Guidelines for central government debt management 2019

Decision taken at the government meeting
15 November 2018

Government of Sweden

Contents

Summary

Direction of central government debt policy
The guidelines decision for 2019 merges the maturity steering of the nominal and inflation-linked krona debt. As a result, the duration of the krona debt is changed to between 4 and 6.5 years. A common maturity target for the krona debt replaces the present steering divided up into nominal (4.3–5.5 years) and inflation-linked (6–9 years) krona debt. The guidelines decision also removes the wording about borrowing in the retail market.

The steering of the maturity of the foreign currency debt remains unchanged, as does the steering of the composition of the central government debt.

The maturity (in terms of duration) of the debt types is to be steered towards:

- Foreign currency debt: 0–1 year
- Krona debt: 4–6.5 years

The composition of the central government debt is to be steered towards:

- Foreign currency debt: A reduction of up to SEK 30 billion per year.
- Inflation-linked krona debt: 20 per cent (in the long term).
- The nominal krona debt is to make up the remaining share.

Change to the steering of debt types and maturity of the central government debt
In its proposed guidelines the Debt Office has analysed the relationship between maturity and cost for the inflation-linked and nominal krona debt. According to the Debt Office's quantitative and qualitative studies this relationship is the same, which means that there are no longer any reasons to steer the maturity of the two types of debt separately. Further advantages of a common benchmark for the krona debt are a better overview of the level of risk and the possibility of reducing the steering interval compared with the present interval for the inflation-linked debt. Maturity is one of several factors that affect the expected cost of and risk in the central government debt.

Objective, division of responsibility and process
The basis for the Government's guidelines decision is the objective of central government debt policy adopted by the Riksdag (Swedish Parliament), Chapter 5, Section 5 of the Budget Act (2011:203). The objective is to manage the central government debt in such a way as to minimise the cost of the debt in the long-term while taking risk in its management into account. The objective is also to manage the debt within the framework of monetary policy requirements.

The responsibility for attaining the objective is divided between the Government and the Debt Office. The Government steers the overall level of risk via its annual guidelines decisions while the Debt Office is responsible for borrowing and management being conducted within the framework of the guidelines and in accordance with the objective. The guidelines decision has to be taken by the Government no later than 15 November each year. This decision is based, in part, on the National Debt Office's proposed guidelines. The Government's guidelines decision for 2019 is largely in line with the Debt Office's proposal.

The Riksbank (Swedish central bank) has stated an opinion of the proposed guidelines from the National Debt Office. The Riksbank has no objection to the Debt Office's proposal for guidelines for the management of the central government debt in 2019–2022. However, the Riksbank has views on the Debt Office's measure of using liquid funds to refinance foreign currency loans (see section 3.6). A report on the attainment of the objective is made to the Riksdag in an evaluation communication every other year. In the intervening years the Government presents a preliminary evaluation of the management of the central government debt in the Budget Bill.

1 Decision on guidelines for central government debt management 2019

The current steering of the central government debt portfolio builds on a large number of analyses and discussions conducted over the years. The present process for the steering and evaluation of central government debt policy has been applied since 1998.

The guidelines for 2019–2021 are set out below; 2021 being the horizon for calculations applied in the Budget Bill for 2019. As in the case of the Budget Bill, the decisions for 2020–2021 are to be regarded as preliminary. In order to provide an overview of the regulations that govern the management of the central government debt, the relevant parts of the Budget Act (2011:203) and the Ordinance (2007:1447) containing Instructions for the National Debt Office are presented here.

The Government's guidelines decision regarding maturity and composition fully matches the Debt Office's proposals. Point 32 of the current guidelines decision –The Debt Office is to contribute through retail market borrowing to reducing the costs of central government debt compared with equivalent borrowing in the institutional market in the long term – is removed (see section 3.5).

The objective for the management of central government debt

1. The central government debt shall be managed in such a way as to minimise the cost of the debt in the long-term while taking risk in its management into account. The debt shall be managed within the framework of monetary policy requirements (Chapter 5, Section 5 of the Budget Act).

The task of the Debt Office and the purpose of borrowing

2. The task of the Debt Office is to raise and manage loans for the central government in accordance with the Budget Act (Section 2 of the Ordinance containing Instructions for the National Debt Office).

3. The Debt Office may raise loans for the central government to:
   1. finance current deficits in the central government budget and other expenditure based on decisions of the Riksdag (the Swedish Parliament);
   2. provide credits and perform guarantees decided by the Riksdag;
   3. amortise, redeem and buy back central government loans;
   4. meet the need for central government loans at different maturities in consultation with the Riksbank; and
   5. satisfy the Riksbank's need for foreign currency reserves

   (Chapter 5, Section 1 of the Budget Act).

Guidelines process

4. The Debt Office shall submit proposed guidelines for central government debt management to the Government no later than 1 October each year (Section 26 f of the Ordinance containing Instructions for the National Debt Office).

5. The Government shall request an opinion from the Riksbank on the Debt Office's proposal (Chapter 5, Section 6 of the Budget Act).

6. The Government shall adopt guidelines for the Debt Office's management of the central government debt no later than 15 November each year (Chapter 5, Section 6 of the Budget Act).

7. The Debt Office shall submit information for the evaluation of the management of the central government debt to the Government no later than 22 February each year (Section 26 f of the Ordinance containing Instructions for the National Debt Office).

8. The Government shall evaluate the management of the central government debt every other year. The evaluation shall be presented to the Riksdag no later than 25 April (Chapter 5, Section 7 of the Budget Act).

9. The Debt Office shall adopt principles for the implementation of the guidelines for central government debt management adopted by the Government (Section 15 of the Ordinance containing Instructions for the National Debt Office).

Previous wording	Wording adopted
10.	
The Debt Office is to adopt internal guidelines based on the Government's guidelines. These decisions are to concern the use of the position mandate, the foreign currency distribution in the foreign currency debt and principles for its market and debt commitment.	The Debt Office is to adopt internal guidelines based on the Government's guidelines. These decisions are to concern the use of the position mandate, *the maturity of the nominal and inflation-linked krona debt*, the foreign currency distribution in the foreign currency debt and principles for its market and debt commitment.

Composition of central government debt – debt shares

11. The share of inflation-linked krona debt in the central government debt is to be 20 per cent in the long term. The shares of the debt types in the central government debt are to be calculated as nominal amounts at the present exchange rate including accrued compensation for inflation.

12. The foreign currency exposure of the central government debt is to decrease. The decrease is to correspond to no more than SEK 30 billion per year. The exposure is to be calculated in a way that excludes changes in the krona exchange rate.

13. The Debt Office is to set a benchmark for the distribution of the foreign currency debt among different currencies.

14. In addition to inflation-linked krona debt and foreign currency debt, central government debt is to be composed of nominal krona debt.

Maturity of central government debt

Previous wording	Wording adopted
15.	
The maturity of the *nominal krona debt* is to be between *4.3* and *5.5* years.	The maturity of the *krona debt* is to be between *4* and *6.5* years.
16.	
The maturity of the inflation-linked krona debt is to be between 6 and 9 years.	*The Debt Office is to adopt maturity intervals for the nominal and inflation-linked krona debt.*

17. The maturity of the foreign currency debt is to be between 0 and 1 year.

18.	
The maturity of the types of debt may deviate temporarily from the maturities stated in points 15, *16* and 17.	The maturity of the types of debt may deviate temporarily from the maturities stated in points 15 and 17.

19. Maturity is to be measured as duration.

Cost and risk

20. The trade-off between expected cost and risk is primarily to be made through the choice of the composition and maturity of the central government debt.

21. The main cost measure is to be the average issue yield. The cost is to be calculated using the valuation principle of amortised cost with continuous revaluation of inflation and exchange rate fluctuations.

22. The main risk measure is to be the variation of the average issue yield.

23. The Debt Office is to take account of refinancing risks in the management of the central government debt, including by issuing instruments with more than twelve years to maturity.

24. Borrowing is to be conducted in such a way as to ensure a broad investor base and diversification in a range of funding currencies in order to maintain good borrowing preparedness.

25. Positions are not to be included in the calculation of debt shares and maturities.

26. When taking positions, market values are to be used as the measure of the costs and risks in the management of the debt.

Market commitment and debt management

27. The Debt Office is to contribute, through its market and debt commitment, to the effective functioning of the government securities market in order to achieve the long-term cost minimisation objective while taking account of risk.

28. The Debt Office is to adopt principles for its market and debt commitment.

Position-taking

29. The Debt Office may take positions in foreign currency and the krona exchange rate.

    Positions in foreign currency may only be taken using derivative instruments.

    Positions may not be taken in the Swedish fixed income market.

    Positions refer to transactions that are intended to reduce the costs of the central government debt while taking account of risk, or to reduce the risks for the central government debt while taking account of cost, and that are not motivated by underlying borrowing or investment requirements.

    Positions may only be taken in markets that permit the management of market risk through liquid and otherwise well-developed derivative instruments and that are potentially a borrowing currency in the context of debt management.

30. Positions in foreign currency are limited to SEK 300 million, measured as daily Value-at-Risk at 95 per cent probability.

    The Debt Office is to decide how much of this scope may be used at most in its ongoing management.

31. Positions in the krona exchange rate are limited to maximum of SEK 7.5 billion. When the positions are built up or wound down, this is to be done gradually and announced in advance.

    The Debt Office is to decide how much of this volume may be used at most in its ongoing management in connection with exchanges between the krona and other currencies. This volume is to be of a limited size and the positions do not need to be announced in advance.

Borrowing to meet need for central government loans

32. The possibility of raising loans to meet the need for central government loans under Chapter 5, Section 1 of the Budget Act may only be used if required on account of threats to the functioning of the financial market.

    The Debt Office may have outstanding loans with a maximum nominal value of SEK 200 billion for this purpose.

33. Investment of funds raised through loans to meet the need for central government loans should be guided by the principles set out in the Preventive Government Support to Credit Institutions Act (2015:1017).

Management of funds etc.

34. The Debt Office shall place its funds, to the extent that they are not needed for payments, in an account at the Riksbank, a bank or a credit market company, or in government securities or other debt instruments with a low credit risk. Investments may be made abroad and in foreign currency (Section 5 of the Ordinance containing Instructions for the National Debt Office).

35. The Debt Office shall cover the deficits that occur in the Government central account (Section 7 of the Ordinance containing Instructions for the National Debt Office).

36. The management of exchanges between Swedish and foreign currency (currency exchanges) shall be predictable and transparent (Section 6 of the Ordinance containing Instructions for the National Debt Office).

Consultation and collaboration

37. The Debt Office shall consult with the Riksbank on matters concerning the components of its borrowing operations that may be assumed to be of major importance for monetary policy (Section 12 of the Ordinance containing Instructions for the National Debt Office.)

38. The Debt Office shall collaborate with the National Institute of Economic Research and the National Financial Management Authority on matters concerning the Debt Office's forecasts of the central government borrowing requirement (Section 11 of the Ordinance containing Instructions for the National Debt Office).

39. The Debt Office should obtain the Riksbank's views on how the funds borrowed to meet the need for central government loans are to be invested.

Evaluation

40. Evaluation of the management of the central government debt is to be carried out in qualitative terms in the light of the knowledge available at the time of the decision. Where possible, the evaluation is also to include quantitative measures. The evaluation is to cover five-year periods.

41. The evaluation of the operational management is to include borrowing and management of the different types of debt, market and debt maintenance measures and management of currency exchanges.

42. The realised cost difference between inflation-linked and nominal borrowing is to be reported for inflation-linked borrowing.

43. The cost saving compared with alternative borrowing is to be reported for retail market borrowing.

44. Positions within a position mandate given are to be recorded continuously in income, and evaluated in terms of market values.

2 Basis for the Government's guidelines

2.1 Introduction

In its annual guidelines decisions the Government steers the trade-off between cost and risk in the management of the central government debt at a general level. This steering is based on the statutory objective for central government debt policy.

The basis for the Government's guidelines decision is that the central government debt is to be managed in such a way as to minimise the long-term cost of the debt while taking account of the risk in its management. The debt shall be managed within the framework of monetary policy requirements. The trade-off is mainly made by choosing the maturity of the central government debt. Historically, a shorter maturity had led to a lower average cost than a longer maturity. This is because it is assumed that the slope of the yield curve is positive over time. If a shorter maturity is chosen the risk in debt management rises, on the other hand, since short rates vary more. So, when the interest rate on a larger part of the debt is rolled over in every period, the variation in the total interest rate costs for the central government debt increases. In recent year, however, the cost advantage of choosing a shorter maturity is judged to have decreased. In general, strong government finances and low central government debt mean that the scope for risk-taking increases in return for lower expected costs. In exceptional cases the absolute level of interest rates can also be taken into account, as can the situation in loan markets and the Swedish krona exchange rate.

Other important parameters are the size of the central government debt and its expected development. At the end of 2017 the unconsolidated central government debt was SEK 1 328 billion (29 per cent of GDP). Forecasts indicate that at the end of 2021 the corresponding debt will be between SEK 874 and 1 113 billion (16 and 21 per cent of GDP). The size and expected development of the central government debt do not change the Government's view of the scope for risk-taking in the management of the central government debt compared with the preceding year.

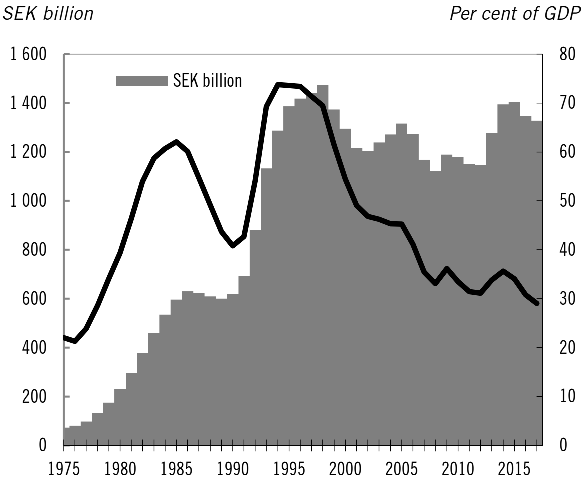
The Debt Office is able to decide on deviations from the benchmarks within the mandates it has been given. Derivatives are used for these deviations, which are defined as positions. These positions are evaluated separately and must not be taken in the Swedish fixed income market.

2.2 Central government debt

Historical development

The central government debt has arisen because, historically, the central government budget has shown larger deficits than surpluses. By definition, the central government borrowing is identical to the central government budget balance but with the opposite sign. Budget deficits are financed by new borrowing, while budget surpluses can be used to amortise the existing debt. The central government debt is very much affected by the development of the economy and by decisions on economic policy. In some years one-time events also affect the development of the central government debt. Examples of this are sales of shares in state-owned enterprises and on-lending to the Riksbank.

Figure 2.1 Unconsolidated central government debt 1975-2017



Source: Swedish National Debt Office

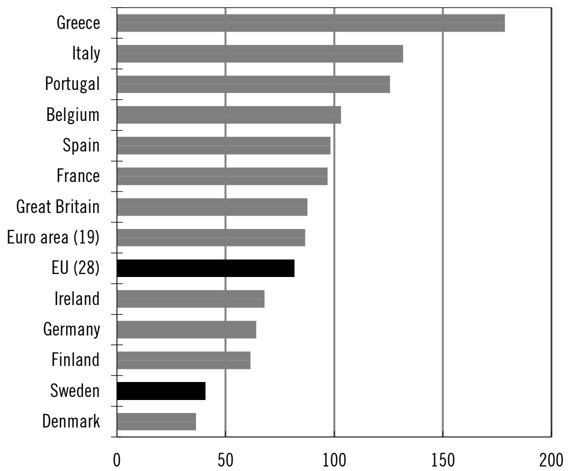
Figure 2.1 shows the development of the unconsolidated central government debt since 1975.[1] The figures shows that the central government debt has increased sharply as a proportion of GDP in two periods. The first period was between 1976 and 1985, when the central government debt increased as a proportion of GDP from 22 to 65 per cent. The second period was between 1990 and 1995, when the central government debt increased as a proportion of GDP from 43 to 77 per cent. As seen from the figure, central government debt has decreased gradually as a proportion of GDP since the mid-1990s, reaching 29 per cent at the end of 2017. The increase in the central government debt in 2009 and 2013 is largely explained by foreign currency borrowing by the Debt Office on behalf of the Riksbank corresponding to SEK 100 billion in each of these years. This borrowing was carried out following a request by the Riksbank, in order to strengthen the currency reserve. At the end of 2017 on-lending to the Riksbank amounted to SEK 238 billion of the unconsolidated central government debt. This on-lending to the Riksbank is a receivable for central government, so it does not affect the steering of the central government debt.

International comparison

Comparisons of general government sector debt in different EU member countries use the 'Maastricht debt'. This measure of debt refers to the consolidated gross debt of the whole of the general government sector, which, for Sweden, means that the central government debt and the local government sector's capital market debts are added together while the National Swedish Pension Funds' holdings of government securities are not included. The reason why this broader measure of debt is used in EU contexts is that the public sector is organised in different ways in different member countries. The Maastricht debt thus makes it possible to increase comparability between countries.

For Sweden the Maastricht debt was 41 per cent of GDP at the end of 2017. At the same point in time the corresponding share for the EU as a whole was 82 per cent and for the euro area it was 87 per cent.

Chart 2.2 Maastricht debt in 2017 as a proportion of GDP



Source: Eurostat

Forecasts of the future development of the central government debt

The development of the central government debt is affected by a large number of factors. Therefore it is difficult to forecast the development of the central government debt over a number of years. Several forecasts of the development of the

[1] The Budget Bill chiefly reports the consolidated central government debt. The difference between the consolidated and unconsolidated debt is made up of government agency holdings of government securities (SEK 63 billion at the end of 2017).

central government debt are therefore presented below. In addition to the Government, the National Financial Management Authority (ESV), the National Institute of Economic Research (NIER) and the Debt Office make forecasts of public finances. These forecasts have different purposes. The forecasting methods and time horizons used also differ.

The Government's forecasts are an important part of the political process since they form the basis for Riksdag decisions on taxes and expenditure. The Government's forecast has been taken from the Budget Bill for 2019 (Govt Bill 2018/19:1).

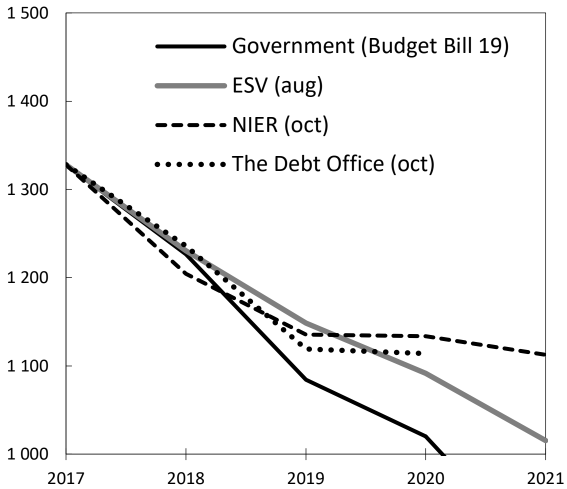
NIER forecasts focus on the development of the real economy in national accounts terms. NIER forecasts also estimate the development of the consolidated central government debt.[2]

The ESV forecasts provide supporting information for decisions and discussions in fiscal policy. These forecasts are based on decisions taken and legislative proposals as well as, in some cases, measures announced by the Government and the Riksdag. The ESV forecast has been taken from the Authority's publication *Forecast of the central government budget and public finances [Prognos Statens budget och de offentliga finanserna]* from August 2018. Both the Government's and the ESV's forecasts are based on impact assessments given proposed or unchanged regulations and on a particular development of the macro economy.

The Debt Office's forecasts are made in cash terms and from the basis for the agency's issue planning. Its reporting of planned borrowing by borrowing instrument makes the government securities market more predictable. In the long term this contributes to lower costs for the central government debt. The Debt Office's forecast has been taken from the publication *Central Government Borrowing: Forecast and analysis 2018:3* from October 2018.

Diagrams 2.3 Forecasts of unconsolidated central government debt

SEK billion



Source: National Financial Management Authority (ESV), National Institute of Economic Research (NIER), Government and Debt Office.

Figure 2.3 presents the forecasts made by the various agencies of the unconsolidated central government debt until the end of the calculation period in 2021, apart from the Debt Office, which extends to 2020. The forecasts show a range for the unconsolidated central government debt at the end of 2021 of between SEK 874 and 1 113 billion (16 and 21 per cent of GBP). At the end of 2017 the corresponding debt was SEK 1 347 billion, or 29 per cent of GDP. On-lending to the Riksbank, which was SEK 238 billion at the end of 2017, is included in the forecasts.

Prospects for the Swedish economy according to the Budget Bill for 2019

Economic developments in Sweden are of great importance for the development of the central government debt. When the economy is strong and employment high, central government receives more taxes at the same time as the pressure on social security systems decreases when unemployment falls. A rapidly growing economy therefore generally results in stronger central government finances and a lower central government debt.

In recent years GDP growth has been high in Sweden. Resource utilisation in the Swedish economy has increased since 2013 and is judged

[2] The NIER forecast of government agencies' holdings of government securities has been used to calculate the unconsolidated central government debt. The unconsolidated central government debt is SEK 63–67 billion higher than the consolidated central government debt in the period 2018–2021.

to be higher than normal in 2018 and 2019. An expansionary monetary policy has contributed to strong growth of domestic demand, both investments and consumption. At the same time a favourable economic situation internationally has contributed to steady export growth. In the first half of 2018 GDP continued to grow at a high rate largely thanks to high growth of household consumption.

This robust growth is also expected to continue in the second half of 2018. Companies are still optimistic about the economic prospects. Households are less optimistic than companies about the future, but their optimism has increased in recent months. GDP growth is judged to slow down slightly in 2019, mainly as a result of lower housing investments and smaller contributions from public consumption than in the previous year. For 2020 and 2021 a scenario is described in which the economic situation moves towards balance resource utilisation and activity in the Swedish economy slows down. GDP growth is therefore expected to be lower in 2020 and 2021, than in the immediately preceding years (see table 2.1).

Table 2.1. GDP forecast (Budget Bill for 2019)

	2017	2018	2019	2020	2021
GDP[1]	2.1	2.5	2.1	2.0	1.6

[1] Constant prices
Source: Budget Bill for 2019 (Govt Bill 2018/19:1)

Sweden is a small and open economy. This means that economic growth in Sweden is greatly affected by international developments.

The US has introduced tariffs on imported steel and aluminium from several trading partners, including the EU. At the same time, the US has also introduced tariffs on a large share on imports from China. This has led to China introducing measures targeted at parts of its imports from the US. There is great uncertainty about how this situation will develop in the future. An escalated trade conflict that may cover more countries could also lead to significantly lower global growth than in the forecast. Another uncertainty is the future shape of economic and political relations between the EU and the UK after the UK leaves the EU in March 2019. The outcome of the ongoing negotiations will affect economic performance in both the UK and the EU member countries, including Sweden, that are closely linked to the British economy.

If international interest rates rise faster than expected, that could result in poorer economic performance than in the forecast on account of falls in asset prices, lower investments and lower consumption.

Many emerging economies are vulnerable financially on account of large current account deficits, high debt and weak balance sheets in the banking industry. Moreover, these economies are sensitive to rising international interest rates, which can lead to large and rapid capital outflows and weaker exchange rates. Since many loans are in foreign currencies, weaker exchange rates increase their vulnerability further. In most cases, however, crises of that kind have a small effect on the Swedish economy.

A severe slowdown of growth in China would have major impact on the world economy, including the Swedish economy, since Chinese demand for raw materials and other input goods is an important driver of global growth. The country still has problems of overcapacity in state enterprises and regional imbalances in the housing market and the market for commercial property. Moreover, an escalated trade conflict could hit the Chinese economy hard.

The performance of the international economy may also be stronger than expected. In the EU resource utilisation is relatively low and monetary policy expansionary. In the US it is conceivable that its expansionary fiscal policy may have greater effects than expected in 2018 and 2019. Stronger growth internationally would benefit Swedish export industry.

Conclusion

The forecasts of the unconsolidated central government debt indicate that in 2021 the debt will be lower as a proportion of GDP than it is today. But these forecasts are associated with uncertainty. The scope for risk-taking in the management of the central government debt is therefore judged to be largely the same as before.

2.3 Loan markets

The yield curve slope

The slope of the yield curve affects the trade-off between cost and risk. When the yield curve has a steep positive slope, the cost saving from borrowing at shorter maturities increases and the other way round. Borrowing at shorter maturities means that an interest rate rise has a quicker impact on interest costs since the debt is refinanced more often. This increases the risk of variations in interest costs.

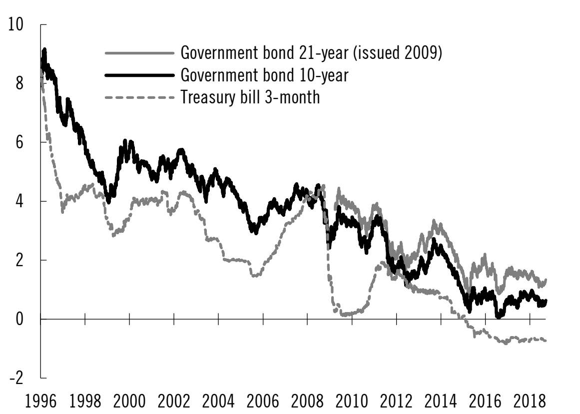
Historically the yield curve has generally had a positive slope, i.e. long interest rates have been higher than short interest rates. This could be explained by market participants expecting, on average, that interest rates will rise (the expectations hypothesis) but it is more likely that they want compensation for binding money if it turns out that they are wrong or if they want to reinvest the funds before the bond matures (term premium).

The level of the yield curve

The level of the yield curve is not normally of importance for the choice of maturity. Considering that increases and decreases in interest rates offset one other in the long run, the gain from having a long-term debt when interest rates rise is reduced by a loss that can be said to arise when interest rates fall again. However, in certain extraordinary cases, the interest rate level has affected the steering of maturities. This happened, for example, in spring 2009 when the Government made it possible for the Debt Office to issue a 30-year bond, partly with the aim of locking in low long rates.

In recent years the Riksbank has pursued an expansionary monetary policy in order to achieve the monetary policy target of inflation of 2 per cent. Since July 2014 the repo rate has been reduced from 0.75 per cent to -0.50 per cent in February 2016. Since then the repo rate has remained unchanged. For monetary policy reasons the Riksbank has also bought government bonds, the volume of these is planned to be SEK 330 billion at the end of August 2018.

Figure 2.4 Swedish government interest rate



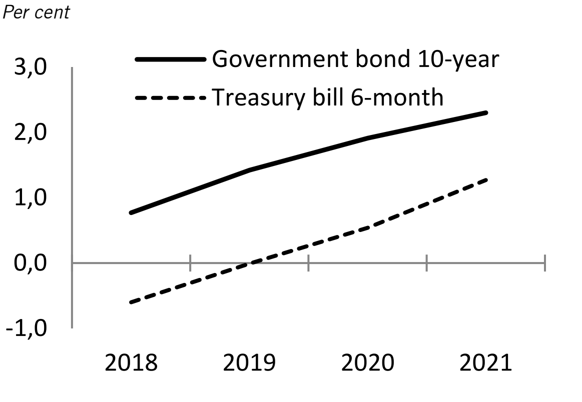
Source: Macrobond

Figure 2.4 shows that both short and long government interest rates have fallen sharply since 2014. The short rate, which follows the direction of the repo rate, has continued downwards while longer interest rates have risen slightly in periods. At the end of September 2018, the interest rate was -0.7 per cent for three-month T-bills, 0.6 per cent for the ten-year government bond and 1.3 per cent for the 21-year government bond.

Government forecast of interest rate developments

In the Budget Bill for 2019 the Government expects interest rates to rise gradually during the forecast horizon up until the end of 2021. The average annual interest rate for T-bills with a maturity of six months is expected to rise from -0.7 per cent in 2018 to 0.7 per cent in 2021. The average annual interest rate for government bonds with a maturity of ten years is expected to rise from 0,7 per cent to 2,1 per cent in the same period, see figure 2.5.

Figure 2.5 Government forecast of Swedish government interest rate, annual average 2018–2021



Source: Budget Bill for 2019 (Govt Bill 2018/19:1)

Conclusion
Term premiums have fallen in recent years, and they are expected to be low for the foreseeable future. The trade-off between the expected cost saving from short-term borrowing in relation to the increased risk this entails has therefore shifted slightly in recent years.

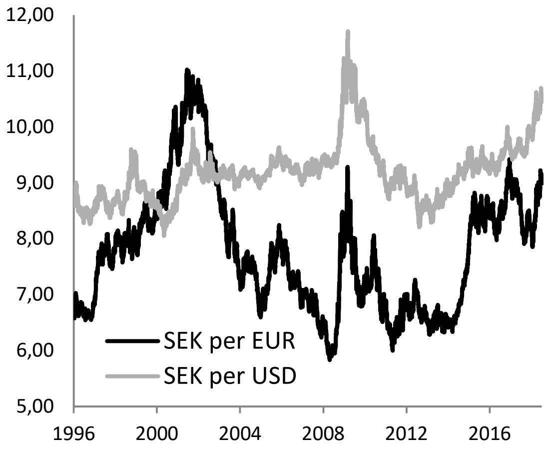
2.4 The Swedish krona

The size of the currency debt expressed in Swedish kronor is affected by the value of the Swedish krona in relation to the currencies against which the currency debt has exposure. In exceptional cases the guidelines for central government debt management have been affected by the expected development of the Swedish krona.

The historical development of the Swedish krona
For countries with a floating exchange rate (like Sweden), their exchange rate is affected by demand in the international currency market. This demand is affected, in turn, by a large number of factors, including expectations regarding the country's economic growth, future level of interest rates and inflation. In periods of financial unrest larger currencies, such as the US dollar and euro, tend to get stronger, while smaller currencies often fall in value. This became clear during the financial crisis in 2008 and 2009 when the value of the Swedish krona weakened sharply against both the euro and the US dollar. As financial markets stabilised and when signals about the performance of the economy became more positive, the Swedish krona then gained strength. In 2018 the krona has lost value in relation to both the US dollar and the euro, probably as a result of downward adjustments of expectations about the future repo rate in combination with periodic unrest in financial markets.

In May the Debt Office decided to take a position for a stronger krona against the euro in order to reduce the costs of the central government debt. The position means that the currency exposure of the central government debt will not decrease at the same rate as previously decided. The position will be taken gradually at different levels of the krona exchange rate and can be at most SEK 7 SEK billion. The Debt Office will provide advance information when the position begins to be wound down.

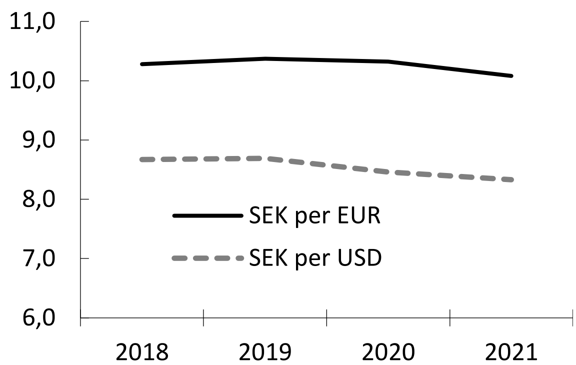
Figure 2.6 Development of the Swedish krona as of 1996



Source: Macrobond/Riksbank

Government forecast of the development of the krona
In the Budget Bill for 2019 the Government expects the krona to strengthen slightly up to the end of the forecasting horizon. against both the euro and US dollar. The annual average for kronor per euro is estimated at 10.3 in 2018 and at 10.1 in 2021. Correspondingly, in the same period the krona is expected to strengthen from 8.7 to 8.3 against the US dollar, see figure 2.7

Figure 2.7 Government forecast of the Swedish krona exchange rate, annual average 2018–2021



Source: Budget Bill for 2019 (Govt Bill 2018/19:1)

Conclusion
Assessments of the development of the krona do not affect this year's guidelines. The mandate for

positions in the krona exchange rate is left unchanged.

2.5 The Riksbank's comments on the Debt Office's proposal

Under the Budget Act the Government has to request an opinion from the Riksbank on the proposal of the Debt Office for guidelines for the management of the central government debt (Chapter 5, Section 6). The Riksbank has no objection to the Debt Office's proposal for guidelines for the management of the central government debt in 2019–2022. However, the Riksbank has views on the Debt Office's measure of using liquid funds to refinance foreign currency loans (see section 3.6).

3 Reasons for the Government's decision

3.1 Trade-off between cost and risk in debt management

The trade-off between cost and risk is set in the annual guidelines and shall, according to them, primarily be made through the choice of the composition and maturity of the debt (point 20). The guidelines state that the main cost measure is the average issue yield (point 21) and that the main risk measure is the variation of this measure (point 22).

The size and expected development of the central government debt

The trade-off between cost and risk takes account of the size and expected development of the central government debt. A low central government debt and strong government finances increase the scope for risk-taking in return for lower expected costs. In exceptional cases the absolute level of interest rates can also affect the guidelines, as can the situation in loan markets and the Swedish krona exchange rate.

Costs of the central government debt

Central government finances in good order and a resulting low central government debt are important factors in ensuring a low cost for the central government debt. Interest rate levels in the Swedish and global interest rate markets are also of great importance for borrowing costs. Exchange rate movements also affect the cost of the central government debt since part of the debt is exposed to foreign currencies. Similarly, the costs of the inflation-linked debt are affected by the development of inflation (CPI).

The decline in global and Swedish interest rates since the financial crisis has contributed to substantially reduced costs for the central government debt.

Risks in the management of the central government debt

The risk in the central government debt is defined at a general level as its contribution to variations in the central government net lending and the central government debt. A lower central government debt, which results in lower costs, contributes to a lower risk since the variation in the costs (expressed in kronor) decreases. A lower central government debt initially also makes it easier for central government to borrow large sums in a crisis situation without a sharp rise in interest rates.

There is no single measure that describes the overall risk in the management of the central government debt. Instead different types of risk are reported, the most important being the refixing risk, the refinancing risk, the financing risk and the counterparty risk.

The refixing risk means the risk that the interest costs on the debt will rise rapidly if market interest rates move upwards. The greater the share of the debt that consists of short and floating-rate loans, the more sensitive is the debt to changes in market interest rates.

The refinancing risk refers to the risk that it will turn out to be difficult or expensive to replace maturing loans with new ones. In general, the refinancing risk appears at the same time as the need for new borrowing rises sharply (financing risk). The refinancing risk reflects the time remaining to maturity, i.e. when the debt needs to be refinanced. The guidelines state that the Debt Office is to take account of refinancing risks in the management of the central government debt (point 23) and that the Debt Office is to ensure good borrowing preparedness in foreign currencies (point 24).

The refinancing risk is taken into account in several different ways in the Debt Office's strategies for borrowing and its market commitment by, for example, ensuring infrastructure, an investor base and liquidity in the loan market. The bulk of the borrowing is done in government bonds that are spread over several loans with different maturity dates. The borrowing is spread continuously across small, regularly held auctions. A large part of the borrowing is carried out in the 10-year government bond, where the investor base is largest. Since 2009 the Debt Office also has nominal krona borrowing at longer maturities than twelve years, which means that the dates when the central government debt reaches maturity are spread over a longer period of time. Moreover, the Debt Office's borrowing in foreign currency reduces the refinancing and the financing risk since the channel to the international capital markets is kept open. The international capital market makes it possible to borrow large volumes in a short space of time.

In its annual evaluation of the management of the central government debt the Debt Office has to report on how the requirements concerning refinancing risks have been met. Finally, it should be underlined that strong and sustainable central government finances are the most important factors in limiting the refinancing risk and the financing risk in the central government debt.

3.2 The steering of the composition of the central government debt is left unchanged

The Government sees no reason to alter the steering of the composition of the central government debt. The guidelines decision for 2017 gave the reasons that still apply (section 3.2). This steering means that the share of inflation-linked krona debt is to be steered towards 20 per cent in the long term (point 11) and that the foreign currency exposure of the central government debt is to be reduced by up to SEK 30 billion per year (point 12), excluding changes in the krona exchange rate. The remainder of the central government debt (currently around 65 per cent) is to consist of nominal krona debt.

3.3 Maturity unchanged in practice

Short borrowing is generally cheaper than long borrowing, which means that a trade-off must be made between expected cost and risk, especially refinancing risk and refixing risk. In recent years term premiums, i.e. the compensation investors demand to invest in government securities with longer maturities, have decreased. Even though term premiums can vary greatly over time and it is not possible to rule out term premiums rising once again, the Government shares the view of the Debt Office that the reasons for having short fixed interest rate periods have been weakened. The maturity of the nominal krona debt has therefore been extended by a total of one year in the period 2016–2018. In practice duration has mainly increased through less use of interest rate swaps.

This year's guidelines decision does not mean a further extension. But since the Government's guidelines decision for 2019 merges the maturity steering of the inflation-linked and the nominal krona debt, the new merged interval is different from what applied in 2018 (see section 3.4). As a result of the merger, the duration of the krona debt is changed to between 4 and 6.5 years. In its guidelines decision for 2018 the Government set the maturity interval at between 4,3 and 5,5 years for the nominal krona debt and between 6 and 9 years for the inflation-linked krona debt.

The steering of the maturity of the foreign currency debt also remains unchanged.

3.4 Steering of the maturity of the inflation-linked and nominal krona debt merged

A common maturity target (interval) is introduced for the whole of the krona debt. The new target thus covers both the inflation-linked and the nominal krona debt. Measured as duration, the maturity of the krona debt is to be between 4 and 6.5 years.

Background

In its proposed guidelines for 2019–2022 the Debt Office sets out the analysis underlying the Debt Office's proposal to merge maturity steering of the inflation-linked and nominal debt.

When inflation-linked bonds were introduced in the 1990s, the strategy was to borrow in longer maturities than using nominal bonds. This strategy was based on the assessment that investors were prepared to pay a premium to have insurance against inflationary shocks. The value of the insurance entailed by the inflation-linked bond was assumed to depend on its maturity. It was judged, at the same time, that any liquidity premiums for this type of debt would be lower than for nominal borrowing because long-term investors did not need to roll over their holdings as often and would therefore attach a lower value to liquidity.

Over time the conditions for borrowing in inflation-linked bonds have been reviewed. Swedish experience shows that investors mainly demand bonds with shorter maturities, i.e. maturities up to ten years. One conceivable explanation may, according to the Debt Office, be that the credibility of the inflation target has helped to reduce the risk for high and varying inflation in the long term. But the main reason why demand for long inflation-linked bonds has been lower than expected is that the bonds have not been used in the way assumed from the outset. There are few investors that have explicit targets for real returns, and regulation is one factor that affects this. The demand profile in terms of maturities has turned out to be the same as for nominal bonds and the Debt Office has therefore gradually gone over to issuing in the same maturities as in nominal government bonds. This means that the Debt Office introduces new ten-year inflation-linked bonds and tops up (makes tap issues of) previously issued bonds whose outstanding maturity has decreased over time.

The Debt Office's study supports the picture that the term premium for both inflation-linked bonds and nominal bonds has shown a trend decrease since year 2000.

As it now has the same strategy as regards maturity for inflation-linked and nominal bonds, the Debt Office considers that there are no longer any strong reasons to steer the inflation-linked debt separately. A common benchmark would instead provide a better overview of the level of risk in the krona debt. The benchmark is set as an interval since there are several factors that influence the duration of the debt alongside the actions of the Debt Office. Both the interest rate and inflation influence duration. If the interest rate and inflation rise, duration goes down. Before maturity reaches its long-term level, it is also expected to be shorter during a transitional period; the reason being that there are individual issues of inflation-linked bonds that have a particularly great impact on the whole portfolio. They are older bonds issued many years ago at a high coupon that have accumulated a great deal of inflation compensation. Before these loans mature, they decrease the average maturity. A common steering interval can also be made narrower than the present interval for the inflation-linked debt since the inflation-linked debt, whose duration varies more, will be part of the total krona debt.

To maintain transparency in relation to market participants the Debt Office is to adopt separate internal guidelines for the inflation-linked and nominal debt. The Debt Office proposes that the maturity of the krona debt should be between 4 and 6.5 years. With this interval the Debt Office considers that there is a margin to deal with a return of market interest rates to more normal levels. (When interest rates rise, duration gets shorter, all else equal.) Moreover, the interval allows the portfolio to have a longer duration than expected if the borrowing requirement were to fall even more due, for instance, to a larger than expected inflow into tax accounts. A decrease in the borrowing requirement means that the share of short-term borrowing decreases, which means, all else equal, that the total average maturity of the krona debt gets longer.

The Debt Office expects the borrowing requirement to remain limited since the Riksdag has adopted a surplus target. When the borrowing requirement is small, the Debt Office's assessment is that the best strategy for maintaining good borrowing preparedness is to give priority to borrowing in maturities up to ten years, where there is most demand. The alternative of spreading borrowing across more and longer maturities risks harming liquidity in the market and thereby increasing the long-term cost.

3.5 Retail market borrowing

The Government's guidelines decision for 2019 means that the present guideline about retail market borrowing (point 32 in the guidelines decision for 2018) is removed. The former guideline stipulates that the Debt Office is to contribute through retail market borrowing to reducing the costs of the central government debt in the long term compared with equivalent borrowing in the institutional market.

Both previous wordings assume that retail market borrowing is consistent with the Budget Act's objective for the central government debt, namely that the central government debt is to be managed in such a way as to minimise the cost of the debt in the long-term while taking risk in its management into account.

The Government considers the present wording as unnecessary and finds that there is also a risk that it leads to a greater lack of clarity. The Government makes the assessment that the Debt Office has both a possibility and an obligation to conduct retail market borrowing if this borrowing is assessed as effective in terms of the overall objective even without a specific guideline for retail market borrowing as such.

As a commission from the Government the Debt Office has considered whether central government should wind up lottery bonds after the pause in issuing them since 2016 (Fi2018/01695/FPM).

In its guidelines proposal the Debt Office presents its analysis to the effect that if it were to begin issuing lottery bonds again this would, according to the Debt Office, result in considerable costs and would require a long-term investment. A long-term investment requires, in turn, a new customer base and sustained higher interest rates, a larger borrowing requirement and effective handling and management of the lottery bonds. The Debt Office's overall assessment is that lottery bonds are no longer able to contribute to reducing the cost of the central government debt. The Debt Office also states that if it sees that some new form of retail market borrowing can contribute to lowering the cost or risk of central government debt in the future, the Debt Office would consider such borrowing within the guidelines then in force. The Debt Office also takes the view that if the Government sees a need to provide a special savings product for some other purpose, this should be investigated.

3.6 About liquidity management and the central government cash surplus

Under point 34 of the guidelines decision, the Debt Office is to place its funds, to the extent that they are not needed for outgoing payments, in an account at the Riksbank, a bank or a credit market company, or in government securities or other debt instruments with a low credit risk. Investments may be made abroad and in foreign currency.

Since 2017 liquidity management has been abnormally large at times. The Government has commissioned the Debt Office to, if possible, take measures to return the central government cash surplus to a normal historical level (Fi2018/01695/FPM). The Debt Office reports on this commission in its proposed guidelines.

In its proposed guidelines the Debt Office sets out the reasons for the situation that has arisen and conceivable measures to reduce the cash surplus. In summary, it can be concluded that this surplus will decrease gradually when large bond loans mature in the next few years and that the decrease is being accelerated by the use by the Debt Office of cash funds to refinance loans to to the Riksbank. Bringing cash funds down to a normal level in the short term would require drastic measures that are not consistent with the objective of long-term cost minimisation.

The cash surplus was built up in 2017 when central government tax income was much higher than forecast, partly because of greater capital investments in tax accounts. Increased demand for the Debt Office's standing repo facility also contributed to more money being received to invest.

The issue volumes of all government securities have been reduced to historically low levels. The Debt Office makes the assessment that further reducing issue volumes, instead of letting the cash surplus decrease gradually, would worsen in the market for government securities in a situation that is already strained. This would lead both to higher costs for central government borrowing and to poorer borrowing preparedness in the longer term. Nor is it certain that the liquid funds would decrease in the short-term since the low supply of government bonds could probably lead to greater demand for the Debt Office's standing repo facility.

The Debt Office is nevertheless taking the measures judged possible to decrease the cash surplus more quickly. One measure is to use cash funds to refinance loans to the Riksbank instead of issuing new foreign currency bonds. In its most recent forecast from June this year the Debt Office assumes that half of the refinancing requirement in foreign currency for the Riksbank is replaced with liquid funds in 2019. With this measure, the cash surplus is expected to come down to its normal level at the end of next year. The Debt Office has also indicated that it is open to buying back foreign currency bonds when there is an interest among investors in selling.

The present cash surplus leads neither to greater credit risks nor to higher expected costs. The surplus is placed in Riksbank certificates. However, the surplus means that the reported central government debt is higher than it would otherwise be.

In its opinion the Riksbank comments on the possible measures identified by the Debt Office to make the cash surplus return to historically normal levels. Under Chapter 5, Section 5 of the Budget Act (2011:203) the management of the debt shall be conducted within the framework of monetary policy requirements.

The Riksbank takes the view that one of the purposes of the Riksbank's foreign currency reserve is to be able to provide liquidity in foreign currency and safeguard the stability of Sweden's financial system. The Riksbank also takes the view that the refinancing of these loans through liquid funds in combination with foreign exchange swaps may entail greater risks than foreign currency borrowing. The Riksbank has noted on several occasions that there can be risks in the foreign exchange swap market in times of crisis. The Riksbank takes the view that the risks are particularly great if the counterparties are Swedish banks since refinancing the currency reserve can present considerable challenges in a situation where support may need to be given specifically to these Swedish banks. The Riksbank also takes the view that such an arrangement would mean that the possibilities of using the currency reserve in times of crisis so as to be able to provide liquidity support in foreign currency will be dependent on the Swedish banks.

Against this background the Riksbank considers that it is more suitable for the Debt Office to refinance loans to the Riksbank by in the first place issuing new bonds direct in the currency concerned. If the Debt Office nevertheless chooses to refinance the loans using liquid funds in combination with foreign exchange swaps, the Riksbank takes the view that this should only be done with foreign counterparties.

The Debt Office's measures to return the central government cash surplus to historically normal levels must not be done in conflict with the objective of central government debt management, i.e. that the debt has to be managed in such a way as to minimise the cost of the debt in the long-term while taking risk in its management into account and that management of the debt has to be conducted within the framework of monetary policy requirements.

A use of foreign exchange swaps to finance part of the currency reserve cannot otherwise be a general problem since the agreements can be entered into with long maturities and the Debt Office has a readiness to raise foreign currency loans when needed. But, as the Riksbank points out, swap agreements with Swedish banks may entail a greater refinancing risk than swap agreements with foreign counterparties in times of crisis.