



# Basis for Decision

DATE: 12 January 2021  
DEPARTMENT: The Markets Department

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DNR 2021-00032

## The financing of the foreign exchange reserves

### Decision by the Executive Board

The Executive Board decides

- that the Riksbank shall change the financing method for its foreign currency reserve with effect from February 2021, by purchasing foreign currency on the foreign exchange market at an even pace and paying for these purchases in Swedish krona, and repaying the foreign currency loans the Riksbank has taken through the Swedish National Debt Office,
- to task the Head of the Markets Department, with the right to delegate this to another, after consultation with the Executive Board, with drawing up a plan for the purchases of foreign currency in accordance with the considerations in this decision, and to decide on the details regarding making the purchases of foreign currency,
- to task the Head of the Markets Department, with the right to delegate this to another, after consultation with the Executive Board, with deciding on whether a particular currency loan should be repaid or refinanced, and to
- publish the decision on 13 January 2021 at 9.30 am.

### Background

The Riksbank, like most other central banks, holds gold and foreign currency reserves to be able to perform its statutory tasks. The gold and foreign currency reserves are central to monetary policy and also contribute to financial stability. The Riksbank's capacity to supply liquidity in both Swedish krona and foreign currencies is a question of ensuring that the monetary policy transmission mechanism functions smoothly and that financial stability is maintained. The foreign currency reserve is also needed to meet international obligations towards, in particular, the International Monetary Fund (IMF). As of 31 December 2020, the gold and foreign currency reserves amounted to SEK 437 billion. The foreign currency reserve is currently financed in two different ways: partly through the Riksbank's own financing, which consists of equity capital, issued banknotes and

coins and deposits from banks, partly through loans in foreign currency on the international capital market through the Swedish National Debt Office.

Under normal circumstance, it is unusual for central banks to fund a large share of the foreign currency reserves by borrowing foreign currency, and it is also unusual for central banks to borrow from their countries' debt offices. The currency borrowing through the Swedish National Debt Office arose during the global financial crisis, when the Riksbank needed on two occasions to quickly reinforce its foreign currency reserves. The first reinforcement took place in 2009, with SEK 100 billion, partly because the Riksbank had lent some of its foreign currency reserve to Swedish banks, and partly because of increased commitments to other central banks and international organisations. The Riksbank decided on a further reinforcement of SEK 100 billion in 2012 when the Riksbank assessed that the uncertain situation abroad entailed a higher risk level in the Swedish financial system, at the same time as the commitments to the IMF increased.

The size of the gold and foreign currency reserve is based on an assessment of the Riksbank's contingency needs, that is, what the Riksbank needs to hold in foreign currency to be able to meet its commitments. The Riksbank regularly reviews its assessment of contingency needs. During 2018, the Riksbank came to the conclusion that the need had declined somewhat as a result of changes in the banks' balance sheets and Nordea's relocation to Finland. The Riksbank therefore reduced the size of the foreign currency reserve by around SEK 70 billion in 2019, by allowing three currency loans from the Swedish National Debt Office fall due for payment. Borrowing in foreign currency via the Debt Office currently amounts to around SEK 178 billion<sup>1</sup>.

## Considerations

The Riksbank has a statutory obligation to ensure that the composition and financing of the foreign currency reserve are fit for purpose, given its tasks and objectives. From this perspective, the Riksbank has assessed what financing is most fit for purpose for the foreign currency reserve in the long run.<sup>2</sup>

The Riksbank's task places high demands on the management of the foreign currency reserves and determines what type of assets it can contain. The assets shall be managed to ensure that contingency planning is always good, which means that they must be able to be converted into liquid funds at very short notice. The Riksbank's internal policy documents *Financial risk and investment policy* and *Regulations for the gold and foreign currency reserves* establish what this means in practice with regard to limits for the currency breakdown in the foreign currency reserve, interest rate risk and credit risk.

In addition, it is important that the foreign currency reserves are pre-financed, that is, they are sufficiently large before a crisis occurs rather than small at the start and only

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<sup>1</sup> This applies to exchange rates as of 31 December 2020. The Riksbank has loans in both dollars and euros. Measured in foreign currencies, the size of the currency loans are USD 14.5 billion and EUR 5.5 billion.

<sup>2</sup> This assessment takes into consideration the requirements of the Treaty on European Union regarding independent central banks. The requirements also apply to member states like Sweden that have not adopted the euro. The ESCB-related information covered by this independence is stated in Article 127.2 of the Treaty on the Functioning of the European Union (responsibility for monetary policy, implementation of foreign exchange transactions, holding and managing the official foreign currency reserves and promotion of a smoothly functioning payment system).

reinforced once a crisis actually occurs. Reinforcing the foreign currency reserves in this situation risks becoming more costly, taking more time, and affecting the impact of monetary policy. A pre-financed currency reserve can also prevent a financial crisis, by creating confidence in the Riksbank's ability to take rapid action in a crisis that threatens the Swedish credit and payment system.

The most appropriate financing of the foreign currency reserve is assessed on the basis of contingency planning and what other consequences the financing has for public finances as a whole. On these grounds, there are some disadvantages with the current financing of currency loans via the Swedish National Debt Office.

One disadvantage is that borrowing foreign currency on behalf of the Riksbank is part of the official measure of the central government debt and the measure often used in international comparisons, the so-called Maastricht debt. The borrowing thus leads to a conflation of the Riksbank's foreign currency reserves and the public finances. If the Riksbank were to instead replace the currency loans with its own financing of the foreign currency reserve, it would entail a clearer separation between the Riksbank's balance sheet and that of the state. The Riksbank's deposits from banks affect the liability side of the Riksbank's balance sheet, but are not included as a liability for the public sector.

In addition, from a contingency planning perspective, there are disadvantages to financing through currency loans on the international capital markets. The Swedish National Debt Office normally issues bonds with a maturity of around three years, which means that around one third of the currency loans falls due every year. The loans therefore need to be regularly refinanced, which entails refinancing risks. This means the risk of the loans maturing not being replaced with new loans other than at much higher costs, or that it will take a long time to obtain a loan. In extreme cases, it could also mean that the loans cannot be refinanced at all.

The refinancing risk is normally low, not least given Sweden's high credit rating as borrower. However, there is a risk that a conflict of interests could arise in more extreme crisis situations if a currency loan falls due at the same time as other state borrowing in foreign currency is at a high level and public finances are strained. In such a situation, there is a risk that a need could arise to prioritise between on the one hand the needs of the Riksbank to refinance the foreign currency reserves, and on the other hand the need for the state to borrow in foreign currency for other purposes. A scenario where these considerations need to be made would be problematic from a contingency preparedness perspective, as it is probable that such a situation would occur on an occasion when the foreign currency reserves had been used. If, in this situation, it was not possible to refinance the currency reserves, or further reinforce them, this would be a threat to financial stability and the Riksbank's independence. With its own financing of the currency reserve, the refinancing risk would disappear, as the Riksbank has purchased the foreign currency instead of borrowing it, and the monetary policy counterparties must always hold the additional reserves when the deposits increase.

The current financing with currency loans via the Swedish National Debt Office is associated with some regular costs as the Riksbank's investments in foreign currency give a lower return than the borrowing cost the Debt Office has for its borrowing, given the assumption that loans and investments are made with the same maturity. The Riksbank has earlier assessed this cost to be around 0.2 per cent on average of the

amount borrowed per year.<sup>3</sup> Given the current size of the currency loans, which is SEK 178 billion, this would correspond to a cost of SEK 350 million a year.

This cost, which can be likened to a premium the Swedish National Debt Office pays to borrow in for example dollars in relation to the United States, would disappear if the Riksbank replaced currency loans with its own financing of the foreign currency reserves. The cost will instead depend on the difference between the new financing interest rate and the return the Riksbank receives on the assets. By purchasing foreign currency and paying in Swedish krona, the deposits from the banks increase on the Riksbank's balance sheet, which means that the financing would be at an interest rate close to the repo rate, which is currently at zero per cent. This is a lower interest rate than the one the Riksbank currently pays to the Swedish National Debt Office to borrow in dollars. On the other hand, the deposit interest from banks is higher than the interest rate the Riksbank pays to the Swedish National Debt Office to borrow in euros, where the interest rate is negative. In total, this means a deduction in costs of SEK 125 million a year in relation to now, in that the Riksbank has larger borrowing in dollars than in euros.<sup>4</sup> This applies given the current interest rates and given that the Swedish krona exchange rate against the dollar and the euro remains unchanged.

Replacing the currency loans with own financing in SEK means that the currency exposure on the Riksbank's balance sheet will increase by an amount equivalent to the size of the currency loans. From a contingency planning perspective, this has no significance, as the preparedness to supply foreign currency is not affected by the value of the foreign currency reserve measured in Swedish krona varying due to exchange rate fluctuations. On the other hand, it can entail increased volatility in the Riksbank's annual results.

An increased currency exposure and the fact that the value of the foreign currency reserves in SEK varies more need not be a problem, given the Riksbank's long time horizon, that is to say, as there is no future point in time when the foreign currency reserves will be phased out. This applies on condition that the Riksbank has a sufficiently large loss-absorbing equity capital to ensure the Riksbank's long-term earnings capacity.

The Riksbank's overall assessment is that the advantages of a completely self-financed foreign currency reserve outweigh the disadvantages. The Riksbank will therefore change its financing method for the foreign currency reserves by buying foreign currency on the currency market at an even pace and paying for the purchases in Swedish krona, which means that the banks' deposits in Swedish krona on the Riksbank's balance sheet increase. At the same time, the Riksbank will repay the currency loans taken by the Swedish National Debt Office at the pace they fall due for payment.

The Riksbank's current loans in foreign currency via the Swedish National Debt Office amount at the current exchange rate to SEK 178 billion, of which SEK 122 billion is loans

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<sup>3</sup> Sveriges riksbank (2019), "The gold and foreign currency reserves need to be reduced somewhat", basis for decision dated 6 March 2019. The cost is not constant, but varies over time. For instance, it was 0.4 per cent in March 2020, but has recently fallen to 0.1 per cent.

<sup>4</sup> The calculation is based on three-year US and German government bond yields. It is not possible to know in advance the size of the cost change in the long term, but as the assets are invested at a longer maturity than the maturity for the financing, this will have a positive effect on the cost if the maturity premium over time is positive. In addition, the results are also affected by the long-term development of the exchange rate.

in dollars and SEK 56 billion is loans in euros. The loan with the longest maturity matures in April 2023. The fact that the Riksbank will phase out the currency loans means that the Riksbank will purchase foreign currency for Swedish krona, starting from February 2021. The exchanges will be spread out over around three years up to 31 December 2023. This means that the Riksbank will make exchanges on the foreign exchange market for an amount of on average SEK 5 billion a month.

The purpose of the exchanges is that the Riksbank shall have a more fit-for-purpose financing of its currency reserve and they thus serve no monetary policy purpose. However, one cannot exclude the possibility that the transition to a self-financed currency reserve could have a limited impact on the Swedish krona exchange rate. The amount the Riksbank will exchange every month is small in relation to the daily turnover on the foreign exchange market. On the global spot market, an average of SEK 160 billion is exchanged every trading day between EUR and SEK and SEK 150 billion is exchanged between USD and SEK.<sup>5</sup> The Riksbank's assessment is that a pace of exchange of on average SEK 5 billion a month would have very little effect on the Swedish krona exchange rate.

The purpose of spreading out the exchanges evenly over a three-year period, instead of only exchanging in connection with the currency loans maturing is to minimise the effect of the exchange on the foreign exchange market and the Swedish krona exchange rate. The transactions will be made with due caution and taking into account the conditions on the market, such as depth, flows and stability. This means that the volumes can vary on individual dates, even though the Riksbank will endeavour to attain an even pace of exchange every month. It is the responsibility of the Head of the Markets Department, with the right to delegate to another person, to implement the currency exchanges. The Head of the Markets Department is therefore tasked with deciding on the details regarding the implementation of the currency exchanges. To ensure the exchanges are made in a form and at a pace that is compatible with the considerations in this decision, the decisions regarding purchases of foreign currency shall be made in consultation with the Executive Board. The consultations can take the form of the Head of the Markets Department presenting an overall plan detailing the amounts, currencies and dates of purchases planned in the coming years.

As the maturity structure of the currency loans and the planned currency exchanges will not match one another, the size of the foreign currency reserve will vary somewhat during the transition to a wholly self-financed currency reserve. To avoid the foreign currency reserve being too small during short periods, the Riksbank may therefore need to refinance some currency loans in the coming years. The need to refinance the currency loans also depends on the pace at which the self-financed part of the foreign currency reserve is built up and the plan for coming foreign currency exchanges. The assessment shall also take into account the views of the Swedish National Debt Office. The Head of the Markets Department is tasked with deciding, after consultation with the

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<sup>5</sup> Bank for International Settlements (2019), "BIS Triennial Central Bank Survey of Foreign Exchange and Over-the-counter (OTC) Derivatives Markets in 2019". This report presents data on global trading. According to the Riksbank's reporting of turnover statistics on the foreign exchange market, which only covers the Riksbank's counterparties, the daily turnover averaged SEK 80 billion between EUR and SEK and SEK 81 billion between USD and SEK in 2019.



Executive Board, whether a particular currency loan should be allowed to mature, or be refinanced.

Even if the current currency loans are phased out, currency borrowing via the National Debt Office will continue to be an important tool for the Riksbank to strengthen the foreign exchange reserves when necessary, as it can be a fast and efficient way to do so, under certain conditions.