

Speech, February 3, 2006

I am grateful to be invited as a speaker today. Over the last year the debt policy of SNDO and the maturity in government debt have been topics of discussion due to expectations about increased demand for duration from insurance companies as an outcome of the new legislation for Life Pension funds. Therefore, this seminar gives me one more opportunity to explain our framework and the implications for the Swedish bond market.

Debt management – Minimizing costs

The main objective in managing the Swedish public debt is to minimize long-term costs, taking into account the risk as well as monetary policy. This is clearly stated in the guidelines from the government, which is the framework for debt management activities. An additional part in our assignment is market maintenance. Good liquidity in our domestic bond market is an important issue to maintain low borrowing costs in the long run. However, minimizing long-term costs is our number one priority and although maintenance activities are regarded as important, they are explicitly said not to interfere with the overall target of cost minimization.

Debt structure

The government guidelines give a broad picture of the long-run allocation between nominal, inflation-linked and foreign currency debt. The guidelines also contain a benchmark for the maturity of the nominal debt. Nominal, domestic debt represents the most important source of our funding. At the end of last year the proportion of nominal SEK debt was about 60 percent of total debt. Looking forward, the proportion of nominal debt in SEK is supposed to increase further to roughly 65 percent of total debt.

The share of inflation-linked debt was 16 percent of total debt at the end of 2005 compared to 10 percent in 2001. Inflation-linked debt has an important function as it diversifies total debt, reducing the overall risk. In the long run inflation-linked debt should also be less expensive than nominal debt, as the government stands the inflation risk. Hence, investors should be willing to pay a premium for inflation protection. So far the cost reduction from issuing inflation-linked bonds has been approximately 16 bn SEK. Inflation-linked debt will be 20 percent of total debt in the future.

Finally, the share of foreign currency debt has dropped from 34 percent in 2001 to 24 percent at the end of 2005. The reduction in foreign currency

debt is partly due to a stronger Swedish currency as well as amortizations. Foreign currency debt will be 15 percent of total debt in the long run.

Although the guidelines contain a long run target for the government debt structure, this far, there is no specific timeframe or any final day for these changes to be in place.

Risk in public debt management

Risk definition

Short maturities are normally less expensive. On the other hand short maturity means you have to reset your debt more frequently and you will be more exposed to variations in interest rate levels – you have a higher refinancing risk. In managing public debt the risk measure in focus is interest rate refixing risk - the risk that interest rates are unattractive at expiration day and has to be refinanced at a higher cost. As a consequence longer maturities are less risky as the funding cost is known for a longer period of time. To understand the way we manage the debt it is important to be familiar with this definition of risk.

Risk in government debt

As long as the yield curve has a positive slope there will always be a conflict between reducing cost of debt and reducing risk. Duration has been used as a proxy for refinancing risk and is regulated in the guidelines by a maturity target. The maturity target gives us an internal guidance of which combination of long and short term funding that gives us our cost minimization.

So far, only nominal debt is included in the maturity target. The benchmark for duration in the nominal debt was reduced to 2.5 years from 2.7 years during 2005. Since 2006 the maturity of debt is measured by “average interest rate refixing period” instead of duration. This measure is basically duration with future cash flows discounted at zero interest rate i.e. not using the conventional market interest rates. The “average interest rate refixing period” corresponding to 2,5 years of duration is 3,1 years.

Why did we change the measure? The using classic duration as a benchmark caused us to make adjustments in borrowing plans that were not obvious from the point of cost minimization. As I said, variations in market value of the debt is not the risk definition for us. With the new measure we are convinced that our work on being transparent and predictable in planning for our funding makes it easier for you to predict and analyze the Swedish bond market.

Issuance of long dated bonds so far

The result of the maturity target as well as our general funding strategy could also be expressed in a diagram showing the outstanding volumes of bonds over the yield curve. Here you can see the amount of issuance that has been done in longer dated issues so far.

Since the introduction the inflation-linked bonds has been issued in longer maturities. The thought has been that investors are more willing to pay for inflation protection in longer maturities. Our longest bond is now 24 year (when we started issuing the bond it was 30 year). Earlier guidelines also said that we couldn't issue IFL bonds shorter than 10 years.

Today this restriction is taken away. Our experience is that there is demand for bonds in the short end of the inflation curve as well. At the same time we have issued a 15 year nominal bond. So the only difference between the two curves is today the 24 year inflation linked bond.

The growing proportion of inflation-linked debt, with longer duration than the nominal debt, has increased the maturity of the entire debt, and hence reduced refinancing risk. Average duration in inflation-linked debt was 10.9 years at the end of 2004. Including inflation-linked debt, duration of the entire debt was 4.1 years at the end of 2004 compared to 3.1 years 3 years earlier.

Looking forward, the maturity of the entire debt will probably continue to increase since the debt structure will continue to change in the same way as has done over the past years.

Approaching the target debt structure, the analysis of risk as well as the benchmark for maturity will be extended to incorporate the entire debt, in contrast to today when we only have target for nominal. In the proposal for this year's guidelines we intend to present an analysis of a maturity measure, which includes both nominal and inflation-linked debt. If successfully adapted to the practical and operational features, this has the potential to improve our internal management of debt as well as our transparency and predictability about our funding to investors.

Risk exposure and public finances

The attitude towards risk exposure can also change over time. With improved public finances and small borrowing requirements like the ones we see today, higher cost of funding is less of a problem than in a situation with a growing budget deficit. At present, the Swedish central government debt is below 50 percent of GDP and borrowing requirements are falling. According to our latest forecast from October we expect central government borrowing requirements to be approximately 26 billions SEK 2006. However, the preliminary surplus of 13 billions SEK for 2005 indicates that government borrowing may decline. Hence, today further risk reduction in public debt management, by extending the maturity of debt, seems far from urgent.

What could alter this situation in the future? Attitude towards risk may change if net borrowing requirements start to grow or expects to grow again. This could be the effect of increased public spending or lower tax revenues, for example due to demographics or weaker global growth.

Debt management in practice

With the current changes in investment rules for insurance companies we have several times been told that the debt office should boost the issuance of long dated bonds to supply insurance companies with duration risk. I imagine that by now, no one has missed that we always operate with respect to our main objective – to minimize cost of funding. What I would like to mention here is the use of one instrument that allows us to issue longer maturities and at the same time keeping a shorter maturity target - swaps.

Swaps in debt management

Interest rate- and currency swaps are important instruments for funding. The debt office has used swap contracts for funding and debt management since 1996. Today we handle an annual volume in the swap market of around 40 billions SEK.

We are using swaps to achieve the combination of good liquidity in the long end of the domestic yield curve and cheap funding, by issuing long maturity bonds swapping to cheaper short-term funding. Moreover, currency- and interest rate swaps are frequently used to obtain a cost efficient alternative to fund in foreign currency and to maintain the benchmark weights in the foreign currency portfolio.

Today we are very cautious to add additional volumes not to have negative effects on prices in the domestic swap market. Hence, we would welcome additional volume and a more diversified investor base in the Swedish krona swap market. Improved liquidity in the swap market would both help us to further reduce our cost of funding and at the same time increase our chances to maintain good liquidity in long dated bonds.

Mandate for the SNDO

Within the framework regulating the management of government debt, changes in debt policy appear on two strategic levels. First, SNDO has the mandate to deviate from the targets set by the guidelines. This is not only for the maturity it also includes the target for amortization of foreign currency debt. Perhaps you are aware of the fact that we are today using that mandate and only amortize with 10 bn for 2006 (25 +/- 15 bn). Second, the SNDO can propose to the government to change the maturity targets in the guidelines.

Predictability and active positions

Our mandate includes the possibility to be positioned for expected changes in interest rates by deviating from the maturity target of debt. This mandate is 0.5 years in duration. That includes interest rate positions in international market that we undertake in our day to day business, for which 0.2 years of duration is reserved. That means 0.3 years of duration remains for interest rate positions of more strategic character and hence should be decided by the Board. This type of strategic position should

primarily be taken in the foreign currency debt. That is in the international markets. This is basically due to three reasons:

- Superior depth and size of the markets
- Liquidity in derivative markets
- Easy to evaluate

To us, a change in duration in the nominal krona debt would be an operation of considerable proportions. Most likely it is too extensive to handle as a temporary arrangement. First of all, as an important player in the Swedish bond market, it would be difficult to carry out such operations on the open market over a limited period of time without considerably negative effects on prices. Hence, we would probably have to extend such operations over a long period of time. As market conditions then could change significantly, there is a huge risk that the opportunity would disappear.

Secondly, a temporary exposure has to be closed at some point in the future with the opposite effects on interest rates and government bond supply, which may be difficult and unwelcome.

Third, our normal way of conducting our funding policy with transparency and predictability would most likely hurt profitability of such positions. All in all, this has made us very reluctant to use our domestic market for temporary positions to interest rate changes. However, there is one exception from this policy view. In case the Swedish yield curve would diverge substantially from the rest of the world, which would make it impossible to replicate the exact same position anywhere else, then we may act in the krona market.

With present low interest rate levels we have of course considered the possibility of extending the duration and thus taking the opportunity to preserve the low interest rates. Over the last two years our assessment has been that interest rates may remain quite low for a relatively long time partly due to low inflation expectations but also this higher demand for long dated bonds. Therefore, extending maturity of nominal debt has not yet been viewed as profitable. So far we have been proved right.

Situation today

Leaving the area of positions and in stead concentrating on our long term assessment of cost minimization with regard to risk, I'm returning to the relative prices for short and long term funding.

As I started off by saying, there's no automatic link between a higher demand for longer dated bonds and us issuing them. A flat or inverted yield curve would contribute to our cost minimization objective and create a situation where cost reduction and risk reduction will go hand in hand. But, we also need to be convinced that the situation is durable. This is more important than an if adaption takes place quickly.

Of course we are closely following the on-going discussion of changed legislation for the pension fund industry and what effects it will have on

the demand for longer dated bonds. This is a topic both in Sweden and elsewhere.

Today we have the situation of low borrowing requirements and stable government debt. This affects the risk awareness of the government where Sweden is in a situation where we can take larger risks in the scope of lowering costs. And that means that the government will not necessarily use the flatter yield curve to reduce risk. A low borrowing requirement also reduces our possibility of issuing a lot of different instrument in various maturities.

This said to illustrate the complex assessments that are important parts of a well-considered central government debt policy.

I've tried to explain our underlying assumptions in the debt policy and what factors that could alter our future strategy. We are welcoming a dialog with all market participants in order to better address and understand the developments in the markets. That is of course helping us to achieve our objective - cost minimization.