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Summary

This year's decision on the guidelines has been made in a surplus environment with excellent prospects for public finances and a declining central government debt. This means that in principle the scope for risk-taking in debt management increases in exchange for lower expected costs. The Government supports the Debt Office's ambition to review the composition of the foreign currency debt with the cost aspect as the basis.

Otherwise the decision on the guidelines for 2008 leaves the Government's central government debt policy unchanged. This is true of both the control system's design and the target shares that govern the three types of debt: the foreign currency debt, the inflation-linked debt and the nominal krona debt. The Government controls the average maturity of the debt with the help of a maturity target that covers the entire debt.

In addition to the *debt's composition* and *maturity*, the debt's size, prevailing interest rate levels and exchange rates affect the cost of the central government debt. The goal of central government debt policy is to manage the debt so as to minimise the cost of the debt in the long term while taking into account the risks inherent in such management.

Central government debt management is long term in nature. In order to develop a central government debt policy that is predictable and long-term in nature, the Government takes a decision on the guidelines with a three-year perspective. This

year's decision on the guidelines covers 2008-2010, but the guidelines for 2009 and 2010 should be considered preliminary.

The main points in the guidelines for 2008

The composition of the central government debt will remain unchanged from the current year and is to be steered towards the targets of:

- 15 per cent foreign currency debt. The amortisation of the foreign currency debt is to be SEK 40 billion, with a possible deviation for the Debt Office of SEK ±15 billion.
- 25 per cent inflation-linked krona debt.
- 60 per cent nominal krona debt.

The Debt Office's amortisation mandate remains unchanged mainly owing to the continued excellent prospects for public finances and the current rapid adjustment of the foreign currency share towards its target.

The central government debt's comprehensive maturity is being steered towards the target of 4.8 years by the end of 2008. Thereafter the maturity will be shortened as outstanding inflation-linked bonds approach maturity. At the end of 2009 and 2010 this means a comprehensive maturity of 4.6 and 4.5 years respectively. The Government found no decisive reason for changing the targets established in last year's decision on the guidelines.

The risk mandate for the Debt Office's position-taking is unchanged and is to be SEK 600 million, measured as daily Value-at-Risk at 95 per cent probability. The positions will be taken exclusively in derivatives and include all positions except those that involve deviations from the amortisation benchmark.

The Debt Office is to promote the proper functioning of the markets for government securities through market and debt support. This must not entail setting aside the goal of long-term cost minimisation.

The Debt Office is to reduce the costs of central government debt by retail market borrowing. The goal has been clarified to refer to the greatest possible savings in relation to equivalent borrowing in treasury bonds or treasury bills

The Government has instructed the Debt Office to continue to review the analysis that forms the basis for the Government's decision on target shares for the foreign currency and inflation-linked debts. The Debt Office should also review the repo facility's function and design.

2 The Central Government Debt Process

Main goal

The conduct of central government debt policy follows an annually recurring process. This process with its decision-making structure and goals was decided by the Riksdag (the Swedish Parliament) in 1998 (Govt. Bill 1997/98:154, Report 1997/98:FiU29, Riksdag Comm. 1997/98:253). 1997/98:154, Report 1997/98:FiU29, Riksdag Comm. 1997/98:253).

The main goal of managing the debt so as to minimise the cost in the long term while taking the inherent risk into account, all within the constraints imposed by monetary policy is stipulated in the Act on Central Government Borrowing and Debt Management (1988:1387).

The process leading to the decision on the guidelines

Under the Act on Central Government Borrowing and Debt Management, the Government is to decide the guidelines for the management of the central government debt by the Debt Office no later than 15 November every year. The decision is to be made after the Debt Office has presented its proposed guidelines and the Riksbank (the Swedish central bank) has been given the opportunity to comment.

The Government decided the guidelines for central government debt management for 2008 on 15 November 2007. The Ministry of Finance received the Debt Office's proposal on

25 September and the Riksbank's comments on the 17 October 2007 (dnr Fi2007/7456).

The process once the management year ends

The Government is to present a Ministry Communication to the Riksdag with an evaluation of central government borrowing and debt management no later than 25 April. The Debt Office is to submit the basis for this evaluation, together with its annual report, by 22 February.

The aim of the evaluation is to provide an overall assessment of how debt management has been conducted as well as guidance for future decisions on central government debt policy.

Since central government debt policy has a long-term objective and temporary fluctuations may occur, rolling five-year periods are used in the evaluation. Previously there was an evaluation every year but beginning in 2008 the Government will present the evaluation of central government debt policy to the Riksdag every second year. A less frequent follow-up is required now that the central government debt's budgetary impact is decreasing and the central government debt policy process has been established. The Government intends to append an external evaluation of the conduct of the debt policy to the evaluation report to be presented to the Riksdag in spring 2008.

Readers' Guide

This section has described the *central government debt process*. Section 3 sets out the *basis* for the Government's decision on the guidelines. The *guidelines* are given in section 4 as are the reasons underlying the decisions on the guidelines. Section 5 contains a description of how central government debt management *is to be evaluated* and lastly section 6 contains the Government's *remit to the Debt Office* aimed at improving control and evaluation of central government debt management still more.

3 The Basis for the Government's Decision on the Guidelines

The Basis for the Government's Decision: As in previous years, this year's decision on the guidelines covers three years. This year's guidelines cover 2008–2010, but the guidelines for 2009 and 2010 should be considered preliminary.

The control system introduced in 2007, with targets set for each type of borrowing composing the debt, a control interval around the foreign currency share when its target is reached and a maturity measure covering the whole debt remains unchanged.

The maturity measure introduced in 2007, that is, the measure that takes into account the aggregate cash flows (including future coupon payments and compensation for expected inflation), also remains unchanged.

The Government's basic starting points for debt policy are that it is to minimise costs with due consideration for risk and be long term, transparent and flexible. The policy is also based on the expected trend in public finances and on the size of the debt, its composition and its maturity.

3.1 The Size of the Debt and Its Development

Central government budgets have historically had larger deficits than surpluses and central government debt is the result. Changes in the exchange rate have also affected the size of the debt since a considerable share of the debt (including debt management measures) is, and has been, denominated in foreign currencies.

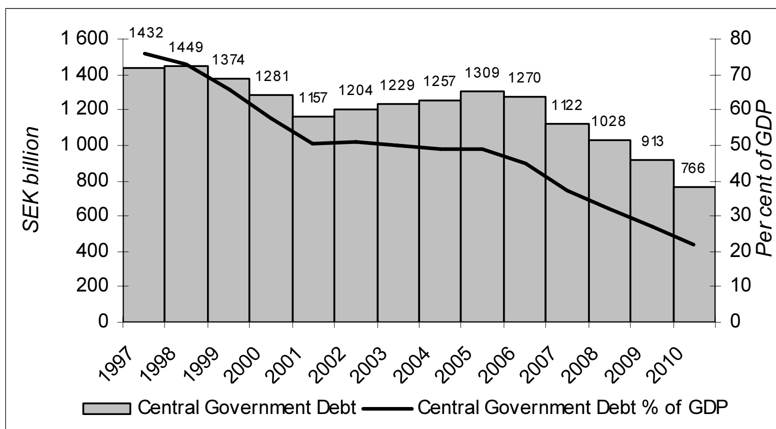
The size of the debt and its risk
Simplified, the cost of the debt is decided by its size and the interest on the loans that constitute the debt. The size of the debt affects not only its cost but also the risks associated with the debt. Generally a larger debt makes the state more sensitive to both rising interest rates and a weaker currency. When there is a large government debt, a deep economic crisis may drive up interest costs to levels that make public finances even weaker. Given these considerations, it is the Government's opinion that a debt portfolio having higher costs when public finances are weak has more risk than a portfolio in which high costs coincide with strong public finances. Thus focused, central government debt policy can help smooth the swings in public finances. The Government has also stated that the debt is to be viewed from an aggregate balance sheet or ALM (Asset-Liability-Management) perspective. This means that the financial risks can be reduced by matching the liabilities' characteristics with those of the assets on the balance sheet.

Trends in central government debt and interest costs
In the last decade, the central government debt has largely been an inheritance from the deep economic and public finance crisis in the early 1990s. Between 1990 and 1994, the debt more than doubled from SEK 600 billion to SEK 1 300 billion, or an increase from 44 to 78 per cent of GDP. A large part of the borrowing was made in foreign currencies, in part to limit the impact on the supply of government securities and interest rates in Sweden.

Public finances have improved in recent years and at the end of 2006, the central government debt came to SEK 1 270 billion, or 45 per cent of GDP. The debt ratio is thus back at the same level it was prior to the crisis in the 1990s.

It is the Government's opinion that the debt will continue to fall in the next few years. In the Budget Bill for 2008 (Govt. Bill 2007/08:1), the debt is estimated to decline to SEK 766 billion[1], or 22 per cent of GDP, by the end of 2010. The lower debt is a result of both expectations of continued strong economic growth and the sale of state assets in the form of shares and public enterprises. The following diagram shows the gradual decline in the debt, both in SEK billions and as a percentage of GDP.

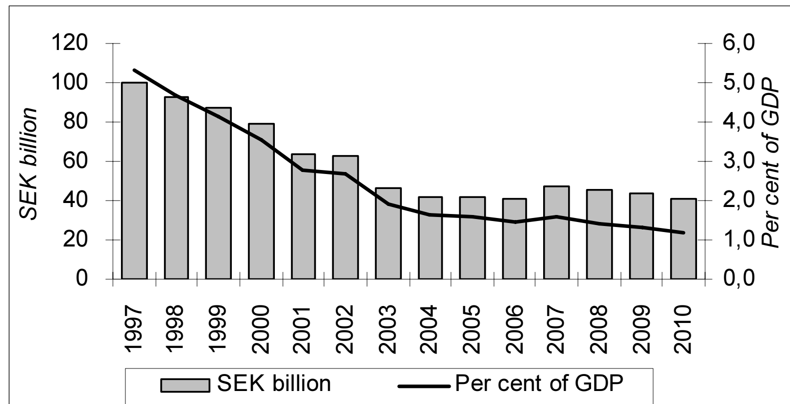
Diagram 1: Unconsolidated central government debt, 1997-2006 and 2007-2010 from the 2008 Budget Bill estimates.



[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 also show a consolidated debt measure that excludes the holding of government securities by government agencies.

Trends in public finances in the coming decades indicate that there will be increased strains on public finances when the proportion of people of working age falls and the proportion of elderly rises[2]. A rising proportion of elderly leads to increased costs for pensions, health care and care for the elderly. These costs certainly have the greatest impact on the old age pension system and the municipal sector. The central government finances may also be weakened as a lower proportion of people of working age also results in lower wage income and thus lower per capita income tax. This may lead to a higher government debt, depending on how robust public finances are to begin with.

Diagram 2: Central government interest costs 1997–2006 and 2007–2010 from estimates in the 2008 Budget Bill.



Concurrent with the reduction in the central government debt, interest costs on the debt have also declined (diagram 2). In the last ten years interest costs have been halved from SEK 100 billion a year to almost SEK 50 billion in 2007. In relation to GDP, the reduction is even steeper as the drop in the same

period is from 5 per cent to 1-2 per cent. As a consequence, the central government debt has less impact on the central government budget than it had previously.

3.2 The Structure and Duration of the Central Government Debt

By controlling the composition and maturity of the debt, the central government can influence expected cost and risk in debt management.

A debt with different types of debt (diversified portfolio) theoretically leads to lower risk. If hypothetically the debt had consisted only of nominal krona loans, interest costs would have been completely dependent on the Swedish nominal interest rate. However, the actual debt includes two other types of debt, inflation-linked krona loans and foreign currency loans. To some extent the interest rates on the two latter types follow patterns of their own.

Three types of debt make up the central government debt:

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

The size of each type of debt in relation to its target

In 2007 a new tool for measuring the proportion of each type of debt that better reflects the total risk exposure in the central government debt was introduced. In addition to the nominal debt, the new CCF measure, the central government debt's *aggregate cash flows*, includes outstanding coupon payments and inflation compensation. In connection with the introduction of this measure, target shares for the different types of debt were also established. The following table shows the actual percentage composition of the debt as measured by the CCF measure at the end of 2006 and 31 August 2007 and the target

shares for the different types of debt (which are the same for 2007 and 2008). The table shows that the proportion of foreign currency debt has fallen during the last six months while the proportion of inflation-linked debt has risen. This trend, which means that the foreign currency debt is declining towards the target share and the inflation-linked debt has moved upwards past its target share, is expected to continue in 2008.

Table 1: Share of each type of debt in relation to its target.(per cent and percentage points).

	Type of debt 061229	Type of debt 070831	Targets 2007-08	Difference (061229 vs	Difference (070831 vs
SEK nom	57	56	60	-3	-4
SEK real	24	26	25	-1	1
Valuta	19	18	15	4	3

Source: The Debt Office

A longer-term look back at trends for each type of debt

The new control system and the share measure were introduced in 2007. There is thus a need to look further back at the trends in the composition of the debt excluding coupons and inflation compensation, that is, in accordance with the old measure.

Looking back, inflation-linked borrowing is the type of debt with the shortest history. The purpose of the inflation-linked loans introduced in 1994 was to contribute to further diversification of the central government debt portfolio. Since their introduction in 1994, the inflation-linked loan share of the debt portfolio has steadily increased as a result of earlier years' guidelines and work to that end.

As for the foreign currency share of the central government debt portfolio, the guidelines have in recent years focused on reducing the foreign currency share of the debt portfolio since the foreign currency debt built up during the crisis in the 1990s was judged to be unjustifiably high from a cost and risk perspective. The foreign currency debt has more risk than the krona debt since it is associated with exchange rate risk. At the same time, interest rate risks decrease as Central Government

Debt is financed in several currencies in addition to the krona. The following table shows developments in the different types of debt both in SEK billions and as a percentage of total debt since the end of 2003. Note that it is the unconsolidated debt excluding coupons and inflation compensation that is shown in the table (unlike Table 1).

Table 2: Composition of the central government debt 2003-2006 and as of 30 September 2007(billions of kronor and per cent).

	2003	2004	2005	2006	2007
SEK nominal	726	766	798	787	676
SEK nominal, share	59%	61%	61%	62%	60%
SEK inflation-linked	173	190	208	217	213
SEK inflation-linked, share	14%	15%	16%	17%	19%
Foreign currency	330	301	303	266	240
Foreign currency,	27%	24%	23%	21%	21%
Central govt. debt	**1 229**	**1 257**	**1 309**	**1 270**	**1 128**

Source: The Debt Office.
Note: The central government debt refers to the unconsolidated debt. The debt in foreign currency, including swaps and forward contracts in foreign currency, has been revalued using exchange rates at year-end.

Maturity of the Central Government Debt

The choice of maturity is of considerable importance for cost and risk in central government debt management. A short maturity in most cases leads to lower expected cost but to higher risk. The reason for this is that the yield curve usually has a positive slope (that is, short interest rates are lower than long rates). A short maturity means higher risk since the debt turns over more often (refinancing risk) and fluctuations in interest expense will be bigger (turnover risk).

In the guidelines for 2007, the Government decided to control the maturity with the help of a *benchmark* for the entire debt, measured as the average interest rate refixing period (IRP). Previously the Government established only a comprehensive benchmark for the nominal krona debt and the foreign currency

debt (that is, excluding the inflation-linked debt). Under the control system, the Debt Office disaggregates the benchmark for the debt as a whole and decides the *benchmark* for each type of debt and sets the deviation interval around it. The Debt Office's proposal for the comprehensive maturity is based on the analyses and considerations for the maturity for each type of debt.

Table 3: Average interest rate refixing period (IRP) per type of debt 2003 – 2006 and on 2 April 2007 (expressed in years).

Years	SEK nominal	SEK inflation-linked	Foreign currency	Total	Total f t s
2003	3.4	13.4	2.6	5.3	-
2004	3.7	12.8	2.2	5.4	-
2005	3.3	12.0	2.1	5.0	-
2006	3.4	10.8	2.1	4.9	-
2007	3.3	11.0	0.2	4.6	4.8

Source: The Debt Office
Note: The debt in foreign currency, including swaps and forward contracts in foreign currency, has been revalued using exchange rates at year-end.

The preceding table shows the IRP for the three types of debt and for the total debt. The column farthest to the right (Total f t s) shows the IRP based on the fixed target share for each type of debt. This is the measure that will be used in the day-to-day follow-up from now on. Using target shares to calculate the comprehensive maturity avoids the adjustment problems and transaction costs that occur when there are temporary changes in the actual shares. The benchmark for the 2007 year-end is 4.7 years. This means that the IRP (with fixed shares) was somewhat higher in April (4.8 years). The benchmark for 2008 is 4.8 years and for 2009 and 2010, it is 4.6 and 4.5 years respectively. As shown in the table, the IRP for the foreign currency debt was shortened markedly in connection with the introduction of the new control system.

The IRP has fallen from over 5 years to 4.6 years during the period reported.

3.3 The Analysis Leading to This Year's Guidelines Proposal

The analysis leading to this year's guidelines proposal has in many respects revolved around issues concerning central government debt management in a surplus environment. As noted, the debt is expected to fall sharply in the next few years. A declining debt is of course a positive development for the state but it presents central government debt management with challenges both in principle and in practice.

The main consequences of a sharp drop in the debt
In principle, a sharp drop in the debt results in an increase in the scope for risk taking in exchange for lower expected costs (section 3.1). The available options for achieving lower expected costs are mainly *shortening the average maturity* and/or *changing the composition of the debt.*

The slope of the Swedish yield curve has continued to decrease in 2007 and at present there is relatively little difference between short- and long-term interest rates. It is thus the opinion of both the Government and the Debt Office that there is no reason to change the benchmark for the *average maturity* since an increased risk would only have a minor effect on cost. On previous occasions, the Government has discussed the slope of the yield curve and its impact on the trade-off between expected cost and risk. In principle a decreasing slope of the curve (ceteris paribus) means that it will be cheaper to reduce the risk by extending the central government debt's average maturity. However, the strong outlook for public finances means that there is little need to reduce risk. Nor is there any reason to assume that the yield curve will be inverted over longer

time periods, a development which would mean that both expected cost and risk could be lowered by extending the maturity. An overall assessment indicates that there is insufficient cause for changing the aim of the average maturity established in last year's decision on the guidelines.

The Debt Office is also of the opinion that the magnitude of the expected costs would not be appreciably affected by a *change in the composition* of the debt based on existing target shares. Here the composition of the total debt has more bearing on the risk level in the debt via the diversification effect that borrowing in different types of debt presents. The reasoning is based on leaving the composition of the foreign currency debt in principle unchanged. However, changes in the composition of the foreign currency debt could lead to lower expected costs if the increased scope for risk, as a result of a smaller debt, was used for this purpose.

The Government has delegated the decision on the distribution of foreign currencies in the foreign currency debt to the Debt Office. With the Government's support, the formulation of the risk-minimising foreign currency benchmark has increasingly become guided by cost considerations in the annual evaluation of debt management. For this reason, the Government supports the Debt Office's ambition expressed in its guidelines proposal to review the composition of the foreign currency debt with the objective of trying to obtain lower expected costs (see section 6).

Remit on the composition of the debt

In last year's decision on the guidelines, the Government instructed the Debt Office to review the assessments underlying the current target shares for the foreign currency and inflation-linked debts. This review was also to be conducted in the light of expectations of a sharp drop in central government debt.

The Debt Office has not proposed any changes to the existing guidelines on the composition of the debt. This is also the Government's decision (sections 4.1-4.3). The Debt Office

points out, however, that the share of inflation-linked debt will increase during 2008 to 30 per cent and then decline to 27 per cent at the end of the year in connection with a loan falling due. The increasing inflation-linked debt is due to the sharp reduction in the total debt and to the fact that there currently is no way to reduce the share of inflation-linked debt at a reasonable cost. Some presence in the primary market is also deemed necessary if the inflation-linked market is also to be a possible source of financing in future.

As to the amortisation rate on the foreign currency debt, the Debt Office's analysis showed that the rate for 2008 should amount to SEK 40 billion annually with a possible deviation interval of ± SEK 15 billion. With this amortisation rate, it is expected that the share-based control system could be introduced around the turn of the year 2008/2009 when the foreign currency debt is estimated to be about 15 per cent of the total debt.

With this in mind and the Debt Office's forthcoming review of the composition of the foreign currency debt, the Government has renewed the Debt Office's remit to review the analysis and the assessments that form the basis for the Government's decision on the target shares for the foreign currency and inflation-linked debts (see section 6).

Remit on the comprehensive maturity

In last year's decision on the guidelines, the Debt Office was instructed to conduct an in-depth analysis of the control of the benchmark for maturity. As part of this analysis, one of its tasks was to shed light on the conditions under which the comprehensive maturity is expected to stabilise.

The analysis clearly indicates that the comprehensive maturity will be shortened in the next few years. The reason is that the maturity in the inflation-linked debt is gradually decreasing as outstanding inflation-linked bonds near maturity. In order for the inflation-linked share not to deviate further from the target share (25 per cent) as the debt declines, no more

new inflation-linked borrowing with longer maturities will be introduced in the next few years. The comprehensive maturity is reckoned to stabilise when the longest inflation-linked loan has become so short that it needs to be replaced with a new longer loan. There is no reason to decide now if the longest inflation-linked loan should be, for example, fifteen, twenty or twenty-five years.

The Government shares the Debt Office's assessment that at present there is no reason to lock in a future comprehensive maturity that would be in force from year to year.

4 The Guidelines Decision for Central Government Debt Management in 2008

Summary
The Government's decision on the guidelines for 2008 leaves the Government's central government debt policy unchanged. This means that the design of the control system and the target values for the composition of the central government debt and its maturity will remain unchanged from 2007. The guidelines decided agree in substance with the Debt Office's proposal and the Riksbank's comments.

4.1 Foreign Currency Debt

The Government's decision: The foreign currency debt is to decrease to 15 per cent of the central government debt.

The benchmark for the amortisation of the foreign currency debt in 2008 is to be set at SEK 40 billion. The Debt Office may deviate from the specified amortisation rate by SEK ±15 billion.

The Debt Office's proposal: It is in accord with the Government's decision.

Reasons for the Government's decision: Since the beginning of the decade, the state has striven to reduce the percentage of foreign currency debt and increase the percentage of inflation-linked debt in the long run primarily to better spread the risks in the debt. Another reason is that the foreign currency debt has more risk than the nominal krona debt as it is associated with exchange rate risk. The current target share for the foreign currency debt of 15 per cent was established in the guidelines for 2005. This percentage is considered to be a reasonable balance between the positive diversification characteristics and the exchange rate risk inherent in a large foreign currency debt.

In last year's guidelines, a new control system for debt shares was decided. Under the control system, the Government is to specify a benchmark for the foreign currency share of the debt and a control interval around this benchmark. In the previous year's decision on the guidelines, the Government provisionally set this interval at ±2 per cent. Since the foreign currency debt has not yet reached the level desired in the long term, the Government has decided to defer introducing the target share and the interval around it. With the aim of reaching the desired target share in the long term, the Government has decided on a benchmark for the amortisation of the foreign currency debt of SEK 40 billion, the same as that for the current year. The chief reasons behind the decision taken last year to raise the amortisation rate for the current year from SEK 25 billion to SEK 40 billion were markedly improved prospects for public finances and a wish to make a swifter adjustment in the foreign currency share of the debt to meet this target. These arguments are also valid this year as even stronger growth in the public finances is expected. This would argue for a further increase in the amortisation rate. However, the argument against this is that the amortisation rate decided already involves a rapid adjustment of the foreign currency share towards the stipulated target level (see section 3.2 and below). In addition the scope for further increases in the amortisation rate is limited since the equivalent of SEK 50 billion in foreign currency will fall due in 2008. An

amortisation rate at this level risks requiring buybacks, which for reasons of cost would probably not be warranted. The Government will therefore keep the amortisation rate for the foreign currency debt unchanged at SEK 40 billion for 2008.

According to the Debt Office's calculations, the desired target share will be reached around the turn of the year 2008/2009 and for this reason, no amortisation amount is being proposed for 2009 onwards. The Government shares the Debt Office's opinion and provisionally expects next year's decision on the guidelines to involve a full implementation of the control system whereby the Government decides the foreign currency share and its associated deviation interval. However, it should be noted that, in this year's decision on the guidelines, the Government has again instructed the Debt Office to review the analysis that forms the basis for the Government's decision on target shares for the foreign currency and inflation-linked debts. Possible proposals on adjusting the target shares may affect the point at which control via a nominal amortisation mandate is abandoned. The Government therefore reserves the right to wait for the Debt Office's analysis before taking a final position on the matter.

The Board of the Debt Office may decide to deviate from the benchmark for the amortisation of the foreign currency debt by SEK ±15 billion. The size of the interval is deemed to represent a reasonable trade-off between providing the Debt Office with flexibility and meeting the Government's need to exercise control. Deviations from the benchmark may be based on strategic assessments of trends in the krona's exchange rate, substantial changes in the central government borrowing requirement over the years or major changes in the borrowing terms in the Swedish market, should they occur.

4.2 Inflation-Linked Krona Debt

The Government's decision: The share of inflation-linked debt is to be 25 per cent of the central government debt.

The Debt Office is to establish a deviation interval around the share of inflation-linked krona debt.

The Debt Office's proposal: It is in accord with the Government's decision.

Reasons for the Government's decision: Before the decision on the guidelines for 2007, extensive analyses of appropriate target shares based on a cost and risk perspective were done. The result of the analysis was that an inflation-linked krona debt of 25 per cent was considered appropriate. The Government has not changed its view.

The declining central government debt over the next few years will increase the proportion of inflation-linked krona borrowing in the debt (see sections 3.1–3.3). The size of the inflation-linked debt is difficult to influence as the issues are small and only small volumes will fall due in the next few years. The possibility of buybacks exists but they are costly. On 31 August 2007, the inflation-linked debt came to 26 per cent of the total debt, that is, over the benchmark but within the deviation interval of ± 2 percentage points. The Debt Office's current borrowing requirement forecasts indicate that the proportion of inflation linked debt will at times approach 30 per cent and then decrease towards the end of 2008 to 27 per cent in connection with the maturity of the inflation-linked bond 3101. After 2008, the inflation-linked share is also expected to reach levels around 30 per cent if the central government debt declines at the rate now estimated. The next major inflation-linked bond (loan 3106) will not fall due until 2012.

Costly buybacks and abrupt changes in the borrowing policy should be avoided. The Government thus sees no obstacle to the Debt Office adjusting the current deviation interval around the

inflation-linked share of the debt if the Debt Office thinks there is cause.

The Government has instructed the Debt Office to continue to review the analysis that forms the basis for the Government's decision on target shares for the foreign currency and inflation-linked debts. Pending this analysis, the use of a larger deviation interval for the inflation-linked debt may, as mentioned, be justified.

4.3 Nominal Krona Debt

The Government's decision: In addition to inflation-linked debt and debt in foreign currencies, the central government debt is to consist of nominal debt in kronor. Since the target shares for the other two types of debt are stipulated, it follows that the target share for the nominal krona debt is the remaining 60 per cent of the central government debt.

The Debt Office's proposal: It is in accord with the Government's decision.

Reasons for the Government's decision: From a control perspective, the nominal krona debt is a residual as target shares are specified for the foreign currency and inflation-linked debts. The nominal krona debt is the most important source of financing for the central government debt and at the turn of the year 2006/2007, it constituted 62 per cent of the debt. The Debt Office holds regular auctions to borrow in nominal kronor in the form of treasury bills and treasury bonds. The nominal krona debt is used to counter swings in the borrowing requirement in view of its form of borrowing and the long-term control of the two other types of debt.

4.4 Maturity

The Government's decision The Government establishes a benchmark for the debt as a whole and this benchmark is used to control the maturity of the central government debt. The Debt Office is to decide on benchmarks for each type of debt and specify operational deviation intervals around them.

The benchmark for the comprehensive maturity in the central government debt is to be 4.8 years by the end of 2008. The aim for 2009 and 2010 at year-end is 4.6 and 4.5 years respectively.

The Debt Office's proposal: It is in accord with the Government's decision.

Reasons for the Government's decision: In last year's guidelines, it was decided that the maturity of the central government debt is to be controlled using a common maturity measure that includes the whole debt. The common maturity measure is calculated by weighing together the maturity for the different types of debt based on the target shares the Government has specified for each type of debt to arrive at a comprehensive measure.

Under the control system for the maturity, the Government decides the benchmark for the central government debt as a whole and thereafter instructs the Debt Office to decide how the maturity should be allocated to the three different types of debt and to specify operational deviation intervals around the benchmark for each type of debt. The Debt Office is of the opinion that it would be desirable in principle for the comprehensive maturity to be derived from what provides an appropriate overall maturity in order to then be allocated according to type of debt. However, in practice the Debt Office is of the opinion that this is not feasible since when weighing cost versus risk, it is also necessary to take the conditions and characteristics of each type of debt into consideration.

The Government shares this view and thinks it remains appropriate to view the comprehensive maturity as an

instrument for the Government's control of the maturity of central government debt as a whole.

As a result of an overall assessment in line with section 3.3, the Government, sees no reason to deviate from the direction stipulated in last year's decision on the guidelines, except for technical adjustments owing to the actual trend in the inflation-linked debt. At year-end 2008–2010, the average maturity is therefore to be 4.8, 4.6 and 4.5 years respectively.

4.5 Position-Taking

The Government's decision: Active position-taking by the Debt Office is to be possible in order to lower the cost of the central government debt, while taking risk into account. Positions are to be taken with derivative instruments. The extent of the position-taking is limited by the Government's specification of a highest risk level, measured in terms of daily Value-at–Risk. The risk limitation is to include all of the Debt Office's positions except those that relate to the krona's exchange rate against other currencies.

The limitation on the Debt Office's position-taking is to be set at SEK 600 million, measured as daily Value-at-Risk at 95 per cent probability. The Debt Office is to decide how the risk mandate is to be divided between the strategic and operational levels.

The Debt Office's proposal: It is in accord with the Government's decision.

Reasons for the Government's decision: The purpose of allotting the Debt Office a limited scope for position-taking is to further reduce the cost of the debt to the state. The Debt Office in actively managing the debt has been given the possibility of taking short-term interest rate and foreign currency positions in the international financial markets

(however, not in the Swedish fixed-income market) based on its view of market trends.

The Board of the Debt Office is to decide guidelines for the active management. In the event that a position is deemed too large to be handled in the normal active management, the decision is taken by the Board. The Board's decisions on position-taking are strategic while the decisions at a lower level in the Debt Office are operational.

The decision about position-taking means that the scope that the Debt Office has for risk-taking is expressed in explicit and comprehensive terms. There is a strength in having a risk measure (Value-at-Risk or VaR), which includes all types of interest-rate and foreign currency positions, both strategic and tactical..[3] The limit on position-taking of SEK 600 million in terms of daily VaR at 95 per cent probability is set to basically correspond to the Debt Office's risk exposure before the system was introduced in 2007. The mandate makes it possible for the Debt Office to take positions with a 95 per cent probability that they will not fall more than SEK 600 million in value in one day. The probability that the loss will be SEK 600 million or more is consequently 5 per cent. Normally the Debt Office uses a limited part of the available risk mandate. The Debt Office is also to ensure that there are clear internal guidelines for the work at both the strategic and the operational levels. The Government's evaluations have noted that the Debt Office's active position-taking aimed at reducing the central government's debt management costs has been profitable. In the five years from 2002–2006, profits exceeded SEK 1 billion.

[3] Value-at-Risk (VaR) is a measure of market risk, calculated using historical data for correlation and volatility in the fixed-income and foreign currency markets.

4.6 Market and Debt Support

The Government's decision: The Debt Office is to promote the proper functioning of the markets for government securities by market and debt support with the aim of achieving the goal of long-term cost minimisation with due consideration for risk.

The Debt Office's proposal: It is in accord with the Government's decision.

Reasons for the Government's decision: It is important for cost and risk in central government debt management for the Swedish fixed-income market to function well. The Debt Office therefore has the task of improving how the market functions by market and debt support with the aim of achieving the long-term minimisation goal with due consideration for risk. However, this task must not lead to setting aside the goal of keeping costs to a minimum.

As previously noted, a sharp reduction in central government debt is expected in the next few years. Such a reduction means smaller volumes of outstanding loans. To lower the risk of the infrastructure with liquid markets, good investor confidence and well-functioning dealer networks suffering damage owing to smaller volumes, measures such as the concentration of borrowing to fewer maturities and auctions as well as a higher concentration of borrowing in nominal bonds will be required. The consideration of such measures is the Debt Office's responsibility.

The Debt Office's strategic market and debt support are conducted primarily by formulating principles for operational borrowing and management. The key concepts in this connection are transparency, predictability and a long-term view.

On the operational level, this concerns such Debt Office activities as open reporting of borrowing plans and forecasts of borrowing requirements for the next two years. This gives investors an opportunity to assess the supply of various borrowing instruments. The Debt Office also provides

operational market and debt support by the exchange and repurchase of bonds and by repos aimed at market maintenance.

The Government has noted that the autumn 2007 global credit squeeze has meant increased demand for Swedish government securities. Activities in the Debt Office's standing facility for market maintenance repos have grown dramatically and they have been used to an extent that was not originally intended. The Government therefore thinks that there is reason for the Debt Office to conduct an analysis of the design and function of the repo facility.

As the Government noted earlier, measuring the value of market and debt support is difficult. Such evaluations are thus mostly qualitative.

4.7 Borrowing on the Retail Market

The Government's decision: The Debt Office is to contribute to reducing the costs of central government debt by retail market borrowing.

The Debt Office's proposal: It is in accord with the Government's decision.
Reasons for the Government's decision: The current target for retail market borrowing means that the form of borrowing is to help lower the cost of the central government debt. It was previously specified that the borrowing is to contribute to the greatest possible cost savings in relation to the Debt Office's alternative forms of borrowing in the capital market.

The Government shares the Debt Office's assessment that the *target* should be made clearer and instead mean the greatest possible savings in relation to equivalent borrowing in the form of treasury bonds or treasury bills. In this way the strict requirement for cost savings in retail market borrowing compared with institutional borrowing is underscored at the same time that it better corresponds to how the evaluation of retail market borrowing is made.

A similar clarification concerns the reason for the retail market borrowing. It is the view of both the Debt Office and the Government that it is difficult to warrant conducting retail market borrowing that is more expensive than equivalent borrowing in treasury bonds or treasury bills. It is particularly important that this should be seen in the light of the declining central government debt. In the last five years (2002–2006) retail market borrowing has contributed to cost savings of almost SEK 1 billion.

5 Evaluation of Central Government Debt Management

The Government's decision: For 2008 the Debt Office is to establish internal guidelines based on the Government's guidelines. The decisions are to refer mainly to the maturity benchmark for each type of debt, possible deviations from the benchmark for the amortisation rate in the foreign currency debt and the Debt Office's position-taking.

The evaluation of the decisions made by the Board of the Debt Office is to be made in qualitative terms in the light of the information available at the time the decision was taken. Where possible, the evaluation is to contain quantitative measures, for example, contrafactual calculations.

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

The results of strategic and operational positions within the prescribed risk mandate are to be calculated on an ongoing basis and evaluation is to be made in terms of market values.

Under the central government debt policy process, the Government is to present to the Riksdag a Ministry Communication evaluating central government debt

management by 25 April every second year. The evaluation was previously presented every year but beginning in 2008 the Ministry Communication will be presented in alternate years. The reason for the change in frequency is that the impact of the central government debt on the budget has lessened, the process has found a suitable form and the central government debt policy is long term in nature.

New to the process before the Ministry Communication in spring 2008 is the Government's intention to append an external evaluation of the conduct of central government debt policy to the Ministry Communication. In connection with the evaluation work being done, the Government and the Riksdag have called attention to the value of an external evaluation. Such an evaluation would contribute to a broader view and external terms of reference for the central government debt policy.

Since the goal of central government debt policy is long term, the result is evaluated in rolling five-year periods. The evaluation of the decision on the guidelines for 2008, which will be made in the spring of 2010, will thus concern the years 2005 to 2009.

Evaluation at three levels

Central government debt management is evaluated at three levels: *the Government's guidelines*, *the Debt Office's strategic decisions* and *the Debt Office's operational management.* The principles that follow are to guide the evaluation. Clear principles for evaluation promote objectivity and consistency in the follow-up over time.

5.1 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 forming the basis for the guidelines decision and in the light of the knowledge available at the time the decisions were taken.

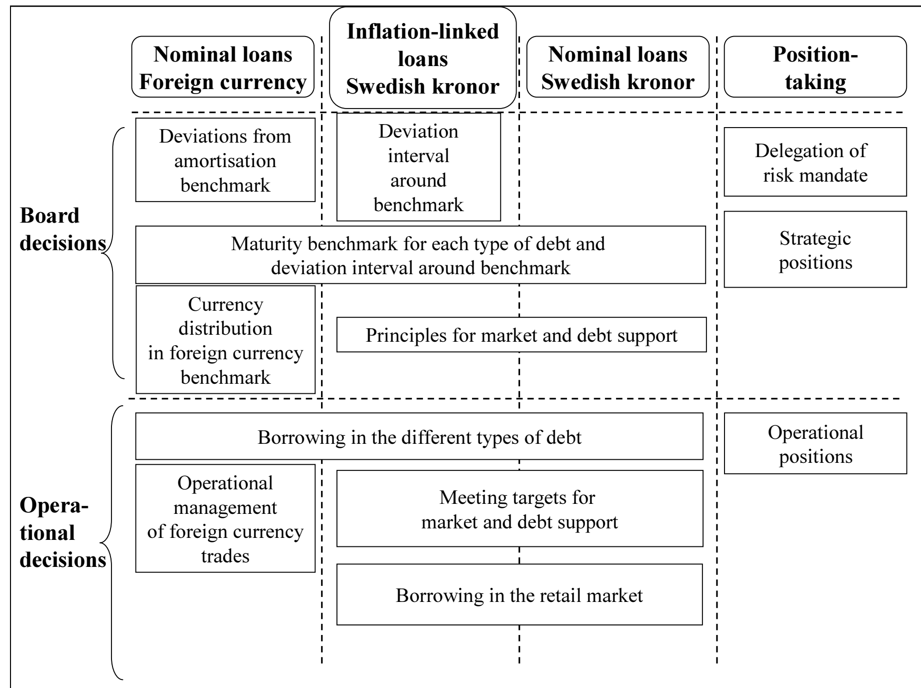
One key factor in the decision on the guidelines should be how much risk the Government is willing to assume. The basic assumption should be that the debt portfolio selected should have a lower cost and/or lower risk than other portfolios. Debt portfolios that have undue risk, for example, those with 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. In the evaluation, quantitative measures should supplement qualitative considerations and judgement, where possible.

5.2 Evaluating the Debt Office's Strategic Decisions

In addition to the Government's guidelines, the Debt Office's debt management activities in such matters as cash management are regulated in the instructions to the authority. The Government also delegates certain decisions to the Debt Office as explained in the following material.

In the figure below, there is a schematic overview of how the evaluation of the Debt Office's decisions is structured. The evaluation covers both *the Debt Office's strategic decisions* (made by the Board of the Debt Office) and *the Debt Office's operational management*.

Figure 1: Evaluation of the Debt Office's strategic and operational decisions.



Decisions by the Board of the Debt Office (Strategic Decisions)

Deviations from the benchmark for the amortisation rate for the foreign currency debt

There is to be an evaluation of decisions on deviations from the decided foreign currency amortisation mandate. Decisions are to be based on strategic long-term considerations. The evaluation must be based to a considerable extent on a review of the reasonableness of the analysis that originally led to the decision.

The quantitative evaluation of the Debt Office's management 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 evaluation period – one corresponding to the benchmark in the guidelines and the other to the Debt Office's decisions. Using the actual amortisation profile is not meaningful since it presents an uneven pattern.

Deviation interval for the inflation-linked debt
Decisions on the deviation interval for the inflation-linked share of the debt are to be evaluated. The evaluation is to be mainly qualitative since the decisions probably cannot be evaluated quantitatively in a meaningful way.

Maturity benchmarks for each of the three types of debt
There is to be an evaluation of the decision on the benchmarks and deviation intervals for the three types of debt in the central government debt. The evaluation of how the maturity for the total debt is to be allocated between the nominal krona debt, the inflation-linked debt and the foreign currency debt is to be primarily qualitative. These decisions can probably not be evaluated quantitatively in a meaningful way.

Allocation of Foreign Currencies in the Foreign Currency Benchmark
Decisions on the currency distribution in the foreign currency benchmark are to be evaluated. Mostly qualitative terms are to be used to evaluate this benchmark since there are no reasonable norms for quantitative comparisons. The Debt Office should report analyses and arguments for the benchmark composition chosen. To the extent that partial analyses have been allowed to influence the currency distribution in the benchmark, a basis enabling a quantitative follow-up is to be reported.

Principles for Market and Debt Support
Decisions on market and debt support principles in the krona market are to be evaluated. The primary concern of the evaluation is to be the choice of principles and the likelihood that they will lead to the desired effects.

Delegation of the risk mandate for position-taking
The decisions on delegating the risk mandate for position-taking are to be evaluated. The evaluation is chiefly qualitative.

Strategic interest rate and foreign currency positions
Decisions on strategic interest rate and foreign currency positions are to be evaluated in terms of market value. The positions are to be taken using derivatives and placed in their own portfolio so that they can be continuously monitored. The Debt Office is to report follow-up indicators relating results achieved to the risk taken.

5.3 Evaluating the Debt Office's Operational Management of the Debt

Borrowing in and managing the different types of debt
There is to be an evaluation of how the borrowing in the different types of debt and their management have been conducted. The evaluation is to be primarily in qualitative terms and on an ex ante basis. Moreover, the realised difference in cost should be reported for the 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 should be reported.

Market and debt support
There is to be an evaluation of the market and debt support conducted with the aim of achieving a well-functioning nominal

and inflation-linked krona market. The evaluation is principally qualitative.

Retail market borrowing

The Debt Office is to report any cost savings realised from borrowing in the retail market compared with equivalent borrowing in treasury bonds or treasury bills. The cost savings for each form of borrowing as well as for total retail market borrowing is to be reported. In addition the Debt Office's position in the market for savings products needs to be specified.

Operational management of foreign currency exchanges

The Board of the Debt Office is to adopt a relatively smooth cost-neutral path for the Debt Office's exchanges between kronor and foreign currency. 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 they seem particularly advantageous or 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.

Operational interest-rate and foreign currency positions

Evaluation of the operational interest rate and foreign currency positions are to be done in terms of market values. The positions are to be taken with derivatives and placed in their own portfolio so that they can be continuously monitored. The Debt Office is to report follow-up indicators relating results achieved to the risk taken.

6 The Debt Office's Remit

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 continue to revise the analyses and estimates that form the basis of the Government's decision on the target shares for the foreign currency and inflation-linked debt, particularly in the light of the current outlook for public finances.

The Debt Office should review the composition of the foreign currency debt with the aim of lowering expected costs.

In the light of the global credit squeeze that has led to increased demand for government securities, the Debt Office is to analyse the repo facility's function and design.

In the guidelines proposal to be submitted in the autumn of 2008, the Debt Office is to present a report on the progress completed during the year.

Reasons for the Government's decision: At present the Government sees no reason to make any changes in the control system and target values owing to the introduction of several major changes in the decision on the guidelines for 2007. The guidelines are to be long term and aim at the goal of minimising costs with due consideration for risk. At the same time the guidelines are necessarily dependent on the state of public finances and financial market conditions.

Under the control system introduced for the guidelines for 2007, the Government controls the composition of the debt through the target shares stipulated for the three types of debt. A new method of calculating the composition of the central government debt was also introduced. It is based on the *debt's aggregate cash flows (CCF)*. The CCF method gives a better picture of the debt's total risk exposure since outstanding coupons and inflation compensation are included in the calculations. Another change was the broadening of the maturity measure to include the entire central government debt. (Previously the inflation-linked debt was excluded).

The basis for the remit

It is the Government's opinion that the central government debt will decline swiftly in the next few years, as a result of both strong economic growth and the state's sale of assets in the form of shares and public enterprises. In the light of the expected sharp drop in the central government debt, the Government thinks it is urgent for the Debt Office to continue to review the analysis and the calculations on which the target shares for the foreign currency and inflation-linked debts are based. This is also warranted by the remit to review the composition of the foreign currency debt (see below).

The sharp drop in the central government debt means that in principle the scope for risk-taking increases in exchange for lower expected costs. However, the Government has not deemed it appropriate to use the increased scope for risk by shortening the debt's maturity. However, as the Debt Office points out in its proposal, changing the composition of the foreign currency debt would be a practicable road to take. The Government therefore supports the Debt Office's expressed ambition to review the composition of the foreign currency debt aimed at lowering expected costs.

The Government thinks that it is also urgent for the Debt Office to analyse the design and function of the repo facility. The matter has now come to the fore as repo volumes have

increased sharply in summer and autumn 2007 as a consequence of the global credit squeeze. The repos have contributed to an increase in liquidity and an expansion of the market for government securities, but in a way that was not intended when the facility was designed.

The Debt Office is to present a report on the progress completed no later than in the guidelines proposal to be submitted in the autumn of 2008.