Guidelines for Central Government Debt Management 2006

Decision taken at the Cabinet meeting
10 November 2005

2006

KOSTNADSMINIMERING FÖRUTSÄGBARHET FLEXIBILITET LÅNGSIKTIGHET

REGERINGSKANSLIET

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1 Summary

The Government's decision on the guidelines for central government debt management has a multiyear perspective aimed at creating a central government debt policy that is predictable and long term in nature. This year's decision on the guidelines covers 2006 to 2008, but the guidelines for 2007 and 2008 are preliminary and may be changed in the decision on the guidelines in years to come.

This year's decision on the guidelines continues to aim at greater risk diversification in Sweden's central government debt in the long term. Thus the percentage of foreign currency debt is to decrease and the percentage of inflation-linked debt is to increase. At the same time, the benchmark for the inflation-linked portion of the central government debt has been fixed at 20 per cent in the long term. The reason for doing so is chiefly to reduce the uncertainty in the allocation of the debt between nominal and inflation-linked borrowing.

The maturity guideline in the central government debt is to remain unchanged from the present guidelines. One of the reasons cited by the Government is that while it has indeed become less costly to reduce the risk in the central government debt by lengthening the maturity, the need for risk reduction in the central

government debt policy is deemed to be limited. An overall assessment indicates now is not the time to change the guideline for maturity in the central government debt.

The goal for market maintenance and debt management is being introduced and clarified in the guidelines for 2006. Market maintenance must not lead in the long term to higher loan costs for central government borrowing and debt management.

The main points in the Government's guidelines for central government debt management are:

- The maturity measure for the nominal krona and foreign currency debts is changing from the duration to the average interest rate refixing period. The risk mandate for the Debt Office to take interest rate positions continues to be stated in terms of duration and covers debt management at both the strategic and operational levels;
- The foreign currency debt is to decrease in the long term to 15 per cent of the central government debt. The foreign currency debt is to be amortised by SEK 25 billion in 2006 and the aim for 2007 and 2008 is an amortisation of the same amount. The Debt Office may deviate from this benchmark by SEK ±15 billion;
- The percentage of inflation-linked debt is to increase in the long term to 20 per cent of the central government debt. The Government is also of the opinion that the goal for the rate of growth in the stock of inflation-linked loans could be lowered somewhat;
- In addition to inflation-linked krona and foreign currency borrowing, central government financing needs are to be met by nominal krona loans;
- The benchmark for the average interest rate refixing period is to be 3.1 years for 2006, with the same benchmark being

the aim for 2007 and 2008. The Debt Office may take interest rate positions not exceeding 0.5 years duration. The risk mandate covers both the strategic and operational levels;

- The Debt Office is to use market maintenance and debt management measures to help make the markets function better. Such measures must not entail setting aside the goal of long-term cost minimisation.

It is the Government's presumption that the requests made earlier concerning the management of the composition of the debt and a comprehensive maturity measure for the central government debt as a whole will at the latest be completed and delivered in the next guidelines proposal, which will be presented in the autumn of 2006.

2 Introduction

In 1998, the Sveriges Riksdag decided on objectives and a decision-making structure for central government debt policy (Government Bill 1997/98:154, bet. 1997/98:FiU29, rskr. 1997/98:253). Section 5 of the statute (1988:1387) on central government borrowing and debt management stipulates that the general goal of central government debt management is to minimise the cost of the debt in the long term while taking into account risk. In addition, the debt is to be managed within the constraints imposed by monetary policy.

The Riksdag's 1998 decision means that the Government is to decide on guidelines for the Debt Office's management of the central government debt no later than November 15 every year. The decision is made after the Debt Office has presented its proposed guidelines and the Sveriges Riksbank has been given the opportunity to comment.

The Debt Office submitted its proposed guidelines on September 21, 2005 and the Riksbank's comments were received on October 17, 2005. These comments are reported in Section 4.4, Maturity. The same section considers parts of the submission of the Swedish Pension Insurance Society for Government Employees (Tjänstepensionsförbundet) (Fi 2005/4550) on measures connected with the implementation of the Pension Fund Directive.

Upon completion of each year of debt management, the Government presents an evaluation of central government borrowing and debt management to the Riksdag no later than April 25. The report contains an evaluation of the Government's guidelines as well as an evaluation of the decisions taken by the Board of the Debt Office and decisions taken at the operational level.

3 The Basis for the Government's Guidelines

3.1 The Structure of the Central Government Debt

The general goal of central government debt policy is to minimise the cost of the debt in the long term while taking into account risk. Thus the decision on the guidelines for debt management involves a balance between the expected total costs and the total risk that the central government is willing to assume.

Three types of debt are used in borrowing and managing the central government debt:

- Nominal loans in Swedish kronor;
- Inflation-linked loans in Swedish kronor;
- Nominal loans in foreign currency.

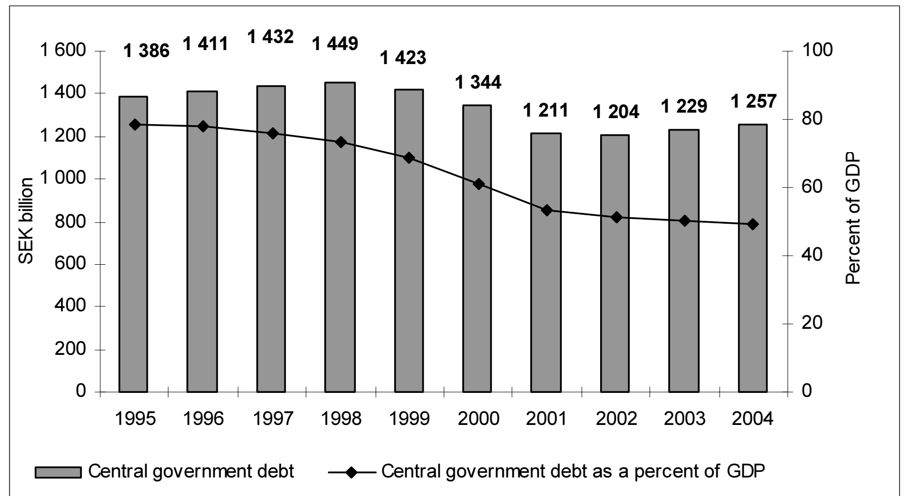
The debt's characteristics are primarily determined by the distribution between the three types of debt and the choice of maturity in the respective types of debt. These quantities, along with the absolute size of the debt, are critical in estimating the total cost and risk that may be expected in the management of the central government debt. The Government's decision on the guidelines therefore is designed so that the central government debt taken as a whole will have the characteristics sought in relation to the long-

term goal. Deviations from the guidelines should, in this context, be regarded as secondary in relation to the goal for central government debt management.

At the end of 2004, the central government debt came to SEK 1,257 billion, an increase of SEK 28 billion compared with the end of 2003.[1] The central government debt as a percentage of GDP comes to less than 50 per cent. The Government's decision on the guidelines refers to all debt instruments issued by the Debt Office, that is, even those held by other central government public authorities. The debt measure is called the unconsolidated central government debt.

[1] Refers to the unconsolidated central government debt, i.e., the official debt that the Debt Office manages and reports. The Budget Bill and the central government's annual report generally show a consolidated debt measure that excludes the holding of government securities by public authorities.

Diagram 1: Central Government Debt, 1995–2004 (SEK billions and per cent of GDP).



Source: Swedish National Debt Office.
Note: From January 1, 2003 the central government debt is reported under new principles. In the diagram, the central government debt has been adjusted and reported for 1999–2004 in accordance with the new principles.

Nominal loans are traditionally the central government's most important source of financing. The percentage of nominal loans came to 61 per cent towards the close of 2004. Most of the nominal borrowing is in treasury bonds (loans having a maturity of more than one year at the time of issue). Also included in the nominal loan category is the bulk of the borrowing in the private market, which offers the Debt Office opportunities to diversify its borrowing to include more lenders such as private persons, smaller companies and organisations. The borrowing in the private market includes lottery bonds and National Debt Savings Accounts. The

percentage of foreign currency borrowing grew rapidly during the first half of the 1990s, from less than 10 per cent to almost 29 per cent of the central government debt in the fiscal year 1994/95.

Table 1. Size and Structure of the Central Government Debt, 2001-2004, and on October 31, 2005 (SEK billion and per cent).

	2001	2002	2003	2004	2005
Nominal debt in kronor	687	671	726	766	767
Per cent	*56*	*56*	*59*	*61*	*60*
Inflation-linked loans	117	158	173	190	202
Per cent	*10*	*13*	*14*	*15*	*16*
Foreign currency debt	407	375	330	301	309
Per cent	*34*	*31*	*27*	*24*	*24*
Unconsolidated central government debt	**1 211**	**1 204**	**1 229**	**1 257**	**1 278**

Source: Swedish National Debt Office.
Note: Debt in foreign currency is revalued using the exchange rates at the end of each year. From 2003, the central government debt is reported in accordance with a new and more accurate measure (see, for example, the Debt Office's 2002 annual report). For comparative purposes, the central government debt for 2000-2002 shown in Table 1 has been recalculated in line with the new definition.

Inflation-linked loans fulfil an important function in the central government debt portfolio because they make possible diversification of the central government debt beyond nominal krona and foreign currency borrowing. The total risk in the central government debt can thus be reduced. The quantity of inflation-linked bonds has steadily increased since they were first issued in 1994. At the end of 2004, they constituted about 15 per cent of the central government debt.

During the latter half of the 1990s, the percentage of foreign currency debt remained stable at about 30 per cent of the central

government debt, only to resume increasing a little at the beginning of the 2000s. However, in the past three years, the percentage of foreign currency debt has fallen sharply and at the end of 2004, foreign currency debt constituted 24 per cent of the value of the central government debt. The lower proportion of foreign currency debt can be explained chiefly by the strengthening of the krona in 2002 and 2003. But the amortisations of the foreign currency debt in recent years have also contributed to the reduction. For reasons of cost, the Debt Office has chosen to raise loans in Swedish kronor and by debt swaps (kronor/foreign currency swaps), convert the loans to debt in foreign currencies. In recent years this has been the main technique for creating foreign currency debt. Today instruments for managing the debt are responsible for almost half of the value of the foreign currency debt.

3.2 The Basis for the Decision on the Guidelines

The Basis for the Government's Decision As in previous years, this year's decision on the guidelines has a three-year perspective and refers to the years 2006 to 2008. The guidelines for 2007 and 2008 are preliminary and may, in future, be changed.

The maturity measure for the nominal krona and foreign currency debts is changing from the duration to the average interest rate refixing period.

The Debt Office's mandate to take interest rate positions should continue to be stated in terms of duration and should cover activity at both the strategic and operational levels.

Key Positions Taken in Previous Years' Guidelines

In earlier decisions on the guidelines, the Government has taken a position on a number of issues with the aim of making clear the principles and preconditions on which central government debt policy is based. For example, the time perspective and advance planning in central government debt policy, cost and risk measures in central government debt management, and the composition and maturity of the debt have been addressed.

Time Perspective and Advance Planning in Central Government Debt Policy

The Government's guidelines are drawn up with a longer and strategic time perspective and are primarily an expression of the

Government's view on how to balance expected cost and risk in managing the central government debt. The guidelines will not normally be based on market trends for such matters as actual or projected exchange rates or interest rate levels. It is primarily the task of the Debt Office to monitor and adjust its actions on an ongoing basis while adhering to the flexibility afforded by the Government's guidelines. However, this does not preclude the Government in certain exceptional cases from taking into account in the guidelines circumstances in the financial markets that are of immediate importance or from being compelled to act during the current financial year. One such example is the depreciation of the krona between 2001 and 2002 when for reasons of cost, the Government chose to rein in the amortisation of the foreign currency debt in a situation in which the krona deviated substantially from what was deemed to be a level justified by economic fundamentals. However, it should be emphasised that such adjustments must always be in line with the general goal of central government debt policy.

The Government's guidelines should thus be drawn up with a strategic and multiyear direction. That it takes time to have any impact on the character of the central government debt, for example, its composition and changes in maturities, also strengthens the argument for a debt policy that is long term in nature and employs advance planning. The Government has chosen to establish a three-year perspective for the guidelines, in part because it has seemed natural for the guidelines to encompass the same time horizon as the expenditure ceilings in the central government budget normally do.

Cost and Risk Measures in Central Government Debt Management

Earlier proposals and decisions on the guidelines discussed how the debt's expected cost and risk were to be defined and measured. In its decision on the guidelines for 2000, the Government stated that in any consideration of the structure of the central government debt and its maturity, the average running yield should be used to measure costs. The risk was to be measured as the variation in the average running yield, which provides a measure of the probability of rising interest rates.

At the same time, the Government decided that the risk in managing the central government debt should also be measured as the debt portfolio's contribution to fluctuations in the budget balance and the central government debt. The Asset and Liability Management (ALM) theory is the inspiration for this supplementary real risk measure. The basic idea is that financial risks can be minimised by matching the liabilities' characteristics with those of the assets. In the implementation of central government debt policy, this means that the central government can reduce the risk in the debt portfolio by structuring a debt portfolio in which interest costs co-vary with the budget balance (excluding interest payments). This means that a debt portfolio that typically has low costs when government finances are strained (for example, due to a deep economic downturn) is less risky than one having high costs in such a situation.

Other, secondary risks that have been identified are the general government balance risk (the risk that interest payments will make the general government balance worse) and the market value risk (referring to fluctuations in the debt's market value).

New Maturity Measure – Average Interest Rate Refixing Period

The Debt Office recommends changing the maturity measure for the central government debt from the average duration to the average interest rate refixing period. The difference between these two measures is that duration is affected by prevailing market interest rates. This is not the case with the interest rate refixing period. Instead the interest rate refixing period is calculated by weighing the time to each cash flow against the nominal values of the cash flows without discounting. It is proposed that the benchmark for the maturity (measured in terms of the interest rate refixing period) in the aggregate nominal krona debt and the foreign currency debt be 3.1 years. This corresponds to the present benchmark of a duration of 2.5 years.

The Debt Office argues that a maturity measure affected by changes in market interest rates may yield undesirable consequences and consequences that are difficult to predict in the course of managing the debt. If interest rates rise, the Debt Office is forced to borrow using longer maturities to compensate for the drop in the duration (and vice versa). In a management system, this characteristic is undesirable. What one wants to control with the choice of maturity is the interest rate refixing risk, that is, the risk of large swings in central government interest rate costs as a result of having to roll over the debt. This can be accomplished by controlling how the debt is structured in terms of bonds with short and long maturities. It is therefore more appropriate to use an instrumental measure that is not affected by changes in market

interest rates since the structure of the short and long maturities will then be independent of the interest rate situation.

In addition to the risk aspect, there are also more practical reasons for changing the maturity measure. It is easier to control the debt in relation to a benchmark expressed in terms of the interest rate refixing period compared with one expressed in duration since the interest rate refixing period is not affected by changes in the interest rate situation. Another advantage is that the borrowing plans become more clearly linked to projected borrowing requirements. With duration as the benchmark, an increase in the borrowing requirement will not necessarily lead to higher bond issuance volumes. For example, currently an increased borrowing requirement, combined with falling interest rates, may entail a drop in the volume of bonds issued. The reason for this is that lower interest rates, other things being equal, lead to an increase in duration, which has to be compensated for by reducing the maturity in the borrowing.

As recently as in this past spring’s evaluation of central government debt policy (2004/05:104), the Government observed that large and unforeseen movements in interest rates risk complicating management of the maturity in the nominal debt and affect the Debt Office's plans for new issues. At the very worst, the Debt Office might be forced to choose between following the maturity guideline or maintaining a liquid bond curve and stable conditions in the Swedish fixed income market. Thus there are reasons for questioning a measure that is affected to such an extent by circumstances outside the Debt Office’s control and that actually risks making an undesirable impact on debt management.

The Government wants to stress the importance of a central government debt policy that is transparent and predictable, a policy in which the maturity measure that is used manages the structuring

of short- and long-term borrowing in a robust and appropriate manner. This points towards the interest rate refixing period as an instrumental measure. The Debt Office also argues in favour of this measure. The argument against this measure is that the duration measure is an internationally accepted concept in the financial world and it also contains information on interest rate risk for a specific position/maturity. Nevertheless, the Government is of the opinion that the reasons for changing to the interest rate refixing period outweigh the counter-argument.

Principles for Limits for Interest Rate Positions

The Debt Office proposes that the risk mandate for interest rate positions be expressed in terms of duration (years), not as a deviation from a maturity benchmark. It is proposed that the mandate for interest rate positions cover all debt management activities, both strategic and operational. The Debt Office should, via its Board, be able to allocate the risk mandate between the two levels.

In the guidelines currently in effect, the Debt Office may deviate from the maturity benchmark for the nominal krona debt and the foreign currency debt by a duration of ± 0.3 years. Changing the maturity measure to the average interest rate refixing period (see above) makes it necessary to revise the deviation mandate.

The Government shares the Debt Office's view on the matter and considers duration to be a suitable measure in a new formulation of the risk mandate. One reason is that duration shows how sensitive a position is to changes in the interest rate, that is, how much the value of the position changes with a change in the interest rate. Furthermore, the duration measure is consistent with the way

in which interest rate positions are normally evaluated. For example, the Debt Office takes strategic positions with the aim of taking advantage for a limited time of longer-term deviations in the fixed income market and thus reducing central government debt costs. Such positions should primarily be evaluated in terms of their market value, an evaluation which implies that the preferred measure is the measure of the interest rate risk in the position (see also the section on evaluation). At the operational level, the active management of foreign currencies is evaluated in terms of market value.

In addition the Government believes that the Debt Office should have the opportunity to decide on the allocation of the risk mandate it has been delegated among strategic and operational activities. Earlier decisions on the guidelines have pointed out that the Debt Office has room for strategic positions based on estimates of interest rate trends in the longer term but that interest rate positions in the active/operational management of the foreign currency debt in certain instances limit the possibilities of taking strategic positions. The formulation of the decisions indicates that it was the Government's intention that the maturity deviation mandate cover all the interest rate risk in the Debt Office's management of the central government debt.The Government sees no reason to abandon the existing principle.

4 Decision on the Guidelines for Central Government Debt Management in 2006

4.1 Foreign Currency Debt

The Government's decision: The foreign currency debt is to decrease in the long term to 15 per cent of the central government debt. The benchmark for the amortisation of the foreign currency debt in 2006 is to be set at SEK 25 billion. The amortisation rate for 2007 and 2008 should remain unchanged at SEK 25 billion a year.

The Debt Office may deviate from the specified amortisation rate by SEK ±15 billion.

The Debt Office's proposal: The percentage of foreign currency loans in the central government debt should be reduced to 15 per cent in the long term. The proposed benchmark for amortising the foreign debt during 2006 is SEK 25 billion. The Debt Office should be allowed to deviate from this benchmark by SEK ±15 billion. The proposed amortisation rate in 2007 and 2008 is SEK 25 billion a year.

Reasons for the Government's decision: From a long-term perspective, the risk arguments clearly indicate that the foreign currency debt should be reduced. The reason for this is that foreign

currency debt has more risk than nominal krona debt since it is associated with an exchange rate risk. Another reason is that there should be scope to increase foreign currency borrowing in a crisis situation. Foreign currency borrowing is a flexible instrument. Experience from the economic crisis of the 1990s indicates that when the borrowing requirement increases dramatically, it may be advantageous to borrow in foreign currency. It eases the pressure on the domestic fixed income market as well as yielding cost advantages since a large borrowing requirement puts upward pressure on domestic interest rates and weakens the krona. However, if the central government is to have good prospects for swiftly borrowing substantial volumes in foreign currency, the foreign currency debt should not be too large at the outset. Nevertheless, the foreign currency debt should not be entirely eliminated since it contributes to the diversification of the central government debt in terms of the interest rate refixing risk. Including foreign currency debt in the central government debt reduces exposure to Swedish interest rates.

To sum up, choosing the percentage of foreign currency debt requires making a trade-off between the positive properties of the foreign currency debt and the exchange rate risk. The Government considers the current benchmark of 15 per cent to be a reasonable trade-off between these factors. Thus the long-term target for the foreign currency debt is to continue to be 15 per cent.

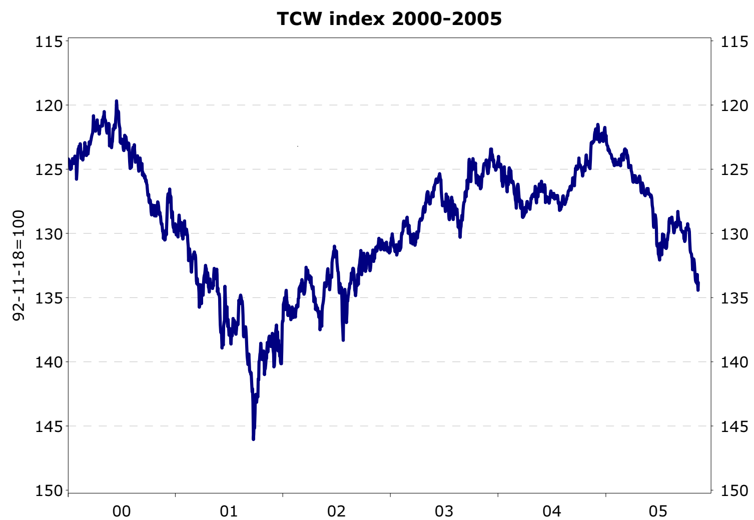
The decision on the guidelines for 2005 specified an amortisation rate for the foreign currency debt of SEK 25 billion a year from 2005 to 2007. This rate constitutes the starting point for this year's decision on the guidelines. The Government sees no reason for abandoning the established direction. The amortisation rate for 2006 to 2008 should be SEK 25 billion a year.

With no change in the central government debt and a stable exchange rate for the krona, an annual amortisation rate of SEK 25

billion means that the target for the percentage of foreign currency in the central government debt will be reached in 2009, according to the Debt Office. Thus for a number of years, the central government's foreign currency debt will be higher than desired in the long term. Because of the relative strength of the Swedish economy, the size of the foreign currency debt is not expected to pose any major problems.

The Swedish krona has been on a downward trend in 2005. The krona is now being quoted considerably below the exchange rate levels forecast in the 2006 Budget Bill.

Diagram 2: The Krona Exchange Rate, 2000-2005 (TCW Index)



The guidelines and the long-term aim for the amortisation rate on the foreign currency debt should not normally be affected by current exchange rates or short-term forecasts of exchange rate trends. Instead it is primarily the responsibility of the Debt Office to adjust the amortisation rate within the prescribed foreign currency mandate, based on a strategic view of the trend in the krona's exchange rate. In the event that the Debt Office chooses to use the deviation mandate for the amortisations of the foreign currency debt, the guideline for the foreign currency debt will be given further analysis. The Government is following developments closely.

In the present situation, the Government believes that in the decision on the guidelines for 2006, deviating from the long-term amortisation aim established in last year's decision is not called for since the weakening of the Swedish krona is deemed temporary. It should also be pointed out that the central government finances and the economy are generally in better shape than they were at the time of the decision on the guidelines in 2001 and 2002 when the Government for reasons of cost considered it necessary to reduce the amortisations of the foreign currency debt. Moreover, on those occasions the foreign currency debt made up over 30 per cent of the central government debt compared with 24 per cent today. This means that the central government debt and the central government finances should now have significantly less exposure to exchange rate risk.

The Debt Office should continue to be allowed to deviate from this amortisation rate by SEK ±15 billion. The decision on deviations from the benchmark should mainly be based on strategic assessments of trends in the krona's exchange rate. Other reasons may be substantial changes in the central government borrowing

requirement, smoothing the borrowing requirement over the years and borrowing terms in the Swedish fixed income market.

Table 2: Foreign Currency Borrowing and Foreign Currency Debt, Central Government Borrowing Requirement, Change in the Unconsolidated Central Government Debt and Its Size and the TCW Index (SEK billion and per cent)

	2003	2004	2005	2006	2007	2008
Govt. guidelines, net foreign currency borrowing	-25	-25	-25	-25	-25	-25
Foreign currency debt, % of total debt[1]	27	24	23	20	-	-
Central govt. borrowing requirement[2]	47	50	28	36	22	12
Unconsolidated central govt. debt, size[2, 3]	1 229	1 257	1 305	1 335	1 356	1 368
Unconsolidated central govt. debt as a percentage of GDP[3]	50	49	50	48	47	45
TCW – closing rates	128	122	127	124	121	121

Source: Ministry of Finance and the Budget Bill for 2006.

[1] For 2005 and 2006, forecasts by the Debt Office are reported in *Central Government Borrowing*: 2005:3 (October 2005).

[2] The borrowing requirement in a given year is not the same as the change in the size of the central government debt. The change in the value of the foreign currency debt as well as transactions affecting the borrowing requirement but not the reported central government debt and conversely, transactions affecting the reported debt but not the borrowing requirement have to be taken into account.

[3] The unconsolidated central government debt refers to the debt that the Debt Office manages and reports, but does not take into consideration debt instruments.

4.2 Inflation-Linked Krona Debt

The Government's decision: The percentage of inflation linked debt is to increase in the long term to 20 per cent of the central government debt. The rate of increase in this type of borrowing is to be weighed against the growth in demand for inflation-linked bonds and the borrowing costs of other types of debt, with due consideration for risk.

The Debt Office's proposal: The Debt Office has proposed that the guideline for the inflation-linked debt be retained unchanged, that is, that the percentage of inflation-linked loans in the central government debt be increased in the long term to 20 to 25 per cent. The rate of increase should be weighed against the growth in demand for inflation-linked bonds and the borrowing costs of other types of debt, with due consideration for risk.

Reasons for the Government's decision: Since the 2001 guidelines, the Government has striven to increase in the long term the proportion of inflation-linked borrowing in the central government debt. The principal reason is that the risk in the central government debt is decreasing. Inflation-linked instruments have in many respects the opposite risk characteristics of those in the nominal krona instruments. Hence the central government debt should contain both types of debt. A higher percentage of inflation-linked debt thus provides more risk diversification in the central government debt and yields less risk of substantial fluctuations in the central government's interest costs. In the long term, inflation-linked borrowing can, moreover, be expected to be less costly than an equivalent nominal krona borrowing since investors can be

assumed to be willing to pay a premium for protection against inflation uncertainty. The central government can thus borrow at a lower cost by assuming the inflation risk from investors. The greater the uncertainty about future inflation trends, the larger the inflation risk premium is likely to be.

In last year's decision on the guidelines, the inflation-linked guideline was quantified through the Government's support of the Debt Office's proposal to increase the percentage of inflation-linked loans to 20 to 25 per cent in the long-term. With these percentage levels, the inflation-linked debt was deemed to permit an inflation-linked bond market with adequate liquidity, while liquidity in the nominal krona bond market was not judged to be negatively affected. As the Debt Office also points out, it is of strategic importance that the nominal krona borrowing function well and that different types of risk premiums are not allowed to drive up the central government's interest rate costs. The percentage of inflation-linked debt came to SEK 202 billion or about 16 per cent on October 31, 2005 and has risen by over one percentage point a year since 2001.

Prior to this year's decision on the guidelines, the Debt Office was requested to make a more in-depth analysis of how a comprehensive maturity measure for the entire central government debt should be defined and handled. The aim was to achieve a broader analysis and basis for a decision on how the inflation-linked and nominal components of the central government debt interact and what central government debt policy considerations ensue. This task, which has only been partially completed in this year's proposed guidelines, will be resumed in next year's guidelines proposal.

The Government wants to emphasise the importance of an overall view and a balance between the nominal and inflation-linked borrowing in the central government debt. The selection of

instruments in both parts of the central government debt may be viewed as communicating vessels; a non-issue of inflation-linked bonds means more issues of nominal instruments. There is therefore a risk that the guideline as it now stands, chiefly in the long term, will create uncertainty about the division between real and nominal borrowing in the krona bond market. It probably would make a difference if the long-term percentage of inflation-linked debt were in future to increase by SEK 50 billion from current bond stocks or if the increase were to be over SEK 100 billion. Such an uncertainty may be assumed to be especially problematic during periods when borrowing and issue needs are small or if the central government debt is in the process of adjusting to a shorter average maturity.

The Government has therefore chosen to fix the lower part of the current target interval (that is, 20 per cent) as the benchmark for the percentage of inflation-linked debt, pending the Debt Office's analysis of the matter. This decision is also supported by the fact that the interval around the percentage of the inflation-linked debt for 2005 was intended to be temporary until the optimal target for the percentage of inflation-linked debt was firmly established. There is nothing to prevent the Government from later revaluing the target for the percentage of inflation-linked debt in the event that important reasons for doing so emerge.

The Government is also of the opinion that the rate of growth in the stock of inflation-linked loans could be lowered somewhat. One reason is that the stock of inflation-linked bonds is now approaching the size and critical mass considered sufficient for stable issuance conditions and functionality in the market for inflation-linked instruments. The favourable trend in the borrowing requirement and current low interest rate levels also mean that there is somewhat less need of rapid risk diversification. In addition some prudence is called for in the allocation between real and nominal

krona debt before 2006 when new rules for occupational pensions are expected to take effect and the demand for nominal instruments in particular is expected to increase.

It is the Government's opinion that all these factors argue for a somewhat slower build-up of the stock of inflation-linked bonds in the years ahead. This can be accomplished, for example, by a decision by the Debt Office on an issuance rate net of inflation-linked bonds that is lower than it has been in recent years. It should be pointed out that the trend in the borrowing requirement and the central government budget, other things being equal, means that the proportion of inflation-linked debt should increase more rapidly than what earlier forecasts called for.

However, it should be made clear that as before, it is the Debt Office that is responsible for judging the trade-off between minimising the expected costs and reducing the risk in debt management. Thus the Debt Office should continue to weigh the rate of increase in inflation-linked borrowing against the growth in demand for inflation-linked bonds and the costs of other types of debt, with due consideration for risk.

4.3 Nominal Krona Debt

The Government's decision: In addition to inflation-linked krona and foreign currency borrowing, central government financing needs are to be met by nominal krona loans.

The Debt Office's proposal: The guidelines for central government debt management are based on a division of the debt into three components: the foreign currency debt, inflation-linked krona debt and nominal krona debt. With stated guidelines for inflation-linked borrowing and foreign currency borrowing, it follows by definition that the central government's financing requirements are otherwise to be covered by nominal krona borrowing.

Reasons for the Government's decision: The nominal krona market represents the central government's most important source of financing. In recent years it has made up about 60 per cent of the central government debt. Given the goal for amortising the foreign currency debt, the limitations on inflation-linked bond issues and the ongoing borrowing requirement in the central government finances, nominal borrowing will also represent the central government's most important source of financing in the coming years. The changes that occur in the gross borrowing requirement during a fiscal year can easily be managed by the Debt Office's regular auctions of nominal bonds and treasury bills. The nominal krona market thus also functions as a buffer in the event that there are fluctuations in the borrowing need, or if plans for the other types of debt should change.

4.4 Maturity

> The Government's decision: The benchmark for the average interest rate refixing period is to be 3.1 years in 2006. For 2007 and 2008, the aim is for the maturity to remain unchanged.
>
> The Debt Office may take interest rate positions not exceeding 0.5 year's duration.

The Debt Office's proposal: The Debt Office has conducted a special analysis of the question of whether the trend in the fixed income market provides grounds for changing the existing benchmark for the maturity. It is the Debt Office's view that there are indications that a more durable change in the relation between short and long maturities may be coming but at the same time, there is reason to hold off on a decision on lengthening the maturity in order to be able to make a better assessment of the nature of the changes. Furthermore, the current interest-rate difference between short- and long-term interest rates (up to 10 years) is not particularly small, viewed in a historical perspective. The Debt Office therefore proposes leaving the benchmark for the maturity (measured in terms of the interest rate refixing period) unchanged in the aggregate nominal krona and foreign currency debt at 3.1 years in 2006. This is in principle equivalent to the existing benchmark of 2.5 years' duration. The aim for 2007 and 2008 should remain unchanged.

Reasons for the Government's decision: The Government decided to lower the benchmark for the average duration in the nominal krona and foreign currency debts from 2.7 years to 2.5 years at the end of 2005. This was done with the aim of reducing the cost of the central government debt. Since the maturity in the total debt had risen as a result of the increase in inflation-linked

borrowing and the decrease in foreign currency borrowing, it was the Government's opinion that there was room for a shorter maturity in the nominal debt without any appreciable increase in the total risk.

The Government notes that some unusual conditions in the fixed income market have emerged during the year. The slope of the Swedish yield curve has been flatter in 2005. The demand for Swedish long-term nominal bonds has been strong. At the same time, short- and long-term interest rates are at historically low levels. Two reasons usually cited are the channelling of Asian countries' surplus savings to the American and European bond markets at the same time that private pension savings are increasingly being invested in long-term nominal bonds. Simultaneously the low inflation in many countries has provided scope for low short-term interest rates. It is unusual for there to be so little difference between long and short maturities at the same time that short-term interest rates persist at a low level. These conditions can be attributed both to an international trend and to specific conditions in Sweden, such as speculation about the effects of the new supervisory model for life insurance companies that the Swedish Financial Supervisory Authority (Finansinspektionen) intends to introduce at the end of the year.

However, it is the Government's view that this state of affairs does not constitute sufficient reason to lengthen the maturity in the central government debt now. The slope of the Swedish yield curve from a long-term perspective is a key issue when the Government has to decide the balance between expected cost and risk in central government debt policy. A relatively flatter yield curve means, other things being equal, that it will be cheaper to reduce the risk in the central government debt policy by lengthening the maturity in the nominal part of the central government debt. The flatter slope of the

Swedish yield curve in 2005 could thus provide a motive for lengthening the average maturity in the debt. However one argument against this is that from a historical perspective, the slope is not particularly flat, at least not for maturities up to ten years. Another factor is how long the flatness of the curve can be sustained. Several factors, such as deeply rooted inflation expectations and changes in demographic savings patterns, indicate that structural changes in the demand for long-term bonds may be under way. However, it is still too early to tell whether or not the changes will be lasting.

In addition, even if it becomes less costly to reduce the risk by lengthening the maturity, there appears to be limited need of risk reduction in the central government debt policy. Central government finances continue to develop favourably, with the borrowing requirement and the central government debt in terms of GDP both estimated to fall in the next few years. In addition risk diversification with a greater percentage of inflation-linked debt is expected to continue. An overall assessment therefore indicates that now is not the appropriate time to change the guideline on the maturity of the central government debt.

Table 3. Interest Rate Refixing Period and Duration (in Parentheses) in the Central Government Nominal Debt at Year-End.

	2001	2002	2003	2004
Nominal krona debt	3.3 (2.7)	3.1 (2.6)	3.3 (2.8)	3.8 (3.1)
Foreign currency debt	2.7 (2.2)	2.6 (2.3)	2.6 (2.2)	2.2 (1.9)
Inflation-linked debt	11.2 (9.6)	12.4 (10.8)	12.4 (11.0)	11.9 (10.9)
Total, excluding inflation -linked debt	3.1 (2.5)	3.0 (2.5)	3.1 (2.6)	3.3 (2.8)
Total, including inflation -linked debt	4.0 (3.1)	4.4 (3.6)	4.6 (3.8)	4.8 (4.1)

Source: Swedish National Debt Office.

In section 3.2, the Government points out that the decisions on the guidelines are to be based on the essential characteristics of the various debt instruments. They should not normally be based on prevailing or projected interest rate levels or exchange rates. Consequently it is not primarily the Government that is to act should the market situation present opportunities that are advantageous to the central government debt policy. The Government therefore wants to underline that it is the Debt Office's task to monitor market trends on an ongoing basis and to adjust its borrowing activities when such an opportunity arises. The Debt Office has also been given the room to enable it to take positions based on its assessment of interest rate trends.

The Government assumes that the Debt Office will make use of this room if it is warranted from a cost perspective and is not contrary to what constitutes good market maintenance. Hence the Debt Office should take advantage of opportunities to reduce the

risk in the central government debt if it is possible to do so without too high an increase in the cost of the central government debt.

The Debt Office's Risk Mandate for Interest Rate Positions

In section 3.2, the Government states the principles for drawing up the risk mandate for interest rate positions. Interest rate positions are to be stated in duration and include the interest rate risk in managing the entire debt, that is, both interest rate positions on the strategic level and interest rate positions in the active foreign currency management at the operational level. The Debt Office is proposing that it be allowed to take interest rate positions in the nominal debt of up to 0.5 year's duration. This is estimated to allow room for interest rate risk positions totalling SEK 5.7 billion[2].

The Government is of the opinion that it is important that the Debt Office be given the room needed to take positions when the guidelines permit and it is deemed appropriate. In the guidelines currently in effect, the Debt Office may deviate from the maturity benchmark for the nominal krona and foreign currency debts by a duration of ± 0.3 years. In addition, the Government has stated that taking positions in the active management of the foreign currency debt (the operational level) in certain instances limits the possibilities of the Debt Office to take strategic interest rate positions. According to the annual report, there has been room in the active foreign currency management in recent years for interest rate positions having a duration of about 0.2 years. Against this background, the room for interest rate positions appears too limited

[2] The calculation of the interest rate risk is based on a market value for the nominal debt of SEK 1,138 billion on July 31, 2005 (Debt Office calculations).

The Government therefore supports the Debt Office's proposal for a risk mandate for interest rate positions not exceeding a duration of 0.5 years. Formally this appears to give the Debt Office more scope to take on interest rate risk, but in practice it does not signify any major change from the current situation. The current strategic maturity measure has mostly been perceived as independent of the interest rate risks at the operational level. According to the Debt Office, the maximum interest rate risk comes to SEK 5.7 billion, an amount that appears reasonable, particularly when the Debt Office has earlier been seen to make use of its assigned risk mandate in the active management of foreign currencies on a limited scale.

The Riksbank's Comments (Fi 2005/4589)

In its comments, the Riksbank states that the Debt Office's proposal seems reasonable from a central government debt policy perspective, but that there may be reason for the central government to take other aspects into consideration in the decision on the guidelines. The Riksbank points out the trend to higher pension savings at the same time that the responsibility for saving is increasingly being transferred from the public sector to individuals and households. This process would be facilitated if there were access to bonds with maturities that meet long-term savings needs better than bonds do today. The central government in taking a broader view would thus have an interest in issuing bonds having a long maturity. Similar views have also been presented from other quarters, for example, in the submission of the Swedish Pension Insurance Society for Government Employees (Fi 2005/4550) to the

Government on instructing the Debt Office to issue bonds with long maturities.

In the Government's judgement, what is stated in the comments and submission does not primarily fall within the goal for central government debt policy or the current mandate of the Debt Office. In principle letting considerations other than cost and risk form the basis for the practical formulation of debt management is questionable.

The Government wishes to point out that the increased demand for bonds with long maturities is not a uniquely Swedish phenomenon but an international fact. Most debt managers operate under a mandate calling for long-term cost minimisation with due consideration for risk. In adhering to this goal, some debt managers, chiefly those of major borrowers, have found the room to issue long-term government securities, thereby providing risk free reference rates in the long end of the yield curve. The United Kingdom, France and Italy were among the countries issuing government securities with very long maturities in 2005.

The possibilities of creating good liquidity in many maturities are limited for smaller debt managers such as the Debt Office. The debt's average maturity and the trend in the central government borrowing requirement largely decide how far out on the yield curve the central government can issue before there is a negative impact on liquidity and issuing conditions for other maturities. Current Swedish conditions with a limited borrowing requirement and, from an international perspective, a debt with a relatively short maturity mean that it is problematical to issue and develop liquid bond loans in the very long maturity segment. Issues of this type, while taking into account the general goal of debt management, must probably be rejected.

There may, however, be other reasons for considering an increase in the supply of long-term government securities compared with 2005. For example, the supply of bonds is especially affected during periods when the maturity of the central government debt is being shortened, as it was in 2005. Issues of long-term government securities are therefore likely to increase once the adjustment to a shorter refixing period is accomplished.

It should also be pointed out that the central government is not the sole issuer in the fixed income market. Other issuers such as housing credit institutions, municipalities, intergovernmental bodies, and others, are becoming increasingly important actors in the creation of a liquid bond market.

4.5 Market Maintenance and Debt Management

The Government's decision: The Debt Office is to use market maintenance and debt management to help make the markets function better. This must not entail setting aside the goal of long-term cost minimisation.

The Government considers it important to have a well-functioning bond market. It is therefore the Debt Office's task to improve the way in which the market functions and create a liquid yield curve in the Swedish fixed income market through market maintenance and debt management. It does this by regular issuances of both nominal and inflation-linked government securities with different maturities. Other important tasks are a transparent and predictable borrowing policy and concentrating the borrowing to a limited number of maturities. However, all market maintenance and debt management must be in line with the general goal of central government debt policy. Hence market maintenance must not lead in the long term to higher loan costs for central government borrowing and debt management.

At a strategic level, market maintenance and debt management deal chiefly with establishing principles under which operational borrowing and management are to be conducted. The Debt Office's borrowing strategy and guiding concepts such as predictability, long-term perspective and transparency are among the important principles found here. At the operational level, it concerns bond trading and purchasing, market maintenance, repos, and so forth. As the Government usually notes in its annual evaluation, it is often difficult to quantify precisely what effect the Debt Office's principles and measures have. Therefore the evaluation is primarily a qualitative art.

In the past, this goal has been expressed with the same wording used in the appropriation decisions for the Debt Office. Beginning in 2006, the goal will become part of the Government's decision on the guidelines.

5 Evaluation of Central Government Borrowing and Debt Management

The Government's decision: For 2006 the Debt Office is to establish internal guidelines based on the Government's decision on the guidelines. The internal guidelines are primarily to deal with the allocation of the debt among the different types of debt in the debt portfolio and the maturity benchmark for the nominal types of debt.

The evaluation of the Debt Office's strategic decisions is to be made in qualitative terms and in the light of the information available at the time the decision was taken. Where possible, the evaluation should be conducted in quantitative terms, for example, by contrafactual estimates. Strategic foreign currency and interest rate positions are primarily to be evaluated in terms of their market value.

The evaluation of the operational management is to concern a quantitative evaluation of the foreign currency management and the conduct of foreign currency trades as well as a qualitative evaluation of the nominal and inflation-linked krona debt management. For inflation-linked borrowing, the realised difference in cost between the inflation-linked and nominal borrowing is to be reported.

Background

By April 25 every year, the Government, in accordance with a decision by the Riksdag, is to present to the Riksdag a written report evaluating central government debt management. Under the decision, the evaluation is to take place at different levels. Thus the Government is to evaluate the decisions made by the Board of the Debt Office as well as the decisions made at the operational level. In addition an evaluation of the Government's guidelines is to be included in the report to the Riksdag.

The Parliamentary Committee on Finance has pointed out in its report (2005/06:FiU12) on central government borrowing and debt management from 2000 to 2004 that the evaluation process for debt management differs significantly from models used in other connections and there is reason for the Government to consider a clearer division of responsibility between the Riksdag, the Government and the Debt Office. The Government intends to deal with the question of the evaluation of central government borrowing and debt management in greater detail in the spring of 2006.

The goal of central government debt policy is long term in nature and it is thus natural to do the evaluation using a time perspective in which temporary fluctuations in the results are smoothed out. The Government therefore uses rolling five-year periods in its evaluation of debt management. The evaluation of the decision on the guidelines for 2006 will thus concern the years 2002 to 2006.

Evaluation of Central Government Debt Management in 2006

Evaluation of the Government's Guidelines

The Government's decision on the guidelines should be evaluated directly against the long-term goal of central government debt management. The report to the Riksdag should thus refer primarily to the strategic considerations and be made in the light of the knowledge forming the basis for the decision on the guidelines. Another requirement is that the evaluation must be conducted following principles established in advance. Otherwise the evaluation risks being arbitrary since it is always possible with hindsight to construct other guidelines or debt portfolios that would have resulted in lower costs and/or lower risk.

One key factor in the decision on the guidelines should be the Government's appetite for risk. The basic assumption should be that the debt portfolio selected should have a lower cost and/or lower risk than other portfolios. Debt portfolios that have undue risk, for example, those with little or no diversification, should thus be rejected even though they afterwards prove to have had a lower cost than a portfolio with less risk. Quantitative measures should, when deemed possible, provide the starting point for the analysis. Quantitative analyses should be supplemented with qualitative considerations and judgements.

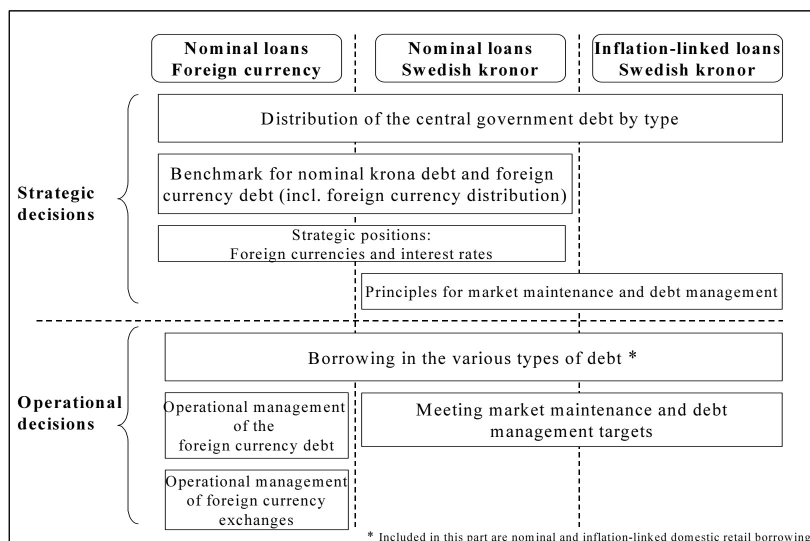
Evaluation of the Debt Office's Management of the Debt

Alongside the Government's guidelines, the responsibilities of the Debt Office and the tasks it performs managing the central government debt are regulated in the instruction for the Debt Office (1996:311). In addition the Government delegates a number of decisions to the Debt Office. These decisions are set out in the section on evaluation of the guidelines (see below). The goal and regular reporting on borrowing in the private market can be found in the appropriation directions for the Debt Office.

Within the framework of the goal of central government debt management and the Government's guidelines, the Debt Office is to establish intermediate objectives and internal guidelines for the operational management of the debt. These decisions, known as strategic decisions, are established by the Board of the Debt Office. The activities of the Debt Office are thus evaluated on two levels; one level is the strategic decisions taken by the Board of the Debt Office and the other is the operational management carried on by the Debt Office. In addition there is a separate evaluation of borrowing in the private market.

The following figure provides a schematic overview of the Debt Office's strategic and operational decisions.

Evaluation of the Debt Office's Strategic and Operational Decisions



The Debt Office's Strategic Decisions

The evaluation of the strategic decisions refers to the Debt Office's internal guidelines and includes several key decisions.

– *Decision on the allocation of the debt between different kinds of debt within the limits for the intervals set by the Government;* the Debt Office's flexibility here stems from the interval around the benchmark for the foreign currency debt amortisation rate and from the guideline on increasing the proportion of inflation-linked debt.

Decisions on using the foreign currency mandate are based on strategic long-term assessments, principally the trend in the krona's exchange rate, and should thus be evaluated from that perspective.

An assessment of the correctness of at some point limiting the amortisation of the foreign currency debt must largely be based on a review of the reasonableness of the analysis that originally led to the decision. The quantitative evaluation of the Debt Office's handling of the foreign currency mandate can be made by contrafactual comparison of two simplified calculations in which the amortisations take place at a uniform rate over the the period to be evaluated – one equivalent to the benchmark in the guidelines and the other corresponding to the Debt Office's decisions. Using the actual amortisation profile is not meaningful since it presents an uneven pattern.

Other decisions on the distribution of the debt between the various types of debt probably cannot be quantitatively evaluated in a meaningful way. The pace of inflation-linked borrowing should be weighed against the costs and risks associated with other types of debt.

– *Decisions on the benchmark for the nominal krona debt and the foreign currency debt*; The decisions taken by the Government include a decision on how the interest rate refixing period it specified is to be divided between the two portfolios and a decision on the distribution of currencies found in the foreign currency debt.

The evaluation of the Debt Office's decision on how the maturity is to be divided between the nominal krona debt and the foreign currency debt is as far as possible to be made using contrafactual comparisons.

Mostly qualitative terms are to be used to evaluate the foreign currency benchmark since there are no reasonable norms for quantitative comparisons. It is primarily analyses and arguments for a specified benchmark composition and an analysis of whether or not the conclusions can be considered valid that should be reported. To the extent that partial analyses have been allowed to influence

the distribution in the benchmark, the grounds for doing so are to be reported and a basis enabling a quantitative follow-up is to be presented.

– *Decisions on strategic positions*; these decisions refer to strategic foreign currency and interest rate positions in foreign currencies and interest rate positions in the Swedish krona debt.

Strategic currency and interest rate positions are primarily to be evaluated in the same manner as the Debt Office's active management of foreign currencies is evaluated; that is, by placing positions in their own portfolio, which is continuously monitored for results and evaluated in market terms. In most cases, strategic interest rate positions are likely to be taken in the foreign currency debt with the help of derivative instruments. The reason for this is that transaction costs are lower and flexibility is greater there than in the nominal krona market. At the same time, the yield curves in various markets generally show significant co-variation.

However, were the Swedish yield requirements to deviate significantly from those in foreign markets it could occasion a situation in which the Debt Office saw cause for changing the duration in the nominal krona debt in particular. Here there is limited room for using derivatives. Instead the decision may be made to change the issuance plans in order to make a gradual change in the duration of the krona debt. In that event, no clear-cut position emerges that can be assessed in terms of market value. A strategic decision such as this to change the duration should therefore be evaluated in terms of its impact on the average running yield.

– *Decisions on principles for market maintenance and debt management*; these decisions refer primarily to the choice of principles and expectations as to whether these decisions may lead to the desired results.

The Debt Office's Operational Management

Evaluation of *the active management of the foreign currency debt* is to be done in market value terms. The result shows the extent to which the management of the debt has led to a gain or a loss.

The nominal and inflation-linked krona debt management is to be evaluated primarily in qualitative terms. This evaluation concerns the market maintenance and debt management that the Debt Office conducts with the aim of incurring the lowest possible interest costs (average running yield). The evaluation will thus be primarily qualitative and on an ex ante basis. Moreover, the realised difference in cost should be reported for inflation-linked borrowing. This means that a cost comparison between borrowing in inflation-linked bonds and borrowing in nominal government bonds for the latest five-year period will be reported.

Under the 2002 guidelines, the Board of the Debt Office is to adopt a relatively smooth and cost-neutral path for the Debt Office's *exchanges between kronor and foreign currencies.* The Board is to specify a certain fluctuation interval around this path within which currency exchanges may deviate for practical reasons. The interval is considered neutral with respect to results. In addition the Board is to specify risk limits on how large the currency positions taken by the operational management may be. Within these bounds, the Debt Office can then vary the trades it makes at times when it seems especially disadvantageous. Possible deviations can then be evaluated ex post by calculating differences in costs between the trajectory for the foreign currency trades that are neutral in outcome and the actual trajectory.

6 Requests to the Debt Office

The Government's decision: The Debt Office is to improve its control and evaluation of central government debt management on an ongoing basis.

The Debt Office is to conduct a more detailed analysis of how the fluctuation interval around each debt percentage's benchmark should be designed and how a comprehensive maturity measure for the whole of the central government debt should be defined and handled.

Development work completed this year, the request for a comprehensive maturity measure and the request that concerns managing the proportions of each type of debt will be reported no later than in the next guidelines proposal, which will be presented in the autumn of 2006.

In the decision on the guidelines and the appropriations directive for 2005, the Debt Office was requested to examine how the fluctuation interval around the benchmarks for the debt percentages should be designed and how a comprehensive maturity measure for the whole of the debt should be defined and handled. The reason for the first request was that for the first time, the guidelines for 2005 put in concrete form what proportion of the debt portfolio each of the

various types of debt is targeted to reach in the long term and that a transition to controlling the central government debt management in terms of such proportions appears appropriate. The second request was motivated by the need to establish a better overall view and co-ordination of the real and nominal parts of the debt. Reports on these requests were to have been included in the current guidelines proposal.

The Debt Office states that complex questions are involved and that more time is needed to examine their operational consequences. With respect to a management system for a comprehensive maturity measure for the central government debt, considerable analysis remains to be done. The Debt Office observes that on the matter of managing the proportions for each type of debt, these proportions should be calculated using the unconsolidated debt measure and as percentages of the total debt. The management system strikes a balance between the need for good management and business, practical and operational aspects, which points to a system allowing the proportions of each type of debt to vary within an interval. However, the Debt Office does not yet have any opinion on the size of these intervals. The Debt Office intends to return to these issues in the next proposal on the guidelines to be presented in the autumn of 2006.

The Government wishes to point out that it is urgent that reports on these requests are made at the times specified. This applies especially to the request for a comprehensive maturity measure. The request that concerns managing the proportions for each type of debt is less urgent in this context, since it will still take a few years before the composition of the debt reaches the targeted proportions.

The task of improving the management and evaluation on an ongoing basis was specified earlier in the appropriation directions for

the Debt Office. It requires the Debt Office, alongside its explicit tasks stated in various decisions on the guidelines, continuously to strive to improve and develop central government debt management. The material parts of the development work in a year are normally reported no later than the following year's proposal on the guidelines.