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SWEDISH NATIONAL DEBT OFFICE

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Financial independence and balance sheet of the Riksbank (SOU 2013:9)

(Fi2013/484)

Summary

The Swedish National Debt Office (hereinafter referred to as the Debt Office) welcomes the fact that the inquiry has given the rules concerning the balance sheet of the Riksbank and related issues a detailed analysis. Based on the principles as to how government assets and liabilities are generally managed, the Debt Office can endorse the main components of the proposals put forward by the inquiry. Also with regards to the Riksbank, the basic principle should be that the government does not earmark funds and does not tie up more capital than is necessary. This will keep the costs of the activities of the Riksbank down, which will ultimately benefit taxpayers.

Thus, firstly, the financial independence of the Riksbank should be assured by giving the bank a statutory amount of interest-free capital that provides a return that with a margin covers the operating costs of the bank. It should be supplemented with a recapitalisation rule that is triggered if the interest-free capital falls below the specified level. An equivalent construction should apply to equity capital. Excess funds should be distributed to the government to reduce central government debt.

Secondly, the rules for when and how the Riksbank should be able to turn to the Debt Office to strengthen the foreign exchange reserves ought to be stated in legislation. In the same manner as with a recapitalisation rule, the Riksbank should be able to turn to the Debt Office for assistance with loans to restore the size of the foreign exchange reserves when parts of the reserves have been used.

The same principle should apply to Sweden's loans to the IMF. This means that when the IMF requests funds from the Riksbank, the Debt Office should borrow the equivalent funds and transfer them to the Riksbank. In this way the Riksbank needs neither a larger foreign exchange reserve, nor a special balance sheet for IMF commitments. The Debt Office also suggests that management of the costs of Sweden's loans to the IMF should be reviewed. It is fundamentally inappropriate that costs are covered by the net interest income of the Riksbank, and without clear disclosure.

Riksgäldskontoret
ORG.NR
202100-2635

POSTADRESS POSTAL ADDRESS
SE-103 74 Stockholm
Sweden

BESÖK VISITORS
Jakobsbergsgatan 13

TELEFON TELEPHONE
NAT. 08 613 45 00
INT. +46 8 613 45 00

TELEFAX
NAT. 08 21 21 63
INT. +46 8 21 21 63

INTERNET
riksgalden@riksgalden.se
www.riksgalden.se

Thirdly, the currency risks in the Riksbank balance sheet should be transferred to the Debt Office using forward contracts. This minimises the need to tie up capital at the Riksbank. At the same time, this allows the Debt Office to efficiently manage the government's overall foreign currency exposure.

1 Introduction

The Debt Office welcomes the fact that the inquiry has given the rules concerning the balance sheet of the Riksbank and related issues a detailed analysis. For a long time the Riksbank has had strong financial independence by virtue of the right to use its own net interest income to finance operations. However, there is a lack of formal regulation regarding how the capital and surplus of the Riksbank should be managed. In connection with the request made by the Riksbank in December 2012 for a loan of an additional SEK 100 billion from the Debt Office to strengthen the foreign exchange reserves, it also emerged that rules regarding foreign exchange reserves are unclear and designed in a way that may have undesirable consequences.

These are also the key subject areas for the inquiry. The first area addressed by the inquiry concerns the financial independence of the Riksbank, for which rules regarding distribution of profits and the bank's requirements and access to capital are the central issues. The second area concerns the Riksbank's need for foreign exchange reserves and how those reserves should be financed and managed (including loans to the IMF). There is a direct connection here to the activities of the Debt Office in that the task to strengthen the foreign exchange reserves when a need arises according to the Budget Act rests with the Debt Office. A third area addressed by the inquiry is the proposal that the currency risk on the Riksbank balance sheet should be transferred to the Debt Office using currency forwards. The intention is to minimise the need to tie up capital in the Riksbank. Also here the Debt Office is directly affected by the proposal.

In the referral response, the Debt Office addresses these three areas in turn. Then the response discusses a number of coordination and transition issues in relation to central government debt management raised by the proposals. However, the response begins with a presentation of certain fundamental starting points for government asset and liability management and how these should be applied to the Riksbank's activities.

2 The starting point for the referral response of the Debt Office

The referral response highlights the inquiry's proposals based on how they influence Debt Office operations. However, there are also reasons for the Debt Office to adopt a slightly wider perspective based on how management of assets and liabilities of the government sector, including the Riksbank, should be set up.

For a long time, the basic principle has been that the government does not take on larger debt than necessary and does not earmark funds or hold assets in actual funds other than in exceptional cases. The Riksbank is one such exception. This is reflected in the fact that the Riksbank – unlike other authorities – has its own balance sheet, with its own assets and liabilities. One reason is that in its function as the central bank, the

Riksbank issues banknotes and coins. Currency is a liability on the Riksbank's balance sheet, but as the public demands currency for other reasons than other financial assets, for example to facilitate payments, the Riksbank does not need to pay interest on these liabilities. At the same time, the Riksbank may invest funds of an amount equivalent to currency in circulation in interest-bearing assets. This creates a positive net interest income.

In principle, it could be envisaged that the whole net interest income should be delivered to an income title in the government budget in the same way as income from other government operations, and that the Riksbank, as other authorities, should be financed by appropriations determined by the Riksdag (the Swedish parliament). However, in practice the Riksbank has been able to use its net interest income to finance its activities and only the amount remaining after deductions for costs has formed the basis of the dividend to the government.

This arrangement means that the Riksbank had strong financial independence long before it was considered essential to provide it with the operational independence regarding monetary policy. In current circumstances, when the issue is to set out more clearly the basis for the Riksbank's financial independence, there is no reason to change this arrangement. Allowing the Riksbank to use net interest income is a simple way to ensure that the central bank can operate without needing to turn to the Riksdag with annual requests for funding. The Riksbank should also thus be able to use the return on the interest-free capital created by currency in circulation for funding of its operations, as up until now.

At the same time, this places a special responsibility on the Riksbank to manage its activities in a way that keeps costs at essentially the same level as if the activities had been funded by grants, and to ensure that assets are managed with due care. In the Bill proposed in the report on Riksbank financial independence (SOU 2007:51), there is an explicit rule stating that the Riksbank must manage assets so they provide a good return taking into account risk and its tasks as the central bank. The Debt Office argues that such a rule should be considered. Possibly, it should be supplemented with a rule regarding the responsible management of the costs. This would provide the Riksdag with a clearer basis for the evaluation of the Riksbank's activities.

Even if there are reasons to make an exception from the usual principles for funding government activities in the case of the Riksbank, there is no reason to place more capital in the Riksbank than what is needed to secure – with margins – its financial independence. Seen from an overall government perspective, capital earmarked for a specific purpose and put into specific funds increases central government debt, in the case of the Riksbank because dividends that could be paid to the government and used to reduce the debt do not occur. Funds tied up for a specific purpose reduce the preparedness and ability of the government to manage shocks and other types of crises other than those for which the funds have been built up. If the return on the funded assets is lower than the funding cost of the government, there is a direct cost to taxpayers. For example, this approach is reflected in that the Stability Fund and reserves of the Debt Office and other guarantee authorities consist of accounts in the Debt Office, not real asset portfolios.[1] Perhaps an even clearer illustration of this principle is that the Debt Office does not make advance funding on a large scale for the borrowing requirements of the government, even when forecasts indicate budget deficits.

Central government asset and liability management is thus based on principles intended to provide the government with the smallest possible debt at all times, maximising fiscal latitude to manage unexpected needs for expenditure, for whatever reason they may arise. Instead, the government borrows if and when needed to cover disbursements.[2]

The same approach can be applied to foreign exchange reserves. A foreign exchange reserve that exceeds the interest-free capital of the Riksbank must normally be financed using loans in foreign currencies through the Debt Office.[3] In the same way as capital invested in the Riksbank, this increases central government debt. In addition, the cost to the government of borrowed foreign exchange reserves is usually higher than the return that the Riksbank may receive on foreign exchange reserves. Consequently, the Riksbank's net interest income is reduced, a cost that is borne by the government through smaller dividends.[4]

It should also be noted that loans in foreign currencies represent a scarcer source of funding than loans in kronor, because in principle the government is always able to fulfil its commitments in kronor. However, it is usually easier to quickly raise large amounts in foreign currencies than in kronor if the government borrowing requirement increases unexpectedly. The reason is that the Debt Office has access to a wider range of investors in foreign currencies than in kronor.

3 Overall comments regarding the inquiry proposals

The Debt Office finds that the inquiry is based on the same starting points as those presented above. In particular, it should be noted that the proposals for a

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[1] The deposit insurance fund is invested in Swedish government securities and as such is an exception. As particularly noted by the Debt Office in its referral response to the Financial Crisis Committee report (SOU 2013:6), the fund should be converted to an account at the Debt Office.

[2] The government has appointed an inquiry which will, inter alia, consider whether there are grounds to build up a general buffer fund which would be at the disposal of the government. The Debt Office is looking forward with interest to the inquiry's analysis of the links between any such buffer fund and the foreign exchange reserves.

[3] The Riksbank may also acquire currency by buying it in the market in exchange for kronor. Such transactions typically have a foreign exchange policy objective. (An example from the outside world is the interventions of the Swiss National Bank to prevent further appreciation of the Swiss franc.) This means the balancing item on the liability side will be loans in kronor as the Riksbank must withdraw the krona liquidity provided. In this way, the government balance sheet is not affected in the same way as if the foreign exchange reserves were financed via loans or equity capital. If such transactions were to result in foreign exchange losses, they would be covered by the recapitalisation rule; see section 4 below.

[4] The inquiry's proposal regarding a levy on banks to cover the cost of strengthening foreign exchange reserves is discussed in section 7 below. It should be noted that when the reserve is used for lending to banks, a positive interest margin arises as the Riksbank then charges a premium on its own funding costs. However, when the reserve is used for lending to the IMF, additional costs may occur; see section 6 below.

recapitalisation rule and for replenishment of foreign exchange reserves only when a need arises are built on these principles. The same applies to the rules that excess funds should be distributed to the government if capital is at the statutorily-mandated levels. This means that the government raises loans for the Riksbank's account only when the money is needed and that this applies irrespective of whether it is done to supply equity capital or foreign exchange reserves. The difference from other government operations is that replenishment must occur before the fund runs out, which in turn reflects that there are good reasons to ensure that the Riksbank has interest-free capital and foreign exchange reserves of a certain size.

The proposal regarding hedging the currency risk for the Riksbank is also well in line with this approach. As long as currency risks are on the Riksbank balance sheet, they provide the arguments for more equity in the Riksbank. The same risks on the Debt Office balance sheet do not tie up capital, because the government's credit worthiness is based on its ability to raises taxes, not on funded capital. In addition, such a transfer of currency risk means that by adjusting the foreign currency share of central government debt, the government can choose whether to have any currency risk in its asset and liability portfolio at all. Unlike the situation in which the currency risk for assets is located on one balance sheet and for debts on another, the government may thus ensure the interest costs and budget balance are only marginally affected by exchange rate fluctuations. The Debt Office can thereby manage the collective currency risk of the government more efficiently.

Against this background, the Debt Office endorses the main elements of the inquiry's proposals. In the following sections, the Debt Office presents more detailed comments on the various proposals.

4 Capital requirements of the Riksbank

Inquiry proposal: The Riksbank should have interest-free capital of at least SEK 75 billion, of which SEK 30 billion in equity capital. Both the interest-free capital and the equity capital should be indexed to inflation and protected by recapitalisation rules. Dividends may occur only if the interest-free capital and equity capital are at the statutorily-mandated levels.

The comments of the Debt Office in brief: The Debt Office considers the proposal well balanced by giving the Riksbank the net interest income required to cover – with a good margin – the operating costs of its activities. A recapitalisation rule connected to a capital concept that includes currency in circulation strengthens the financial independence of the Riksbank by preserving the financial independence of the Riksbank also if currency in circulation were to fall significantly.

The Debt Office agrees that the Riksbank, through rules in the Riksbank Act, should be guaranteed a certain equity capital. Therefore, a recapitalisation rule that is triggered if the equity capital falls below a specified statutory amount should be introduced. However, the justification for giving the Riksbank equity capital of a certain size would have benefitted from a more detailed analysis of which role this equity capital plays for the Riksbank's ability to fulfil its tasks.

Interest-free capital

An important starting point for the inquiry's analysis of the capital requirement is the report on financial independence of the Riksbank (SOU 2007:51).[5] The inquiry also chooses to apply the same basic perspective on financial independence as the previous inquiry. This means that financial independence is defined as the ability of the Riksbank to operate without being dependent on continuing appropriations from the Riksdag. This is achieved by guaranteeing the Riksbank an interest-free capital that allows the bank to cover – with a margin – its costs using the return on the assets in which the interest-free capital is invested. The inquiry additionally recommends that banknotes and coins in circulation are included in the interest-free capital. Crucial to the assessment of capital need is therefore, firstly, the Riksbank's costs and, secondly, the return on the interest-free capital.

The Debt Office finds that the inquiry's estimate of the interest-free capital requirement is prudent and thus well-balanced. Given that the currency in circulation in the starting position is also considerably larger than SEK 75 billion (and the proposal is that the Bank should also have equity capital; see below), in practise the margins for the foreseeable future are even greater. Through the dividend rule and the recapitalisation rule being connected to a capital concept that includes currency in circulation, the Riksbank is protected against both operating losses and a decrease in demand for currency as a result of changes in payment customs.

Equity capital

The inquiry's conclusion that the Riksbank should have a minimum equity capital of SEK 30 billion has a different basis than that which applies to interest-free capital as a whole. Here, the starting point is how much risk of loss is inherent in the activity and what the consequences would be if the equity capital of the Riksbank should drop below zero.

The Debt Office notes that the inquiry does not provide any real analysis of the connection between the equity capital of the Riksbank and its ability to fulfil its tasks. It states that financial independence is not threatened as long as the interest-free capital base is sufficiently large. Instead, the argument is that negative equity would "risk reducing confidence in the ability of the Riksbank to perform its duties in the public eye. This can lead to uncertainty and instability in the financial system. More generally there should be a relationship between public confidence and the financial capacity of the Riksbank. However, it is worthwhile noting that the financial capacity is determined

[5] The report was circulated for comment but did not lead to legislation. The Debt Office's official response (in Swedish) is available here:
https://www.riksgalden.se/Dokument_sve/om_riksgalden/remissvar/2007/Riksbankens%20finansiella%20oberoende%202007-11.pdf

by both total assets and the borrowing opportunities for the Riksbank, not necessarily only of total assets." (p. 160).

The Debt Office agrees with the latter statement and believes that these aspects should have been elucidated in more detail. The relationship between the Riksbank's equity capital and the views regarding financial stability (or the price stability target) is not explained. The Riksbank is rightly understood to be a part of the state. This means that a necessary condition for the Riksbank to appear financially strong is that the government is strong. However, it is difficult to imagine that a central bank that is – in some sense – financially strong can lend credibility to a state with faltering central government finances.

As such, public confidence in the central bank is therefore probably governed more by its actual and expected actions in important policy issues. The relevant question is therefore whether the equity capital of the central bank plays a significant role in this regard. This aspect is not discussed in the inquiry but economic literature mentions the connection between the capital of a central bank and its policy decisions. However, these are based on mechanisms that are strange in a Swedish context.

One such mechanism is that a central bank that has large interest-bearing debts out of concern for the effect on its own interest income would be reluctant to raise interest rates even though inflation is expected to be above target. The Debt Office believes that such a development is excluded in the case of the Riksbank, given the transparency and clarity surrounding monetary policy decisions. In addition, this mechanism is based on the fact that the interest-free capital is small relative to interest-bearing debts. Therefore it provides no guidance on how large the equity capital should be. In particular, with a recapitalisation rule connected to the interest-free capital, it is difficult to see that this mechanism is relevant.

Nevertheless, for pragmatic reasons, the Debt Office still regards it as appropriate that the Riksbank can consistently report a positive equity capital. Therefore, there should be a recapitalisation rule introduced that is connected to equity capital as proposed by the inquiry.

How much the equity should be is ultimately a matter of assessment. The Debt Office refrains from commenting on the exact figures.

5 The Riksbank's need for foreign exchange reserves

Inquiry proposal: In normal times the Riksbank shall have a foreign exchange reserve equivalent to the interest-free capital, i.e. at least SEK 75 billion. To be able to fulfil the task of providing liquidity in foreign currency with a secure margin, the Riksbank shall be entitled to strengthen the foreign exchange reserves in advance to SEK 200 billion (indexed) through loans from the Debt Office. When the Riksbank has provided liquidity support, it shall be entitled to replenish the foreign exchange reserves by borrowing from the Debt Office. No limits on total borrowing for foreign exchange reserves shall be set.

The comments of the Debt Office in brief: The Debt Office backs the inquiry's proposals regarding overall regulation and decision-making arrangements. The Debt Office refrains from specifying how large the foreign exchange reserves should be.

In a memorandum submitted to the Ministry of Finance in January 2013, in connection with the decision to grant the request from the Riksbank to increase the foreign exchange reserve, the Debt Office wrote:[6]

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

Thus, the Debt Office shares the inquiry's opinion that it is appropriate and desirable to establish in legislation the conditions under which the Riksbank should be able to turn to the Debt Office to strengthen the foreign exchange reserves.

The size of the foreign exchange reserves needed by the Riksbank is ultimately a matter of judgement. The Debt Office finds no reason to state a specific figure. However, the Debt Office wishes to comment on the grounds for the assessment which must be made. It is as important to distinguish on one hand between how large the reserve needs to be in the starting position and how much foreign currency the Riksbank needs to have access to on the other. For the bank to be able to perform its task of providing liquidity in foreign currency, the latter factor is crucial. Foreign exchange reserves at the start of the crisis will be of decisive importance only if the Riksbank is not able to access foreign currency in any way other than by reducing the reserve. Likewise, it is of crucial importance whether other methods of supporting bank funding are available or not.

This is illustrated by the limited extent to which the Riksbank turned to the initial foreign exchange reserves during the financial crisis. The bulk of the funds used had instead been obtained from the Federal Reserve. The Riksbank also borrowed euro from ECB. In addition, the foreign exchange reserves were strengthened by the Debt Office borrowing SEK 100 billion in foreign currency on behalf of the Riksbank.

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[6]The memorandum can be read here: https://www.riksgalden.se/Dokument_eng/about/PRM_20130129_Riksg%c3%a4lden%20l%c3%a5nar%20ut%20100%20miljarder%20till%20Riksbanken_eng.pdf

Furthermore, the government guarantee programme supported the foreign exchange funding of the banks by the same magnitude as the Riksbank's lending did.

If it is assessed that the possibilities for the Riksbank to borrow foreign exchange from other central banks in a crisis are uncertain, the latter two factors are of crucial importance. This is also the starting point for the inquiry: "The Riksbank foreign exchange reserves should be large enough for the bank to be able to provide liquidity support with an adequate margin to the extent necessary until the foreign exchange reserves can be replenished through borrowing via the Debt Office and state guarantees for borrowing by the banks can be provided." (p. 125).

The Debt Office believes that there are strong reasons to assume that the Debt Office has on-going possibilities to borrow in foreign currency and that state guarantees provide an effective means of support for the banks' funding in a crisis. This assessment is supported by practical experience.

The inquiry notes that during the crisis in the 1990s, the central government debt in foreign currency increased from the equivalent of SEK 60 billion in June 1992 to SEK 340 billion in June 1993. The drop in value of the krona in this period affects the numbers, but the bottom line is a massive increase in borrowing. During the same period the government maintained confidence in the banking system through a blanket guarantee. Thus, despite the prevailing severe economic and fiscal situation, the international debt markets were available to the Swedish government and the state guarantees were fully credible.

The start of the financial crisis in Sweden in 2008 was characterised by a move *to* Swedish government securities, which meant the Debt Office made extra issues of Treasury bills. During an otherwise troubled period in 2009, the Debt Office also quickly borrowed SEK 100 billion extra in foreign currency for the Riksbank. The attraction of Swedish government securities – in both kronor and foreign currency – has since only strengthened. Therefore to raise SEK 100 billion in a short period of time in 2013 was problem-free.

The government guarantee programme would also have been able to manage larger commitments than was the case. The limit was set at SEK 1,500 billion. If in 2008-2009 the banks had not been able to acquire foreign currency via the Riksbank on favourable terms, by all accounts more of them would have covered their foreign exchange needs by joining the guarantee programme. How aid came to be distributed between the Riksbank and the Debt Office thus reflects the fact that banks chose the more beneficial option rather than the credibility or potential of the measures.

Thus these experiences support the view that the basic principle stated by the Debt Office in section 2 applies also in critical situations. The government does not borrow more funds than required to meet current commitments other than in exceptional cases.

No justification for assuming that the Debt Office would be unable to borrow in foreign currencies or that state guarantees would not work has been given. Even if such justification existed, this would not be a reason to lock the government (in certain situations scarce) access to foreign exchange in the Riksbank's foreign exchange reserves, where they are earmarked for support of the funding of the banks. In a hypothetical situation in which the Debt Office cannot borrow and state guarantees do not work, the Swedish government would by definition have deep financial and credibility problems. It is then the government's needs for foreign exchange to meet its own commitments that must take priority, not the banks'.[7] Any concern that the government will have funding problems would thus speak in favour of the creation of a buffer fund at the disposal of the government, but not to consolidate foreign exchange reserves.[8] If the situation permits, these funds can also be used to provide liquidity support in foreign currencies to banks.

The Debt Office therefore supports the inquiry's proposal to consider the ability of the Debt Office to borrow foreign currency when needed and to establish credible funding guarantees as the fundamental basis for analysis of the appropriate size of the foreign exchange reserves. The Debt Office also endorses the proposal that the amount the Riksbank may borrow via the Debt Office to strengthen the foreign exchange reserves should be statutorily mandated and that the Riksbank shall be entitled to borrow foreign currency via the Debt Office in order to return the fund to that level.

From a fiscal standpoint, it may seem adventurous to not establish any limit on how much the Debt Office will be able to borrow for this purpose. However, the Debt Office considers that in practice it will not be a question of unmanageably large amounts. Firstly, there are other crisis management tools, not least state guarantees, which achieve the same purpose without requiring government borrowing. Secondly, since the crisis of 2008-2009, preventive measures have been taken to reduce the short-term funding of the banks with more on the way. For example, the Swedish Financial Supervisory Authority introduced requirements for liquidity buffers in foreign exchange. Therefore, the Debt Office sees no reason for establishing a statutory ceiling on the amounts that can be borrowed for the Riksbank.

In this context, the Debt Office notes that the inquiry's proposal provides the Riksbank with more flexible access to foreign currency than the ECB has. The basic structure is the same in the sense that the ECB also has a statutory foreign exchange reserve and

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[7] It is uncertain whether one can really make a difference between the banks' and government's needs for foreign exchange in such an acute crisis, i.e. it is conceivable that if the banks fail then the government will also suffer. However, it is obvious that if the government defaults, the banks cannot be saved through liquidity support taken from foreign exchange reserves. The only salvation for the government (and the banks) in this case is international support, i.e. Sweden would need an IMF programme or similar.

[8] An assumption here is that not even in such a crisis would the foreign exchange reserves be at the disposal of the state, i.e. the Government. This is likely to depend in practice on the circumstances, but there are no rules that give the government the power of disposal over the foreign exchange reserves. (There is also a connection here to the inquiry mentioned in footnote 2.)

may request more foreign currency to bring the reserve back to that level. In the ECB statutes there is a cap on how much can be added. The Riksbank, on the other hand, may in principle under the proposal have at its disposal any amount of foreign currency. Moreover, the basic reserves of the Riksbank will be indexed. By clearly going beyond the rules that apply to the ECB, the inquiry's proposal must be considered as complying with the rules in the ECB statutes with a good margin.

6 Management of Sweden's commitments to the IMF

Inquiry proposal: Sweden's commitments to the IMF shall be reported on a separate balance sheet. Loans to the IMF shall be financed through borrowing from the Debt Office.

The comments of the Debt Office in brief: The Debt Office recommends that loans to the IMF be financed via the Debt Office. However, the proposal for a special balance sheet for IMF commitments appears unnecessarily complicated. The intention that the government is responsible for Sweden's lending can be achieved more directly through the principle that the Debt Office replenishes the foreign exchange reserves if they have been made use of applying also to loans for the IMF.

The Debt Office agrees with the view regarding loans to the IMF as essentially a government commitment. In accordance with the current system, the Riksbank functions as the central government's bank and foreign exchange reserves as a form of deposit account in which the government has funds deposited, pending a possible request from the IMF for disbursement of loans. From the principles stated by the Debt Office in section 2 above, it follows that such advance borrowing and earmarking of funds is not a suitable arrangement.

However, the Debt Office questions whether it is necessary to introduce a special balance sheet to overcome the disadvantages of the current system. If the principle that the Debt Office stands ready to replenish the foreign exchange reserve if it is made use of is applied also to loans to the IMF, the same result is achieved. In particular, the Riksbank's access to foreign currency for liquidity support is unaffected, while the government avoids borrowing funds before they are needed for payments. In this context it should be noted that IMF programmes are put together in a way that gives considerable advance notice. This enables the Riksbank to forewarn the Debt Office, which in turn will be well positioned to raise the funds efficiently.

The inquiry also suggests that it must be stated in the Riksbank Act that the Riksbank does not bear credit losses on loans to the IMF. However, neither this purpose justifies a separate balance sheet. Following the inquiry's other proposals, any credit loss will still always be borne by the state via reduced dividends or through triggering of the recapitalisation rule.

A more radical change would be to transfer the task of providing loans to the IMF directly to the state (via Debt Office), i.e. without using the Riksbank's balance sheet. It corresponds to the way the government manages other lending, such as the bilateral loans to Iceland and Ireland. The Debt Office lacks the information to assess other conditions and the further consequences of such a solution, but by virtue of appearing to be much simpler, it deserves to be considered.

The cost of lending to the IMF should be reduced and clearly reported

The Debt Office would additionally like to note that there is a cost to the IMF commitments, which the inquiry does not discuss. It is connected to the interest rate conditions on loans to the IMF. IMF pays an interest rate equivalent to the weighted average interest rate on three-month government securities, where the weights are the same as in the currency baskets making up the SDR ("special drawing rights"). However, loans to the IMF are usually long term, which means that they should be funded by borrowing at maturities longer than three months. Given that long-term loans usually have higher interest rates than short-term, a cost may arise – unlike the liquidity support paid to banks – in addition to the cost related to the fact that the Swedish government cannot borrow at the same rates as the home countries of the currencies included in the SDR.

The magnitude of the effect on the cost will be affected by how lending to the IMF is financed and otherwise managed. One way of reducing the cost is, as the inquiry proposes, to finance lending through the Debt Office when the IMF uses its line of credit. This will avoid the government having to have loans and assets in foreign currencies at the same time for as long as possible.

A second step is to try to ensure that the difference between the interest rate the IMF pays and the government's own borrowing cost is as small as possible. Given that the IMF receives long-term loans with variable interest rates, it would be appropriate for the loans to be financed in a corresponding manner. For example, this could mean that the Debt Office raises loans with long maturities, while simultaneously shortening the interest fixing period to three months using interest rate swaps. This means (somewhat simplified) that the cost is limited to the difference between Debt Office interest costs for example for three-month (swapped) dollar loans and the interest rate on three-month U.S. government securities. The government can thus avoid paying the higher cost for a loan with a fixed interest rate.

The Debt Office notes that the current system, under which IMF lending is financed directly from foreign exchange reserves, is more expensive. Firstly, the government has a cost for foreign exchange reserves that has been strengthened in advance, partly with reference to these IMF commitments. This cost is according the Riksbank's assessments about 0.20 percentage points. Secondly, the Riksbank raises loans via the Debt Office without making swaps, i.e. the bank pays fixed interest even when the funds are used for on-lending to the IMF.

The Debt Office does not have enough information to estimate the costs of Sweden's IMF commitments. These are influenced, inter alia, by how the Riksbank rearranges foreign exchange reserves when loans are paid to the IMF. However, it is possible to conclude that such costs exist. Furthermore, it should be noted that under the current arrangements, the costs are covered by the Riksbank's net interest income, i.e. the surplus distributed to the government becomes correspondingly smaller.

The Debt Office considers it inappropriate to manage the government's costs for the loans to the IMF in this way. Firstly, the IMF loan is a form of international aid which should be financed and accounted for in the same way as other measures of this kind. The arrangement can also be compared with the loans Sweden has given directly to Iceland and Ireland. These are financed and managed by the Debt Office. Results are also reported. In these cases there is a surplus as interest rates on the loan exceed the funding costs of the Debt Office.

Secondly, the costs for the IMF commitments affect the earnings that form the basis for the financial independence of the Riksbank. This could be compensated through the Riksbank having more interest-free capital, but for reasons stated above this also entails a cost and is therefore inappropriate. Moreover, as it is unclear how extensive lending to the IMF will be in practice, it is difficult to assess how much capital would be needed in such cases.

Against this background, the Debt Office considers that there should be special rules introduced for managing interest charges on loans to the IMF. A conceivable solution is that the budget law specifies that if the foreign exchange reserve is strengthened as a result of lending to the IMF, the Riksbank shall not be liable for covering Debt Office costs, but only for forwarding the interest paid by the IMF to the Debt Office.

However this is not sufficient. The result would be that the costs of IMF obligations fall on the appropriations for interest payments on the central government debt, which would also not be consistent with requirements in budget legislation regarding transparency in reporting of government costs. Instead, the difference between the borrowing cost the government pays and the interest rate the borrower pays – in this case the IMF – should be regarded as a subsidy in accordance with the principles of government lending incorporated in the budget legislation. The Riksdag should – also under the principles embodied in budget legislation – assign funds to cover this cost. As it is the Riksdag that decides Sweden's commitments to the IMF, it is also appropriate that the Riksdag makes the decision to allocate funds to cover the costs.

7 The costs for the borrowed portion of foreign exchange reserves

Inquiry assessment: Banks that have borrowing and lending in foreign currencies should be included in a mandatory insurance scheme that guarantees them liquidity support if necessary. The details of the insurance scheme should be further investigated.

The comments of the Debt Office in brief: Transferring the costs of an insurance scheme to those that benefit from it is a reasonable starting point. However, the Debt

Office thinks that the question of how the government should manage risks arising from the foreign currency loans by the banks should be given a more broad analysis. Incentive problems can arise due to the fact that in a systemic crisis the banks are insured against liquidity risks in foreign exchange, even if the foreign exchange reserves is not strengthened in advance. It is sufficient that the banks know that the foreign exchange reserves will be replenished as required or that the government is ready to introduce a guarantee scheme.

The inquiry chooses to link the effects of the banks having an implicit insurance against liquidity crises in foreign currencies to the fact that this can make the Riksbank increase the foreign exchange reserves in advance and that this will lead to fiscal costs. According to the inquiry these costs should be financed by fees paid by banks.

Transferring the costs of an insurance scheme to those that benefit from it is a reasonable starting point. The implicit guarantee of the banks' foreign currency funds constitutes a subsidy (to the extent it is not offset by other elements of the regulatory system; see below). An insurance fee would reduce the value of the benefit the banks have from this guarantee.

However, the Debt Office considers the inquiry's suggestion to link the fee to the fiscal costs of strengthening the foreign exchange reserves is based on an overly narrow view. The costs to society of the banks' foreign currency borrowing have, by all accounts, weak or no relation to the cost of strengthening the reserves. Furthermore, the costs would be of the same size even if the government chose to strengthen the reserves only when necessary. The incentive problems referred to by the inquiry arise also in that situation, and also if support is expected to come by way of a guarantee programme.

If there are distortions due to the government being forced to provide liquidity support in a financial crisis, they should be corrected irrespective of how that support is provided. One illustration of this is that the government has reason to limit bank funding risks also in kronor, although there is no direct cost to the government to be prepared to provide liquidity support in kronor (via the Riksbank).

It is also worth noting that the current regulatory framework includes measures intended to limit the banks' funding risk. This is most clearly apparent from the Swedish Financial Supervisory Authority requirement for the large banks to hold liquidity buffers. These regulations also place a special emphasis on funding in foreign currency by including requirements for separate buffers in dollars and euros. The goal of limiting the refunding risk in foreign currency has thus already been identified and measures have been taken.

It should also be emphasised that liquidity buffers have effects reminiscent of fees, since a bank incurs a cost to maintain such a buffer. In principle, the cost is equivalent to the difference between the bank's borrowing cost in foreign currency and the return it has on assets it is allowed to include in the liquidity buffer. Furthermore, the cost is borne directly by the bank, which as a result has reason to consider how the liquidity requirement will be affected when it decides how large the funding amount in foreign exchange should be and at which maturity term it should borrow. In this respect, the cost is risk-related.

An analysis whether additional measures to influence foreign currency funding of the banks are called for should, as a first step, consider if there are inadequacies in the current regulatory framework. A second step should consider if any deficiencies can be corrected through adjusting current policy instruments. Only in a third step is it appropriate to consider further policy instruments, for example explicit fees. In this context, it would also be reasonable to test whether a risk-related stability fee should take bank funding risks into account before a new fee with special processes for collection etc. is introduced. And these analyses should be based on the underlying objective, i.e. to limit the costs and risks to society associated with banks' foreign currency funding.

The Debt Office notes that borrowing to strengthen the foreign exchange reserve in advance can functionally be seen as a liquidity buffer created by the Riksbank for the banks as a collective. The inquiry defines this as an insurance scheme and such elements exist. But as it is not specified in more detail in what circumstances a bank can access liquidity support from the Riksbank, it is difficult to assess the value of such insurance. For example, it is important whether the Riksbank is prepared to provide loans to an individual bank with funding problems or if support is only to be provided in a systemic crisis. Thus it would be difficult to determine with any degree of accuracy a fee which can be allocated among the banks in such a way that it has a governing effect on their funding.

However, there are reasons to suggest that a collective buffer in which the banks collectively bear the Riksbank's cost of having a larger reserve is cheaper for the banks than the equivalent amount in individual liquidity buffers. If it is assumed that assets in foreign exchange reserve and the bank buffers have roughly the same return, the difference will arise because the Riksbank – via the Debt Office – is able to borrow more cheaply than the banks. Whether this is a desirable characteristic is difficult to assess without a deeper analysis, for example the interaction between the Swedish Financial Supervisory Authority's liquidity requirements and this collective insurance.[9]

The inquiry offers no suggestions regarding how an insurance charge would be constructed but proposes further analysis. With the preceding comments the Debt Office wants to point to need to analyse how the risks associated with banks' borrowing in foreign currency should be managed in a broader perspective than the

[9] One aspect is how the costs of liquidity buffers vary over time. If the borrowing costs to the banks rise sharply during a crisis, it increases the cost of holding buffer assets which can have undesirable pro-cyclical effects. These would be mitigated if the buffer is provided by the government. For a more general discussion, see Jeremy C. Stein, "Liquidity Regulation and Central Banking" (http://www.federalreserve.gov/newsevents/speech/stein20130419a.pdf).

inquiry indicates. The starting point should take into account the effects on the functioning of the financial markets, including the financial stability, of foreign currency loans. Pending such analysis, the charging of a funding fee is conceivable, but a better approach would be to reduce the foreign exchange reserves in accordance with the inquiry's proposal.

8 Exchange rate risk in the Riksbank's asset management

Inquiry proposal: The inquiry proposes that the exchange rate risk in the Riksbank's asset management be eliminated by transferring the risk to the Debt Office via forward contracts.

The comments of the Debt Office in brief: The Debt Office endorses the inquiry's proposal. Such a solution reduces the need to tie up capital in the Riksbank. At the same time the state's exchange rate risks can be managed in a more efficient manner by gathering them at a single authority. With regards to the technical design, the Debt Office advocates cash settlement rather than debt settlement.

The Debt Office shares the view of the inquiry that hedging provides for more efficient management of the state's exchange rate risk. If the exchange rate risk is transferred to the Debt Office, assets will be clearly offset by a portion of the central government debt in foreign currency. This is particularly true if hedging is designed so that settlement takes place via payments, since currency gains and losses offset each other in the interest payments on the central government debt. In this way, variations in interest payments can be reduced, which in turn (on the margin) reduces variations in the interest expenditures on the central government debt and thus in the budget balance.

Whether it is desirable to retain some exposure to foreign currencies in the central government debt should be determined on the basis of the central government debt management targets, i.e. cost minimisation with due regard to risk. Decisions on this issue should therefore be made within the regular governance structure for central government debt management and they are in principle independent of whether the Debt Office takes over the Riksbank's exchange rate risk.

Settlement methods

The Debt Office proposes that the results from forward contracts are regulated by payments between the Riksbank and the Debt Office. The method is described in more detail in an appendix to the inquiry.

The Debt Office sees big advantages with cash settlement compared with the alternative of debt settlement. With cash settlement the forward contracts are managed in the same way as other derivatives that are included in the central government debt. Gains and losses are incorporated in the interest payments on the central government debt and offset against exchange rate effects on the foreign currency debts. The reporting of the central government debt and its costs will be more transparent.

Practical management will also be simplified as there are already system support and processes for such a standardised solution.

An additional aspect that may be worthy of note is that if the profits are regulated with payments the Riksbank is not required to have a debt with the Debt Office against which gains and losses can be offset. The inquiry concludes that under normal circumstances, there is no need for strengthening foreign exchange reserves by borrowing via the Debt Office. The debt settlement method would therefore require a permanent increase of foreign exchange reserves, which runs counter to efforts to reduce the cost of foreign exchange reserves.

Cash settlement may entail certain disadvantages, since this method may require more transactions.

When the krona appreciates, this increases the value of outstanding forward contracts in favour of the Riksbank. This is an entirely normal result for a forwards transaction, but the issue may still arise if the claim held by the Riksbank on the Debt Office until the maturity date should be interpreted as the government having borrowed from the Riksbank. If so, this would be contrary to the prohibition against monetary funding. If a legal inquiry were to show that the regulatory framework should be interpreted in this strict way, it could be solved using daily settlement so that the market value of the forwards transactions is always zero at the end of the day. Daily settlement will probably mean more administration but is standard practice for certain derivatives and can be managed in business systems.

When the forwards transactions mature (or continuously in the case of daily settlement) an amount in kronor equivalent to the value of the forward contract will be exchanged between the Riksbank and the Debt Office. Such changes will have to be offset within the Riksbank's framework for keeping the overnight interest rate in line with the policy determined repo rate.

The Debt Office notes that both settlement methods are feasible. Roughly stated debt settlement has practical advantages for the Riksbank, whereas cash settlement has reporting advantages for the Debt Office. In addition, there some other practical differences, but they are manageable. How these effects should be balanced and assessed can and should be discussed, but these considerations do not change the conclusion that using forward contracts to secure the Riksbank's foreign exchange reserves constitute a sensible and suitable solution for the state as a whole.

9 Management of the transfer of funds to the government

Inquiry proposal: The inquiry's proposal means that SEK 73 billion can be transferred from the Riksbank to the government as a special dividend. The inquiry also proposes a ceiling on the size of foreign exchange reserves equivalent to SEK 200 billion. This means that the government lending to the Riksbank will be reduced by an estimated SEK 125 billion.

The comments of the Debt Office in brief: A special dividend of SEK 73 billion to the government can be handled in the liquidity management of the Debt Office. In the view of the Debt Office, the transfer should occur via a payment made in foreign currency. The Debt Office considers the loan-financed assets in the foreign exchange reserves that exceed the statutorily-mandated level should be phased out gradually in line with when the loans raised by the Debt Office to finance lending to the Riksbank mature.

The Debt Office can manage a one-off dividend payment to the government of SEK 73 billion in its liquidity management. For reasons of transparency the transfer should be made via a payment and not by way of the Debt Office taking over assets. In this manner the reporting is clear and no ambiguity arises regarding the market value of the transferred securities.

To avoid strains on the foreign exchange market for kronor the Debt Office believes it is appropriate to make the transfer in foreign currency. The funds can then be used primarily to finance repayment of loans in foreign currencies as they fall due. To the extent a portion of the amount will be exchanged into kronor, this can be done within the framework of the Debt Office's regular foreign exchange mandate. The mandate is designed so that net exchanges in kronor are spread out evenly over time to avoid affecting the exchange rate.

In the summer of 2008, the Debt Office took care of the revenue from the sale of Vin & Sprit which was equivalent to SEK 50 billion in foreign currency. The money was used to gradually amortise the foreign exchange debt. Then an equivalent volume of foreign currency bonds fell due within the space of about six months. Here a dividend is proposed of a larger amount and at a time when the outstanding stock of foreign exchange loans (apart from on-lending to the Riksbank) is less than that of 2008. It may be worth noting that it may therefore be necessary to maintain assets in foreign currencies for a somewhat longer period in this case. However, the Debt Office cannot see that it would be a problem.

The strengthened foreign exchange reserve should wound down gradually

A ceiling for foreign exchange reserves to the equivalent of SEK 200 billion would mean that the Debt Office's lending to the Riksbank would be reduced by an estimated SEK 125 billion compared with today. The Debt Office believes that such a reduction should be made gradually at the same pace as the loans mature.

If the Riksbank were to realise assets and repay the amount immediately, the Debt Office would have to invest funds in foreign currency until the loans mature. For cost reasons, it is neither appropriate nor possible to buy back the bonds which the Debt Office has issued to finance loans to the Riksbank. Including the proposed SEK 73 billion in the form of a one-off dividend, the Debt Office would therefore initially manage the corresponding amount of close to SEK 200 billion. It is therefore more efficient that the assets remain in foreign exchange reserves and are managed by the Riksbank until the loans gradually mature. With the rules proposed by the inquiry for dividends, the outcome for the government will in principle be the same in both cases.

The board of the Swedish National Debt Office has decided the content of this response following a presentation by Chief Economist Lars Hörngren. Head of Department Daniel Barr, Head of Analysis Magdalena Belin, Deputy General Director Pär Nygren and General Counsel Charlotte Rydin have also participated in the preparation of the response.

Hans Lindblad

Lars Hörngren