
Highlights of Government Debt Policy

Demand for Danish government securities was high in 2011, and Danish borrowing costs declined to a historically low level. The yield spread to Germany became negative at the end of the year due to the extraordinarily large demand for Danish government bonds.

Since the European sovereign debt markets are still characterised by great uncertainty, the central government's issuance policy and risk management are aimed at maintaining low sensitivity to rising interest rates and sudden shifts in the financing requirement. This is achieved by:

- Initiating the financing of the 2013 issuance requirement this year.
- Maintaining a substantial liquidity reserve.
- Ensuring a broad investor base by means of a broad range of on-the-run issues.
- Issuing a larger share in the longer maturity segments and maintaining long duration for the central-government debt.

THE EUROPEAN SOVEREIGN DEBT MARKETS IN 2011

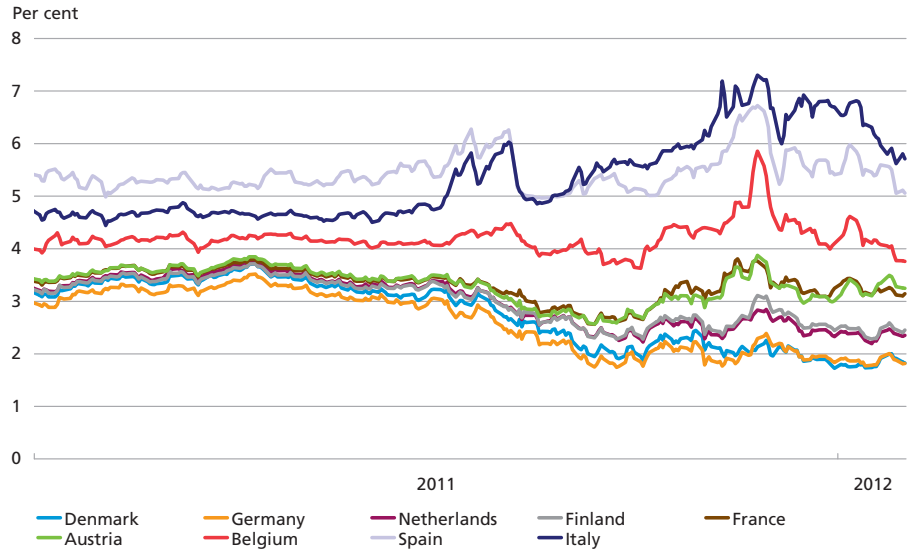
The European sovereign debt crisis intensified in 2011. Growing risk aversion, uncertainty as to the political willingness to implement reforms and deteriorated growth prospects contributed to a considerable increase in financing costs for some euro area member states, cf. Chart 1. Fears that major euro area member states could lose access to the lending markets caused significant turmoil in the capital markets. In light of the deterioration of the crisis the euro area member states and the ECB expanded their crisis measures.

The pronounced uncertainty and increased risk aversion boosted demand for government securities issued by countries with the highest credit ratings, causing interest rates to decline to historically low levels.

Danish government bond yields mirrored developments in Germany in 2011 and fell in all maturity segments, cf. Chart 2. Towards the end of the year, uncertainty over the implications of the debt crisis led to increased demand for government securities issued by non-euro area countries with the highest ratings, including Denmark. At year-end, Danish government yields were historically low, and the yield spread to Germany was negative.

10-YEAR GOVERNMENT YIELDS IN EUROPE

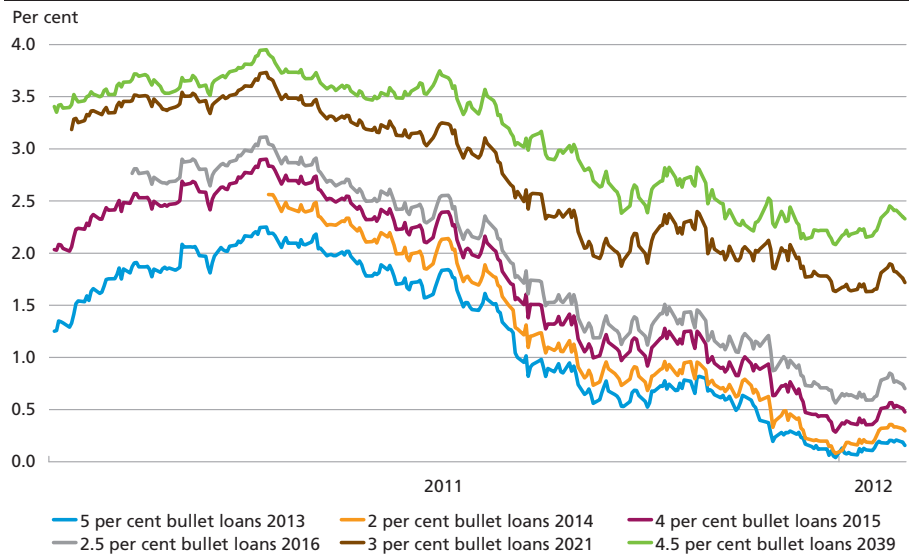
Chart 1



Source: Bloomberg.

YIELDS TO MATURITY OF DANISH KEY ON-THE-RUN BONDS

Chart 2



CENTRAL-GOVERNMENT DEBT

In 2011, the central-government deficit amounted to kr. 28 billion and the central-government debt rose to kr. 413 billion, i.e. kr. 74,000 per capita or 23 per cent of GDP, cf. Chart 3. Interest costs on the central-government debt were kr. 17 billion, corresponding to 1 per cent of GDP. Interest costs have been stable in recent years despite the increase in debt. This reflects low interest rates on new government issuance and low interest payments on the central government's interest-rate swaps.

The central government's interest costs are robust to negative shocks

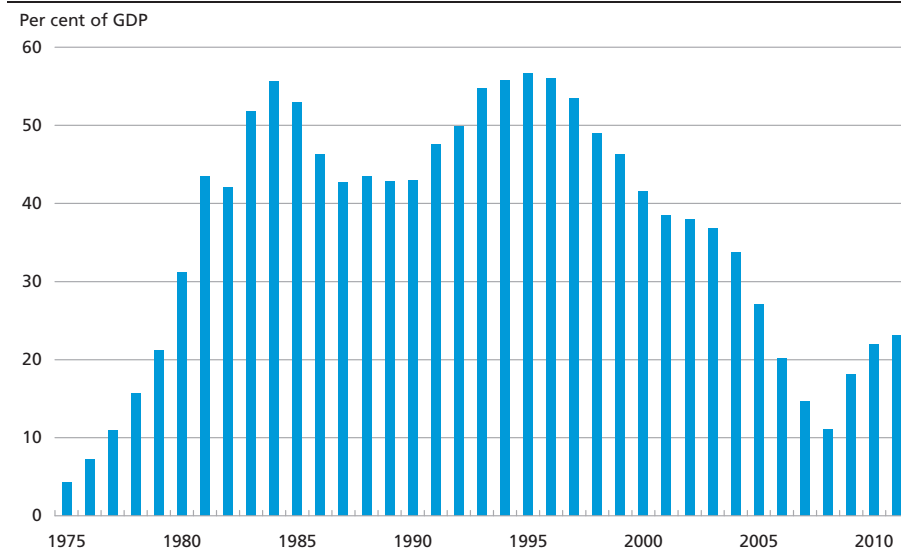
The sensitivity of the central government's interest costs to rising interest rates is very low. Even in a risk scenario with pronounced interest-rate increases and deterioration of economic growth and government finances, interest costs will account for only a modest share of GDP in the coming years, both in relation to previous years and compared with other countries, cf. Chart 4. The limited sensitivity reflects Denmark's low debt ratio and the long average interest rate re-fixing period for the central-government debt.

Low debt compared with other countries

In recent years, the balance on the central government's account has increased significantly. The increase has been financed by issuance of gov-

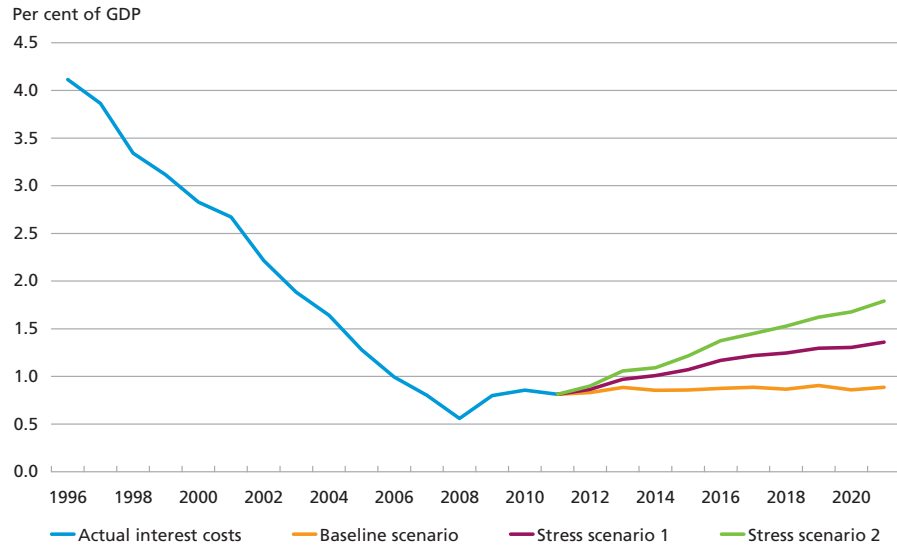
CENTRAL-GOVERNMENT DEBT

Chart 3



INTEREST COSTS IN BASELINE AND STRESS SCENARIOS

Chart 4

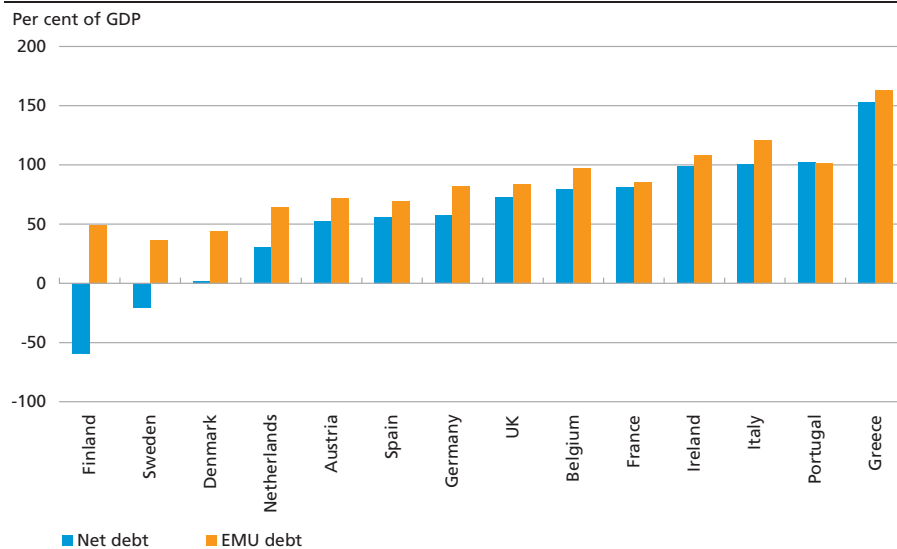


Note: Interest costs adjusted for interest income from re-lending. The projection of interest costs in the baseline scenario is based on the government balance in *Budget Outlook 3*, December 2011 and *Reform Agenda 2020 – funding Danish welfare* (only in Danish), Ministry of Finance, 2011. Stress scenario 1 is based on the government balance in the stress scenario in the *Danish Economy*, Autumn 2011, The Economic Council. In the stress scenario, the average annual deterioration in the government balance relative to the baseline scenario amounts to 1.5 per cent of GDP. Stress scenario 2 is identical to stress scenario 1, but shows the 95th percentile for interest costs in the Cost-at-Risk model.

ernment securities, reflecting the strategy of maintaining a high liquidity reserve. This has increased the gross general-government debt, EMU debt, as the balance on the central government's account at Danmarks

EMU DEBT AND NET DEBT IN SELECTED EU MEMBER STATES, END-2011

Chart 5



Source: IMF World Economic Outlook, September 2011 and European Commission's autumn forecast, November 2011.

Nationalbank is not offset in the EMU debt. Despite the increase, Denmark's debt is still low compared with other EU member states, cf. Chart 5.

Estimates of the long-term sustainability of public finances are based on net general-government debt, comprising all financial assets and liabilities of the public sector, including the balance on the central government's account and shareholdings in government-owned companies. At end-2011, Denmark's net general-government debt was close to zero.

Denmark's central-government debt has the highest rating

The central government's domestic and foreign debt has the highest ratings from Fitch Ratings (AAA), Moody's (Aaa) and Standard & Poor's (AAA) with a stable outlook. The respective ratings were confirmed by Moody's in February 2012, Standard & Poor's in December 2011 and Fitch Ratings in July 2011.

GOVERNMENT BORROWING IN 2011

Issuance of domestic government bonds totalled kr. 124 billion in 2011, whereby the central government financed a large part of the 2012 issuance requirement. This reflects strong demand for Danish government bonds, low yields and the intention of maintaining a high liquidity reserve in order to reduce the central government's refinancing risk. The balance on the central government's account can fully cover the redemptions and the expected budget deficit in 2012. The average yield was 2.2 per cent on issuance of government bonds and less than 1 per cent on T-bills.

The T-bill programme was increased by kr. 19 billion to an outstanding volume of kr. 44 billion at the end of the year. At the auction at the end of December, T-bills were issued at negative interest rates.

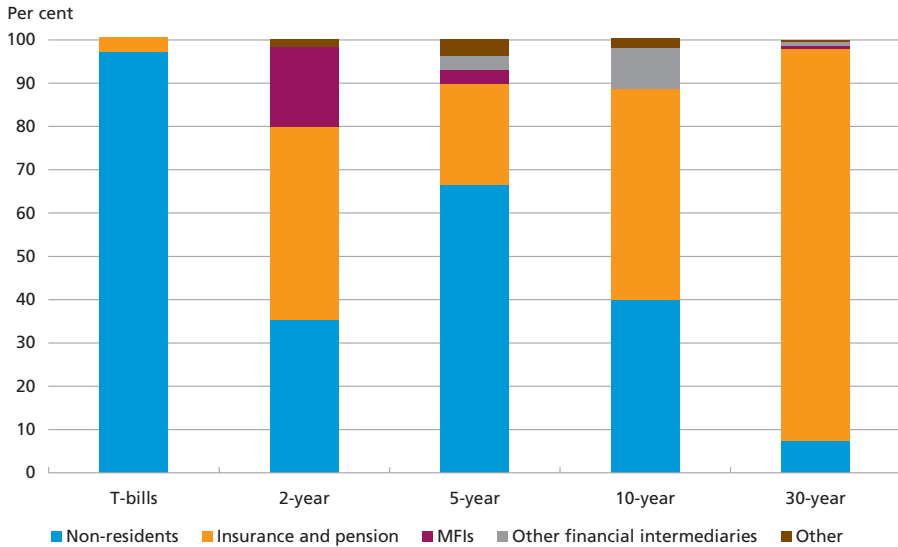
Non-residents increased their holdings of Danish government securities

At end-2011, non-resident investors had increased their ownership share of domestic government securities to 40 per cent. The ownership shares were largest in T-bills and government bonds with maturities of up to five years, cf. Chart 6. The main reason is that foreign central banks often have a mandate to invest in maturities of up to five years.

The insurance and pension sector's ownership share was 50 per cent, primarily comprising bonds in the longer maturities. This reflects that Danish pension companies have a natural interest in long-term krone-denominated bonds as they have long-term commitments in kroner.

OWNERSHIP SHARES OF DOMESTIC SECURITIES, END-2011

Chart 6



Note: Ownership shares are calculated on the basis of nominal stocks excluding the portfolios of the government funds. MFIs primarily include banks and mortgage credit institutes. Insurance and pension includes restricted associations.

Source: Danmarks Nationalbank, *Securities Statistics*.

GOVERNMENT ISSUANCE STRATEGY FOR 2012

As a result of the excess sales in 2011, the central government's borrowing requirement in government bonds is kr. 28 billion this year. In order to reduce the refinancing risk, the strategy is to maintain a high balance on the central government's account and to initiate the financing of the 2013 borrowing requirement. This increases the target for issuance of government bonds in 2012 to around kr. 75 billion. The central government had issued for just under kr. 20 billion, mainly in the 10-year and 30-year maturity segments, until the beginning of February.¹

Larger share of issuance in the longer maturity segments

In the past few years, the issuance strategy for government bonds has been to build up liquid series on the basis of a 40-20-40 percentage distribution on the 2-, 5- and 10-year maturity segments. In view of the low long-term yields and to maintain low interest-rate sensitivity and refinancing risk, the strategy is to issue a larger share in the longer maturity segments in 2012. The strategy for T-bills is to maintain the outstanding volume in the programme at around the level of kr. 44 billion.

¹ Sales up to and including 7 February 2012.

Opening of inflation-linked bond

In the 1st half of 2012 the central government will open an inflation-linked bond maturing in 2023. Supplementing the key on-the-run issues with an inflation-linked bond will enable the central government to expand its investor base. There is increasing demand from the Danish pension sector for inflation-linked assets, and Government Debt Management has received a number of indications of investor interest.

The bond will be linked to the Danish CPI, with characteristics corresponding to the international market standard. Issuance will take place via auctions supplemented with tap sales, and a price quotation scheme will be established. The strategy is to build up the series to at least kr. 20 billion over the coming years.

The central government's foreign borrowing

The central government raises foreign loans in order to maintain the foreign-exchange reserve. In 2012, the central government's foreign redemptions total 4.2 billion euro (kr. 31 billion). The strategy for foreign borrowing in 2012 is to raise loans for 1-1.5 billion euro. As a starting point, a 5-year euro loan will be issued.

The strategy of Government Debt Management is summarised in Box 1.

ISSUANCE STRATEGY AND MARKET RISK MANAGEMENT IN 2012

Box 1

Domestic strategy

- In the past few years, the issuance strategy for government bonds has been based on a 40-20-40 percentage distribution on the 2-, 5- and 10-year maturity segments. In 2012 the intention is to issue a larger share in the longer maturity segments.
- The build-up of the existing securities in key on-the-run issues will continue in 2012. No new nominal government bonds are expected to be opened in the 1st half of 2012.
- An inflation-linked bond maturing in 2023 will be opened in the 1st half of 2012.
- The outstanding volume in the T-bill programme will be maintained at around kr. 44 billion.

Foreign strategy

- Foreign loans of 1-1.5 billion euro will be raised.
- As a starting point, a 5-year euro loan will be issued.
- Current limited issuance in Commercial Paper to retain investor interest and ensure access to the markets.

Market risk

- The target for the average duration of the central-government debt is maintained at 9 years +/- 1 year for 2012.

TRADING IN AND ISSUANCE OF DOMESTIC GOVERNMENT SECURITIES

Demand was high in 2011 at the auctions of domestic government bonds, with bids totalling twice the amount sold, cf. Chart 7. The deterioration of the European sovereign debt crisis in the 2nd half of 2011 resulted in larger fluctuations in the demand for government securities also across maturity segments.

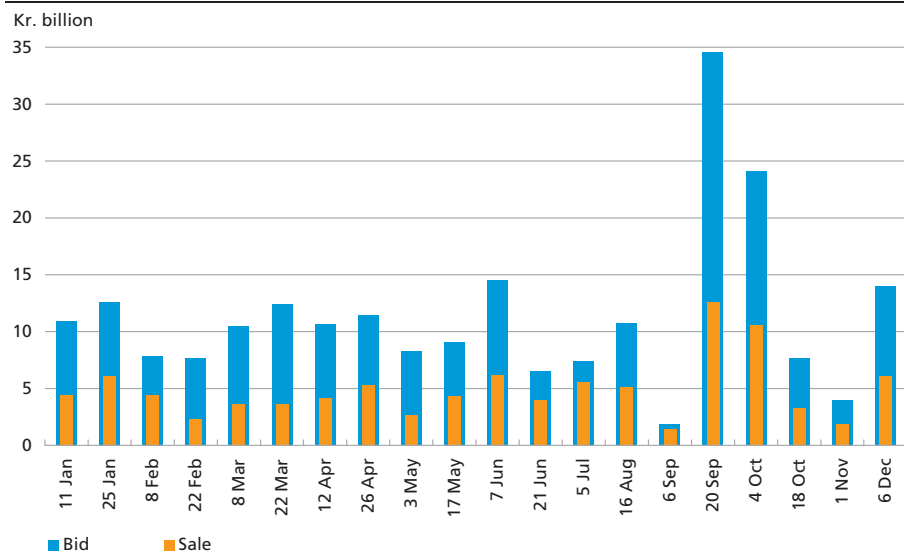
After the financial crisis, proposals for new regulation have been put forward both within and outside the EU. These regulatory initiatives may affect the markets for government securities. It is important to ensure that the new regulation will not impede liquidity in the capital markets and lead to higher financing costs.

CREDIT RISK MANAGEMENT

The swap counterparties have concluded unilateral collateral agreements with the central government. This means that the central government's swap counterparties pledge collateral if the market value of the swap portfolio is positive for the central government, but the central government does not pledge collateral to the counterparty if the market value is positive for the counterparty. The costs for the central government of transacting swaps with unilateral pledging of collateral have increased due to higher bank funding costs as a result of the financial

BID AND SALE OF GOVERNMENT BONDS AT THE AUCTIONS IN 2011

Chart 7



crisis. Moreover, regulatory initiatives impose stricter requirements on the banks' liquidity and capital. Government Debt Management is looking into the operational, liquidity and risk consequences of switching to bilateral pledging of collateral. The analysis is expected to be completed in 2012.