2 BAN ON MONETARY FINANCING

2.1 Introduction

Monetary financing (printing money) refers to a situation where central government expenditure is financed with loans from the Riksbank (Sweden's central bank). If practised over a considerable period, such a form of financing may be perceived as resorting to the printing press in order to pay for government spending. The procedure involves a substantial risk of increased inflation. In a developed market economy such procedures are not normal practice, except as a way of managing the central government's short-run liquidity, and in recent years even this possibility has been restricted by most countries in order to preclude any form of government financing in the central bank. A prohibition on monetary financing serves to enhance the confidence of financial markets and also contributes to a clearer separation of responsibility for monetary policy from that for government debt policy. In the European Union a prohibition on government credit facilities in central banks is already in effect.

In this Bill the Government therefore proposes that the Riksbank be explicitly prohibited from providing the State with credit. The short-run management of central government liquidity is outlined in the next section, together with the Government's proposed prohibition and a proposal for how to handle foreign currency loan requisitions for the specific purpose of strengthening the foreign exchange reserves. The following section takes up the Riksbank's capital contributions to international financial bodies and the new arrangement proposed by the Government. Finally a Government proposal is presented for adapting legislation to the Riksbank's new system for interest rate management.

2.2 Short-run liquidity management

Article 23 of the Sveriges Riksbank Act (1988:1385) entitles the Riksbank to "grant the Government overdraft facilities ... to cover the Government's short-term fund requirements". In the autumn of 1993 the Government decided to replace this form of credit with a system in which the National Debt Office, which the Government has authorized to be responsible for State borrowing, manages liquidity outside the Riksbank. However, this was not accompanied by any legislative amendments.

In the earlier system the National Debt Office had access to a credit facility on its account in the Riksbank. Normally this facility was used, not for financing the central government budget deficit, but solely in the management of day-to-day fluctuations in the balance on the central government cheque account. Temporary debit and credit balances on the cheque account could be financed and deposited in this account. As the fluctuations in the account affected liquidity in the banking system, for monetary policy it was necessary to forecast the daily balance on the central government cheque account. The liquidity effects were countered by the Riksbank, mainly with repos. In the event, for instance, of a bank liquidity surplus occasioned by central government payments, the Riksbank neutralized this by selling treasury paper with a simultaneous agreement to buy back at a future date. The degree of success with which the Riksbank managed liquidity was largely determined by the accuracy with which central government payments could be forecast.

The Government decision in autumn 1993 made the National Debt Office entirely responsible for the management of short-term State financing. The credit on account was replaced in stages by open market financing during the spring and summer of 1994 and the account was closed from 1 July 1994. For the National Debt Office the change meant that the customary borrowing in the money and bond markets, against treasury bills and bonds, was supplemented with short-run market financing or liquidity management with repos, short-maturity treasury bills and transactions in the overnight market. The fact that borrowing by the Office is now arranged outside the Riksbank means that central government payments no longer affect bank liquidity. This has made the central government payment system more efficient and helped to reduce the need of Riksbank operations for the management of liquidity.

The rearrangement of short-run liquidity management by the National Debt Office did not, however, rule out all forms of State financing in the Riksbank. Funds for the State could still be provided by the Riksbank purchasing treasury paper from the National Debt Office. Direct purchases or requisitions were used for purposes of monetary policy, partly to enable the Riksbank's counterparties (primary dealers) in the Swedish money market to borrow securities in repo transactions as a way of improving liquidity conditions and improving the monetary policy channels, and partly so as to be able to influence treasury bill rates via interventions.

In addition, the Riksbank is currently entitled, under special circumstances, to requisition treasury paper for the purpose of making sizable additions to the stock of securities that is needed for market operations. Similarly, the Riksbank may request the National Debt Office to borrow foreign currency in order to cover the Riksbank's need to replenish foreign exchange reserves. Since the move to a flexible exchange rate, however, there has been less need to requisition treasury paper and foreign currency. At the time of the currency unrest in 1992 the Riksbank requisitioned large volumes of treasury paper and foreign currency from the National Debt Office so as to be able to intervene in the money and currency markets and thereby influence short interest rates and defend the fixed exchange rate.

The foreign currency that the National Debt Office borrowed on behalf of the Riksbank in autumn 1992 was booked in the Riksbank's balance sheet as a foreign asset, i.e. under foreign exchange reserves, and the Riksbank compensated the Office by crediting the latter's account in Swedish kronor. Today, this procedure would entail a direct payment by the Riksbank to a specific account in the banking system. Regardless of the payment procedure, the system means that when foreign currency is borrowed at the Riksbank's request, the exchange risk is carried by the National Debt Office.

The funds accruing to the National Debt Office in return for the Riksbank's sizeable requisitions of treasury paper or foreign currency have not normally been disposable for the financing of central government deficits. After the norm precluding central government net foreign-currency borrowing had been rescinded in December 1992, however, the National Debt Office, subject to Government approval, was enabled to use about SEK 160 billion for the regular financing of State expenditure in 1993 and the first half of 1994. The funds received by the Office from the Riksbank were booked on the credit account that was then open in the Riksbank.

The Government Borrowing Act (1988:1387) prescribes that borrowing for the purpose of providing the Riksbank with treasury paper for market operations or foreign exchange reserves is decided by the Government. However, as the

Government has made the National Debt Office responsible for central government borrowing, the decision is actually made by the Office at the request of the Riksbank. Under the existing arrangements, the conduct of government debt policy is subject to the restrictions imposed by monetary policy. In order to avoid conflicts between the goals for monetary and government debt policies, effective consultation is desired between the National Debt Office and the Riksbank. The Ordinance (1989:248) with instructions for the National Debt Office sets out the provisions for this consultation. Similarly, Article 42 of the Riksbank Act stipulates that prior to the Riksbank making a monetary policy decision of major importance, the Cabinet Minister designated by the Government shall be consulted. The need of consultation is thus provided for.

The Riksbank Commission

In autumn 1990 the Government appointed a Commission to analyze the status of the Riksbank and submit proposals concerning objectives and forms for the Riksbank's activities with a view to creating a clear and appropriate framework for monetary policy. The terms of reference also called for consideration of the ongoing development of monetary cooperation in the European Community. The Commission's report, "The Riksbank and Price Stability" (SOU 1993:20), was presented to the Government in spring 1993 and has been circulated for comments.

2.2.1 Standpoints on new legislation

Government proposals: The State shall not borrow from the Riksbank. Neither shall the Riksbank purchase or requisition treasury paper directly from the National Debt Office. The Riksbank's possibilities, for the purpose of monetary policy, of issuing debt instruments in its own name are extended.

The National Debt Office shall continue to be in a position to meet the Riksbank's need to strengthen the foreign exchange reserves. Funds received by the National Debt Office from the Riksbank in connection with borrowing to strengthen the foreign exchange reserves may not be used to finance State expenditure unless the Government, in consultation with the Riksbank, decides otherwise. In order to ensure observance of this procedure the Government proposes as the main rule a system involving an exchange of debt instruments.

Riksbank Commission's proposals: The Commission's and the Government's proposals are broadly the same. The Commission, however, has proposed a special "stand-by" credit in the Riksbank to safeguard the short-run liquidity of the State in exceptional situations. Moreover, the Commission proposes that borrowing by the National Debt Office on behalf of the Riksbank is to be decided by the Government in each case because such borrowing is pertinent for risk management by the State and of importance for matters outside the area of competence of monetary policy.

Submissions: The Commission's proposals are supported in the main by the submissions. The Governing Board of the Riksbank, however, questions the proposed procedure whereby borrowing on behalf of the Riksbank is decided by the Government in each case. The Governing Board considers that a formal Government decision would be impractical and not sufficiently flexible in that borrowing is to be resorted to only if the Riksbank's need of foreign currency and treasury paper cannot be met in other ways. This is tantamount to critical and exceptional situations. The Board therefore considers that the present system should be retained, that is, a general authorization for the National Debt Office to raise loans for the purpose of covering the Riksbank's need of treasury paper and foreign currency.

In order to create symmetric rules for interventions in the domestic and the foreign exchange market, the Governing Board of the Riksbank proposes amendments to the Riksbank Act, Articles 12 and 19. The Board notes that if purchases of long-maturity treasury paper from the National Debt Office are to be paid for by the Riksbank with debt instruments in its own name, then the Riksbank must be entitled to issue such instruments. The Board therefore proposes that the words "short-term" be omitted from Article 19. Furthermore, the Board notes that if the same rules are to apply to foreign currency borrowing for the purpose of strengthening the foreign exchange reserves, then the Riksbank must be accorded the right to issue debt instruments denominated in foreign currency, which calls for an addition to Article 12 of the Riksbank Act.

Reasons for the Government's proposals: An abolition of every possibility of monetary financing of government deficits contributes to the enhancement of monetary policy credibility and thereby to the achievement of sustainably low and stable price formation and low interest rates. The proposed legislative amendments also help to clarify the institutional framework for monetary policy and government debt policy and are a natural consequence of the Government decision in autumn 1993 that short-run liquidity management by the National Debt Office is to be arranged outside the Riksbank. Moreover, the proposals serve to adapt Swedish statutes to EU legislation, as required by Sweden's accession to the European Community. Sweden's current rules for central government borrowing from the Riksbank are not compatible with Article 104 of the Treaty on European Union.

The Treaty on European Union, in force from 1 November 1993, provides for the achievement of economic and monetary union (EMU) in three stages, of which the second stage began on 1 January 1994. For Sweden, the initiation of stage two coincided with accession to the Community on 1 January 1995. During this stage the Member States are to prepare the transition to the third stage, at the beginning of which the European Central Bank (ECB) is to be established, possibly with the concurrent introduction of a single currency. This process presupposes that the countries concerned have a common opinion about the objectives of economic policy and undertake to comply with the rules for achieving the objectives during the second stage. The Treaty provides for a reinforcement of the monitoring and coordination of the economic policies of the Member States in this period.

Article 104 of the EU Treaty explicitly prohibits the ECB and the central banks of the Member States from providing any type of credit facility, including overdraft facilities, for "Community institutions or bodies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States". Neither may debt instruments be purchased directly from them by the ECB or national central banks. The central banks may, however, extend credit to and purchase debt instruments from State-owned financial institutions within the framework of the regular supply of liquidity to the banking system. The prohibition applies from the beginning of the second stage. The purpose of the regulations is to establish strict conditions for general government financing. The implementation of the provisions in Article 104 is particularized in a Council Regulation (EC 3603/93). So as not to exclude central banks from a major role in the central government payment system, credit to the State is permitted during a day (intra-day credit). Central banks may purchase treasury paper in the secondary market provided this is done for the purpose of monetary policy. A general freedom to purchase in the secondary market has not been granted because of the ease with which the prohibition on direct purchases of treasury paper can be circumvented. No central bank in the Community now purchases treasury paper directly and many Member States have explicitly legislated against such purchases.

With Sweden's membership of the European Union, the conditions for the Riksbank's acquisitions of treasury paper directly from the National Debt Office have therefore changed. The situation has also changed in that the Riksbank no longer uses treasury bills in its management of liquidity. In its operations to adjust bank liquidity, since 20 October 1993 the Riksbank has relied entirely on Riksbank certificates. Under these circumstances, in March 1995 the Governing Board of the Riksbank decided to terminate the Riksbank's participation in treasury paper issues by the National Debt Office.

In that regular liquidity management by the Riksbank is undertaken with its own certificates, the Riksbank has less need of treasury paper. The Riksbank does have in interest in holding a portfolio of treasury bonds and bills, partly because treasury paper is the most liquid instrument in the Swedish money and bond markets. This requirement, however, can be met by the Riksbank in the secondary market. The Riksbank therefore considers that the decision to terminate primary purchases of treasury paper is of little consequence for its monetary policy operations.

The decision by the Riksbank to withdraw from the primary market for treasury paper is in harmony with the EU regulations prohibiting monetary financing. The Government shares the opinion of the Riksbank that the decision to stop purchasing treasury paper directly at issue does not appreciably affect the operationalization of monetary policy. Besides using its own certificates for the management of liquidity, the Riksbank can intervene with these certificates in order to influence the longer money rates. The latter, however, presupposes that the Riksbank is entitled to issue its own certificates with longer maturities. The Government therefore proposes an amendment to Article 19 of the Riksbank Act; the provision about special circumstances and the restriction on maturity are rescinded. This leaves no limitations on the construction of the debt instruments the Riksbank chooses to issue.

The stipulations in the EC Council Regulation concerning purchases in the secondary market do not call for any changes in Swedish legislation. In Article 19 of the Riksbank Act, secondary market operations by the Riksbank are restricted to the domain of monetary policy.

The introduction of stand-by credit facilities in Swedish legislation, in accordance with the Riksbank's proposal, could counter the purpose of prohibiting monetary financing. There is also a risk that stand-by credit provisions would weaken the confidence-enhancing effects of the legislative proposals. The Riksbank Commission's proposal concerning stand-by credit should therefore not be adopted.

Pursuant to the amendment to Article 23 in the Riksbank Act, an amendment to Article 41 is proposed whereby the State credit facility in the Riksbank is replaced by a deposit facility. The interest terms for such deposits are set by the Governing Board of the Riksbank.

Foreign currency requisitions for strengthening foreign exchange reserves

The concept of monetary financing is not applicable to borrowing in foreign currency in order to cover the Riksbank's need of foreign exchange reserves. The liquid assets received by the State from the Riksbank in such contexts constitute payments for currency which the State has borrowed on market terms. Such a procedure could be practised without contravening the prohibition on monetary financing. The task of borrowing in the international capital market has been assigned to the National Debt Office rather than to the Riksbank because the Riksbank lacks resources for this and the Office's competence in this field enables it to obtain good borrowing terms.

The Riksbank should be fully responsible for the costs of borrowing foreign currency when this is done to strengthen the foreign exchange reserves. A system is therefore proposed whereby the Riksbank presents debt instruments denominated in foreign currency to the National Debt Office in exchange for foreign currency receipts. The debt instruments should be constructed to match the Office's foreign currency loans as regards interest rates, maturities and currency composition. The system requires that the Riksbank is enabled to issue debt instruments in foreign currency as well as debt instruments with no maturity restrictions. Other technical arrangements might be applicable provided they meet the same conditions, that is, compensation for State borrowing costs is to cover the total cost to the State, including interest rate costs and costs arising from exchange rate movements. Under special circumstances, however, the Government, in consultation with the Riksbank, should be able to decide a different assignment of costs provided the proposed liability for compensation is to the Riksbank's substantial disadvantage.

The main rule proposed by the Government precludes the National Debt Office from using its receipts from borrowing to strengthen foreign exchange reserves for any purpose except the repayment of the foreign currency loans. This means that the State is debarred from using such funds for financing central government expenditure or other purposes specified in Article 1 of the Government Borrowing Act. This means that Riksbank debt instruments received by the National Debt Office may not be disposed of prior to maturity. However, the Government, in consultation with the Riksbank, should be in a position to decide exemptions from this main rule if special circumstances are at hand. This means that the Government, in consultation with the Riksbank, can decide that the foreign currency loans may be used for financing the central government budget and be included as a regular component of central government foreign currency debt. An example of special circumstances in this context is situations where the foreign currency borrowing undertaken to reinforce foreign exchange reserves adds appreciably to the cost of or otherwise impedes the foreign currency borrowing the Government decides on for financing the central government budget.

In other respects the existing forms for consultation in the fields of monetary policy and government debt policy may be considered appropriate for reconciling the considerations of monetary and government debt policy in connection with borrowing on behalf of the Riksbank. To require a Government decision in each case, as proposed by the Riksbank Commission, would be liable to impair the flexibility which the situation requires.

2.3 The Riksbank's capital contributions to international financial bodies

The EU rules on monetary financing also curtail the ability of the central banks to provide capital contributions to international financial bodies. Apart from the credit facilities under the Community's medium-term financial assistance, central bank financing is permitted only as regards payments to the International Monetary Fund (IMF). Capital contributions to other international institutions shall not be carried by the central bank. The background to the Community's prohibition in this respect is that the financing of other international financial bodies, e.g. investment and development banks, cannot be regarded as a task for monetary policy.

For Sweden this affects the forms for capital contributions to the World Bank. To date it is the Riksbank which has been responsible for the capital payments to the International Bank for Reconstruction and Development (IBRD), which is the original component of the World Bank and now concentrates on lending on market terms to middle-income countries. The other main component of the World Bank is the International Development Association (IDA), which provides "soft" loans to low-income countries and is financed from development assistance appropriations.

The paid-in component of Sweden's contribution to the IBRD is booked in the balance sheet of the Riksbank at SEK 593 million. In addition to this component, which is a minor part of Sweden's total share, the contribution to the IBRD includes guaranteed or callable capital. At present this guaranteed commitment stands at USD 1,696 million (c. SEK 12,300 million).

When Sweden jointed the IBRD, as well as in conjunction with each addition to the capital contribution, the Government, acting on a Riksdag authorization, has provided the Riksbank with a guarantee against any losses in connection with the capital contribution. There has never been occasion to invoke this guarantee.

The European Community's medium-term financial assistance is intended for Member States with difficulties as regards the balance of payments. The legal foundation for the assistance is contained in Article 109h of the Treaty on European Union and in an EEC Council Regulation (1969/88). If a Member State is in difficulties or is seriously threatened with difficulties as regards its balance of payments, the Commission shall, after consulting the Monetary Committee, recommend to the Council the granting of mutual assistance and appropriate methods for this. The funds granted under such assistance are borrowed by the Commission with guarantees in the Community budget. In the normal case, credit is not provided by the Member States. At present the frame for these balance of payments Community loans totals ECU 16 billion. The regulations entitle the Commission to lend a maximum of ECU 14 billion and the remaining ECU 2 billion is advanced to the recipient country in the form of direct credits from the other Member States.

If conditions in the capital market are such that the Commission has difficulty in borrowing capital in the usual way, or if the assistance framework is insufficient, the Member States are to contribute funds directly within the ceilings specified in Council Regulation 1969/88. The key for contributions by member states is not an exact formula; the share for each Member State is determined on the basis of a set of parameters, including GNP, exports of goods and services, population, Council votes and the contribution to IMF capital. In conjunction with accession to the Union, Sweden's share was set at 4.93 per cent of the total credit facility. Medium-term financial assistance with this procedure has been granted on five occasions: to France in 1983, Portugal in 1985, Greece in 1985 and 1991, and Italy in 1993.

2.3.1 Standpoints on new legislation

Government proposals: The Riksbank's powers to contribute capital to the international financial bodies of which Sweden is a member is limited to contributions to the International Monetary Fund. The Riksdag should authorize the Riksbank to make an unrequited transfer to the Government of the paid-in proportion of Sweden's capital subscription to the World Bank/IBRD, totalling SEK 593 million. Moreover, the Riksdag should authorize the Government to take over all commitments associated with Sweden's capital contribution to the World Bank/IBRD.

Furthermore, the Riksbank shall be entitled, for the purpose of foreign exchange policy, to provide credit within the framework for the European Community's medium-term financial assistance.

Reasons for the Government's proposals: In a submission to the Government on 2 March 1995 the Governing Board of the Riksbank, with reference to the EU rules, raised the issue of the transfer to the Government of Sweden's paid-in contribution to the World Bank/IBRD. The Board requests the Government to obtain a Riksdag authorization for the Riksbank to make an unrequited transfer to the Government of Sweden's paid-in contribution to the World Bank/IBD, totalling SEK 593 million. The Board finds no reason for this very special case of an asset transfer between two authorities to generate effects for the central government budget. This is avoided by making a corresponding reduction of the Contingency Fund on the balance sheet of the Riksbank.

The submission from the Governing Board also takes up a technical matter that may affect Sweden's capital contributions to the IBRD. When the IBRD decided to adopt a new monetary unit in 1987, it reintroduced the obligation on member countries to maintain the value of contributions in their own currency. This means that a member country can be obliged to make supplementary contributions in the event of its currency depreciating appreciably against the Special Drawing Right (SDR), in accordance with a specific valuation procedure. Conversely, a country with an appreciating currency can be entitled to refunds from the IBRD. In Sweden's case the 1987 rules have not yet entailed any such adjustment of the capital contribution but the possibility of future adjustments cannot be ruled out. This may mean, for instance, that the Government has to make supplementary payments on existing capital contributions.

The Government shares the opinion of the Governing Board that responsibility for contributions to the IBRD must be transferred from the Riksbank to the Government. The Government considers that this change, quite apart from the EU regulations, can be seen as an adaptation to international practice. Nowadays it is very unusual for a central bank to be responsible for contributions to the World Bank and similar financial institutions.

As regards the forms for this change, the Governing Board proposes that the Riksbank be authorized to make an unrequited transfer to the Government of the paid-in contribution to the IBRD. The Government agrees and Sweden's paid-in capital contribution to the World Bank/IBRD, totalling SEK 593 million, should accordingly be transferred to the Government without compensation.

The proposed transfer also involves the Government taking over all commitments associated with Sweden's capital contribution to the IBRD, in the first place the direct responsibility for Sweden's contribution to the callable capital. The Government, moreover, will be responsible for Sweden's contributions to future increases in the capital stock. As matters to do with the IBRD are assigned to the field of the Ministry of Finance, the ensuing payments will be financed under this ministry. The Government does not foresee any increment to the capital stock in the next few years.

In addition to the proposal to restrict the Riksbank's contributions to those connected with the IMF, the Government proposes that the Riksbank also be enabled to provide credit within the framework of the European Community's medium-term financial assistance to Member States with balance of payments difficulties in accordance with the conditions stipulated in EEC Council Regulation 1969/88 of 24 June 1988 (OJ. L 178, 8.7.1988, p. 1). The share of the Riksbank in this credit facility is based on the procedure included in the Council Regulation.

2.4 Marginal rate as a legislative concept

In the new system for the management of interest rates which the Governing Board of the Riksbank introduced from 1 June 1994, the concept of a marginal interest rate ceased to be applicable. But the concept still features in Article 52 of the Riksbank Act. Article 51 of the same Act stipulates that a credit institution that does not fulfil its established reserve requirement shall pay a special fee to the State. This fee is specified in Article 52 as a daily rate of interest on the reserve requirement deficit, calculated as twice the discount rate at each time. This interest rate, however, is to be adjusted if it is less than three percentage points above the corresponding maximum interest rate (formerly the marginal rate) on advances to the banking system as a whole. In such cases the fee is to correspond to a rate of interest on the deficit that is three percentage points higher than the marginal rate, unless special circumstances warrant a reduction of the fee. At present, however, the reserve requirement is zero per cent.

2.4.1 Standpoints on new legislation

Government proposal: The concept marginal interest in Article 52 of the Riksbank Act shall be replaced by lending rate.

Reasons for the Government's proposal: The earlier concept, marginal interest rate, should be replaced by lending rate, which is more congruent with the Riksbank's new system for interest rate management. Moreover, the main rule, specifying the special fee as twice the discount rate, should be rescinded. In certain periods of pronounced interest rate volatility this main rule has been liable to entail a special fee that is unduly low compared with the overnight rate (which closely followed the marginal rate), with the attendant risk of providing an incentive to banks to use the system in ways that were not intended. With the new interest management system, this risk can be eliminated if the main rule is reformulated as twice the lending rate. That also avoids the problems of delays in connection with the setting of the discount rate.