

Sweden's Approach to Monetary Policy

The Sveriges Riksbank, the Swedish central bank, is an authority under the Riksdag (parliament) with responsibility for monetary policy. Its objectives are to maintain price stability and to promote a safe and efficient payment system. With the advent of the new regime, which went into effect in January 1999, the Riksdag appoints the Riksbank's Governing Council, which, in turn, appoints its Executive Board, including its Chairman, who serves as Governor of the Riksbank. A member of the Executive Board may not be a member of the Riksdag, a government minister, or an employee of the Government Office. Further, Executive Board members may not take or seek instructions with regard to monetary policy. Thus, the Executive Board has instrument, but not goal, independence.

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Central Bank Assets

In the week of June 15, 2000, the Riksbank held assets of 219 billion kronor, of which 64 percent were foreign currency claims on residents outside of Sweden. These claims were mainly balances with banks and investments in securities. Gold accounted for an additional 7 percent. Lending to monetary policy counterparties denominated in Swedish kronor made up another 16 percent of the Riksbank's total assets. Main refinancing operations, or regular repo transactions, accounted for the

great bulk of this entry. Assets related to fine-tuning operations were a very small fraction of total assets. The final components of Riksbank assets were securities denominated in kronor and issued by Swedish residents (11 percent, entirely government debt) and “other assets” (1 percent).

Objectives

Between 1977 and 1992, Sweden directed its monetary policy toward maintaining a unilateral exchange rate target, pegging the krona in terms of a currency basket and, later, the ecu.¹ In the currency turmoil of late 1992, however, Sweden abandoned its fixed exchange rate and adopted an explicit inflation target with no other intermediate objective. Policymakers believed that the central bank’s inflation forecast actually serves as a good intermediate target and provides for efficient monitoring by the public. The Riksbank chose a 12-month inflation target of 2 percent with a tolerance band of plus or minus 1 percent, to become effective in 1995, once the impact of the krona’s sharp 1992 depreciation had been absorbed. The target applies to headline CPI inflation, but the authorities have indicated that if the impacts of changes in mortgage rates, taxes, or subsidies, or of large external shocks, are deemed to be transitory, they are likely to be accommodated. If so, the expected deviation from target must be explained in advance.²

Operating Procedures

The Riksbank influences the demand for money by adjusting short-term interest rates. Its ability to influence interest rates in the overnight market stems from its right to determine the terms under which it accepts deposits from and lends to banks participating in the central payments system. The policy framework encourages, but does not require, banks to achieve a zero balance in their kronor accounts with the payments system at the end of the day. The overnight rate, in turn, affects price developments in the economy via many different channels.

Standing Facilities

The Riksbank’s Executive Board sets the repo rate—and, thus, the overnight deposit and lending rates—to steer monetary conditions. Since mid-1994, the Riksbank has made its overnight deposit and

lending facilities available at a single unified interest rate for each facility.³ These rates are set, respectively, 75 basis points below and above the repo rate and are currently 3.5 percent and 5.0 percent. A bank needing liquidity can use the lending facility without limit as long as it can present eligible assets as collateral. However, the gap between the interest rates for the lending facility and the deposit facility is sufficiently large that banks have an incentive to eliminate any deficit or surplus in their payments position in the overnight market. Moreover, the Riksbank has indicated that it will normally supply enough liquidity that the banks will not need to use its facilities.

Open Market Operations via Repurchase Agreements

The Executive Board sets the repo rate by buying securities under repurchase agreements with a one-week maturity (when a liquidity deficit exists) or issuing debt certificates (when there is a liquidity surplus).⁴ The fixed repo rate, announced weekly, is the Riksbank’s target for the overnight rate in the interbank market and serves as its primary operating objective and signaling device. (The Riksbank has also used variable-rate tenders on rare occasions.) Currently and for the foreseeable future, the Riksbank plans to conduct all open market operations via repos rather than via outright purchases. The primary dealers, a group currently composed of seven banks, are the counterparties in the Riksbank’s weekly auctions.

Because reserve requirements were set to zero in 1994 and because the demand for bank notes is not very sensitive to changes in interest rates over the short run, any unexpected shift in the demand for

¹ In August 1977 Sweden left the prevailing European exchange rate system and unilaterally pegged the krona in terms of a currency basket, a trade-weighted exchange rate index in which the U.S. dollar had a double weight because of its role as a transactions currency. In May 1991 the basket was unilaterally redefined to equal the ecu in preparation for closer ties to the European Union.

² Recently, policy has been based on assessments of UNDI_X and UNDI_{NHX} inflation, which exclude the impact of interest payments and the direct effects of changes in indirect taxes and subsidies, and in the case of the UNDI_{NHX}, the impact of import prices.

³ Under the previous system, the banks’ marginal cost of borrowing increased with the amount borrowed. The new system allows the Riksbank to send clearer signals about its intentions.

⁴ When the banking system faces a liquidity deficit, the Riksbank supplies money by buying securities through weekly repos. When the system is in surplus, the Riksbank withdraws liquidity by issuing Riksbank certificates. On occasion, the Riksbank also engages in foreign exchange swaps.

reserves quickly pushes the banks into the lending or the borrowing facility. As their marginal cost of funds changes, so too does the interbank rate. Thus, the Riksbank intervenes in the interbank market (at a rate equal to the weekly repo rate plus or minus 10 basis points) to fine-tune the overnight rate. Because a few large banks dominate the interbank market, it is relatively easy to monitor the banks' liquidity positions on a continuous basis.

Assets Used for Repo Operations

As required by law, the assets used in open market operations are Swedish Treasury paper and other "readily marketable" securities. Currently, these securities must be booked by the Swedish Register Centre (VPC) and included in its clearing system. Thus, the issuer must be Swedish, and the set of acceptable assets is narrower than the set accepted as collateral for Riksbank overnight credit and the Rix system, as described below.⁵ In late 1999, however, the Riksbank's Executive Board amended its policy on collateral in part to bring the set of eligible assets more in line with those used for other Riksbank operations. The new standards put more emphasis on external credit ratings and have so far only been implemented for intraday and overnight credit.⁶ The securities used for repos are marked to their market value, including the value of accrued interest, and an initial safety margin of 4 percent of the amount paid out is deducted.

The Rix Payments System

The electronic Rix system is the hub of the Swedish payments system. All transactions in Swedish kronor are settled through Rix. In late 1999, 24 institutions participated: all 19 banks, the Bankgiro Centre, the Securities Register Centre, OM Stockholm AB, the National Debt Office, and the Riksbank itself. The participants must meet capital, risk management, and technical qualifications and have access to SWIFT or a similar electronic payment information system. Rix is a real-time gross settlement system, although some types of payments are bundled or netted. It has a daily turnover of about SKr 300 billion (equivalent to about 20 percent of Sweden's GNP).

Although Sweden has not joined the European Monetary Union, it is a part of the European Union. Thus, the Riksbank is a member of TARGET, the Trans-European Automated Real-Time Gross Settlement Express Transfer System, the common payments sys-

tem that went into effect on January 1, 1999. Since only national central banks and the European Central Bank (ECB) are members of TARGET, the Swedish commercial banks are linked to TARGET through the Riksbank's E-Rix system (for euros). The banks can choose to have an account with the Riksbank in kronor, in euros, or both.

Rix Risk Management

The Rix risk management system requires that payments be placed in a queue if the payor institution does not have an adequate positive balance or credit available in its Rix account. To facilitate the efficiency of the system, the Riksbank supplies intraday credit. For kronor transactions (K-Rix), it can provide intraday credit against acceptable collateral⁷ up to the market value⁸ of the collateral offered less a margin or haircut.⁹ Although the policy framework encourages participants to achieve zero balances in their K-Rix accounts by the end of the day, they may carry positive or negative balances in these accounts overnight.¹⁰ By contrast, in the case of euro transactions, the ECB sets a ceiling of 1 billion euros on the amount of intraday credit that the Riksbank can provide (against collateral approved by the ECB). It also requires that participants must settle euro credits by the close of the day. The Riksbank cannot provide intraday credit in euros after 5 p.m.¹¹

⁵ In addition to central government Treasury bills and bonds, the current list includes bonds and certificates issued by eight other institutions including the National Swedish Housing Finance Corp., Nordbanken Hypotek, AB Spintab, and SEB BoLan AB. In other words, the set includes debt issued by large private financial institutions without a government guarantee.

⁶ In the new system, the external credit rating must be at least single A. Banks will not be accepted as eligible issuers, but the securities of other private firms from Sweden or other highly rated OECD countries will be accepted if they meet the required credit rating. Practical considerations about location eliminate some foreign collateral, but collateral held in Euroclear will be acceptable. While these securities became acceptable as collateral for intraday and overnight credit in late 1999, some administrative problems and legal aspects have delayed the implementation of the new policy with regard to repo operations.

⁷ Except in the case of the state, which does not need to provide collateral. This provision is the only exception to the proscription against Riksbank lending directly to the state.

⁸ The Riksbank conducts market valuation on a daily basis.

⁹ The market value of a security is adjusted for residual maturity and foreign exchange risk. No deduction is made if the residual maturity is less than 1 year. The margin is 1.5 percent for maturities of 1 to less than 3 years, 2 percent for maturities of 3 to less than 7 years, 3 percent for coupon instruments over 7 years, and 5 percent for zero-coupon bonds of over 7 years. Foreign exchange risk requires a haircut of 3 percent. In addition, a 1 percent initial margin applies to all credits. The initial margin is an addition to the utilized credit.

¹⁰ Government agencies cannot receive overnight credit.

Collateral

The Riksbank provides continuously updated lists of securities that are accepted and used as collateral.¹² For kronor credit, the Riksbank accepts Swedish or foreign debt instruments issued by a government, central bank, local government or other public body, or a company that is not a bank (but settlement banks and the like are not excluded).¹³ However, the issuer must be a country or domiciled in one of the countries that have been approved by the Riksbank. The Riksbank also accepts foreign currency. These assets must be listed at a Swedish or foreign security exchange or be regularly traded at another regulated market or be deemed otherwise sufficiently liquid. They must also be registered at a central securities depository or be subject to other adequately secure arrangements for pledging and transfer.

Fiscal Issues

In June 1999, Sweden's total stock of government securities and paper issued by mortgage institutions equaled about SKr 1,700 billion. (These two assets represent the great bulk of all securities issued in kronor.) At that time, the banks held SKr 200 billion in securities approved as collateral, of which only SKr 50 billion were actually being used as collateral for loans from the Riksbank. Because the supply of collateral seemed ample (and banks are entitled to borrow as much as they need as long as they can offer collateral), the Riksbank saw no need to establish a special borrowing facility for the century date change.

Sweden achieved a public sector financial surplus in 1998 for the first time since 1990, and ongoing surpluses are expected. Indeed, the government and Parliament have set a public sector surplus averaging 2 percent of GDP over the business cycle as a central target for budget policy. In 2000, the general government surplus amounted to just over 4 percent of nominal GDP, in part reflecting the partial privatization of Telia, the Swedish telecom system. The OECD projects a surplus of 3.6 percent of GDP for 2001.

Sweden also started to repay government debt in 1998 and plans to continue to do so. Gross debt has fallen from over 70 percent of GDP in the mid-1990s to a projected 56 percent in 2001.¹⁴ The OECD anticipates that general government net financial liabilities will fall from 23 percent of GDP in 1995 to 4 percent in

2001. The unusually big gap between the government's gross and net liabilities largely reflects the accumulation of pension reserves.

As the Swedish National Debt Office has discussed, the government's fiscal policy implies an increased scarcity value for government bonds and will affect the government's borrowing strategy. In 2000 the Debt Office offset the impact of the Telia sale through a combination of reduced issuance of Treasury bills and the repurchase of less liquid bonds, in order to meet its duration target and maintain supplies of debt issues that are attractive to investors. It also intends to amortize SKr 25 billion in foreign currency debt, in part to support issue volumes in the domestic market.¹⁵ In addition, refinancing of foreign debt will occur by borrowing in kronor and swapping the proceeds into foreign currency, instead of borrowing foreign currency directly. The motives again include the reduction of borrowing costs and the maintenance of kronor issues. Over the longer term, the Debt Office plans to focus debt issuance on market benchmarks. It also intends to encourage electronic trading, since more efficient trading arrangements improve liquidity.

Recently, moreover, pension reform has widened the investment options for the accumulated pension funds, which equal about 25 percent of Swedish GDP, to include equities and foreign assets. Previously, these funds were largely invested in Swedish government securities. Now, up to 40 percent of these assets may be subject to foreign exchange risk, while exposure to companies listed on the Stockholm exchange is allowable up to a ceiling of 8 percent.

¹¹ If a euro credit is not settled by the close of business, the interest payable equals the European System of Central Banks' marginal lending rate plus 5 percentage points plus an additional penalty that rises with each subsequent failure to settle. Repeated infractions will lead to suspension or denial of access.

¹² For euro credit, the Riksbank only accepts assets approved by the ECB.

¹³ Except for mortgage securities issued by the borrowing bank's subsidiary.

¹⁴ The central government debt represents the bulk of public sector debt. The central government's debt in kronor and foreign currencies fell from 81 percent of GDP in 1995 to just under 70 percent in 1999.

¹⁵ About 30 percent of the Swedish government's outstanding debt is denominated in foreign currencies. Because it believes that a broad investor base contributes to lower borrowing costs, it has sought to attract foreign investors, and 30 percent of its kronor debt is owned by foreigners.

The Riksbank sees maintaining the liquidity of the government debt market as desirable because that market is an important part of the transmission mechanism for monetary policy. Further, an illiquid govern-

ment bond market would distort the government yield curve, which the Riksbank uses to extract information about market expectations regarding future monetary policy.

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