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Separate comment on the Riksbank's consultation response regarding the Ministry of Finance's draft referral to the Council on Legislation regarding the Riksbank's financial independence and balance sheet

The draft referral to the Council on Legislation contains a proposal by the Ministry of Finance for a new profit allocation model and structure for the Riksbank's equity and new provisions regarding the Riksbank's possibilities to borrow for the foreign currency reserve. I concur with the views the Riksbank gives regarding these proposals. One view, which I thus share, is that the Executive Board of the Riksbank must be able to make decisions on the size of the foreign currency reserve to be able to conduct an independent monetary policy. The size of the foreign currency reserve should therefore not be limited by legislation.

However, the Riksbank's consultation response does not only discuss the decision-making process regarding the foreign currency reserve, but also the appropriate size for the reserve. I would like to point out that the starting point when analysing the appropriate size for the foreign currency reserve can be called into question. The starting point in the consultation response is that the Riksbank shall have a sufficiently large foreign currency reserve to be able to carry out its role as "lender of last resort" (LOLR) in both Swedish krona and other currencies.

A generally accepted principle is that central banks shall act as LOLR when there is a shortage of liquidity in the financial markets. However, this principle is based on the assumption that central banks, despite not having taken special preparatory measures, have a better access to liquid funds than market participants. As the Riksbank can create unlimited liquidity in Swedish krona, the Riksbank has good potential to act as LOLR in Swedish krona. But the Riksbank cannot create unlimited liquidity in other currencies and therefore does not have the same self-evident role as LOLR in foreign currencies. This role is limited by the Riksbank's access to currency in a crisis situation, which can in turn be affected by preparatory measures before the crisis occurs. How extensive a role the Riksbank shall play as LOLR in foreign currency, and in a broader sense to manage liquidity risks in foreign currency, is thus a choice on which one needs to take a stand.

Many have observed that the best way to manage liquidity risks in foreign currency is for central banks to cooperate in supplying liquidity in relevant currencies if the need arises.[1] In countries where Swedish banks are major operators, it will normally be in the interests of the host country to help the Riksbank provide Swedish banks with emergency liquidity assistance if the need arises. But there are no guarantees that this will be the case, and one can also paint scenarios whereby foreign central banks see no reason to help the Riksbank gain access to liquidity. The question is therefore how the Riksbank and other Swedish authorities can best limit or manage the banking system's liquidity risks in foreign currencies when they cannot rely on the help of other central banks.

The answer to this question is not self-evident, and the choice of approach involves assessing which costs are linked to which measures and balancing these against the value the measures generate and how large systemic risks one are prepared to accept. For preventive purposes, one can use regulation to encourage the banks to hold larger liquidity buffers or to limit the short-term funding in foreign currency.[2] If a liquidity crisis nevertheless arises, the Riksbank can to some extent supply liquidity by using the foreign currency reserve that is held for other reasons, or through loans or purchases on the market try to convert SEK to foreign currency at a lower cost than the one the banking system has to pay.

[1] See, for instance, Cecchetti (2014) and Landau (2014).
[2] Cecchetti (2014) and Dobler et al. (2016) list various measures the authorities can consider to prevent and manage crises.

However, a further alternative is thus that the Riksbank builds up an extra large foreign currency reserve to be able to supply Swedish banks with foreign currency if a liquidity crisis arises. Let me develop my views on the considerations regarding this alternative.

The costs linked to strengthening the foreign currency reserve through borrowing are not only monetary but are also linked to so-called moral hazard behaviour.[3] The monetary costs arise because the Riksbank (or the Swedish National Debt Office, if they are managing the borrowing), normally borrows foreign currency at a somewhat higher interest rate than the return on the assets held in the foreign currency reserve. Moral hazard arises if the foreign currency reserve induces the banks to take larger liquidity risks in foreign currency in the belief that the Riksbank will supply liquidity if the market does not do so. Moral hazard behaviour can be limited if a risk-based fee is charged by the banks. Determining such a fee is difficult in practice, however, and ultimately a well-designed fee would probably mean that the banks reduce their liquidity risks in the same way as could more easily be attained through regulation (see footnote 4).

The value the Riksbank can generate with a reinforced foreign currency reserve is a greater ability to assist Swedish banks in the event of a liquidity crisis, and this ability may also entail that the risk of a crisis arising declines. But as I see it, a reinforced foreign currency reserve does not generate any actual insurance value. The starting point in the analysis of the need for a foreign currency reserve is a scenario in which a systemic crisis arises. In that scenario all of the major Swedish banks demand liquidity support in foreign currency at the same time. There would not then arise any value through risk sharing or insurance if the Riksbank accumulates a total foreign currency reserve compared with if the banks themselves, for instance because of regulation, hold corresponding liquidity reserves.[4]

It would be unfortunate if we found ourselves in a situation where the commercial banks rely on short-term funding of their lending in foreign currency to reduce their costs, while the Riksbank holds foreign assets with longer maturities to counteract the banks' liquidity risks. In these cases, the cost savings attained by the commercial banks through maturity transformation in one direction (short-term borrowing and long-term lending) will correspond to the Riksbank's costs for reinforcing the foreign currency reserve to ensure that the equivalent maturity transformation is made in the opposite direction.

To conclude, I would also like to point out that further discussion is needed regarding the allocation of responsibility between authorities in Sweden that is most effective in managing risks linked to liquidity in foreign currency. *The Riksbank* has a clear role to play as LOLR in Swedish krona, but it is not self-evident what expectations there are or should be with on the Riksbank's role as LOLR in foreign currency. The need for an LOLR in foreign currency depends on what liquidity risks the banks are exposed to and the responsibility for overseeing and regulating such risks lies with *Finansinspektionen* (the Swedish financial supervisory authority). At the same time, the *Swedish National Debt Office* is the authority that can borrow foreign currency at the lowest cost and thus contribute to funding a build-up of liquidity in foreign currency if this is assessed as necessary. It is also the authority that would have to supply the banks or their customers with foreign currency if the banks enter resolution or if the deposit guarantee is activated. If a liquidity buffer is to be held in foreign currency, one may consider which authority is the most appropriate to take responsibility for

[3] A further cost that is sometimes mentioned is that pricing of safe assets on international markets can be distorted (interest rates become too low) if many countries build up large foreign currency reserves (see Landau, 2014).

[4] However, one difference is that the Riksbank (and especially the Swedish National Debt Office) can borrow foreign currency at a lower cost than the commercial banks. Using this as an argument for the Riksbank, rather than the commercial banks, to accumulate foreign currency would have far-reaching consequences for the way we view the role of the state in the market economy. One could then, for instance, use similar arguments to say that the Riksbank or the Swedish National Debt Office should in normal circumstances provide the banks with cheap funding in SEK as these authorities can borrow at lower interest rates than those the banks pay to borrow on the market. This insight also has consequences for what is considered a well-designed fee for the foreign currency reserve. To avoid moral hazard behaviour, the fee charged should not reflect the *Riksbank*'s costs for borrowing in foreign currency, but rather the costs the *commercial banks* face on the market. But if the fee reflected the costs, the banks could just as well turn to the market. Rather than building up large liquidity reserves, the banks would then probably extend the maturity of their funding in foreign currency. The conclusion of this reasoning is hardly that such fees should be charged, it is rather that the banks' liquidity risks in foreign currency need to be transparent and well-regulated when the Riksbank has limited capacity to assist as LOLR.

this buffer, for what purposes the funds should be used, how decisions on the size of the buffer shall be coordinated with regulation of the banks' liquidity risks, and who shall make decisions regarding a fee to fund such a buffer.

It is hardly desirable that preventive measures are taken to entirely eliminate the risk that a systemically important liquidity crisis in foreign currency arises. Instead, the extent to which one wishes to reduce systemic risks is a choice where risk reduction must be weighed against the costs linked to various preventive measures. If several authorities are to share the responsibility for these questions, mechanisms are also needed to coordinate decisions on which preventive measures are best suited to use and decisions on what extent of systemic risk one is prepared to accept. Such coordination is complicated by the fact that the Riksbank is an independent authority under the Riksdag, while Finansinspektionen and the Swedish National Debt Office are authorities under the Ministry of Finance. The Riksbank's role in this work must therefore be clearly stipulated in the Sveriges Riksbank Act, and I therefore welcome that the question of the Riksbank's responsibility for financial stability and liquidity support will be discussed by the committee for reviewing the monetary policy framework and the Sveriges Riksbank Act (dir. 2016:114).

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