

Handling category:

Open

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Borrowing to satisfy the Riksbank's need for foreign exchange reserves

Proposed board decision: The board grants the Director General of the Swedish National Debt Office a mandate to borrow, on behalf of the Riksbank, foreign currencies with a maximum value equivalent to SEK 200 billion in order to satisfy the bank's need for foreign exchange reserves. This entails a widening of the previous mandate for on-lending to the Riksbank by SEK 100 billion.

The Director General is also authorised to make such decisions, including agreements with the Riksbank, as are required to handle on-lending effectively, e.g. having regard to how the refinancing of borrowing on behalf of the Riksbank should be handled.

In order to inform the government of the Debt Office's views on the current regulatory framework, the documentation supporting the decision should be submitted to the Ministry of Finance for information.

1 The matter and the contents of this memorandum

The Debt Office received a request on 12 December 2012 from the Riksbank for loans in foreign currency in order to strengthen the foreign exchange reserve by the equivalent of SEK 100 billion. This request represents a supplement to the strengthening of the foreign exchange reserve by SEK 100 billion made in 2009.

In its request, the Riksbank refers to a concern that the current foreign exchange reserve may be insufficient in order for the Riksbank to grant the Swedish banks sufficient foreign exchange liquidity support in the event of a crisis. The bank also refers to the undertaking by the Swedish government to grant borrowing to the International Monetary Fund (IMF). This borrowing is mediated via the Riksbank and therefore funds in the foreign exchange reserve may be needed.¹

This memorandum explains the legal and fundamental prerequisites for the lending of the Debt Office to the Riksbank. This analysis concludes that the Debt Office shall, in the current situation, grant the Riksbank's request.

The memorandum begins, however, with a review of the discussion about the need for foreign exchange reserves between the Debt Office and the Riksbank since the crisis

¹ The Riksbank's decision (with an enclosure) is an enclosure to this memorandum.

2008-2009. The scenario analysis on which the Riksbank's request is based is then commented upon. The conclusion is that the scenarios do not provide sufficient grounds for increasing the foreign exchange reserve.

This leads to the conclusion that the current rules for decision-making are inappropriate. There is a need for a clearer framework concerning how and on what grounds decisions about the size of the foreign exchange reserve should be made. The Debt Office therefore looks forward to the review of rules which an enquiry appointed by the Government will submit at the end of January 2013.

2 The strengthening of the foreign exchange reserve in 2009

During the financial crisis 2008-2009, major efforts were required on the part of the government through various forms of liquidity support in order to maintain financial stability. Not least, it was necessary to support the banks' funding in foreign currency. This was achieved partly through lending by the Riksbank, and partly via the guarantee program for banks' securities lending which was handled by the Debt Office. At the peak, the government provided the equivalent of SEK 450 billion as foreign currency support, around half of which originated from the Riksbank and half from the Debt Office.

Guarantee programs do not impose any immediate requirements on government financial resources. Such requirements arise only if a guarantee must be honoured. The Riksbank's lending in foreign exchange on the other hand requires that the bank has access to foreign currency. In 2008-2009 the major part was procured via the Riksbank's borrowing of dollars via swaps with the U.S. Federal Reserve, but parts of the existing foreign exchange reserve were also used. When the informal consultations concerning the need to strengthen the foreign exchange reserve through borrowing from the Debt Office were initiated at the beginning of 2009, the Riksbank had used around SEK 65 billion of the foreign exchange reserve.

Based on discussions with the Riksbank, the Debt Office deemed it appropriate to restore the Riksbank's foreign exchange reserve to the original level in order to ensure that its resources to provide further support were intact. Thus, the board decided in April 2009 to grant the Director General a mandate to borrow the equivalent of SEK 65 billion for on-lending to the Riksbank. At this time, no formal request for strengthening of the foreign exchange reserve had been made by the Riksbank, but since the Director General held this mandate, we were ready to complete the necessary borrowing pursuant to the request we assumed would be forthcoming.

During the continued consultations, the Riksbank expressed a desire to strengthen the foreign exchange reserve by more than what represented a restoration to its original level. These discussions ended with a request by the Riksbank for an increase by SEK 100 billion, which the board of the Debt Office decided to grant. The decisions were made public by way of coordinated press releases on 27 May 2009.

According to the Riksbank's decision, the foreign exchange reserve would be normalised once the support measures were ended. Having regard to the lingering uncertainty in the international financial markets, the Riksbank chose to keep the larger foreign exchange reserve. The Debt Office has not deemed this problematic, in view of Sweden's strong public finances and the government's limited borrowing requirements in recent years. Lending to the Riksbank has not competed with other requirements during the period in question. In addition, a review of the rules around the foreign exchange reserve was pending.

3 Discussion regarding an additional agreement

The discussion between the Debt Office and the Riksbank about the forms of supplementing the foreign exchange reserve continued. This resulted in a proposed agreement which would specify the conditions for when the Debt Office would lend foreign currency to the Riksbank when parts of the existing reserve had been used up. The purpose was to provide a clearer framework for on-lending in order to restore the foreign exchange reserve. The proposal fixed the base level for restoring purposes as the level at the turn of 2009-2010, i.e. including the increase in 2009. The agreement also said that if the Riksbank had used SEK 25 billion or more of the foreign exchange reserve, the Debt Office would within ten banking days borrow and on-lend to the Riksbank an equivalent amount in order to restore it to the base level.

The Debt Office viewed the agreement as implied in the assignment we have under the Budget Act, and not as a new or expanded obligation. The board therefore decided in February 2010 to grant the Director General a mandate to conclude an agreement with the Riksbank to restore the foreign exchange reserve. The discussions within the Riksbank continued for some time. Eventually we were informed that the Riksbank had chosen not to put this issue up for decision.

4 Discussions about further increases

Since the issue concerning the agreement was removed from the agenda, the Debt Office and the Riksbank had no further discussions about strengthening the foreign exchange reserve. In July 2012, however, the Riksbank initiated a meeting between the senior management of the Riksbank and the Debt Office.

At this meeting, the Riksbank stated that they had made scenario analyses which led to the conclusion that the foreign exchange reserve should be increased by SEK 100 billion. The Debt Office questioned the Riksbank's assessment and the need to increase the foreign exchange reserve in the current situation (see further below). We referred to the previous proposal regarding an agreement to borrow in order to restore the foreign exchange reserve if and when needed as a cheaper and more efficient solution. A few days after this meeting, we also gave the Riksbank a specific description of how we intend to proceed in order to borrow the equivalent of SEK 100 billion in foreign currencies within ten banking days if required in order to restore the foreign exchange reserve.

No further discussions took place until in December. At this time, the Governor of the Riksbank informed the Director General of the Debt Office that the Riksbank's Executive Board had decided to request that the foreign exchange reserve be increased. The Riksbank published this decision two days later.

5 The current need to strengthen the foreign exchange reserve

The analysis behind the Riksbank's request is set out in an enclosure to the Executive Board's decision. This describes a number of scenarios characterised by extreme liquidity stress experienced by banks. The Riksbank states that these scenarios are very unlikely, however they are "relevant since the foreign exchange reserve should provide insurance against precisely events which are unlikely but not impossible". The situations described are far worse than the stress scenario which the Swedish Financial Supervisory Authority uses for the Liquidity Coverage Ratio (LCR), which in its turn is based on the model in the preliminary Basel III Accord. This scenario in its turn is worse than the situation of the Swedish banks in 2008-2009. To this is added the assumption that the IMF will use parts of or all of the loan commitment in foreign currency which Sweden has undertaken to provide to the IMF.

It would take too long to analyse the Riksbank's assessments. However, a few comments regarding assumptions directly associated with the Debt Office's activities are in order.

First, the Riksbank assumes that the banks are not able to issue government-guaranteed securities. No grounds are provided for the assumption that a government guarantee program would not function. The Debt Office sees no reason for assuming that a guarantee program could not be an important and effective tool in a future crisis.

Second, the Riksbank's calculations are based on an assumption that the bank will not have access to borrowing via the Debt Office. This is reflected in the scenarios by the premise that no funds are provided to the Riksbank by way of borrowing from the Debt Office, not even in calculations comprising two to three months. The Debt Office is not concerned that our ability to complete our assignment under the Budget Act, even in an extremely stressed international situation, could deteriorate such that we could not, if needed, borrow to strengthen the foreign exchange reserve. We believe it is reasonable to expect that the foreign exchange reserve requirement can be satisfied by borrowing via the Debt Office also in such a situation.

Although it has become apparent in recent years that a government is not guaranteed funding and that the standing of the financial sector and the government can become connected in a fatal manner, it does not follow necessarily that it is useful or appropriate to fill up the foreign exchange reserve on a large scale in advance with funds which have been earmarked for liquidity support to banks in the event of an unlikely scenario.

If the situation deteriorated to the point where the ability of the National Debt Office to lend on a day to day basis to cover the government's obligations would be deemed threatened, a buffer fund of this type should be at the Government's disposal, to be used

for the purposes with the highest priority in the urgent crisis which the country is in. Such purposes could include supporting the banks' foreign exchange financing, but do not need to do so.

In conclusion, we believe that the assessment of the need to increase the foreign exchange reserve is exaggerated. In more reasonable scenarios, a solution based on the Debt Office's replenishing the foreign exchange reserve when needed is sufficient – in combination with a guarantee program – to cope with the banks' requirement for liquidity support in foreign currency. In preparation for extreme scenarios where the Debt Office would not have access to borrowing in foreign currency, it is inappropriate to freeze large amounts of funds in the Riksbank's foreign exchange reserve.

6 The formal prerequisites for the Debt Office's decision

Rules for government borrowing and debt management are set out in Chapter 5 of the Budget Act (2011:203). Pursuant to Article 1, the parliament grants a special mandate for one budget year at a time under which the Government may borrow for certain specified purposes. The Government transfers this mandate to the Swedish National Debt Office, under the rules of the ordinance (2007:1447) containing instructions regarding the Debt Office.

The borrowing purposes listed include some obvious ones, such as financing budget deficits and other expenses which the parliament has decided, and to refinance maturing borrowing. A fifth item specifies the purpose to "satisfy the Riksbank's need for foreign exchange reserves".

Preparatory works regarding the provisions on borrowing to the foreign exchange reserve are set out in Bill 1994/95: 150, Annex 7, p. 108. This discusses among others whether the Government should have a deciding role, as proposed by the Riksbank investigation. The conclusion in the Bill is that such a regime could limit flexibility and that borrowing directly via the Debt Office is more suitable. As grounds for this assessment, reference is also made to the fact that "current consultation forms in the fields of monetary policy and government debt policy are well designed to handle the trade-offs which arise between the monetary and debt policy in connection to borrowing on behalf of the Riksbank".

The legislator thus seems to assume that decisions to strengthen the foreign exchange reserve should be preceded by consultations. As noted above, there was also extensive consultation prior to the decision of 2009, including coordination of the public announcement of the decisions. Having in mind that borrowing for the Riksbank directly affects the budget balance, it is obvious that the Debt Office informed the Ministry of Finance of the discussions we had with the Riksbank and about the decision we were preparing.

The need for consultation is also underlined by the fact that the foreign exchange reserve is to be used to handle financial crises. This is an area where responsibility is shared by

the Riksbank, the Government, the Swedish Financial Supervisory Authority and the Debt Office and where consultation is continuous, not least in the context of the Stability Council.

The Budget Act provides that we *may* borrow for specified purposes. This means that a decision on our part regarding the matter in question is called for. The interpretation of the word *may* is not self-evident, however. The decisive question is in what circumstances the Debt Office should say yes and no, respectively, to a request by the Riksbank.

For example, it is obvious that the Debt Office not only *may* but has an obligation to borrow to finance the budget balance. This is a condition for the payments arising as a consequence of the parliament's decisions to be made. Likewise, we must obviously borrow in order to repay old debt instrument which are due for payment.

On the other hand, it is not evident that the Debt Office has a duty – or even a right – to borrow unlimited large amounts in order to increase the foreign exchange reserve at the request of the Riksbank. Such borrowing is not necessary for the state's on-going activities in the same way as borrowing to finance budget deficits. At the same time, it is unclear on what grounds the Riksbank's need for foreign exchange reserves should be determined. The legal provisions are thus difficult to interpret. These uncertainties are one important reason for the government's appointment of a special inquiry to review and clarify the rules.

Nevertheless, these are the rules which must be applied here and now. One reference point for interpretation is provided in a response from the Government to the parliament's Committee on the Constitution (CC) in a matter concerning the Government's role in the decision to strengthen the foreign exchange reserve in 2009:

The provisions of [chapter 5 Article 1 point 5 of the Budget Act] cannot be deemed to entail that the Riksbank has an unqualified right to an injection of funds by the state in order to secure the need for foreign exchange reserves. Such a regime would be unreasonable since the state's ability to borrow foreign exchange is limited. It must therefore be possible to make a trade-off between the Riksbank's need to strengthen the foreign exchange reserve and the need for borrowing in foreign currency for other purposes, such as payment of interest on outstanding borrowing and repayment of matured foreign currency borrowing.²

The Riksbank agreed in its response to CC on all substantial matters with the Government's interpretation. The Debt Office concurs. The above cited preparatory works also indicate that trade-offs must be made between the Riksbank's need and government debt policy. However, under the current rules the parliament has

²A memorandum from the Ministry of Finance (dated 03/03/2010) in connection with review matter number 33 of the Committee on the Constitution – the Riksbank's independence and measures taken by Minister Anders Borg, p. 2.

commissioned the Debt Office - following delegation by the Government - to "meet the Riksbank's need for foreign exchange reserves" without specifying how this need should be determined. In practice, this grants the Riksbank extensive discretion in specifying the size of the foreign exchange reserve.

7 Response to the Riksbank's request

Against this background, the main issue is whether there is a conflict between borrowing, in the current situation, SEK 100 billion for the Riksbank and other needs for government borrowing, such as financing day to day government expenses.

In the opinion of the Debt Office, there is currently no such conflict. Sweden's strong central government finances and otherwise stable economy mean that we do not perceive any binding restrictions in our access to borrowing. On the contrary, the demand for Swedish government bonds is strong and interest rates are low, both in Swedish kronor and foreign currency. Nevertheless, by increasing borrowing by SEK 100 billion, the budget deficit (the net borrowing requirement) increases significantly. The Debt Office forecast of October 2012, i.e. excluding further on-lending, indicated a deficit of SEK 56 billion in 2013. An increase of the borrowing requirement up to around SEK 150 billion would likely lead to at least a small increase of the government borrowing rates. This leads to some additional costs to the government (in addition to the one reported in the documentation supporting the Riksbank's decision), but not of a size that would give the Debt Office reason to say no. According to the applicable regulatory framework the Debt Office must therefore grant the Riksbank's request.

It is therefore proposed that the board grant the Director General a mandate to borrow on behalf of the Riksbank foreign currency with a maximum value equivalent to SEK 200 billion in order to satisfy the Riksbank's need for foreign exchange reserves. This entails a widening of the previous mandate for on-lending to the Riksbank by SEK 100 billion.

8 Practical management of on-lending to the Riksbank

In order to finance the first on-lending to the Riksbank, the Debt Office issued a number of loans with various maturities. Similarly, increased on-lending must be covered by borrowing. The Director General should therefore be granted a mandate to agree with the Riksbank about how and at what pace new foreign currency borrowing should be undertaken in order to cover this increased requirement. The starting point for the Debt Office is that the borrowing should be handled in a business-like manner and in accordance with the cost minimisation target, while taking risk into account.

Borrowing raised on behalf of the Riksbank mature in due course and must then be replaced with new borrowing. Decisions regarding refinancing are also made following consultations with the Riksbank. It must also be possible to handle the practical management of refinancing effectively and efficiently. Borrowing in foreign currency

where the mandates – of both the Debt Office and the Riksbank – are expressed in Swedish kronor requires certain flexibility.

First, the exchange rate affects the value in kronor of the stock of loans. It can thus not be excluded that the value in kronor will change to the extent that it exceeds the stated maximum amount. Measures to repay outstanding borrowing at short notice are not, however, suitable or efficient. In such cases, it should therefore be possible pursuant to the mandate to postpone the adjustment of the loan portfolio measured in foreign currency until loans mature.

Similarly, the mandate must provide for a secure and effective management of refinancing of maturing borrowing. It is not appropriate, for example, to refinance a large bond loan on the date when repayment is due. The mandate should thus authorise the Debt Office lending temporary in excess of SEK 200 billion to the Riksbank in the context of a major redemption.

The Director General should therefore be granted a mandate to manage the borrowing limits so that the financing can be handled safely and efficiently. However, any overdraft beyond the SEK 200 billion limit must be temporary and adjusted as soon as possible without the Riksbank or the Debt Office incurring unnecessary additional costs.

Further, the mandates existing at the Riksbank and the Debt Office respectively should be mutually consistent. The Debt Office has initiated a discussion with those in charge at the Riksbank concerning these issues. The board may therefore be provided with further information and potentially proposals for new decisions as our discussions with the Riksbank progress.

9 Final comment – a clearer framework is needed

For the reasons stated above, the Debt Office's opinion with regard to the current need to increase the foreign exchange reserve differs from that of the Riksbank. However, under the current rules the parliament has commissioned the Debt Office – following delegation by the government – to "satisfy for the Riksbank's need for foreign exchange reserves" without specifying how this need should be determined. As also explained above, this regime affords the Riksbank a possibility to state within a wide framework how large the foreign reserve should be. As long as the Debt Office considers that a request by the Riksbank does not conflict with our ability to finance the government's other expenses, we have an obligation according to the current regulations to grant the Riksbank's request.

There is a need for a clearer framework concerning how and on what grounds decisions about the size of the foreign exchange reserve should be made. To delegate without clear restrictions and instructions decisions to authorities that may increase the central government debt by three-digit billion amounts entails that decisions can be made beyond democratic control and erodes the parliament's influence over government finances. This must be seen as inappropriate. As for other government borrowing, the

limits on borrowing for the foreign exchange reserve should be fixed by a decision made by parliament.

The Debt Office should inform the Ministry of Finance of its views on the current regulatory framework. This memorandum should therefore be submitted to the Ministry for information.