lack of investment opportunities, for example in domestic physical and digital infrastructure and green investments. This means that some of Sweden's pension assets are going abroad instead. However, the impact on the krona is ultimately determined by whether this also means a change in the currency risk in pension assets.

Multinational companies reinvest abroad. It is quite logical that Swedish companies allow a significant percentage of the profits they generate abroad to be reinvested abroad. Today's new global trade landscape implies that international value chains need to be built with increased resilience. This means that additional investments will be made abroad. Only when these investments are sold does a positive krona effect arise, but it may take many years before this happens.

Extra risk premiums. The krona is a cyclical currency that strengthens in environments of global growth and good risk appetite. Sweden has built up a high level of debt in its household sector for many years and now has challenges in the real estate sector, which suggests that the krona should carry a risk premium.

Unconventional monetary policy. Riksbank policies from 2015 onwards — negative key interest rates and repeated threats of currency interventions (selling SEK to reduce deflation risk) — reduced the world's appetite for Swedish government securities. Our conclusion is that central banks reduced their holdings of these securities when the potential for a stronger SEK failed to materialise. Foreign investors instead bought mortgage backed securities. This has apparently had a limited effect on the SEK since global private portfolio managers normally hedge holdings in fixed income securities.

Government debt issuance may prop up SEK

The Riksbank's latest communication gives the impression that it sees limited opportunities to use monetary policy to help the krona appreciate permanently from its current levels. Hiking its policy rate even more merely to strengthen the krona is a blunt weapon, especially because some investors are already worried about particularly interest rate-sensitive segments of the Swedish economy. It may also reduce the clarity of inflation policy.

In June, the Riksbank announced that it would step up its issuance of government securities to SEK 5 billion per month. The idea is that the yields on these securities will rise more than the expected policy rate and that the SEK will eventually appreciate. Swedish government bond yields are still low in relation to the expected policy rate. Foreign investors have continuously reduced their holdings of Swedish government bonds due to low yields rates and a poorly functioning market. We believe that this has contributed to the weakening of the krona.

The fact that the Riksbank is now issuing more government securities is helping to narrow the yield spread between government securities and swap rates. The fixed income market may begin to function better again after years of low liquidity and very limited supply. This will help make the Swedish government securities market more attractive to foreign investors and provide room for the Swedish krona to appreciate. However, the positive flow effect is expected to be rather limited.

The Riksbank is considering FX hedging

When the Riksbank published its latest monetary policy report in June, the central bank announced that it was considering currency hedging part of its foreign exchange reserve. This decision will be preceded by an inquiry that is expected to be completed in the “early autumn”. Such a step, if taken, will aim to reduce the Riksbank’s financial risk. According to the Executive Board, it should not be regarded as an action motivated by monetary policy.

The Riksbank has already suffered large losses on its securities holdings of around SEK 80 billion and will most likely need to ask the Riksdag (Parliament) for a capital injection early in 2024. If the krona appreciates to the same level as at the start of 2022, the estimated exchange loss will total nearly SEK 60 billion. It is likely that the currency hedge idea mainly reflects the Riksbank’s reluctance to sustain further losses, but the timing of the announcement suggests that the central bank still hopes that such action will lead to an appreciation of the krona. However, we do not believe that the amount proposed, about SEK 100 billion, is large enough to generate lasting krona appreciation. Positive effects on the krona did not materialise; the SEK appreciation that took place in July was instead related to favourable US inflation data.

The weakness of the krona is increasing the value of foreign assets in krona terms, but we are also risking a sell-off of Swedish assets. Today the value of foreign assets totals nearly SEK 22 trillion. Swedish pension fund managers are hedging the value of shares and fixed income securities, for example. Roughly speaking, if we use the government-run AP Funds’ benchmark of a maximum 40 per cent currency risk and assume that other assets are unhedged, a 10 per cent krona depreciation would have a positive wealth effect of just over SEK 1.7 trillion. From a foreign point of view, it would be cheaper to buy Swedish companies and real estate, which in the current situation of real estate market challenges might be a stabilising factor.

Investment opportunities strengthen SEK?

So is there anything that can help the Swedish krona return to stronger levels? Perhaps the answer lies partly with fiscal policy rather than monetary policy. For example, Swedish direct investment abroad has increasingly exceeded the corresponding foreign investments in Sweden. The lack of investment alternatives for Swedish pension assets in Sweden explains the choice of asset managers to invest abroad. This can generate a structural SEK outflow, although the actual effect on the krona exchange rate depends on how this currency exposure is managed by investors.

Swedish public sector debt has decreased steadily since the early 1990s, while many other countries have increased theirs. It is of course a difficult balancing act, but when the inflation trend allows it, the krona could benefit from initiatives to generate investment opportunities in such areas as digital and physical infrastructure. It is simply a matter of making it more attractive to invest in Sweden than abroad.

Source: <https://sebgroupp.com/our-offering/reports-and-publications/nordic-outlook-highlights/highlights-may-2023/theme-the-krona-and-flows>