RIKSGÄLDS KONTORET
THE SWEDISH NATIONAL DEBT OFFICE

Reducing the government debt

Speaking notes for address by Mr. Thomas Franzén, Director General of the Swedish National Debt Office, in London on June 13, 2000

Thank you for inviting me to this seminar. I will concentrate my comments to some questions concerning, first, how to inform markets and, second, how to formulate strategies for repayments of government debt. I will not present any new figures. On Thursday we will present our forecast concerning the government borrowing requirement and debt during 2001. But I hope that my comments will make it easier to understand some aspects which will be dealt with in our press release on Thursday.

Public finances and privatisations

My first observation is self-evident but still important: the basis for amortisation is strong public finances. This year we expect a surplus in the budget amounting to 80–90 billion kronor. This surplus is to a large extent due to temporary factors. Most important is the sale of shares in Telia. Adjusted for these the estimated surplus amounts to 25 to 35 billion.

We have a fairly good record in forecasting the budget outcome except for some of these temporary factors. The simple reason is that the decision process governing privatisations contains many complex elements. It is inherently unpredictable to outside observers and, sometimes at least, even for the decision makers themselves. A case in point is the aborted plan to merge Telia and Telenor.

One alternative would be to abstain totally from including them when we publish our forecasts for the borrowing requirements. That would have resulted in figures far from the market expectations. Since we have to make borrowing plans on the basis of the best estimates we can make, we would also have been far from the numbers actually guiding our borrowing. That would be impractical and illogical. We, as well as the market, have to deal will these asset sales and the

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POSTADRESS POSTAL ADDRESS SE-103 74 STOCKHOLM SWEDEN
BESÖKSADRESS OFFICE ADDRESS NORRLANDSGATAN 15
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 MAIL: sndo@sndo.se WEB: http://www.sndo.se
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associated uncertainties. The Debt Office needs to act with flexibility and the market must understand that this is the case.

So our strategy is to include our best guesses for asset sales in our forecasts and underline the uncertainties. We, as well as the market, have been and will be surprised by the actual developments. One consequence is that the borrowing programs and issuance plans sometimes will be adjusted. It has proved difficult – from our point of view surprisingly difficult – to communicate the extent of the uncertainties involved. Now and then our figures tend to be taken for granted even if we try to stress the uncertainties.

We have emphasised repeatedly – and I do it again –that the Debt Office does not have any inside information concerning events such as the Telia sale. And, actually, I believe that this is a good thing, because otherwise our forecasts would become a part of the governments announcement of their privatisation strategies.

Large payments of this type mean that the National Debt Office gets excess liquidity. We have chosen to reduce that by buying back bonds via pre-announced reversed auctions during a relatively short period. Indicating what and when we are going to do is a way to be more transparent. One alternative is to spread transactions over a longer period and be more flexible. But then there is a risk that the market will be characterised by uncertainty during a longer period. It is too early to judge the outcome of the buy-backs but it is clear that some pessimists have been proven wrong. Tender ratios have been high and prices in line with the prevailing market rates.

Let me also note that the existence of a duration target simplifies the interpretations of the consequences of budget surpluses. It means that the repayment of debt will be evenly distributed over the yield curve.

A more general observation is that the market, including issuers, is now learning that government bonds will become more scarce. This means that the expression gilt-edged will be increasingly appropriate. The learning process, however, seem to come in waves, triggered more by announcements of transactions than by the more fundamental changes in the long-term fiscal outlook. This makes the process less smooth than it need be.

Special factors affecting next year

The development during next year will contain the usual uncertainty concerning asset sales. The government has in its budget a figure for asset sales amounting to 15 bn kronor. The government stresses, however, that this is not a forecast. It is rather a technical assumption.

One may note that 15 billion is a low figure taking into account that there is a possibility that an additional part of Telia will be sold during 2001. In our forecast we have to make the best guess possible. This means, which I have indicated earlier, that the assumed number for privatisation in our forecast for 2001 will deviate from the budget figure.

Next year the national pension fund will make a transfer to the central government of cash, government bonds and mortgage bond amounting to 155 billion kronor. The reason is that the new pension system is more robust than the old one and that the buffer funds are considered unnecessarily large. The transfer corresponds to some 12 percent of the government debt, that is, we will see a sharp debt reduction in 2001.

But the composition of the transfer will affect both the time profile of the reduction in the registered debt and the impact on the borrowing requirement. The composition has not been decided yet. A committee, including representatives from the Debt Office and the pension funds, is discussing the issue. But let me to illustrate the technical aspects by using some concrete numbers. Let us assume that the transfers consists entirely of government bonds. Then there will be an immediate reduction in the government debt by a corresponding amount (ignoring differences between market values and book values, for simplicity). But the borrowing requirement and the budget balance are not affected. This is because the borrowing requirement is by definition affected only by payments and a transfer – effectively a gift – of bonds does not constitute a payment. But of course, lower debt means lower interest payments and that in turn means that that in the coming years the borrowing requirement will be lower by an amount corresponding to the interest paid on the transferred bonds.

If we assume instead that the transfer also contains some mortgage bonds, these will be kept by the Debt Office until they mature. They will not result in a direct reduction in government debt, of course. However, they will generate interest income and as a result of that lower the net interest payments. When the bonds are redeemed they will directly affect the government borrowing requirement and through that mechanism reduce the outstanding debt.

To the extent the transfer is made in the form of cash, it will result in an immediate decrease in government borrowing requirement and a corresponding reduction in the debt.

The conclusion is that the composition of the transfer payment will be important for the figures in the coming year. But the recorded figures for the debt, as well as the borrowing requirement, will be affected by the composition of transfer from the national pension funds. The message I want to send is that people analysing Swedish government finances should be aware of this, and concentrate on the underlying developments, that is, look behind the reported numbers. Then they will see a sharp reduction in the Swedish central government debt next year.

Public finances in the longer run

As I said earlier the forecast for 2001 will be presented on Thursday so I cannot give you any figures here and now. But let me turn to a longer term issue. According to the targets laid down by the parliament, public sector financial savings shall show a surplus of 2 percent of GDP on average over the business cycle. We in the debt office do not make any long-term forecasts for the borrowing requirement. But longer term calculations made by the government and the National Institute of Economic Research show that this in the longer run means that there will be a surplus exceeding 2 percent in the public pension system and small deficit in the central government budget.

I want to stress two aspects. The first is that too few countries have reformed their pension systems. Calculations of what is needed to construct robust pension systems will probably show that there is a need for substantial surpluses over the business cycle. Seen from this perspective present policies are not sufficient in many countries, including several EU member states. This creates a potential for disappointment and market reactions in the coming years.

The second aspect relates more specifically to Sweden. That is that the size of the government bond market depends on the central government finances. We have and will continue to have sharp reduction in the government debt between 1999 and 2001. But in the longer run, assuming that no further privatisations are made, the government debt will no longer decrease in absolute terms. However, as the economy grows the central government debt will continue to fall expressed in relation to GDP.

Given the debt trends, it is reasonable to give priority to the domestic market. Since 1995 the Debt Office has created foreign currency debt by swapping krona debt into foreign currencies. This has been the most cost efficient way of borrowing in foreign currencies. These swaps also support the liquidity in the domestic market. So there is no direct conflict between foreign currency borrowing and the issuance in the domestic market. However, Sweden is repaying the foreign currency debt. This year it is done at a rate that keeps the share of foreign currency roughly unchanged. The target for next year will decided in the autumn.

The Swedish National Debt Office has for several years stated that it is appropriate in the longer run to gradually reduce the foreign currency share. Seen from a cost-risk angle, there are several arguments for reducing the currency debt. At present the foreign currency debt corresponds to 30 percent of the total debt. Sound public finances and longer term policies compare favourably with core economies in the EMU have reduced Swedish interest rates relative to other markets. Currently, there is a negative gap to Germany, for example. This strengthens the arguments for reducing the foreign currency debt. But the reduction should of course be made in a cautious and gradual way.

A consequence of better public finances in a number of countries is that there will be more room for other types of borrowers in the bond market. We can se this tendency clearly in the euro bond market where non-sovereign issues have expanded sharply. This will of course mean that the need for credit assessment and risk management will increase. We can also note that stronger public finances have resulted in larger credit spreads. Again a sound scarcity accentuates the gilt edge on government bonds.

To sum up. I think that there are no threats to liquidity coming from a reduction in the outstanding debt. The long-term projections indicate that the Swedish government debt will not disappear. There will, however, be somewhat fewer issues and somewhat lower volumes in the outstanding issues than in the past years. As a first step, the Debt Office has announced that there will be no introduction of a bond maturing in 2010. A more consolidated debt with fewer and larger loans is also in line with the organisation of electronic trading systems. In the future electronic trading systems will probably focus on fewer segments, for example two, five and ten years. But the need to reduce the number of loans is marginal and changes will be gradual, since Sweden already has fewer loans than most comparable issuers.

The Social Democratic Party congress in March took a decision in favour of a future EMU-membership. The timing will, among other things, depend on wage agreements and the business cycle. The question of membership will be decided by a referendum. The parliament has not yet decided about the procedure, but the general view is that there will be a referendum after the next election, which takes place in September 2002. This probably means that Sweden can enter the EMU in 2004 at the earliest.

Our borrowing strategy includes measures for a smooth changeover to EMU-membership. The debt office tries to broaden the investor base in various ways. A stable investor base contributes to lower borrowing costs.

Sweden has an advantageous starting point, as a large number of foreign investors already are holding Swedish bonds. About 30 percent of the kronor debt is owned by foreigners. Adding the foreign currency debt, which is about 30 percent of the total debt, some 50 percent of the debt is in foreign portfolios. This is a high share compared to other countries in the EU. There are international banks in our authorised dealer group. Web site information and road shows are other ways to broaden the investor base.

The Swedish bond market is moving towards electronic trading. This process has been slow, but I think that the Swedish market will get such a system before the end of this year. This is not too soon. Sweden has recently gained a reputation, also in international media, as an IT economy. It is to be hoped that more of the innovative spirit fuelling this development spreads to the Swedish bond market. The way things are done in financial markets is changing rapidly.
I believe that much more is to come, not least in the ways that instruments are traded, and issuers and investors interact. The bond markets are lagging behind the stock markets. Technical improvements is another means to offset the effects on liquidity of shrinking supplies of government bonds. This potential for increased efficiency and transparency must not be ignored.