



The Riksbank's
management of
interest rates
– monetary policy
in practice



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Foreword

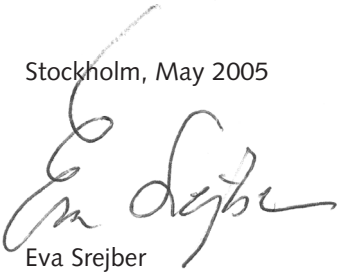
The Riksbank's staff gives frequent lectures about the Bank's role in society and about how the Bank works to achieve the statutory objective assigned to it by the Riksdag, namely to maintain price stability. This publication describes how the Riksbank conducts monetary policy in practice. It is intended both for reading on its own and in connection with the Riksbank's lectures.

The primary target group is third-level students of economics. It is hoped that the publication will also reach a wider audience with an interest in how the Riksbank steers interest rates.

The publication begins with a description of the Riksbank's objectives and tasks, with a focus on monetary policy. That is followed by the Bank's practical implementation of monetary policy.

A list of sources for further information and reading as well as a glossary can be found at the end of the publication.

Stockholm, May 2005



Eva Srejber

First Deputy Governor

Introduction

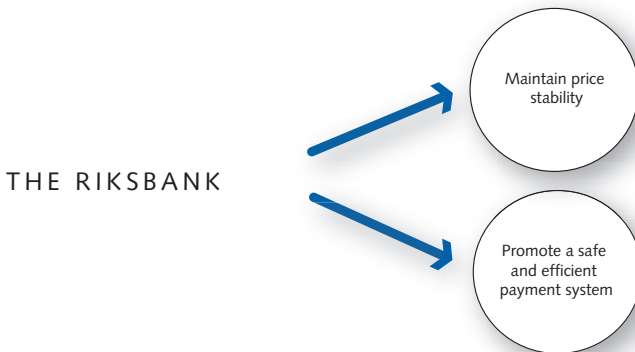
The Riksbank

The Riksbank is Sweden's central bank. Its core tasks are to maintain price stability and to promote a safe and efficient payment system (see Figure 1).

Price stability is taken to mean low and stable inflation. The Riksbank influences inflation developments with the aid of its key interest rate. The key interest rate indicates the Riksbank's desired level for the money market's shortest interest rate, the overnight rate. The overnight rate in turn affects market rates at longer maturities and, over time, activity and price developments in the economy. This process forms part of what is commonly known as the *transmission mechanism*. To find out more about this mechanism, see the suggested literature under "Further information and reading".

In order to promote a safe and efficient payment system the Riksbank monitors and analyses risks and threats to the stability of the financial system. This task is not covered here, however; instead, the publication focuses on the Riksbank's objective of maintaining price stability.

Figure 1. The Riksbank's core tasks



Monetary policy in Sweden aims to keep inflation at a low and stable level so as to facilitate decision-making in the economy and thereby foster economic growth. Households that wish to save and companies that want to invest can thus feel confident that their economic decisions will not be undermined due to a decreasing value of money.

The Riksbank's monetary policy

The Riksbank's inflation target, measured in terms of the consumer price index (CPI), is a rate of price increases of 2 per cent a year, with a tolerance for deviations of 1 percentage point above or below this target.

The reason for choosing this particular target level is to allow room for price increases due to improvements in the quality of goods and services and to avoid the risk of deflation.

In order to achieve the objective of price stability the Riksbank adjusts its key interest rate. Since the effect of an interest rate change on the economy is exerted with a lag, the greatest impact being attained one to two years after the adjustment, the key interest rate is changed mainly on the basis of a forecast of inflation during this period. The Riksbank presents these inflation forecasts in its Inflation Report, which is published four times a year. The forecasts are based on analyses of economic developments in Sweden and abroad, as well as on developments in the Swedish krona's exchange rate and the inflation expectations of the general public.

In simplified terms the Bank's monetary policy can be described in the form of a rule. If inflation one to two years ahead is forecast to be above the Bank's target, the key interest rate is raised, and vice versa if it is forecast to be below target.

■ Monetary policy in practice

Once the Riksbank has decided on the level of its key interest rate, *the repo rate*, the decision has to be implemented in practice.

This chapter describes how this is done. The Riksbank's ability to steer interest rates derives from the fact that only the Riksbank can create completely new money in the form of banknotes and coins as well as intraday credit. That means that it is always risk-free for banks to deposit funds at the Riksbank. The banks therefore hold accounts at the Riksbank in order to obtain "new money" and deposit "old money" according to variations in public demand. The Riksbank sets the terms and conditions for the banks' deposits and loans through these accounts. In this way the Bank also determines the conditions for the overnight rate.

Fundamental conditions for the Riksbank's management of interest rates

When banks need to borrow or deposit funds in kronor, they can do so with each other at different maturities. The most interesting maturity, which constitutes the essence of the Riksbank's ability to steer interest rates, is the banks' borrowing or deposit requirement *overnight*.

Banks' need to borrow funds from, or deposit funds with, each other overnight stems from the payments that occur between them during the day. But in order for banks to be able to carry out these payment transactions at all, a common *payment system* is required.

THE RIKSBANK'S PAYMENT SYSTEM – A PREREQUISITE FOR STEERING INTEREST RATES

When households and companies pay their bills they do so through the bank in which they hold their accounts. The bank then forwards the payment to the recipient's account. If this account is held in a different bank the process requires a payment system, that is to say, an infrastructure that makes it possible to forward a payment from one bank to another. In Sweden the Riksbank provides such a payment system, called RIX.¹

¹ The Riksbank's payment system RIX is the hub of the Swedish payment infrastructure. For more information, see the chapter entitled "The financial infrastructure" in The Swedish Financial Market 2004.

Payments in RIX are made in Swedish kronor only and go via the participant banks' accounts at the Riksbank. Those banks that do not participate in RIX have to go through the participant banks.

To ensure that payments can be made smoothly in RIX the Riksbank gives participants the opportunity to borrow interest-free funds from the Bank during the day, known as intraday credit. The banks can do so on condition that they have provided sufficient eligible assets to the Riksbank.

The payments in RIX are processed one by one, known as real-time gross settlement, when payers have sufficient funds in their accounts or adequate collateral to obtain intraday credit.

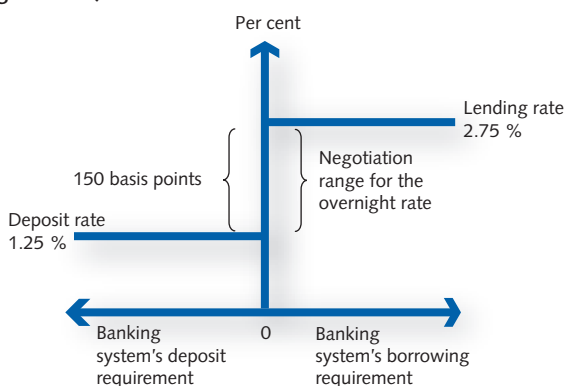
DEPOSITS AND LOANS AT THE RIKSBANK SET THE BOUNDARIES FOR THE OVERNIGHT RATE

Before the payment system closes, the banks' accounts in RIX must be balanced. That means that banks with intraday credit at the end of the day have to finance this in some way. Likewise, banks with a surplus in their Riksbank accounts have to make sure that they deposit these funds.

Banks can resolve this by turning to the overnight market or by borrowing or depositing funds at the Riksbank *overnight*, that is to say, by making use of the Riksbank's *marginal lending and deposit facilities* (the Riksbank's standing facilities). In other words banks can extend their loans overnight (through the marginal lending facility) or deposit funds overnight (through the deposit facility) at the Riksbank at interest rates announced in advance.

The lending rate is 150 basis points higher than the deposit rate (see Figure 2). This interest rate differential creates an incentive for

Figure 2. The Riksbank's deposit and marginal lending facilities (standing facilities)



Note: Interest rate levels as at 28 January 2005.

banks to borrow from, and deposit with, each other at a rate of interest between the Riksbank's deposit and lending rates, thereby setting the boundaries for the overnight rate.²

A very narrow interest rate corridor (for example, a rate differential close to zero) would remove the incentive for banks to borrow from or deposit with each other since the risk-free alternative of depositing funds at the Riksbank would be more attractive. The banks would thus deposit and borrow funds at the Riksbank. There is no reason, therefore, to eliminate a market mechanism that obviously works.

The Riksbank's mode of procedure

The Riksbank's steering of the overnight rate is not only aimed at bringing it within the interest rate corridor, however; the Riksbank also wants it to be *close to and stable around* the Bank's key interest rate – the repo rate. In other words the Riksbank wants the overnight rate to be predictable over the coming week and not to fluctuate within the interest rate corridor. That is because the Bank wants to give clear signals for longer-term market rates. Since short-term market rates (up to six months or so) represent an average of the expected overnight rate at the respective maturities, a fluctuating overnight rate could give rise to unnecessary volatility at these maturities. This could also create undue speculation over why the overnight rate is lying closer to the ceiling or the floor of the interest rate corridor. A sharply fluctuating overnight rate could therefore be misinterpreted as monetary policy signalling.

So how does the Riksbank ensure a stable overnight rate? The first step is to ensure that the banking system is in balance, that is to say, that its need to borrow or deposit funds through the standing facilities is minimised. Before going into this in more detail, we need to look briefly at how the banking system's borrowing or deposit requirement vis-à-vis the Riksbank changes. The easiest way to explain this is to take a simplified picture of what happens when the public varies its demand for banknotes and coins.

When people demand more banknotes and coins they withdraw them from banks, which in turn acquire the corresponding amount of banknotes and coins from the Riksbank. However, the banks have to pay for these notes and coins, which essentially means that they incur a liability in relation to the Riksbank.³ If public demand for notes and coins

² Banks usually have a liquidity plan that extends over a longer period than overnight. Nevertheless, the overnight market is important for banks to be able to manage the deficits and surpluses that arise in their payment flows on particular days.

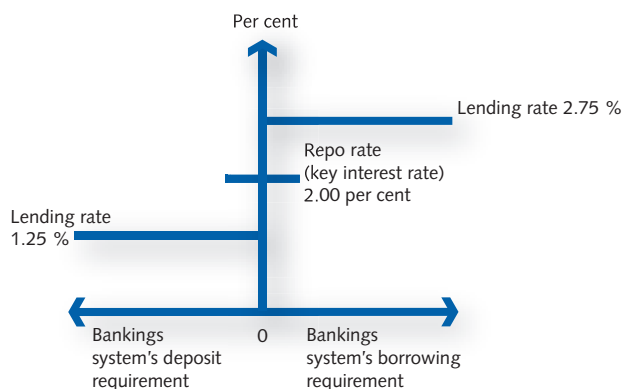
³ On condition that the banks can provide sufficient eligible assets to the Riksbank.

drops, the banks instead return the corresponding amount of notes and coins to the Riksbank, thus decreasing their liability vis-à-vis the Riksbank.

Currently, the banking system as a whole has a borrowing requirement.⁴ In the absence of any Riksbank measures the banking system would borrow funds at the Bank's lending rate (the marginal lending facility) and the market's overnight rate would thereby be close to the lending rate. However, the Riksbank wants the overnight rate to be in the very middle of the interest rate corridor. For that reason the Riksbank has an arrangement whereby the banking system in the first place can borrow funds at the repo rate. This is done as follows: Every week the Riksbank forecasts the quantity of notes and coins that will be demanded by the public. The Bank then carries out a *repo transaction* (repo). Through this repo the Riksbank satisfies the banking system's borrowing requirement and also signals the level at which it wants the overnight rate to be in the week ahead (see Figure 3).

Since the Riksbank's repo is based on a forecast for the following week the banking system's actual borrowing requirement will vary from day to day. That means that on certain days the banking system may need to avail of the Bank's standing facilities to borrow or deposit funds, and if the amounts are large this could cause the overnight rate to fluctuate within the interest rate corridor in spite of the repo. To prevent this from happening, the Riksbank carries out *fine-tuning operations*.

Figure 3. The Riksbank's official interest rates



Note: Interest rate levels as at 28 January 2005.

⁴ The banking system can just as well have a deposit requirement at the Riksbank. That is because the Riksbank's demand for assets to conduct monetary and exchange rate policy may exceed both the public demand for banknotes and coins and the Riksbank's capital. For example, under a fixed exchange rate, appreciation pressures may force the Riksbank to purchase such large volumes of foreign currency that the banking system as a whole needs to deposit funds at the Riksbank.

These operations involve meeting the banking system's borrowing or deposit requirement on a particular day at a rate of interest that is 10 basis points above or below the repo rate.

In short, the Riksbank steers interest rates by providing standing facilities through which it can fix the market's overnight rate in the interest rate corridor. By means of weekly repo transactions and (almost) daily fine-tuning operations the Riksbank ensures that the overnight rate is anchored close to the repo rate (see Figure 4).

The Riksbank's practical implementation of monetary policy

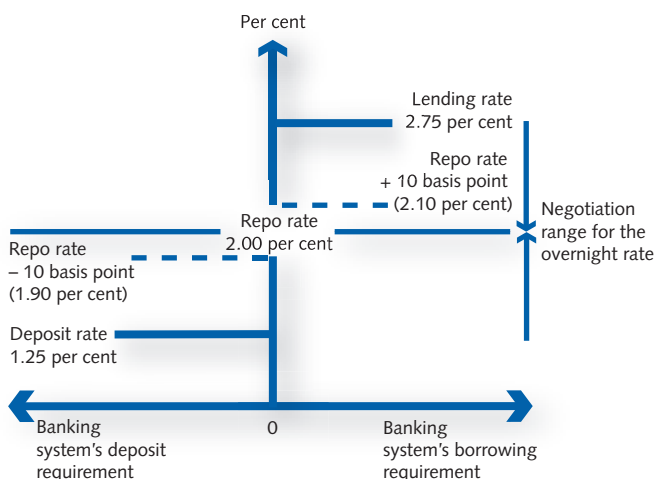
So what happens step by step when the Riksbank steers interest rates?

STEP 1. FORECAST OF THE SIZE OF THE MONETARY POLICY REPO

Every Tuesday the Riksbank forecasts how large the banking system's borrowing requirement⁵ in relation to the Riksbank will be on average in the coming week, that is to say, from Wednesday to Wednesday. The forecast is based on an estimate of changes in the Bank's assets and liabilities (the balance sheet).

The Riksbank's assets comprise the gold and foreign exchange reserve, which, besides gold, consists of securities denominated in foreign currency and receivables from the International Monetary Fund

Figure 4. Negotiation range for the overnight rate



Note: Interest rate levels as at 28 January 2005.

⁵ In cases where the banking system as a whole has a deposit requirement and thus needs to deposit funds during the week the Riksbank issues certificates (instead of implementing a monetary policy repo), which means that the Riksbank pays weekly interest to the banking system for the deposited funds.

(IMF). In addition, the Bank's assets are composed of other assets⁶ as well as lending to banks, which, in simplified terms, is due to the banks obtaining notes and coins from the Riksbank. Thus, in principle, the item "lending to banks" should equal the item "banknotes and coins in circulation". However, in order to be able to intervene in the foreign exchange market and to generate as high a return as possible on its assets, the Riksbank has chosen to exchange some of its claims on the banking system for foreign currency.

The Riksbank's liabilities largely comprise banknotes and coins in circulation as well as capital. In addition, the Bank's liabilities are composed of deposits from banks and other liabilities⁷ (see Figure 5).

Figure 5. The Riksbank's balance sheet (adjusted) as at 31 December 2004

ASSETS	SEK MILLION	LIABILITIES	SEK MILLION
Gold and foreign exchange reserve	162 649	Banknotes and coins in circulation	108 894
Lending to banks		Deposits from banks	
Monetary policy repos	16 473	Deposit facility	86
Marginal lending facility	2	Other liabilities	9 836
Other assets	3 205	Capital (incl financial result for the year)	63 513
Total	182 329	Total	182 329

Note: The item "Monetary policy repos" includes fine-tuning operations (net).

Source: The Riksbank

It is relatively easy to forecast changes in the Riksbank's assets because generally speaking these items are influenced by the Bank's own decisions. This applies first and foremost to changes in the gold and foreign exchange reserve that are connected to sales or purchases of foreign currency, which as a rule derive from intervention in the foreign exchange market.

As regards the liability side it is generally only changes in the volume of banknotes and coins in circulation, that is to say, public demand for notes and coins, that needs to be forecast. This demand follows a clear and stable seasonal pattern, making the item "banknotes and coins in circulation" relatively easy to estimate. In the run-up to major holidays such as Christmas, demand increases sharply.

The other items on both the asset and liability side display only very small, predictable changes, for example payments to the State in connection with the allocation of the Riksbank's profits, which affects the Bank's capital, financial result and lending in Swedish kronor to the banking system.

⁶ Other assets include accrued interest income and fixed assets.

⁷ Other liabilities include liabilities denominated in foreign currency and revaluation accounts.

When the changes in all the items have been estimated and summed up, the Riksbank can see how the banking system's average total borrowing or deposit requirement at the Bank over the coming week will change compared with the week before. If the borrowing requirement has grown, the Bank increases the size of the monetary policy repo and vice versa (see step 2).

Figure 6 shows how the different items in the balance sheet contribute to the banking system's total borrowing requirement at the Riksbank. The example is based on the Bank's balance sheet as at 31 December 2004.

Figure 6. Calculation of the banking system's total borrowing requirement at the Riksbank as at 31 December 2004

	SEK MILLION
Banknotes and coins in circulation	108 894
Deposit facility	86
Other liabilities	9 836
Capital	63 513
Gold and foreign exchange reserve	– 162 649
Marginal lending facility	– 2
Other assets	– 3 205
Banking system's total borrowing requirement at the Riksbank and size of the monetary policy repo (or banking system's total deposit requirement and size of the Riksbank's certificate issue)	16 473

Source: The Riksbank

STEP 2. IMPLEMENTATION OF THE MONETARY POLICY REPO

Having arrived at the liquidity forecast and calculated the banking system's average total borrowing or deposit requirement⁸ the Riksbank implements a monetary policy repo (or issues certificates).

The Riksbank's repo⁹ is designed in the same way as an ordinary repo instrument in the financial markets.¹⁰ Repos in the financial markets are sale and purchase agreements whereby one party agrees to sell a security to another party and to repurchase the security at a predetermined price on a specific future date. The price of a repo is represented by the repo rate, that is to say, the lending rate over the maturity of the repo.¹¹

⁸ It is usual to say that the banking system has a structural liquidity deficit or liquidity surplus, therefore indicating how much liquidity the Riksbank needs to provide or absorb in the market. This terminology creates some confusion, however, since the Riksbank neither provides nor absorbs liquidity in the market. For that reason it is more correct to say that the banking system has a borrowing or deposit requirement at the Riksbank.

⁹ The term "repo" is short for repurchase agreement.

¹⁰ Strictly speaking, the Riksbank's repo in this case is a "reverse repo" since the Riksbank first buys securities and subsequently sells them back. A repo is when a party first sells and then repurchases securities.

¹¹ The repo rate for a repo instrument in the financial markets should not be confused with the Riksbank's repo rate, which is the Bank's key interest rate.

As a rule, a monetary policy repo has a maturity of one week, from Wednesday to Wednesday. Thus, once a week the Riksbank buys securities from the banks and simultaneously agrees to resell them to the banks a week later.

When the repo matures, the banks pay interest (the repo rate) on the past week's "loans". At the same time, the Riksbank implements a new repo, giving the banks the opportunity to renew their "loans" and thereby "borrow" from the Riksbank for another week. The size of the "loans" from the Riksbank may vary from week to week, however, depending on the Riksbank's forecast (see Step 1).

Because the repo in most cases has a maturity of only one week the Riksbank can change the repo rate each week.¹² In other words, one could say that over time the banking system borrows funds at a variable rate of interest from the Riksbank but that the rate is fixed for one week at a time.

So the starting point for the monetary policy repo is the banks' borrowing requirement in relation to the Riksbank, which the Bank essentially meets through repo transactions. The fact that the repo is basically constructed as a purchase of securities in exchange for capital is a purely technical issue.

If the banking system instead has a deposit requirement the Riksbank issues certificates. A Riksbank certificate is a debt instrument that represents a short-term claim on the Riksbank. The Riksbank sells these certificates to banks for a period of one week. When the certificates mature, the Riksbank repays the funds plus interest – the repo rate – to the banks.¹³

The banking system as a whole currently has a borrowing requirement at the Riksbank, which is why the description will focus on the monetary policy repo. Whether the banking system needs to borrow or deposit funds at the Riksbank has no significance, however, for the Riksbank's capability to steer interest rates.

The terms and conditions of the repo (or certificate issue) are announced every Tuesday at 9.30 a.m., covering the type of transaction (monetary policy repo or certificate issue), maturity, repo rate, and the minimum and maximum bids. The process is carried out in the form of an auction whereby the banks notify the Riksbank of how much they need to borrow. There is no obligation to submit a bid, however.

¹² In practice, the repo rate is adjusted in connection with the Bank's pre-announced monetary policy meetings, which as a rule are held eight times a year. Extra meetings may be called, as was the case when the repo rate was cut after the terrorist attacks in New York on 11 September 2001.

¹³ From July 1994 to May 1997 the Riksbank issued certificates as the banking system as a whole had a deposit requirement at the Riksbank. Since then the banking system has had a borrowing requirement.

The banks must tender their bids to the Riksbank before 9.45 a.m. An allotment is then made according to a percentage share that is calculated on the basis of the Riksbank's intended size of the repo and its proportion of the banks' total bid volume. If, for example, the intended size of the repo is 50 per cent of the total bid volume, each bank will be able to borrow 50 per cent of its tendered bid. If the banks' bids fall short of the intended size the Riksbank fine-tunes the borrowing requirement.

The Riksbank announces the result of the repo at 10.00 a.m. Figure 7 shows the different steps involved in the implementation of a repo transaction. The figure also shows the steps in a certificate issue.

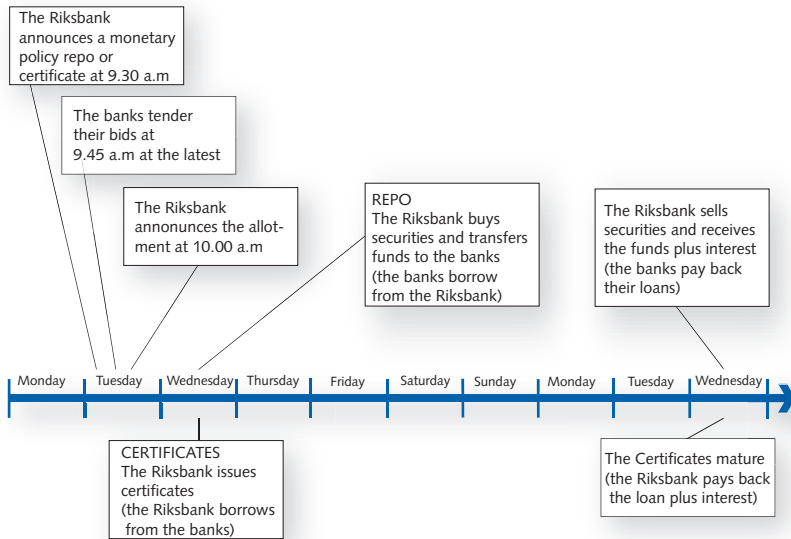
STEP 3. IMPLEMENTATION OF THE FINE-TUNING OPERATIONS

The banking system's actual daily borrowing or deposit requirement at the Riksbank may differ from the Bank's forecast for the average requirement over the week. That means that the banking system may need to borrow or deposit funds through the standing facilities.

Since the Riksbank wants a stable overnight rate, the Bank therefore carries out fine-tuning operations.

Those banks that have a borrowing or deposit requirement at the end of the day, and that have not managed to resolve this in the overnight market, will call the Riksbank after 4.20 p.m. to ask whether the Bank is offering fine-tuning. The Riksbank has details of both individual banks' account balances in RIX and of the banking system's

Figure 7. Schedule for the Riksbank's monetary policy repo or issue of certificates



total position in relation to the Riksbank. If the requested amount can be matched by another bank the Riksbank asks the enquiring bank to contact other banks. If there are no matching positions at the other banks the Riksbank performs a fine-tuning operation equal to the requested amount or parts thereof with the enquiring bank.

If, for example, the banking system as a whole has a borrowing requirement of 100 and the Riksbank is contacted by a bank with a borrowing requirement of 150, the Riksbank will only perform fine-tuning operations for 100. That is because a different bank (or several banks between them) needs to deposit 50, and the banks are thereby expected to balance this out in the overnight market.

The Riksbank performs fine-tuning operations between 4.20 p.m. and 4.40 p.m. as it is not until 4.20 p.m. that the Riksbank has full details of the banking system's borrowing or deposit requirement.¹⁴

¹⁴ The banks can return banknotes up to this time.

Further information and reading

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The Riksbank publications and published speeches can be found on the Riksbank's website (www.riksbank.se).

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Glossary

Banking system	In this publication, banking system refers to all banks in Sweden excluding the Riksbank.
Basis point	A basis point is one hundredth of one per cent, that is, 0.01 per cent. 100 basis points thus correspond to 1 per cent.
Certificates	A certificate is a debt instrument that represents a short-term claim on a bank or company, for example.
Consumer price index	The consumer price index is one of the indices used by Statistics Sweden to measure how the prices of goods and services for private domestic consumption evolve over time.
Deflation	Deflation means a fall in the general level of prices, which results in a rise in the value of money (measured in terms of goods and services).
Deposit rate	The Riksbank's overnight deposit rate. See standing facilities.
Eligible asset	Eligible assets are financial assets, such as securities denominated in kronor or foreign currency, which can be submitted as collateral when borrowing from the Riksbank. The Riksbank sets general criteria – including type of security, credit rating and accounting arrangements – that must be fulfilled if the assets are to be eligible.
Financial markets	The financial markets consist of the equity market, the fixed-income market and the foreign exchange market.
Financial system	The financial system has essentially three core functions: to convert savings into financing, to manage financial risk and to provide efficient means of payment.

Fine-tuning operation	Fine-tuning operations mean that the banking system as a whole either borrows or deposits funds at the Riksbank at the repo rate ± 10 basis points. This occurs only on those occasions when the banking system as a whole has a borrowing or deposit requirement in relation to the Riksbank and only in one direction (either borrowing or depositing).
Fixed-income market	The fixed-income market is a market for trade in instruments that provide a return in the market in the form of interest. The fixed-income market is usually divided into the bond market and the money market.
Foreign exchange market intervention	Foreign exchange market intervention is the purchase and sale of domestic currency for foreign currency with a view to influencing the exchange rate.
Inflation	Inflation means a rise in the general level of prices, which results in a fall in the value of money (measured in terms of goods and services).
Intraday credit	Intraday credit is interest-free credit that the Riksbank grants during the day to the participants in the Riksbank's payment system, RIX.
Key interest rate	The Riksbank's key interest rate, the repo rate, is the Riksbank's desired level for the overnight rate.
Lending rate	The Riksbank's overnight lending rate. See standing facilities.
Maturity	Maturity is the period of time remaining until a loan must be repaid.
Monetary policy	Monetary policy is conducted by the central bank. By stabilising demand, monetary policy can influence inflation developments in the economy.
Money market	Money market is a collective term for markets for interest-bearing assets which generally have a maturity of up to one year. See also fixed-income market.

Overnight market	The overnight market is the segment of the money market in which the shortest-term securities are traded. This market is mainly used by banks to deposit and borrow funds from one day to the next, that is overnight, and up to one week.
Overnight rate	The overnight rate is the rate of interest paid by market participants when borrowing or depositing funds from one day to the next. The overnight rate is the shortest-term market rate.
Payment infrastructure	The infrastructure of institutions, payment instruments and technical and administrative systems used for payments and securities transfers.
Payment system	A payment system is an infrastructure used to execute payments.
Repo	A repo is a sale and repurchase agreement whereby one party agrees to sell a security to another party and to repurchase the security at a predetermined price on a specific future date.
Repo rate	The repo rate is the price of a repo. In the Riksbank's case the repo rate is the Bank's key interest rate. See key interest rate.
RIX	RIX is the name of the Riksbank's payment system. See payment system.
Settlement	Settlement means the payment of a debt or claim, that is to say, the transfer of a payment from one account to another.
Standing facilities	Standing facilities are a central bank facility available to banks whereby they can borrow or deposit funds on their own initiative (provided that they have collateral) at pre-announced interest rates. At the Riksbank these facilities are offered to RIX participants only.

**Transmission
mechanism**

When the key interest rate is adjusted, the impact on total demand and, finally, on inflation will be exerted through different channels in the economy. This process is known as the transmission mechanism. The channels through which monetary policy is expected to have an effect are usually called the interest rate channel, the credit channel and the exchange rate channel.

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