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SWEDISH NATIONAL DEBT OFFICE

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Central Government Debt Management

Proposed guidelines 2014–2017

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Summary

In this report, the Swedish National Debt Office proposes guidelines for 2014-2017. For 2015 to 2017, the proposals are preliminary. The goal is to manage central government debt in such a way as to minimise the long-term costs while taking risk into account. Debt management is to take place within the framework of monetary policy.

In last year's proposed guidelines, the Debt Office showed that there is no evidence that a fixed share of foreign currency debt exposure can reduce the risk in terms of cost variation of central government debt. This conclusion called for a reassessment of the current fixed foreign currency debt share of 15 per cent.

In this report the Debt Office continues to analyse the share of foreign currency exposure by looking more thoroughly into the cost and financing risk aspects of foreign currency debt.

It is the Debt Office's view that central government debt should have a share of foreign currency exposure if that share contributes to reducing the expected cost while taking risk into account. Since the possibility of reducing costs may change over time depending on market conditions, the share of foreign currency debt should be allowed to vary.

Consequently it is not ideal to have a fixed target for the share of foreign currency debt. The Debt Office suggests that the Government decide instead on a ceiling for the foreign currency debt share. The size of the foreign currency share will then vary depending on the Debt Office's assessment of the possibility of reducing expected costs while taking risk into account.

The mandate to determine the size of foreign currency exposure is not to be confused with the mandate to take positions in the krona exchange rate. The assessment of the foreign currency share must be based on long-term, structural market conditions, as must the analysis of the average time to maturity. This analysis is not affected by temporary movements in the fixed income or foreign currency markets.

The Debt Office proposes that the ceiling is set at15 per cent, i.e. the same size as the current target for the share of foreign currency debt.

The Debt Office expects to maintain the share of foreign currency debt more or less unchanged during the coming year. There is good reason to await a decision on the Inquiry on the Riksbank's financial independence and balance sheet, which submitted its report in January. The outcome of the Inquiry and a government bill may affect currency exposure in central government debt and also what role that the Debt Office may have in financing the foreign currency reserve. According to the Debt Office there are no strong arguments from an interest rate cost perspective against waiting to make changes in the foreign currency debt.

Prerequisites

The size of the central government debt and the future borrowing requirement affect central government debt management. Debt management is also designed to take into account the functioning of the markets. In this section, the Debt Office sets out its view of the borrowing requirement and the development of central government debt over the next few years.

1 The development of central government debt until 2017

This section describes central government debt in a historical perspective, the uncertainty about the future development of central government debt and finally, current forecasts of the borrowing requirement and central government debt by official forecasters.

Different measures of government debt are used in different contexts. *Unconsolidated debt* comprises all instruments issued by the Debt Office. This debt is reported in nominal amounts and the Debt Office publishes this measure on a monthly basis. *Consolidated debt,* which is presented in the state's annual report, excludes local government holdings of government securities. For these guidelines the central government unconsolidated debt is the appropriate measure. The term central government debt below thus refers to the unconsolidated debt.

1.1 The concept of net borrowing requirement

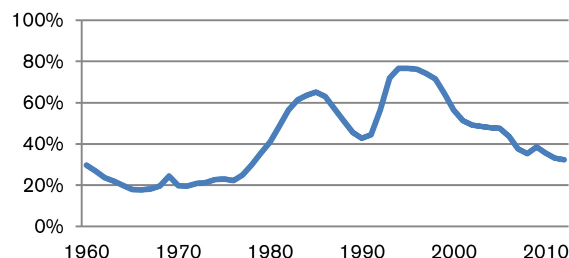
Changes in central government debt can, somewhat simplified, be equated with the central government net borrowing requirement. The net borrowing requirement is identical to the central government budget balance although with the sign reversed. If there is a budget surplus, the Debt Office will amortise central government debt (negative net borrowing requirement) and if there is a deficit, central government debt will increase as the Debt Office will borrow to fund the deficit (positive net borrowing requirement).

Central government debt is also affected by factors other than the net borrowing requirement. These go under the generic term *debt-related dispositions*. This may, for example, be revaluation of the foreign currency debt to current exchange rates and revaluation of inflation-linked bonds in Swedish kronor whose value is linked to the consumer price index (CPI).

1.2 Downward trend for central government debt as a share of GDP since the 1990s crisis

In a historical perspective, the net borrowing requirement has varied sharply from year to year. In general, the net borrowing requirement decreases in upturns and increases in downturns. When the economy grows above trend, incomes often rise quickly while the expenditures develop weakly or even decrease. The opposite applies in downturns when income grows slowly or decreases while expenditure increases. The fact that income and expenditure are out of step strengthens the fluctuations in the net borrowing requirement.

FIGURE 1 CENTRAL GOVERNMENT DEBT IN SEK AND AS A SHARE OF GDP 1960-2012

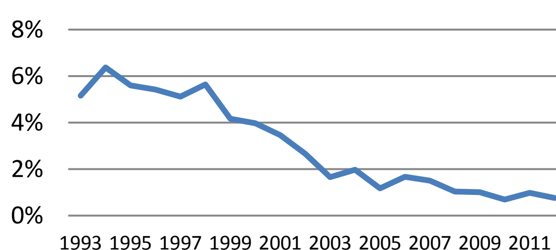


Source: The Debt Office, Statistics Sweden

Looking back all the way to the 1950s, central government debt expressed as a share of GDP has increased sharply during two periods. From 1976 to 1985 central government debt rose from 22 per cent to 65 per cent as a share of GDP. After some years of falling central government debt, it rose again from 43 per cent in 1990 to 77 per cent of GDP in 1995. After 1996, central government debt as a share of GDP has decreased gradually to around 32 per cent in 2012.

After the crisis in the early 1990s, it was decided to strengthen the fiscal policy framework in Sweden. An expenditure ceiling was introduced in the central government budget along with a surplus target for the entire public sector.

FIGURE 2 INTEREST PAYMENTS ON CENTRAL GOVERNMENT DEBT AS % OF GDP, 1993-2011



Source: The Debt Office, Statistics Sweden

The expenditure ceiling has not been exceeded in any year and the surplus target has also been complied with on the basis of the indicators used by the Government to evaluate the surplus target. The fiscal policy framework has worked well and contributed to stronger and more stable central government finances. The high level of confidence in Swedish central government finances also contributes through lower interest rates to keeping down the cost of central government borrowing.

The introduction of an inflation target for the Riksbank and a floating exchange rate have had positive effects on the Swedish economy as a whole, which has indirectly also had a stabilising effect on central government finances. As the credibility of the inflation target has increased, this has contributed to considerably lower market interest rates.

In recent years, the global economic downturn and the financial turmoil in the euro zone have led to even lower interest rates in Sweden. In part this is because Swedish government bonds are regarded as a safer investment than bonds issued by many other countries. Interest payments on government debt as a share of GDP have decreased significantly over time, see Figure 2 above.

1.3 Uncertainty factors and risks in future developments

There are a number of uncertainty factors which make the assessment of the development of public finances in the coming years difficult. Some of these factors are discussed below.

Economic growth

One uncertainty factor for the central government finances, primarily in the medium and long term is global macro-economic developments. Sweden is a small, open economy with a large export sector in relation to GDP and therefore dependent of the rest of the world. Growth in the Swedish economy affects important tax bases such as consumption and wages. Put simply, tax bases grow at the same rate as nominal GDP over time.

Expenditures are also cyclically dependant although they have become less sensitive as the regulatory framework for various benefit systems has been made stricter. Furthermore, the central government budget is designed in such a way that expenditure normally grows at a slower rate than income, in the absence of new political decisions. This is because many appropriations are linked to the development of prices rather than income, or are expressed in nominal amounts. The difference between development of incomes and expenditures decreases when economic growth is slow.

Demography

Sweden is in a period where the number of young and elderly is rising gradually relative to the number of people in working age. This is mainly because people live longer. An older population will lead to increased costs, mainly for local governments. Some of the increased costs will, however, probably be carried by the central government in the form of increased government grants and transfers.

Fiscal policy

This fiscal policy framework says that the general government should have a surplus of 1 per cent of GDP on average over a business cycle. The business cycle is not a clearly defined concept, which represents an uncertainty about how long such a period is. Rules for taxation and expenditure can also be changed. This involves uncertainty, particularly in the medium term, since it takes time tom implement new proposals. In the long term, the uncertainty is likely to be smaller since an economic policy that gives excessive surpluses or deficits creates a political pressure to balance the budget.

Major unanticipated events

Major more or less unanticipated events tend to affect and reinforce changes in the net borrowing requirement in both cyclical upturns and downturns. In recent years, for example, sales of state-owned assets and lending to the Riksbank in order to strengthen the currency reserve have taken place. Both these types of transactions affect the net borrowing requirement and central government debt. However, they do not affect central government financial net lending as the net worth of the state is not affected. In one case, the state exchanges shares for cash and in the other, the state has a claim for exactly the same amount as the loan.

One risk often discussed in various contexts is a potential drop in asset prices paired with a high level of household debt. Such a development could have effects on the real economy, as well as on the financial system. This has happened in many countries in the world in recent years, but Sweden so far has not been affected.

Reduced risks with the fiscal framework

The fiscal policy framework, which has been discussed above, has provided more stable central government finances and thus reduced risk compared to the crisis in the early 1990s.

Interest payments are an item in the state budget that cannot be altered markedly by political decisions, apart from indirectly. Lower central government debt and lower market rates have led to lower interest payments. Central government debt itself thus constitutes a lower risk than in the early 1990s.

1.4 The Debt Office and other forecasters

There are four agencies that forecast public finances: the Government, the Swedish National Financial Management Authority (ESV), the National Institute of Economic Research (NIER) and the Debt Office. The purpose of the forecasts and the methods used differ somewhat, as do

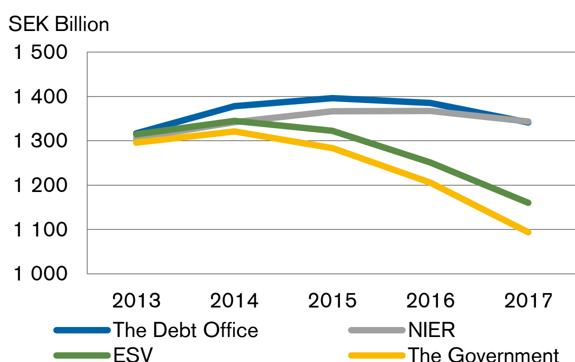
the demarcations in terms of what the different agencies forecast.

The Debt Office only forecasts the central government net borrowing requirement and central government financial net lending. Other agencies forecast the entire public sector. The NIER and the Debt Office makes assessments of future fiscal policy changes that will affect the net borrowing requirement and the government financial lending. All the agencies, except for the ESV, make assessments of sales of state-owned assets where decisions have yet to be made. The Government and ESV base their calculations on revenue and expenditure in the state budget. The Debt Office has a cash-flow model based on the actual payments by agencies. The NIER's forecasts are based on the national accounts and result in a measure of financial net lending that can then be converted into a budget balance. The NIER and the Debt Office have the shortest forecast horizon and the Government and ESV the longest, see table 1 below.

1.5 The development of central government debt up to 2017

In this section we present the calculation of the development of the unconsolidated central government debt according to the assessments of the Government, ESV, the NIER and the Debt Office for the years 2013-2017.

FIGURE 3 UNCONSOLIDATED CENTRAL GOVERNMENT DEBT AT THE END OF THE YEAR



The Debt Office only has forecasts for the net borrowing requirement as far ahead as 2014 using its regular methods. For the period 2015 to 2017 the net borrowing requirement has instead been estimated using a simplified method. The method is based on the assumption that the GDP output-gap will close in 2017 when the economy is in balance. A second assumption is also made: that when the economy is in balance the public sector shows a surplus of 1 per cent of GDP. This is purely a technical assumption for the calculation and not a forecast in a proper sense.

Total financial net lending is estimated for the years 2015 to 2017. Financial net lending in the local government sector is assumed to be weakly negative whereas net lending in the old age pension system is assumed to be weakly positive. Central government financial net lending and the net borrowing requirement are calculated as residuals. Implicitly this means that fiscal policy reforms amounting to an average of SEK 10 billion per year will be implemented during the period 2015 to 2017.

The Government's forecast is taken from the Spring Budget Bill for 2013 and the ESV's forecast from its most recent report from June 2013. Both the Government and the ESV publish forecasts for central government debt for the entire period.

The most recent NIER forecast is from June 2013 and contains forecasts for the net borrowing requirement for 2013 and 2014. The NIER also reports forecasts for consolidated central government debt for the entire period in what is called a medium-term forecast. In order to make this forecast comparable with central government unconsolidated debt the National Debt Office has estimated the level of consolidation.

The calculations indicate a range for central government debt at the end of 2017 of between SEK 1100 billion and SEK 1,350 billion or 25 respectively 31 per cent of GDP

Both the Debt Office and the NIER estimate central government debt at around SEK 1350 billion at the end of 2017. The Debt Office and the NIER have used similar methods assuming that public financial net lending gradually recovers as the economy moves toward balance.

The Government has the lowest estimate, which is approximately SEK 250 billion lower than the Debt Office´s estimate for the end of 2017. The difference is mainly explained by the fact that the Government assumes income from sales of state assets and does not include any fiscal policy reforms.

The Governments and the ESV's forecast methods are similar and can be seen as impact calculations, given unchanged regulations and certain macroeconomic developments. One difference between the methods is that the Government makes a standardised assumption of sales income amounting to SEK 15 billion per year.

All calculations are of course very uncertain. For periods as long as up to 2017 macroeconomic developments are crucial for any changes in central government debt.

TABLE 1 FORECAST ON PUBLIC FINANCES

	Government	NIER	ESV	Debt Office
Demarcation	Entire public sector	Entire public sector	Entire public sector	Only the Government
Own macro assessment	yes	yes	yes	yes
Takes new fiscal policy into account	no	yes	no	yes
Sales	yes	yes	nej	yes
Basic data	income/expenditure	net financial lending	income/expenditure	cash flows
Forecast time line	4–5 years	1.25–2.25 years [1]	4–5 years	1.25–2.25 years

[1] Plus medium term

Proposed guidelines 2014-2017

Here we present our proposed guidelines for central government debt management in 2014–2017. The proposed guidelines are preliminary for 2015 to 2017. In the cases where we propose changes to the guidelines, the current wording is given in the left column and the proposed new wording in the right column. With a view to creating an overview of the decisions controlling central government debt management, the relevant parts of the Budget Act (2011:203) and the Ordinance (2007:1447) containing instructions for the National Debt Office have been included.

The objectives for the management of central government debt:

1. Central government debt is to be managed in such a way as to minimise in the long-term costs while taking risk into account. Management is to take place within the framework of monetary policy requirements. The Budget Act (2011:203).

The task of the Debt Office and the purpose of the borrowing

2. The remit of the Swedish National Debt Office is to raise and manage loans on behalf of the central government in accordance with the Budget Act (2011:203). Regulation (2007:1447) with instructions for the Debt Office.
3. According to the Budget Act (2011:203), the Debt Office may raise loans for the Government in order to:
    1. finance current deficits in the central government budget and other expenditure pursuant to decisions made by the Riksdag,
    2. provide such credit and perform such guarantees as decided by the Riksdag,
    3. amortise, redeem and buy back central government loans,
    4. satisfy the requirement for central government loans with different maturities in consultation with the Riksbank, and
    5. satisfy the Riksbank's requirements for foreign currency reserves.

The guideline process

4. The Debt Office is to submit proposed guidelines for central government debt management to the Government by 1 October each year. Regulation (2007:1447) with instructions for the Debt Office.
5. The Government is to allow the Riksbank to comment on the Debt Office's proposed guidelines. The Budget Act (2011:203).
6. The government is to make a decision by 15 November each year on the guidelines for the Debt Office's management of central government debt. The Budget Act (2011:203).
7. The Debt Office shall, no later than 22 February each year, submit to the Government a basis for the evaluation of the management of central government debt. Regulation (2007:1447) with instructions for the Debt Office.
8. The Government shall evaluate the management of central government debt every other year. The evaluation is to be submitted to the Riksdag no later than 25April. The Budget Act (2011:203).
9. The Debt Office shall establish principles for how the guidelines stipulated by the Government for the management of central government debt are to be implemented. Regulation (2007:1447) with instructions for the Debt Office.

Current wording	Proposed wording
10. The Debt Office shall establish internal guidelines based on the Government's guidelines. The decisions shall concern deviation intervals for the maturity benchmark values that the Government has decided on for the individual types of debt, the distribution of the risk mandate, the currency distribution in the currency benchmark and principles for market and debt maintenance.	11. The Debt Office shall establish internal guidelines based on the Government's guidelines. The decisions shall concern deviation intervals for the maturity benchmark values that the Government has decided on for the individual types of debt, *the utilisation of the position mandate*, the currency distribution in the currency benchmark and principles for market and debt maintenance.

The composition of central government debt — debt shares

12. Over the long term the share of inflation-linked SEK debt shall be 25 per cent of central government debt.

Current wording	Proposed wording
13. The share of foreign currency debt *shall be* 15 per cent of central government debt. *The control range around the benchmark shall be ±2 percentage points.* *If the foreign currency share goes outside the control range, the share of the currency debt shall be returned to the benchmark or inside the range if the deviation is due to changes in the exchange rate movements.*	12. The share of foreign currency debt *may not be greater than* 15 per cent of central government debt. *If the foreign currency share goes above the limit of 15 per cent, the share of foreign currency debt shall gradually be restored to below the limit.*

13. The Debt Office is to stipulate the benchmark for the distribution across different currencies of the currency debt.

14. In addition to the inflation-linked SEK debt and debts in foreign currency, central government debt shall consist of nominal krona debt.

The maturity of central government debt

15. The maturity of the nominal krona debt for maturities up to twelve years shall be between 2.7 and 3.2 years.

Current wording	Proposed wording
16. For maturities above twelve years, the benchmark for the outstanding volume is to be 70 billion SEK.	16. For maturities above twelve years, the *long-term* benchmark for the outstanding volume is to be 70 billion SEK.

17. The maturity of the inflation-linked krona debt shall be between 7 and 10 years.

18. The maturity of the currency debt is to be 0.125 years.

19. The maturity of the types of debt may temporarily deviate from the maturities that are stated in items 15, 17 and 18.

Cost and risk

20. The balance between the expected cost and risk shall mainly be maintained through the choice of the composition and maturity of central government debt.

21. The overall cost measure shall be the average cut-off yield.

22. The overall risk measure shall be the average cut-off yield risk.

23. The Debt Office should take the refinancing risk in the management of central government debt into account.

24. The different types of debt's share of central government debt are to be calculated using a measure that considers all the cash flows in central government debt, that is also future coupon payments and expected inflation compensation.

25. The maturity is to be measured using an average interest rate refixing period where all cash flows including the expected inflation compensation are included. Cash flows are not to be discounted.

26. Positions are not to be part of the calculation of the debt shares and maturity.

27. When taking positions, the market value is to be used as a measure of the costs and risks in the management.

Market and debt maintenance

28. Using market and debt maintenance, the Debt Office shall contribute to the efficient functioning of the government bond market with the intention of achieving the long-term cost reduction target taking risk into account.

29. The Debt Office is to decide on principles for market and debt maintenance.

Active management

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

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

    No positions may be taken on the Swedish fixed income market.

    Positions refers to transactions that aim to reduce the cost of central government debt taking risk into account and are not motivated by underlying needs for borrowing or investment.

Current wording	Proposed wording
Positions may be strategic (long-term) or operative (continuous)	

Positions may only be taken in markets that allow for the market risk to be managed by liquid and otherwise well-developed derivative instruments and that potentially constitute a funding currency within the framework of the debt management.

31. Positions in foreign currency are limited to SEK 450 million, measured as a daily value-at-risk at 95 per cents probability.

Current wording	Proposed wording
The Debt Office shall decide how much of this mandate that may be *used at most in its operational activities.*	The Debt Office shall decide how much of this *mandate that may be used in its running management*.
32. *Strategic positions in the exchange rate of the krona* are limited to a maximum of SEK 7.5 billion and are to be built up and liquidated gradually and be announced beforehand.	32. *Positions in the exchange rate of the krona* are limited to a maximum of SEK 7.5 billion and are to be built up and liquidated gradually and be announced beforehand.
33. Operative positions in kronor in connection with exchanges between kronor and other currencies may be taken to a limited extent. The Debt Office is to state the maximum scope.	*The Debt Office shall state how much of this mandate may be used in the running management in connection with exchanges between kronor and other currencies. The extent shall be limited and the positions do not have to be announced beforehand.*

Borrowing on the retail market

33. The Debt Office shall contribute, via retail market borrowing, to reducing the costs of central government debt in relation to corresponding borrowing on the institutional market.

Borrowing to satisfy the need for public loans

34. The possibility of issuing loans to meet the need of central government loans in accordance with the Budget Act (2011:203) may only be utilised if this is necessary due to threats to the functioning of the financial markets.

    The Debt Office may have a maximum nominal value of SEK 200 thousand million outstanding to this end.

35. Investment of the funds that have been raised through loans in order to satisfy the need for public loans should be guided by the principles set out in the Act (2008:814) about public support for credit institutions.

Management of funds, etc.

36. The agency shall invest its funds, to the extent that they are not needed for payments, in an account at the Riksbank, a bank or a credit market company or in government bonds or in other bills of exchange with a low credit risk. Investments may be made abroad and in foreign currency. Regulation (2007:1447) with instructions for the Debt Office.

37. The Debt Office shall cover the deficits that occur in the Government's central account. Regulation (2007:1447) with instructions for the Debt Office.

38. The management of swaps between Swedish and foreign currency (currency swaps) shall be marked by predictability and clarity. Regulation (2007:1447) with instructions for the Debt Office.

Consultation and co-operation

39. The Debt Office shall consult with the Riksbank on matters concerning the parts of the borrowing activities that can be expected to have a greater fiscal importance. Regulation (2007:1447) with instructions for the Debt Office.

40. The Debt Office is to co-operate with the National Institute of Economic Research and the Swedish National Financial Management Authority in matters concerning the authority's forecasts of the Government's borrowing needs. Regulation (2007:1447) with instructions for the Debt Office.

41. The Debt Office should obtain the views of the Riksbank on how to invest funds borrowed to satisfy the need for public loans in accordance with the Act (1998:1387) on the borrowing and debt management of the Government.

Evaluation

42. Evaluation of the management of central government debt is to be carried out in qualitative terms in light of the knowledge that was available at the time of the decision. When possible, the evaluation shall also include quantitative measures.

43. The evaluation of the operative management shall, among other matters, concern borrowing in and the management of the different types of debt, market and debt maintenance measures and the handling of currency bills.

44. In the case of inflation-linked borrowing, the realised cost differential between the inflation-linked and the nominal borrowing shall be reported.

45. For borrowing on the private market, the cost savings compared with alternative borrowing shall be reported.

Current wording	Proposed wording
46. The result of *strategic and operative positions* within a given *risk mandate* shall be recorded continuously and evaluated in terms of market value.	46. The result of *positions* within a given *position mandate* shall be recorded continuously and evaluated in terms of market value.

Reasons for proposed changes

In this section the Debt Office describes the background to proposed changes to the guidelines. The Debt Office proposes that the target for foreign currency debt share be replaced by a maximum level for the foreign currency debt share. For reasons of clarity, the Debt Office also proposes new wording for a few of the existing guidelines.

1 Changed steering of the foreign currency debt share

The Debt Office proposes that guideline for the foreign currency debt share be changed from a fixed target to the following:

“The share of foreign currency debt may not be greater than 15 per cent of central government debt.

If the foreign currency share goes above the limit of 15 per cent, the share of foreign currency debt shall gradually be restored to below the limit.”

A conclusion in last year’s proposed guidelines was that there is no evidence that a fixed share of foreign currency debt exposure can reduce risk in terms of cost variation of central government debt. A share of foreign currency exposure can, however, be called for if that share contributes to reducing the expected cost while taking risk into account.

Since the possibility of reducing costs in this way will vary over time, it is not ideal to have a fixed target for the share of foreign currency debt. The Debt Office therefore suggests that the Government decide instead on a ceiling for the foreign currency debt share. The size of foreign currency share will then vary depending on the Debt Office’s assessment of the possibility of reducing expected costs while taking risk into account.

The Debt Office proposes that the ceiling be set at 15 per cent, which is the same level as the current target for the share of foreign currency debt.

The Debt Office expects to maintain the share of foreign currency debt more or less unchanged during 2014. Like last year there is good reason to await a decision on the Inquiry on the Riksbank’s financial independence and balance sheet. According to the Debt Office there are no strong arguments from an interest rate cost perspective against waiting to make changes in the foreign currency debt.

Finally it should be noted that this year’s and last year’s analysis is to be seen as a first step in the assessment of the foreign currency exposure. The ongoing analysis together with possible future changes to the regulations for and management of the foreign currency reserve will affect the conditions for managing foreign currency exposure in central government debt.

2 Clearer wording regarding position-taking

For reasons of clarity, the Debt Office suggests omitting the terms “strategic” and “operative positions” respectively and solely using the term “positions”. The change affects paragraphs 30-32 and 46. For the same reason the Debt Office suggests replacing the term “risk mandate” with “position mandate” in paragraph 10.

The terms strategic and operative positions may be confusing since all positions are taken in the tactical, not strategic, portfolio. The distinction serves no purpose in the guidelines since the mandate from the Government comprises all positions-taking. In accordance with the guidelines, the Debt Office’s board decides how much of this room that may be delegated to the day-to-day (running) position-taking.

The suggested terminology is discussed in more depth in the analysis section below.

3 Long-term target for bonds with long maturity

The Debt Office proposes that the word “long-term” be added to paragraph 16.

”For maturities over twelve years in nominal krona bonds, the long-term benchmark for the outstanding volume shall be SEK 70 billion.”

The proposal implies no change in practice but aims to clarify the current regulation. As the Government states in the reasons for the guideline decision, the benchmark is to be viewed as a long-term target. The rate of increase in relation to the benchmark is to be weighed against the growth of demand for long bonds and the cost of borrowing at other maturities.

Analysis and inquiry responses

Here the Debt Office follows up last year's analysis by analysing cost and financing risk aspects connected to the foreign currency debt.

1 Background

In last year's proposed guidelines, the Debt Office showed that it was not possible to prove that a fixed share of foreign currency debt in central government debt reduces the risk in terms of cost variation. Therefore, there was reason to reconsider the current fixed currency share of 15 per cent.

However, the Debt Office saw two reasons for waiting to make changes. A reconsideration of the currency share needed to be based on a deeper analysis of cost and financing risk aspects related to the currency debt. The Debt Office analyses these issues in this year's proposed guidelines.

An additional reason for waiting to make changes was to wait for a decision on the Inquiry on the Riksbank's financial independence and balance sheet. The outcome of that Inquiry, which was presented in January this year, and a coming bill from the Government may affect the foreign currency exposure in central government debt and also the Debt Office's role in the financing of the currency reserve.

The latter reason for waiting to make changes is still applicable. The Debt Office therefore is expecting to keep the currency share unchanged in principle during 2014. From an interest rate cost perspective, there are no strong reasons according to the Debt Office's assessment against waiting to make changes to the currency share. Therefore in summary, there is no reason to change the foreign currency share in the immediate future.

Section 2 gives further details about what the Debt Office analyses in this year's proposed guidelines. Then in section 3 the difference between financing and exposure is described and the issue of financing risk is analysed. Section 4 analyses the issue of cost.

In order to make clear the difference between decisions related to management within the framework of the strategic portfolio (guidelines and other decisions that form a benchmark for central government debt) and tactical decisions in form of positions intended to reduce costs based on assessments of interest rate and exchange rate changes, the terms strategic and tactical portfolio respectively will be used in the future.

The *strategic* portfolio refers to the composition of the debt that central government debt should have according to the guidelines in the form of guidelines for shares and maturities. The *tactical* portfolio refers to the position-taking. The Debt Office describes these terms more thoroughly in section 5. This section is an attempt to clarify the terms used in the guidelines for the position-taking and in the analysis of the exposure in foreign currency.

2 Further details about this year's analysis

Part of this year's analysis is about the issue of financing risk associated with the currency debt. In previous proposed guidelines the Debt Office has described the justification for having a certain regular issuance of bonds in foreign currency in order to reduce the financing risk. In order to achieve that, it is not necessary to retain the currency exposure resulting when the Debt Office issue a loan in foreign currency. Decisions about financing on one hand, and currency exposure on the other, are normally two separate issues that are dealt with separately. Having currency exposure in the debt is only justified if it can contribute to reducing the expected costs while taking risk into account.

This particular issue, whether it is possible to reduce the expected costs through currency exposure, is analysed in this proposed guidelines. According to the guidelines, the Debt Office has the opportunity to take positions with currency exposure for this specific purpose. However, this year's analysis does not concern this position-taking mandate. Instead the focus is on the strategic portfolio and the possibility of reducing the expected costs by having currency exposure there. If there is an expected cost saving, it must be large enough in relation to the increased risk the currency exposure leads to.

3 Funding versus exposure

There are two reasons for the Debt Office to issue foreign currency bonds. The first reason is to reduce the financing risk. Foreign currency bonds are the loan instrument where the Government has the greatest opportunity to borrow large amounts in a short time. To ensure that the Government always has efficient access to the international capital market, it is essential that an infrastructure for the borrowing is established.

This infrastructure covers many areas: knowledge among employees, routines, systems, access to the investors, legal prerequisites concerning, for example, the necessary

agreements and dealers. It may therefore be justified to have a regular issuance of bonds in foreign currency so as to ensure in that way that necessary conditions always are in place.

In the current situation, the on-lending to the Riksbank's currency reserve means that the Debt Office has borrowing in foreign currency that corresponds more than well to what is needed to maintain such borrowing channels. In the future however, it may be necessary for the Debt Office to borrow on its own account for this purpose.

The second reason for issuing foreign currency bonds is in situations where the borrowing requirement increases significantly and there are reasons to spread the borrowing among several types of debt. This means that the issue volume for government bonds does not have to change that much and the risk that the government bond interest rate will be pushed up by an increasing supply decreases.

When the Debt Office borrows in foreign currency bonds, the currency exposure that arises does not have to be retained. It can be converted into exposure in Swedish kronor through derivatives. Similarly, the Debt Office can create currency exposure without first having borrowed in foreign currency.

If the market depth for government bonds in kronor is sufficiently large, the interest rates will not be affected if the Debt Office increases the issue volume for government bonds, and then there is no connection between funding and exposure. Theoretically, the analysis of the currency share, which has to do with currency exposure, is independent of the analysis of the financing risk aspects and the choice of different financing alternatives. In practice however the market depth is not so large that the interest rate is not affected by supply. Normally, this would probably involve relatively small effects, but on rare occasions the effects can be significant, such as during the crisis in the 1990s.

If the effect is expected to be large, it becomes necessary to analyse the issue of funding and currency exposure in parallel, i.e. to take into account how the market prices are expected to be affected by the choice of funding. In other cases, the choice of currency exposure depends on the possibility of reducing the expected cost taking account of the risk of having currency exposure in central government debt. This is discussed in section 4 below.

4 Cost aspects

In previous guideline proposals the Debt Office has assumed that there are no theoretical reasons for believing in any systematic cost advantage with currency debt compared with debt in Swedish kronor (given a maturity-matched comparison).

The analysis in last year's proposed guidelines led to the conclusion that there was reason for a deeper study of this assumption. The Debt Office describes in this section how it could be possible to reduce the expected cost for central government debt by having foreign interest rates instead of Swedish interest rates in the strategic portfolio.

A natural starting point is uncovered interest rate parity which implies that if the interest rate is lower for a particular currency compared to the interest rate in kronor, the Swedish krona is expected to depreciate corresponding to the interest rate differential.[1] Given that the expectations are correct on average over time, it follows that on average it will cost the same in the long-term to borrow in all currencies. One condition for being able to reduce the cost through currency exposure is therefore that uncovered interest rate parity does not hold.

In the economic literature, empirical studies have shown that this is the case, i.e. the uncovered interest rate parity does not hold. It has even been shown that on average, low interest rate currencies, which according to theory should appreciate, have tended to depreciate instead.[2]

These studies typically comprise a wide selection of currencies studied over long time periods. It often turns out that a strategy that tries to take advantage of this phenomenon, consistently borrowing in low interest rate currencies and investing in high interest rate currencies, has resulted in a risk-adjusted return that stands up well in comparison with other strategies and investment alternatives. Strategies that try to take advantage of this, 'carry-strategies', are therefore common in the foreign exchange market.

4.1 Carry-strategy in the strategy portfolio

Under current regulations the Debt Office is not allowed to borrow with the purpose of investing in order to reduce the expected cost. The Debt Office views this regulation as good given that there are no assets in the portfolio. A carry-strategy basically means borrowing money in one currency and investing it in another currency. In practice however, the strategy is carried out using derivatives. Even though this does not actually involve a loan and an investment, it can readily be interpreted it that way.

Therefore, the Debt Office considers that a carry-strategy in the strategic portfolio should be limited to Swedish kronor as an investment currency (high interest rate currency) in the strategy. In practice this is as though the Debt Office borrows in foreign currency instead of in Swedish kronor.

[1] This is not to be confused with the covered interest rate parity which is an arbitrage condition saying that the price of forward exchange rates is fully given by today's spot exchange rate and the interest rate differential between two currencies.

[2] See for example Froot & Thaler (1990) and Engels (1996).

Since the strategy is limited to Swedish kronor as an investment currency, it is unlikely that there will always be an expected cost saving. If there is, it will probably be lower and the risk will be higher than in a more general carry-strategy.

Today the Debt Office already has a mandate to apply carry-strategies in the tactical portfolio. There, the strategy does not have to be limited as described above. The question is then why it may be advantageous to also have a carry-strategy in the strategic portfolio.

The strongest reason is that the Government has an advantage in its ability to take a long-term view and bear temporary losses. This particular ability has proved to be important empirically since carry-strategies can from time to time result in losses that may be hard for private players to bear.

The Debt Office believes that the Government's advantage in being able to be long-sighted is best utilised if the carry-strategy is in the strategic, rather than the tactical, portfolio. The strategy would be worse if the risk is seen in terms of market values since that would lead to a risk of acting in more short-sighted way.

For it to be possible to reduce the expected cost in this way there must be foreign interest rates that are low enough compared to corresponding Swedish interest rates. The currencies that would be relevant are probably typical low interest rate currencies like the Japanese yen and the Swiss franc. Furthermore, the assessment made must be that the interest rate differential will not be offset by a depreciation of the krona over time.

To best meet the objective of minimising the cost with regard to risk, the Debt Office believes that it is appropriate to have the possibility of applying a carry-strategy in the strategic portfolio. It will be the Debt Office's task to assess whether there is an expected cost saving with currency exposure and, if so, whether it is large enough in relation to the risk.

4.2 Ceiling for the currency share

A consequence of the above analysis is that there is no reason to have a fixed currency share. Instead, this share should be allowed to vary over time. If the Debt Office considers that there is no long-term expected cost saving, or that this saving is too small in relation to the risk, the currency share should be low. But if the expected risk-adjusted cost saving is large enough, the Debt Office should have currency exposure in the debt.

In order to adjust the management of the currency share in line with this, one solution is for the Government to decide on a ceiling for the size of currency exposure. The ceiling would limit how much currency risk is allowed in the strategic portfolio. It will then be the Debt Office's task to assess what the currency exposure should be.

A currency share ceiling gives the Debt Office a mandate to reduce the currency risk in the debt if the currency exposure is not expected to give a sufficiently large cost saving. Such a mandate should not be confused with the mandate to take positions in the Swedish exchange rate. There is a clear difference.

One condition for currency exposure in the strategic portfolio is that it is expected to give a sufficiently large cost saving to motivate the currency risk. The analysis is not affected by short-term movements in the interest rate and foreign exchange market. The assessment of the size of the currency share in the strategic portfolio is not based on a view about specific market movements like, for example, exchange rate movements but on assessments of long-term structural relations. Such structural cost advantages can be compared to the expected cost saving from borrowing in shorter maturities compared with longer ones, the 'term premium'. Changes in the currency share in order to take advantage of exchange rate movements are only allowed within the framework of the mandate for position-taking.

4.3 Ceiling of 15 per cent

The currency share should therefore be based on the possibility of reducing the expected cost by shifting exposure from Swedish interest rates to foreign interest rates. The Debt Office has not yet completed the analysis of these opportunities, but will analyse them continuously in the future.

A reasonable starting-point is for the ceiling for the currency share to be set at the current share of 15 per cent. At most the currency risk will then be about the same size as it is today.

4.4 The currency share in 2014

One factor to be considered regarding changes of the currency exposure in the near future is the outcome of the proposals presented by the Inquiry on the Riksbank's financial independence and balance sheet in January this year. Under its proposals the currency risk in the Riksbank's currency reserve will be hedged with forward contracts that the Riksbank enters with the Debt Office. In that case, the Debt Office will receive assets in foreign currencies in the form of forward claims on the Riksbank, reducing currency exposure for the Government.

The Debt Office is expecting to keep the currency share unchanged in principle in 2014. From an interest rate cost perspective, there are no strong reasons according to the Debt Office's assessment against waiting to make changes to the currency share. A ceiling for the currency share instead of a fixed benchmark gives the flexibility to reduce the share if this assessment were to change. For

example, the Debt Office could avoid rolling-over maturing basis swaps if they would no longer give an expected cost saving.

However, if changing the currency share were to be considered, this will be announced beforehand and thereafter carried out gradually over a long period of time.

4.5 Evaluation

The Debt Office intends to report how the ceiling for the currency share has been used and follow up the cost in the report 'Basis for evaluation of central government debt management'.

4.6 The inflation-linked share is unaffected

The alternative to currency exposure according to the Debt Office's proposal is exposure in nominal krona debt. This means that the inflation-linked share will not be affected by a change in the currency share. Therefore, there is no reason to change the inflation-linked share because of the analysis.

5 The terms strategic and tactical portfolio

In this section, the Debt Office describes the terms strategic and tactical portfolio. The section should not be seen as a part of the analysis above but rather as supplementary information for the purpose of clarifying the terms used in the guidelines for position-taking and in the analysis of the exposure in foreign currency.

The central government debt portfolio can be divided into two parts; a *strategic* portfolio and a *tactical* portfolio. It is common for portfolio managers to make this distinction since there are reasons to analyse and above all to evaluate different parts of the portfolio in different ways.

In general, the composition of a strategic portfolio is based on analysis of long-term market conditions and theoretical reasoning. This means that decisions related to the strategic portfolio are not made for the purpose of trying to take advantage of specific market movements. A choice is made in the strategic portfolio of what risks the portfolio should be exposed to in the long-term and what the risk level should be.

The Debt Office's strategic portfolio

The decisions concerning the strategic portfolio are primarily taken by the Government when approving the guidelines. In addition, the Debt Office's board makes decisions that affect the strategic portfolio within the framework of the guidelines.

Decisions about how to fund central government debt, and how to achieve the exposure that follows from the decisions about the strategic portfolio, are made within the framework of operative management.

The Debt Office's tactical portfolio

Decisions about positions are taken in operative management and are delegated from the Debt Office's board. These decisions belong to the tactical portfolio. Such tactical decisions are based on attempts to take advantage of specific market movements. These decisions are usually short-term, but can also involve taking advantage of market movements with longer-term strategies.

5.1 The purpose of the division

The primary distinction between the two portfolios, and also the very purpose of the division, is the possibility of evaluation. A strategic portfolio cannot and should not be evaluated on the basis of annual results, since the strategy has been chosen in the light of long-term and theoretical considerations. A very long time horizon is needed to evaluate the strategy. Therefore, the continuous follow-up is typically conducted in qualitative terms where the assumptions and assessments made are evaluated and reconsidered in light of the knowledge that was available at the time of the decision. This basically corresponds to the principles for long-term evaluation of the Government's guideline decisions.

For a tactical portfolio the decisions are taken with the purpose of improving the result. Since the purpose of the portfolio is clear, the evaluation can be carried out in absolute terms and can moreover be made with great accuracy. Connection to central government debt

This division of central government debt into two portfolios offers advantages, and the current guidelines are largely structured in this way.

The Debt Office's strategic portfolio

The strategic portfolio is simply the composition of central government debt according to the guidelines in the form of benchmarks for shares and maturities. The choice of composition and maturities is based on assumptions about future long-term market conditions in the light of financial and economic theory, quantitative analysis and qualitative reasoning. The government decides on the most important characteristics of the portfolio composition and thereby determines the trade-off between expected cost and risk. Some additional decisions, such as the composition of the foreign currency debt, are taken by the Debt Office's board.

The starting point for the strategic portfolio is that the time horizon is long and that the loans are held to maturity. That is why changes in market values are not viewed as risk. This means that the evaluation is not made in terms of market values but instead in terms of cost according to the cost measure that the Debt Office outlined in last year's proposed guidelines. The risk is measured as the variation in the cost.

The benchmarks for the strategic portfolio can be achieved in several ways and transactions can be made at different times. Moreover, consideration must be given to intermediate objectives such as striving for good liquidity, a broad investor base, the demand situation and current price relations in the market. The management of the portfolio therefore requires continuous attention with active decision-making. For example, this applies to the borrowing plans that the Debt Office makes, which include the choice of maturities and instruments. All these operative decisions are taken in order to achieve the benchmarks according to the strategy in the best way possible and are therefore not tactical decisions, since they do not involve deviations from the strategic portfolio and are not based on assessments about interest rate and exchange rate developments, even though they involve taking an active stance.

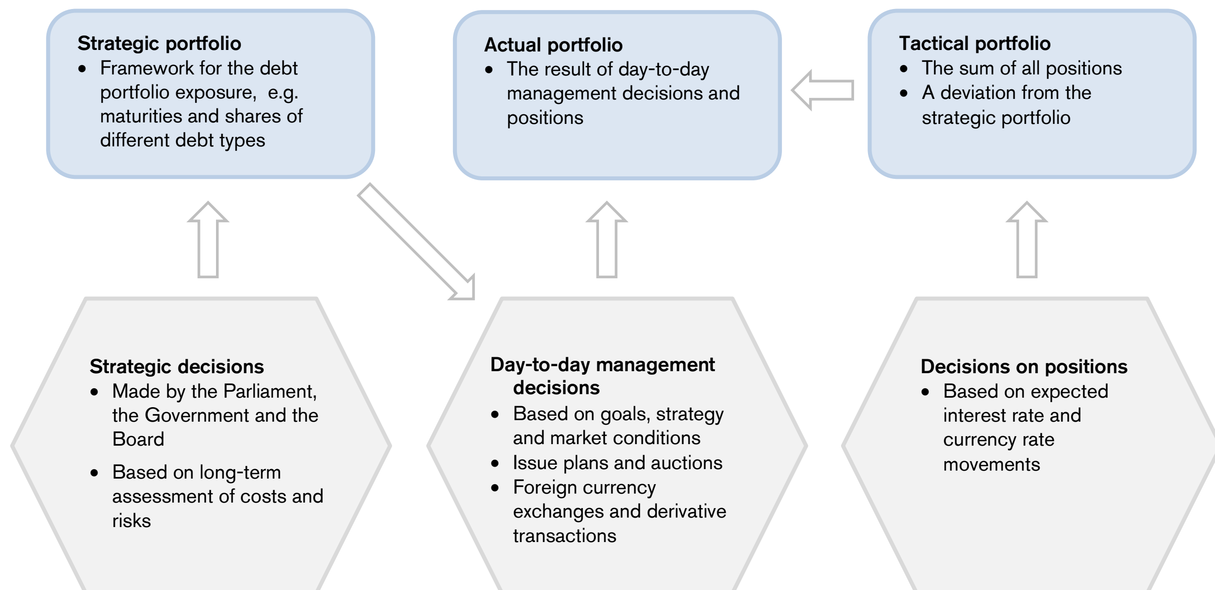
The Debt Office's tactical portfolio

The Debt Office has a mandate from the Government to take positions with the purpose of reducing the expected cost by taking advantage of specific market movements. The positions can be delegated, after decision by the Debt Office, to day-to-day management. Otherwise, the positions are taken by the board. Whether or not the positions are taken in day-to-day management, they are tactical decisions. That is why the Debt Office proposes that the term *strategic positions* be abolished since it can be confused with the strategic portfolio.

The evaluation of the position-taking is carried out in terms of market values. The risk is therefore measured in terms of changes in market values. Also the mandate for the portfolio is expressed in the guidelines in terms of market values.

FIGURE 4 SCHEMATIC OVERVIEW OF DECISIONS AND PORTFOLIOS IN THE DEBT MANAGMENT

Overall goal: Minmizing long-term costs while taking risks into account.
Sub goals: Openness, transparency, broad investor base and good liquidity.



The Parliament and the Government decide on goals and guidelines that constitute the strategic portfolio. The framework includes for example a benchmark for the share of foreign currency debt and the average time to re-fixing for different types of debt. Within this framework, decisions are made in the day-to-day management on the borrowing in terms of different instruments and maturities. In these decisions, the Debt Office takes market conditions into account as well as the sub goals, such as supporting liquidity in the government bonds market. Derivatives, like swaps and forwards, are also used in order to achieve the desired exposure. Positions are taken by adjusting the exposure of the debt portfolio, based on a view on interest rate and exchange rate developments, with a view to reduce costs and manage risks. The composition of the actual debt portfolio is a result of running management decisions and positions together.

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