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# Medium-term strategy for debt management in central government on-budget finances 2024–2028

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## 1. Introduction

Debt management in central government on-budget finances refers to the management of borrowing for the purpose of balancing central government on-budget finances, debt in central government on-budget finances and central government cash funds, and the associated risks. Risks refer to market risks, financing risks, credit risks, legal risks, operational risks and risks related to the analysis models utilised in debt management.

The strategic objective of debt management is to secure central government liquidity and minimise the financing cost over the long term while taking account of risk. The subject of debt management is the central government debt at any given time. Decisions on central government net borrowing, and ultimately the amount of debt, are made in the central government budget. Government debt management is significant not only in terms of central government finances but also the national economy as a whole. The central government's ability to cover its payment obligations in all circumstances secures the operations of society as a whole and the continuity thereof.

The operating environment for central government debt management is challenging at present and will remain so in the coming years. Central government indebtedness has increased sharply since 2008, and debt is expected to continue to increase quickly in the coming years as the operating environment is characterised by a subdued economic growth outlook. The development outlook for monetary policy and the fixed-income markets is exceptionally uncertain.

The strategy document for debt management in central government on-budget finances describes the key choices in debt management policy and the justifications thereof, as well as the underlying assumptions concerning the near-term operating environment in debt management. The purpose of the document is to support the implementation of government debt management based on medium-term and long-term developments and the assessment of the effectiveness of debt management. The effectiveness of the strategy will be reviewed at the conclusion of the strategy period extending to 2028 so that the debt management policy can be adjusted if necessary.

## 2. The regulatory environment of debt management

Pursuant to section 82, subsection 1 of the Constitution of Finland, the incurrence of central government debt shall be based on the consent of the Parliament. The consent shall indicate the maximum level of new debt or the total level of central government debt.

Under the authorisation of the Parliament, the Ministry of Finance as the competent government ministry has assigned the responsibility for borrowing, debt servicing, operational risk management included in debt management and the investment of central government cash funds to the State Treasury.

The State Treasury performs the aforementioned debt management tasks within the framework established by the debt management guidelines issued by the Ministry of Finance to the State Treasury. The guidelines specify the objectives of debt management, the debt management instruments to be used and the risk management policies, which specify the objectives for the management of the identified risks and the limitations to be followed in the management of the risks. The Ministry of Finance

monitors adherence to the guidelines on the basis of reporting produced by the State Treasury. The contents of the reporting are specified in the debt management guidelines.

## 3. Operating environment

The operating environment for central government debt management has become increasingly challenging in recent years. Central government indebtedness has increased sharply, and central government liabilities have been further increased by the substantial growth of contingent liabilities. The central government's borrowing needs have increased as a result of the increased indebtedness. At the same time, economic growth has been more subdued than previously. Due to these factors, it can be estimated that the central government's risk-bearing capacity has declined and its preparedness for negative economic shocks has weakened. Also at the same time, general economic uncertainty has increased due to factors including higher volatility in the fixed-income markets and geopolitical tensions.

**Key macroeconomic variables 2015–2018**

| | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 | 2023* | 2024* | 2025* | 2026* | 2027* | 2028* |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| GDP, EUR bn | 211,4 | 217,5 | 226,3 | 233,5 | 239,9 | 238,0 | 250,9 | 268,7 | 282,1 | 289,0 | 301,5 | 313,4 | 324,6 | 335,6 |
| GDP, vol. change, % | 0,5 | 2,8 | 3,2 | 1,1 | 1,2 | -2,4 | 3,2 | 1,6 | -0,5 | 0,7 | 2,0 | 1,6 | 1,3 | 1,1 |
| debt in on-budget finances, EUR bn | 99,5 | 101,7 | 104,8 | 103,9 | 105,3 | 123,6 | 127,3 | 140,0 | 154,3 | 167,1 | 180,8 | 192,9 | 204,1 | 214,7 |
| debt ratio | 47,1 | 46,8 | 46,3 | 44,5 | 43,9 | 51,9 | 50,7 | 52,1 | 54,7 | 57,8 | 60,0 | 61,6 | 62,9 | 64,0 |
| net borrowing, EUR bn | 4,3 | 2,2 | 3,1 | -0,9 | 1,4 | 18,3 | 3,7 | 12,7 | 14,4 | 12,8 | 13,7 | 12,1 | 11,1 | 10,6 |
| gross borrowing, EUR bn | 15,9 | 16,7 | 20,2 | 14,1 | 14,8 | 39,3 | 27,8 | 34,3 | 42,4 | 43,1 | 45,5 | 45,7 | 45,2 | 45,9 |
| gross borrowing/GDP, % | 7,5 | 7,7 | 8,9 | 6,0 | 6,2 | 16,5 | 11,1 | 12,8 | 15,0 | 14,9 | 15,1 | 14,6 | 13,9 | 13,7 |

Source: Ministry of Finance

The operating environment for debt management also appears challenging during the strategy period 2024–2028. Economic growth is projected to be slightly slower than in the pre-pandemic years, with the average annual growth forecast being approximately 1.3 per cent. Central government finances are expected to remain substantially in deficit, and central government indebtedness is projected to continue at a rapid pace. Central government debt is projected to increase from the current level of approximately EUR 154 billion to nearly EUR 215 billion by the end of the strategy period. At the same time, the central government debt ratio would increase by approximately nine percentage points to 64 per cent at the end of 2028. Annual net borrowing is projected to be slightly over EUR 12 billion on average. Taking the maturities of existing debt into account, the central government's annual gross borrowing need will be approximately EUR 45 billion during the period 2024–2028.

## 4. The objective of debt management

The objective of government debt management is to meet the borrowing needs of the central government in all circumstances and to minimise the cost of the debt in the long term with a prudent degree of risk. In seeking to minimise the costs of debt management, it is necessary to simultaneously ensure that decisions and policy choices concerning debt management do not lead to the central

government facing circumstances where its borrowing opportunities are substantially weakened or the cost of debt increases suddenly and in a potentially unsustainable manner. To achieve this objective, a borrowing strategy and risk management policy for debt management have been drawn up, which aim to identify the key risks associated with debt management and specify the targets for the management of those risks and the limitations to be followed in the management of the risks. A general description of these is provided below.

## 5. Borrowing

The key aim of the borrowing strategy is to support the general objective of debt management, which is to secure the operations of the central government and the continuity thereof in such a way that the borrowing needs in central government on-budget finances can be met at the lowest possible cost and maturing debt can be repaid under all circumstances. To accomplish this, it is necessary in borrowing to avoid temporal risk concentrations or excessive reliance on individual sources of funding by maintaining instruments and the ability to operate broadly in the international financial markets and, in those markets, access various types of investors, predominantly investors that engage in long-term investment activities.

Central government borrowing is primarily carried out by means of long-term fixed-rate euro-denominated serial bonds, which are known as benchmark bonds. Long-term in this context refers to having a maturity of over one year at the time of borrowing. In pursuing cost-efficient pricing, new debt issues are concentrated over a small number of selected maturities for which investor demand is seen. This helps ensure adequate issue sizes and secondary market liquidity for bonds, which leads to a low liquidity premium and lower costs for the central government. The Ministry of Finance has specified the acceptable borrowing instruments and the targeted instrument-specific structure of debt.

## 6. Risk management

### 6.1. Interest rate risk

Interest rate risk refers to an unexpected increase in interest expenditure due to fluctuations in interest rates. The objective of interest rate risk management is to achieve the lowest possible interest expenditure of debt in the long term. However, at the same time, interest rate risk management must ensure that the central government avoids circumstances where the interest expenditure of debt increases suddenly and in an unsustainable manner, thereby jeopardising the central government’s liquidity.

Interest rate risk management is not aimed at predicting fluctuations in interest rates. The starting point is that, in efficient markets, there are no grounds to assume that the central government is able to systematically predict fluctuations in interest rates more successfully than other market participants. However, interest rate risk management is influenced by the assumption that the yield curve is typically upward sloping, which means that, most of the time, long-term interest rates are higher than short-term interest rates. This assumption is supported not only by theories of the term structure of interest rates but also observations of the typical shape of the yield curve based on interest rate data.

Due to the upward sloping yield curve, a short-term interest rate risk position can be estimated, in the long term, to lead to lower interest expenditure on average than a long-term interest rate risk position. However, with a short-term interest rate risk position, fluctuations in interest rates are reflected more quickly in the interest expenditure of debt, which means that the exposure to fluctuations in interest expenditure is higher than with a longer-term interest rate risk position.

The central government has sought to take advantage of the upward sloping yield curve and achieve lower expected interest expenditure for debt in the long term by choosing an interest rate risk position that is relatively short compared to Finland's peer sovereigns. However, the choice of the short-term interest rate risk position was made in a time when central government debt was low and decreasing relative to GDP. Economic growth was brisk at the time, and the growth outlook was favourable.

The operating environment of debt management has changed substantially in these respects over the past decade or so. Debt has increased significantly and remained on a rising trend. The trend of increasing debt is projected to continue in the coming years.[1] The declining size of the working-age population and the weak development of productivity dampen the longer-term growth prospects of the economy, and there is no repeat of the period of rapid economic growth seen in the early 2000s on the horizon. The central government's liabilities have also been increased by the significant growth of contingent liabilities.[2]

It can be estimated that the central government's risk-bearing capacity has declined as its liabilities have increased sharply and general economic development has been weak. Based on current information, the situation is not expected to improve in these respects in the near future. With this in mind, it has been deemed justified to lengthen the average fixing of debt moderately, by approximately two years, during the strategy period 2024–2028. Lengthening the average fixing reduces the sensitivity of the interest expenditure of debt to fluctuations in the general level of interest rates. It provides the central government with protection against increases in interest rates, increases the predictability of interest expenditure and supports the planning of economic policy in the coming years.

In addition to the decline in the central government's risk-bearing capacity, another factor behind lengthening the average fixing is that taking advantage of the shape of the yield curve is not perceived to involve similar benefits in the current situation as it did in the past. Yield curves have flattened in the euro area. For a long time now, the yield curve has been inverted, which means that short-term interest rates have been higher than long-term interest rates.[3]

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[1] In 2002, the ratio of central government debt to GDP was 40 per cent, and debt was on a downward trend. When the Finnish economy was on the cusp of the financial crisis of 2008, the debt ratio fell to under 28 per cent. Since then, the debt ratio has trended upwards, and it was over 53 per cent at the end of 2022.

[2] These include central government guarantees and capital liabilities, which refers to callable capital remitted to international financial institutions. In 2010, the central government's guarantee liabilities were slightly over EUR 23 billion. At present, they amount to approximately EUR 68 billion.

[3] The yield curve has been flattening for a long time. This development is likely to be attributable to multiple factors, including the ageing of the population and the slowing development of productivity. In addition, the monetary policy of recent years, which has included extensive purchasing programmes of securities, has also affected the term structure of interest rates. Based on current information, the Eurosystem will reduce its holdings in securities, but the reduction of the balance sheet will take place gradually. Consequently, the Eurosystem will remain a significant holder of sovereign bonds in the coming years, which will contribute to reducing pressure for a significant and sudden steepening of the yield curve. The aforementioned structural factors in the economy have a similar effect.

The management of interest rate risk has relied heavily on interest rate swaps, but their use in the current situation involves a number of negative externalities due to the changes that have occurred in the regulatory environment, among other things. For this reason, the central government will no longer enter into new interest rate swaps. Doing this and engaging in borrowing in accordance with the existing borrowing policy will lengthen the average fixing during the strategy period in line with the objective.

To support the setting of the average fixing target, an external assessment of central government debt has been carried out. A stochastic debt sustainability analysis was utilised in the assessment. Debt management choices were analysed in the long term, and the key macroeconomic variables – GDP growth, central government deficits and interest rates – involved uncertainty and the choices were affected by limitations related to financing risk and debt dynamics. According to the results of the modelling, for a country like Finland, which has weak growth prospects, high deficits, high borrowing needs and a rising trajectory of debt, the appropriate average fixing of debt is 2–4 years longer than the current average fixing. The new average fixing target is in line with the results of the external assessment.

### 6.2. Refinancing risk

Financing risk refers to risk associated with the availability or terms of financing. This can be a threat of insolvency or an increase in borrowing costs caused by exceptional market conditions, the downgrading of the central government's credit rating or otherwise unfavourable economic conditions. In the government debt management policy, financing risk is divided into liquidity risk and refinancing risk. The review horizon for liquidity risk management is the next 12 months. Refinancing risk is reviewed over a longer period.

The management of refinancing risk is generally based on diversification so that the aim is to have a balanced temporal maturity profile of debt and make diverse use of different sources of funding. This reduces exposure to market disruptions and economic shocks and thereby helps secure the continuity of the central government's activities.

To manage refinancing risk, borrowing relies on long-term debt with a maturity of more than one year at the time of borrowing. During the strategy period, the annual gross borrowing need is projected to be approximately EUR 45 billion, which requires the issuance of three new benchmark bonds annually. This means issuing one short-term bond (3–7 years), one medium-term bond (8–12 years) and one long-term bond (15, 20 and 30 years) annually.

In addition to new benchmark bonds, long-term bonds are issued by conducting tap auctions on existing benchmark bonds. During the strategy period, these tap auctions will cover approximately one-third of the gross borrowing amount. Long-term borrowing is also carried out under the EMTN programme, but this serves mainly as a complementary form of borrowing.

### 6.3. Liquidity risk

The management of liquidity risk involves estimating the size of the cash buffer necessary to cover known and anticipated expenditures and the extent to which it is possible to rely on the central

government’s ability to borrow the necessary funds from the market. In practice, the management of the central government’s liquidity largely relies on the central government’s ability to borrow funds. However, market disruptions or unfavourable economic conditions, for example, can lead to situations in which the central government is temporarily denied access to cost-efficient market financing. Indeed, maintaining a cash buffer of a certain size is justified for securing the continuity of central government activities. It is a question of balancing the costs incurred from maintaining a cash buffer and the risk of being unable to cover all expenditures due to market disruptions, for example.

To manage liquidity risk, the Ministry of Finance has set limits for the State Treasury on how heavily the management of liquidity risk can rely on the central government’s ability to obtain loans from the market in all circumstances. In setting the limits, the Ministry of Finance has utilised information from the cash forecasting system into which government agencies enter their revenue and expenditure forecasts.

Maintaining a cash buffer and setting a minimum target time for how long the central government must be able to cover its known expenditures without new borrowing is a common approach in the management of central government liquidity risk. The many crises of recent years and the general uncertainty in the operating environment have led to increased attention on maintaining adequate liquid assets.

### 6.4. Exchange rate risk

Exchange rate risk refers to the risk of losses incurred from fluctuations in the exchange rate between the euro and a foreign currency. The central government does not take on exchange rate risk in its debt management. The central government is able to carry out its necessary borrowing largely denominated in its own currency. Central government revenue is also practically entirely denominated in euros. To diversify the sources of funding and support cost-efficiency, the central government may borrow funds denominated in foreign currencies within separately established limits, but the exchange rate risk involved can be fully hedged by means of currency derivatives.

The choice concerning exchange rate risk is also supported by the view that, in an efficient market, the central government is not in a position to anticipate changes in exchange rates better than the average market participant. Moreover, due to the nature of its tasks and activities, the central government has no reason to seek financial gain by anticipating fluctuations in the relative prices of currencies.

### 6.5. Credit risk

Credit risk means the risk of losses arising from the insolvency of a contractual counterparty. Credit risk is measured by the amount of the receivable that is subject to risk. The central government is exposed to credit risk through cash asset investments and derivative contracts. The aim of credit risk management is to minimise the risk.

This is pursued by adhering to sound general principles in credit risk management. These include requiring good credit ratings from counterparties in investment activities, diversifying credit risk between different contractual counterparties and requiring the counterparties of derivative contracts to put up collateral securing the market value of the contracts.

### 6.6. Operational and legal risks

Operational risks refer to risks of financial losses arising from operating practices related to debt management, the systems used in the activities, inadequate internal control or external events. The aim of operational risk management is to minimise the risk.

To minimise operational risks, the Ministry of Finance has established general requirements for operational risk management for the State Treasury, which is responsible for debt management operations. According to the requirements, the State Treasury must draw up a debt management audit plan for several years ahead, regularly review and audit debt management processes and systems, report on the observations of internal auditing in debt management to the Ministry of Finance and immediately take corrective action if any inadequacies or unsatisfactory operating practices are observed.

Legal risk means the risk of financial losses arising from non-compliance with legislation and market practices or the non-implementation, invalidity, objectionability or inadequate documentation of an agreement or decision, or changes in the legal operating environment. The aim of the management of legal risk is to minimise the risk.

To achieve this aim, the requirement is that borrowing is carried out in accordance with Finnish legislation as a rule. In addition, commonly accepted master agreements should be used in debt management to the greatest possible extent. The State Treasury is further required to monitor the legal operating environment so that it has adequate information and competence regarding domestic and foreign legislation governing financing and other areas, as well as legal practices and pending legislative projects that potentially have an impact on debt management.

### 6.7. Model risk

Model risk means the risk of financial losses arising from the use of analysis models in debt management.  Model risk primarily arises from erroneous or inadequate modelling, the erroneous use of models or the erroneous interpretation of their results.

The aim of model risk management is to minimise the risk. The risk is minimised by identifying risks related to analysis models and their use, producing and maintaining knowledge and expertise related to models and their use, and ensuring the accurate documentation of the models. The documentation must include descriptions of the models, including the model’s purpose, function, underlying assumptions and the responsibilities concerning the maintenance of the model.