Assets and liabilities for government

A short introduction
Balance sheet objectives
The Danish case

All share the common objectives of a macroeconomic stability oriented framework:

• Fixed exchange rate to the euro

• Sustainable medium term fiscal orientation

• Government foreign debt finances currency reserve – not deficit
Objectives of the Central Bank and the DMO

• Central Bank and DMO have both common and exclusive objectives ⇒ scope for some coordination

• Central bank:
  • Fixed exchange-rate policy against the euro (foreign exchange reserve)
  • Financial stability (low level of risk appetite)

• Debt management:
  • Finance government deficit
  • Finance currency reserve
  • Low long term costs taking risks into account
  • Facilitate access to the financial markets in the longer term
  • Support well-functioning domestic financial market, monetary policy and financial stability
Foreign exchange exposure before and after coordination

DKK billion

-15
-10
-5
0
5
10
15

Loss

Central government

Central bank

Net
Stable DKK

DKK per 100 EUR

Fluctuation band +/-2.25 per cent

Central rate (1 euro=7,46038 kroner)

Market value

Net buying of euro as intervention

billion kr.
Two types of currency movements

- **Own currency vs. the rest**
  - Unavoidable risk associated with FX borrowing/investing
  - Reflect exposure against risk minimizing basket.

- **In Denmark:**
  - Risk vs Euro
  - Not so simple in other cases

- **Other currencies vs. each other**
  - Avoidable
  - Reflect risk reward tradeoff.
Coordination of exchange-rate risk on Government debt and FOREX-reserves

• Benefits from coordinating exchange-rate risk

• Government borrows in foreign currency to supplement the central bank foreign-exchange reserve (peg of DKK to the Euro)

• When separating the management of assets from liabilities – potentially large net exposures

• Objective:
  • Avoid borrowing in one currency and investing in another
  • Manage gross currency exposure
  • Currency swaps and forwards to manage currency exposure

• No forecast of future exchange rates
Borrowing to fill the currency reserve:
Avoid large net exposure

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Avoid large gross exposure in high risk currencies

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Small net and gross exposure

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ALM process

- 1991 debt management function shifted from Treasury to Central bank
  - Central bank is an agent of the treasury

- One objective was to facilitate management of assets and liability on a consolidated basis.
  - Report from national audit authority.

- Quarterly strategy meeting
  - Treasury, Central bank and Ministry of economic
  - Treasury forecast net lending
  - Central bank analyses strategies and makes proposals
  - Treasury sign off on guidelines
Mean variance portfolio model
Foreign exchange exposure before and after coordination

DKK billion

Coordination

Euro

Loss

Central government

Central bank

Net
Interest rate risk is different in government debt and central bank

- Government looks at the risk of higher debt servicing cost
  - Not a tradable portfolio
  - Accounts based on interest payments
  - Long maturity gives lower risk

- Central bank looks at the risk of lower value.
  - Assets can be sold
  - The effective size of portfolios is relevant
  - Short duration gives lower exposure to interest rate hikes.

- **Coordination** of interest rate risk is very challenging
Concluding remarks

- Full integration of national balance sheet not possible and not wanted

- SALM is important to DMO’s risk management

- Institutional set-up consistent and transparent