Macro Research

Sweden

Time to pay the piper – The Riksbank's QE programme largesse is not a free government lunch...

The Riksbank has flagged that it expects a huge loss for 2022, partly due to dramatic write-downs in the value of its QE programme asset holdings, and partly due to interest payment costs driven by its own policy rate hikes. We now believe that the loss will be even worse than signalled by the Riksbank, requiring the treasury to recapitalise the Riksbank in 2023, with a multibillion injection of approximately SEK 50-70 billion, in the midst of a period of extraordinary fiscal policy challenges. We judge that, de facto, this ordeal will not impede fiscal policy in Sweden, despite key government finance indicators deteriorating. Nevertheless, the Riksbank risks tough public scrutiny, with a heightened need to prove that QE's benefits really do outweigh the costs.

First, some background – Why use QE at all? The Riksbank's asset purchases – aka quantitative easing, QE – aided the global central banking community in preventing the acute phase of the pandemic crisis from becoming a new Lehman Brothers moment for the world economy. Apart from that, since 2015, the asset purchases have also been wielded as an unconventional monetary policy tool in an attempt to stave off the low inflation problem that the Riksbank has been grappling with.

Riksbank flags huge loss for 2022...

Because of its QE, the Riksbank is set to report a huge loss for fiscal year 2022 – a staff report paints a scenario with a SEK 65 billion loss.

For years, the secular downward trend in interest rates, made the Riksbank's asset portfolio rise in value, and hence resulted in unrealised gains. These have not been reported as earnings, but instead balanced in a "revaluation account". However, with the ongoing sharp rise in interest rates, the value of the Riksbank's holdings is being slashed and this deals a severe blow to the reported result in 2022.[1]

...partly owing to its policy rate hikes

On top of the asset portfolio's value losses, the Riksbank's liabilities are now becoming much more costly too. The reason for this is that the Riksbank created new money to pay for its asset purchases over the years – money that counterparties deposit with the Riksbank at a variable interest rate, which is now sky-rocketing hand in hand with the policy rate rises.

"It's only a timing issue!" No, think again

The way in which gains and losses in the QE portfolio are recorded in the Riksbank's annual report, is a product of the European system of central banks' accounting principles. This system actually gives rise to a different periodisation of the results than some other accounting principles, rather than a different end result aggregating over time. One might imagine that this whole ordeal with the huge 2022 loss is merely a timing issue. After all, the Riksbank intends to hold its bonds to maturity and the gains in the portfolio will, in the end, be dictated by the purchase yield.[2]

But the flipside is the liability side cost mentioned above, and summing it all up, the current environment of sharply rising interest rates could well imply that the QE programme ends up being a loss in the Riksbank's accounts. That is far from the free lunch for the government that it appeared to be before the interest rate turnaround brought on by the inflation crisis, back when the Riksbank's position improved with continuously falling interest payment costs on its liabilities.

Recapitalisation need; the treasury steps up

With this year's impending loss, not only will the Riksbank's usual dividends to the treasury cease, but (according to the staff report) the Riksbank's equity will also be, more or less, wiped out. This could

[1] Asymmetric, cautious accounting standards dictate that market valuation changes of the portfolio that lead to losses should affect the central bank's result, even though the valuation changes have not yet been realised in an outright sale of the portfolio assets.

[2] The market value write-downs in 2022, and possibly 2023, would be countered by previous balanced market value rises, and the future overall value gains when the bonds' prices rise as they approach their maturity dates.

turn the tables and possibly mean that the treasury would need to inject capital into its central bank. According to the new Riksbank Act, the Riksbank shall petition to parliament for a recapitalisation up to equity of SEK 40 billion, but under certain circumstances even SEK 60 billion.[3] However, because the asset side of the Riksbank's balance sheet has funds in the "revaluation account"[4], the government may decide not to inject the full amount petitioned for. The Riksbank staff report even raises the possibility of a scenario in which the government could refrain from injecting funds completely, without going against its own new Riksbank Act. But we judge that as very unlikely, because...

Loss set to be worse than signalled

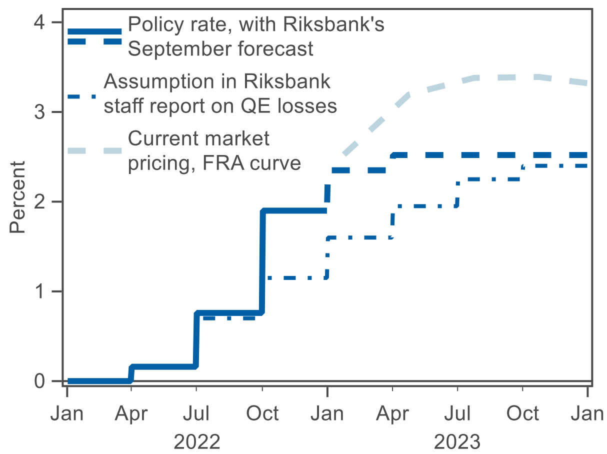
The Riksbank's loss looks set to be worse than estimated in the staff report, making the case for a recapitalisation by the treasury all but done, we judge.

The Riksbank staff scenario published in early July, assumed a less dramatic policy rate rise than current market pricing (i.e. a somewhat more muted rise than both the Handelsbanken forecast of 2.75 percent policy rate in April 2023 and the Riksbank's latest forecast of 2.5 percent). The scenario also assumed lower government bond yields (higher bond prices) than have has since materialised and are now being forecast. All told, this signals a significantly worse result in 2022 than the staff report's estimated SEK -65 billion (assuming that this estimate was valid at the time). Not only will the bond portfolio losses be even bigger but, on top of that, interest rate costs should end up higher than described in the staff scenario.[5]

The result is expected to be negative equity on the Riksbank balance sheet, and hence it is likely that the Riksbank will need to petition for more than the SEK 40 billion mentioned above, possibly in the region of SEK 50 to 70 billion. Consider the following example: The Riksbank reports a 2022 loss of between SEK 75 and 95 billion, causing equity to reach negative levels of around SEK -10 to -30 billion.[6] This leads the Riksbank to petition for an injection in the region of SEK 50 to 70 billion.

In our view, a smaller injection than that, which would only take equity back to some level below the SEK 40 billion "basic level" is less likely.[7] It is important to consider the risk of a serious economic downturn and associated financial turmoil, as well as the recent lessons learned from the UK's fiscal policy debacle and ensuing market mayhem. We expect the government to act prudently and not risk sending signals that could raise questions around the Riksbank's independence and the potency of its toolbox.

Higher interest rates than Riksbank scenario



Sources: Macrobond, Riksbank and Handelsbanken

Government finances hurt by cost of injection

On balance, we judge that the capital injected by the government into the Riksbank will be considered to be an expenditure that drags down key indicators such as government net lending and, all else being equal, forces the parliament to raise the expenditure ceiling. Our example of an injection in the region of SEK 60 billion would knock approximately 1 percentage point off government net lending (which is expressed as a percentage of GDP)

The national account's rules are not crystal clear on these points, however, and investigations are on-going at Statistics Sweden. But historically, capital injections to cover losses in government-owned entities, where there is no clear view to a reasonable return on investment, have been considered to be expenditures and this is the way that we think the Riksbank recapitalisation will be handled. After all, it is far from certain that the QE programme will be profitable at all.

[3] This assumes the new Sverige Riksbank Act is approved into law ahead of 2023.
[4] This account is made up of historic accumulated value gains on FX and bond holdings, as the accounting principle is asymmetric and means the Riksbank has not reported profits from unrealised market value increases.
[5] The scenario also assumed a stronger krona than current outcomes and expectations, which goes the other direction and somewhat boosts the revaluation account. The accounting principles do not permit the larger-than-anticipated FX portfolio gain to be squared against bond losses, so the annual result is not helped.
[6] The exact result depends on not least the interest rate sensitivity of the Rikbank's portfolio of bonds. Here, we have not made thorough calculations, only an illustrative example.
[7] However, such action is not impossible, since the new Riksbank Act has some leeway in the regulation.

Regardless of how it is treated in the national accounts, the capital injection will affect the budget balance and the government borrowing need, increasing the government debt.

Unlikely that fiscal policy will be hampered

Despite the potentially large implications for government finances, we believe that the capital injection can be framed as a one-off. And in combination with the fact that Sweden's government finances are in good shape at the outset, with e.g. low public debt, this leads us to the conclusion that the fiscal policy 'room for manoeuvre' is unlikely to be curtailed. In the coming years, at least from 2025 onwards (related to financial year 2024), Riksbank dividends are likely to resume, even if, in the end, the QE programme generates a loss.

But monetary policy under renewed public scrutiny

The bigger issue is that QE programme losses that hurt the government coffer will draw renewed, and potentially hostile, public scrutiny. Unconventional policies like QE and negative rates have already been questioned before. With the impending 2022 loss and 2023 recapitalisation, it becomes clear that there is a bill to pay, and the price tag is monumental.

Naturally, the public debate should weigh this negative against the positives. Any aggregate portfolio profits or losses, resulting from the Riksbank QE programme should not be analysed in isolation, but seen in the light of 1) the likely overall positive policy effects in the economy, which 2) also indirectly strengthen the government budget balance, and 3) opportunity costs (positive or negative) for the government sector as a whole when QE effects on the fiscal room for manoeuvre may affect government spending including investment. The Riksbank staff report concludes that "[t]he broad benefits for the Swedish economy from asset purchases should therefore outweigh the dis-advantage of the Riksbank's expected financial losses."

This last conclusion can be questioned, and the requirement for the Riksbank to provide credible proof and clear public communication will quickly mount. Do the benefits of QE really outweigh the costs? The stakes are high, as any too far-reaching public backlash against the practice of asset purchases would risk limiting the Riksbank's crisis toolbox.

Want to know more?

Read the staff report mentioned above, an Economic Commentary with the somewhat unassuming title "The Riksbank's financial result and capital are affected by higher interest rates", where Riksbank staff economists set out the scenario for the QE programme losses that can be expected this year, and explain much of the nitty-gritty behind the analysis in this comment.

And a related story from Bloomberg, concerning the Bank of England: "UK Treasury to Transfer £11 Billion to BOE to Cover QE Losses".

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