

DNR 2008-332-AFS



Swedish market participants' views of risks and the functioning of the Swedish fixed-income and foreign exchange markets

POLL SPRING 2008

Swedish market participants' views of risks and the functioning of the Swedish fixed income and foreign exchange markets

Summary

The Swedish fixed income and foreign exchange markets have functioned well throughout the entire period of global financial turmoil, although the volumes have been somewhat lower and the market depth slightly poorer. This picture is confirmed by the Riksbank's risk survey, which will be sent to participants in the Swedish market once every six months, with effect from spring 2008.

The purpose of the survey is partly to gain an overall picture of the view of risk among participants active in the Swedish financial market, and partly to assess the functioning of the market. The survey supplements the annual discussions the Riksbank has had since the beginning of the 1990s with its monetary and foreign exchange policy counterparties on developments in the financial markets.

Since summer 2007 the price of risk has increased substantially. A majority of the responding participants in the Swedish fixed income and foreign exchange markets assess that this is a permanent change. However, half of the market participants believe that willingness to take risk will return to a normal situation during the coming six months.

Over the past six months the buffers of liquid assets held by many market participants have increased. However, many respondents expect their own institution's liquidity buffer to remain at a normal level for the foreseeable future. In general, liquidity has been good with regard to both government and mortgage bonds as well as the krona market over the past year, even seen in an international perspective.

The general impression of participants in the Swedish fixed income and foreign exchange markets is that the recent financial turbulence has changed views and prices of risk. However, opinions are divided as to whether or not the financial market turbulence will soon be over. The markets' focus will be on economic activity in Sweden and how this is affected by developments in the United States both in the short and long term. The participants' assessment is that there may still be a danger of liquidity shortages in the markets. Moreover, continuing high interest rates entail a risk that borrowing will be more expensive for both companies and households.

The results of the survey carried out this spring are reported below. The survey, which concerned risks and functioning of the Swedish fixed income and foreign exchange markets, was sent to 89 market participants.¹ The groups surveyed are the Riksbank's monetary and foreign exchange policy counterparties and active participants in the Swedish fixed income and foreign exchange markets. The results are presented in four sections: risks in the Swedish fixed income and foreign exchange markets, the functioning of the Swedish fixed income market, the functioning of the Swedish foreign

¹ The survey was carried out between 10 and 25 April. The Riksbank commissioned the survey company Markör to send out the questionnaires on its behalf.

exchange market and the effects of the financial turbulence on Swedish financial markets and their future growth.

Risks in the Swedish fixed income and foreign exchange markets²

The price of risk has increased substantially since the summer of 2007. A majority of the responding participants in the Swedish fixed income and foreign exchange markets, three out of four, assess that this is a permanent change (see Figure 1). At the same time, the financial turmoil has affected the participants' attitude to risk. More than half of the participants state that their propensity to take risk has declined since the summer of 2007, that is, before the financial turmoil (see Figure 2). It is primarily participants in the fixed income market who have changed their risk propensity, while participants in the foreign exchange market state that they have been relatively unaffected.

Figure 1. The price of risk has increased since the summer of 2007. Do you consider this to be a permanent shift?

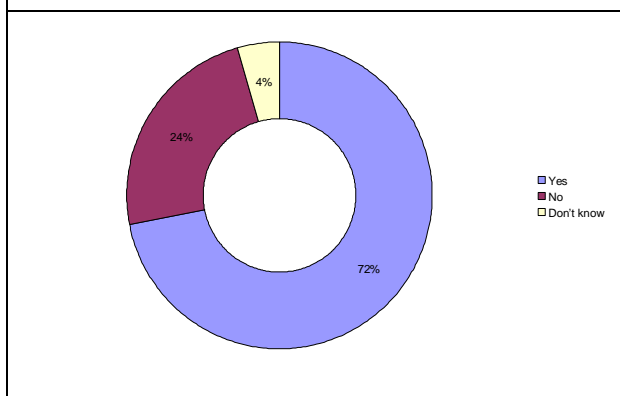
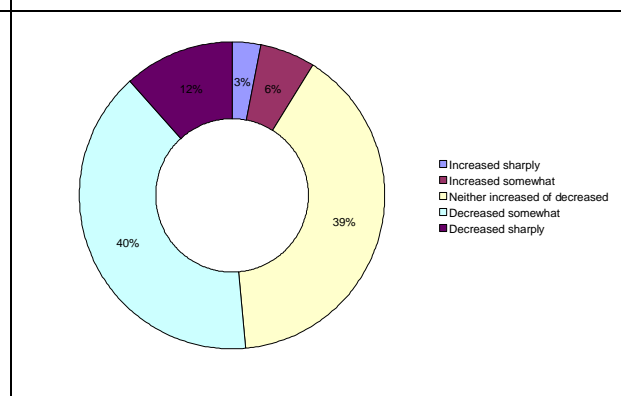
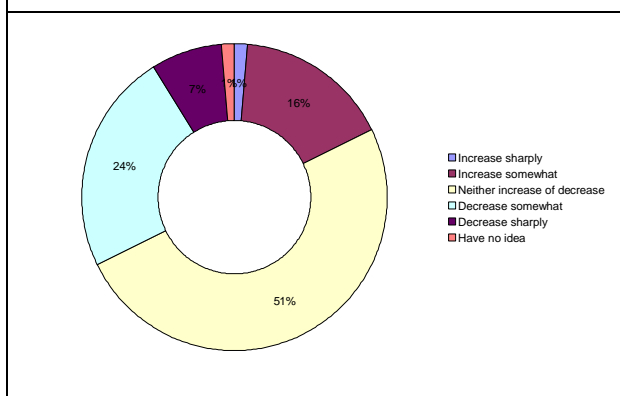


Figure 2. How has your propensity to take risk changed since the summer of 2007, i.e. prior to the financial turmoil?



Looking at all of the participants, around half believe that the propensity to take risk will return to a normal level over the coming six months (see Figure 3). However, a majority of the participants in the fixed income market are assuming that the propensity to take risk will be slightly lower than normal six months ahead.

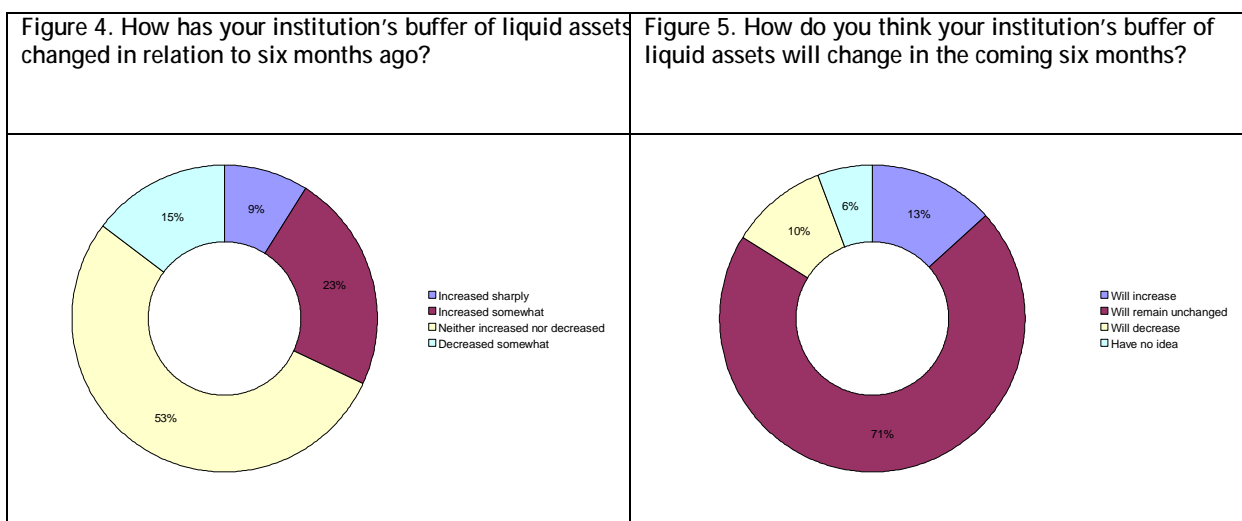
Figure 3. Compared to a normal situation, how do you foresee your propensity to take risk six months ahead?



² The percentage of answers for this part amounted to 76%.

At the same time, many participants have increased their buffers of liquid assets over the past six months. One in three participants states that liquid assets have increased, while around half of them state that they have remained unchanged (see Figure 4).

Over the coming six months more than 70 per cent of respondents expect their own institution's buffer of liquid assets to be at a normal level (see Figure 5). Of the remainder, approximately equal numbers believe that they will increase as believe that they will decrease.



The functioning of the Swedish fixed income market³

A general impression is that the Swedish fixed income market has functioned well, according to the survey responses. Generally, liquidity is considered to have been good with regard to both government and mortgage bonds in the year 2007 (see Figures 6 and 10). Almost half of the participants consider that the market for government bonds has functioned roughly the same as in 2006, while around one third consider that it has functioned better. With regard to the market for mortgage bonds almost four out of ten state that the market functioned less well in 2007 (see Figures 7 and 11).

From an international perspective, fixed income market participants' assessment is that the market for government and mortgage bonds functioned well in 2007 (see Figures 8, 9, 12 and 13).

When the international financial turmoil has been particularly intense, the Swedish market for government and mortgage bonds has also been influenced by reduced liquidity. However, liquidity has not deteriorated to such an extent that it is perceived as a general problem. In the open responses many participants emphasise that the Swedish mortgage bond market has functioned well, even when the corresponding market in Europe ceased functioning.

³ Only participants in the Swedish fixed income market have responded to this part of the survey, a total of 39 participants where five are the Riksbank's monetary policy counterparties. There is a partial non-response for questions 6, 7, 10, 11 and 12, which had responses from 29 participants and questions 12-13 which had responses from 38 participants.

Several respondents state that they have experienced problems in interpreting the Riksbank's communication, which is considered to have led to unnecessarily large fluctuations in prices.⁴

⁴ The survey was carried out before the Executive Board of the Riksbank decided to update its communication policy and published a special appendix on monetary policy communication. See the Riksbank's website for further information: www.riksbank.se.

Figure 6. How do you assess that the Swedish fixed income market has functioned in 2007 with regard to government bonds?

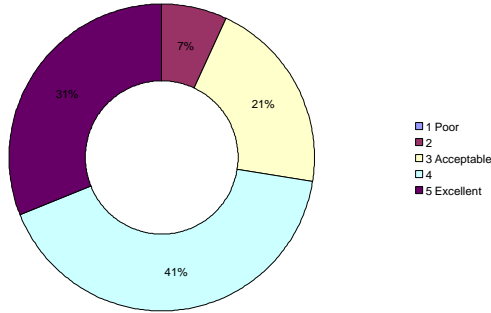


Figure 7. How do you assess that the Swedish fixed income market has functioned in relation to 2006 with regard to government bonds?

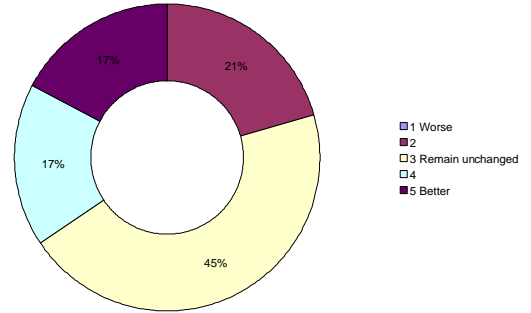


Figure 8. In an international comparison, how do you assess that the Swedish fixed income market has functioned in 2007 with regard to government bonds?

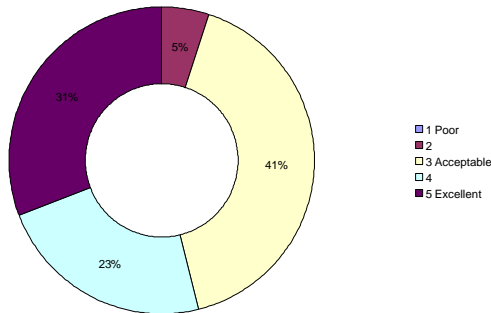


Figure 9. In an international comparison, how do you assess that the Swedish fixed income market has functioned in relation to 2006 with regard to government bonds?

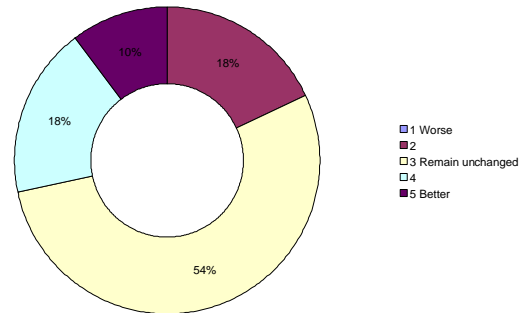


Figure 10. How do you assess that the Swedish fixed income market has functioned in 2007 with regard to mortgage bonds?

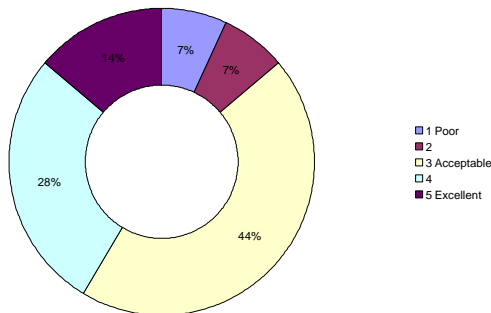


Figure 11. How do you assess that the Swedish fixed income market has functioned in relation to 2006 with regard to mortgage bonds?

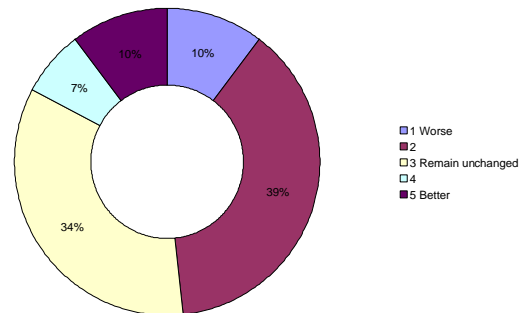


Figure 12. In an international comparison, how do you assess that the Swedish fixed income market has functioned in 2007 with regard to mortgage bonds?

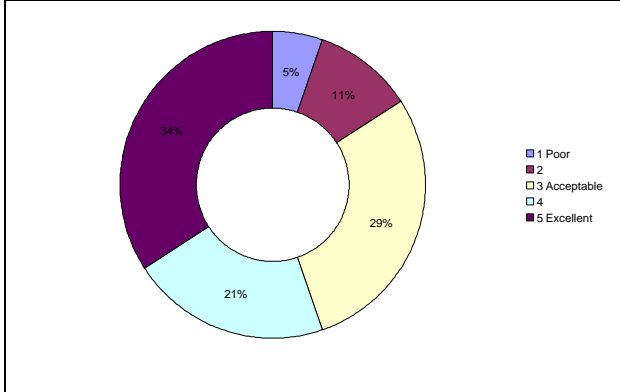
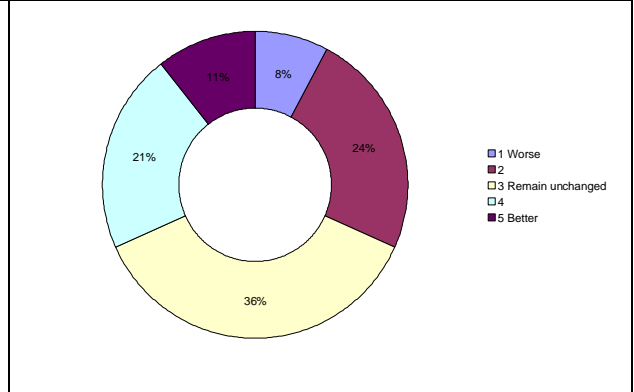


Figure 13. In an international comparison, how do you assess that the Swedish fixed income market has functioned in relation to 2006 with regard to mortgage bonds?



Liquidity in individual fixed income markets

Two out of three fixed income market participants give the *market for treasury bills* an acceptable grade for the year 2007 (see Figure 14). However, one in four respondents states that liquidity was not good, and some have responded that it was poor. Almost three out of ten consider that liquidity in the market for treasury bills deteriorated during 2007 (see Figure 15). Relatively few participants give liquidity in treasury bills a better grade than acceptable during this period.

Figure 14. What is your view of liquidity regarding treasury bills in 2007?

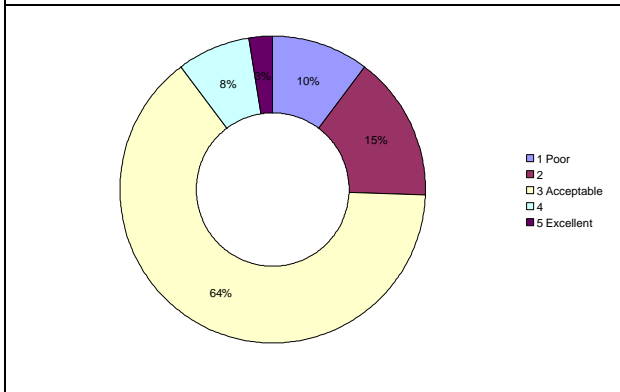
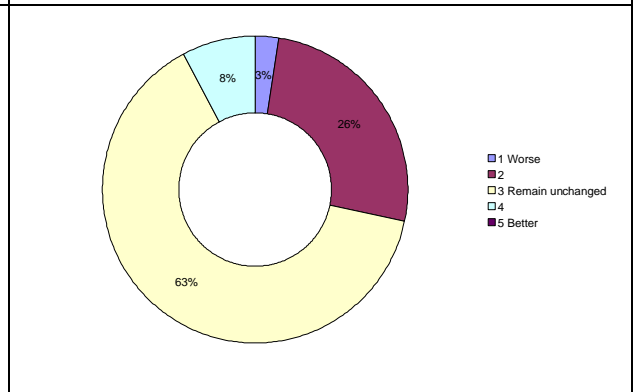


Figure 15. What is your view of liquidity regarding treasury bills in relation to 2006?



The liquidity in the *market for government bonds* has functioned better than that for treasury bills, according to the survey responses. The opinions regarding this market are better than for any of the other individual fixed income markets. Most market participants consider that there has been no shortage of liquidity in the *government bonds market* (see Figure 16). Six out of ten consider that market functioning in 2007 was the same as in 2006 (see Figure 17). There were slightly more who considered the market to have deteriorated than who considered it had improved.

Figure 16. What is your view of liquidity regarding government bonds in 2007?

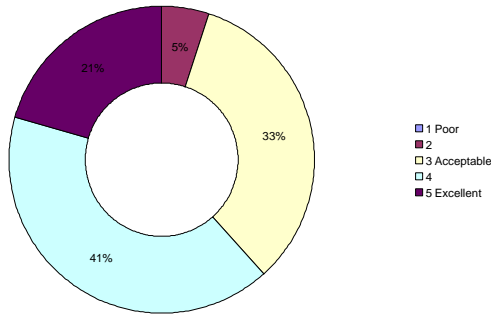
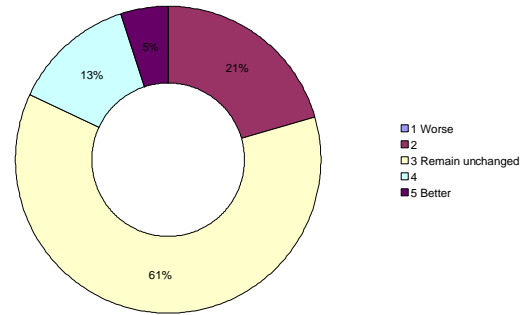


Figure 17. What is your view of liquidity regarding government bonds in relation to 2006?



Approximately half of the respondents considered that liquidity in the *market for mortgage certificates* was good in 2007. More than one in three gave a poorer grade (see Figure 18). This is a poorer grade than those received by the market for treasury bills and the market for government bonds. Approximately one half considered that liquidity was the same in 2007 as in 2006, while one in four considered that liquidity had deteriorated somewhat (see Figure 19). There were few market participants who had extreme views.

Figure 18. What is your view of liquidity regarding mortgage certificates in 2007?

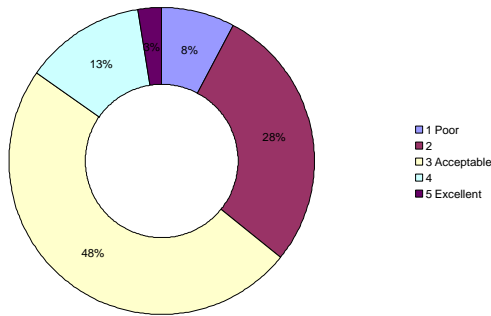
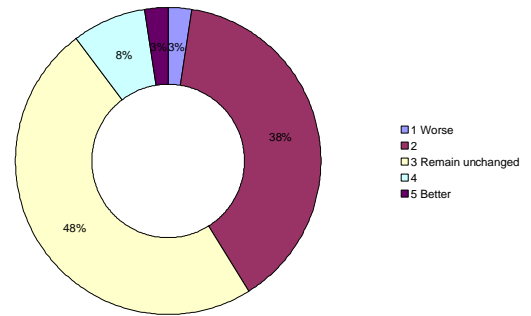


Figure 19. What is your view of liquidity regarding mortgage certificates in relation to 2006?



The *market for mortgage bonds* has functioned better than that for mortgage certificates in the year 2007 (see Figure 20), according to the survey responses. Four out of five respondents gave an acceptable grade or higher to the mortgage bonds liquidity. However, almost half of the respondents considered that the market functioning had deteriorated compared with the year 2006 (see Figure 21).

Figure 20. What is your view of liquidity regarding mortgage bonds in 2007?

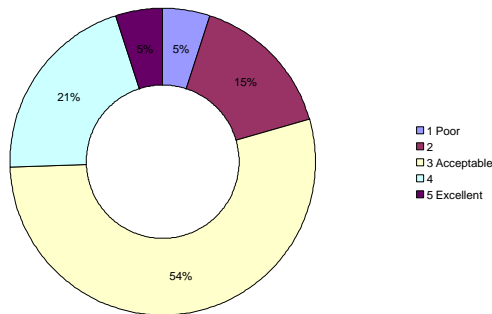
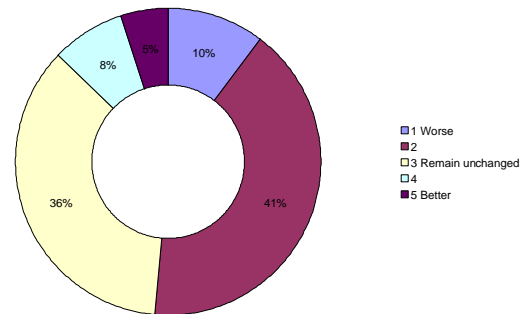


Figure 21. What is your view of liquidity regarding mortgage bonds in relation to 2006?



More than half of the fixed income market participants consider that liquidity in the *market for fixed-income swaps (SEK/SEK)* deserved an acceptable grade (see Figure 22). Almost one in three assesses that the market functioning was better than this. In relation to the year 2006, around half considered that liquidity was the same, while roughly one in three considered that liquidity had deteriorated (see Figure 23).

Figure 22. What is your view of liquidity regarding swaps (SEK/SEK) in 2007?

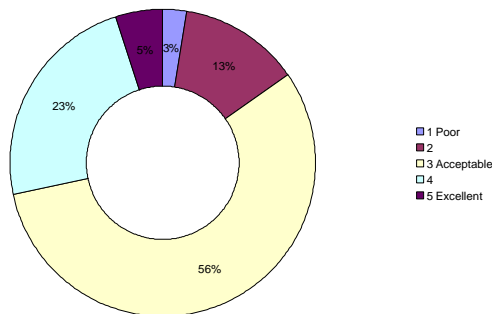
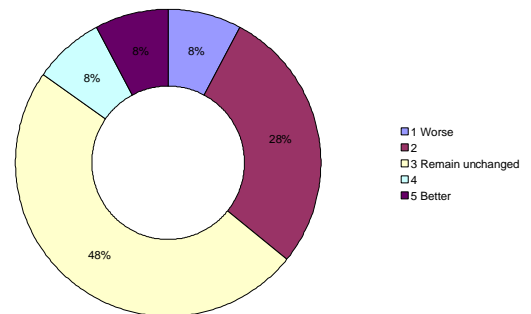


Figure 23. What is your view of liquidity regarding swaps (SEK/SEK) in relation to 2006?



Like the above individual fixed income markets, the *repo market* has functioned well in 2007, according to the survey responses. 70 per cent of the fixed income market participants consider that liquidity in repos was acceptable (see Figure 24). One in four participants gives a higher grade than this. This means that market participants give the least negative grade to the repo market (eight per cent) and to the market for government bonds (five per cent) (see also Figure 16). Three out of four market participants consider that liquidity in repos remained unchanged or improved in relation to 2006 (see Figure 25).

Figure 24. What is your view of liquidity regarding repos in 2007?

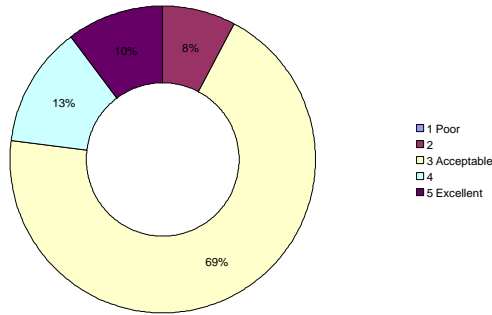
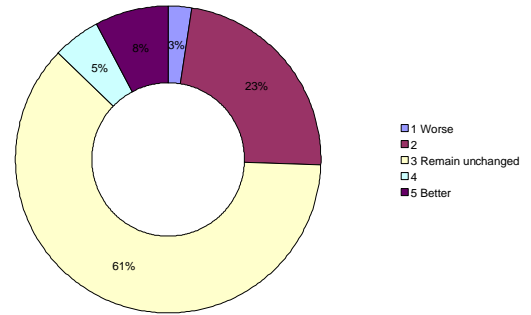


Figure 25. What is your view of liquidity regarding repos in relation to 2006?



Comments on instruments in individual fixed income markets

In response to the question of whether the respondents had changed their view of which instruments are important, or alternatively whether a specific instrument would play a more important role in the Swedish fixed income market, several participants respond that they do not have an opinion. However, some participants mention that the importance of credit derivatives and government bonds may increase.

The functioning of the Swedish foreign exchange market⁵

In general, the Swedish foreign exchange market has been associated with good liquidity in the years 2006 and 2007 (see Figures 26 and 27), according to the survey responses. The Swedish krona market has also functioned well in an international perspective (see Figure 28). Half of the participants consider that the market functioned better in 2007 than in the previous year, and only one in ten foreign exchange market participants considered that the functioning had deteriorated. A corresponding picture is given in an international perspective (see Figure 29).

Some participants take up the point that the Riksbank's communication during the year could have been better. There is no clear-cut picture of what the most important changes or trends were in 2007. Some examples of open responses to this are the global credit turbulence, the krona being steered by the actions of the Riksbank, the weakening of the USD and GBP setting the tone for the whole foreign exchange market, a considerable focus on interest rate differentials and that the international turbulence meant that the krona was affected as it is a peripheral currency.

⁵ Only participants in the Swedish foreign exchange market have responded to this part of the survey, a total of 28 participants where eight are the Riksbank's foreign exchange policy counterparties. There is a partial non-response for question 40, which had responses from 25 participants, and question 41, which had responses from 26 participants.

Figure 26. How do you assess that the market for Swedish krona has functioned in 2007?

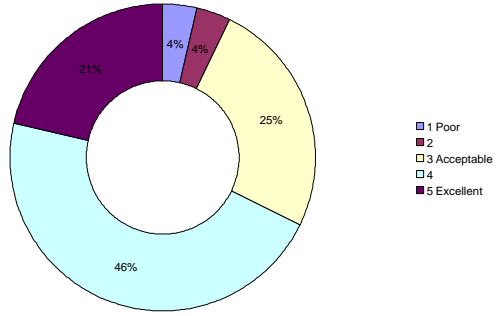


Figure 27. How do you assess that the market for Swedish krona has functioned in relation to 2006?

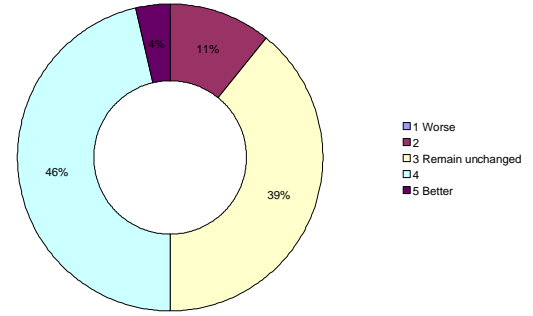


Figure 28. In an international comparison, how do you assess that the market for Swedish krona has functioned in 2007?

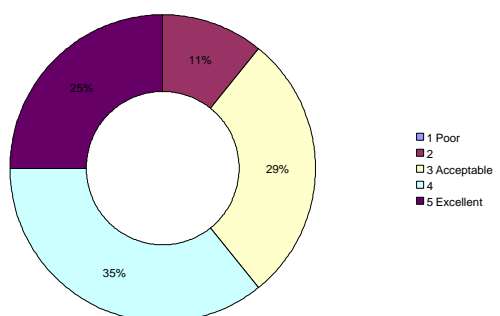
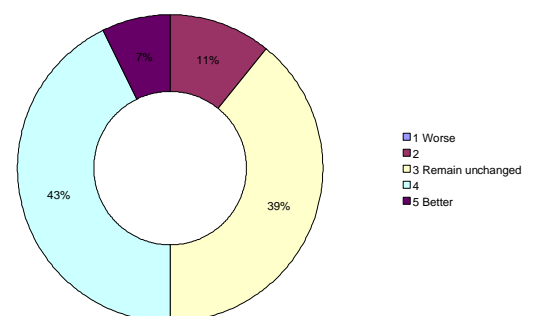


Figure 29. In an international comparison, how do you assess that the market for Swedish krona has functioned in relation to 2006?



Liquidity in individual foreign exchange markets

Several actors in the *forward market for SEK/USD* state that liquidity was acceptable or better in 2007 (see Figure 30). Less than one in ten considered that liquidity was poor. Around half considered that liquidity was the same in 2007 as in the previous year. Almost three out of ten considered that it had improved, while two out of ten considered that liquidity had deteriorated (see Figure 31).

Figure 30. What is your view of liquidity regarding forwards (SEK/USD) in 2007?

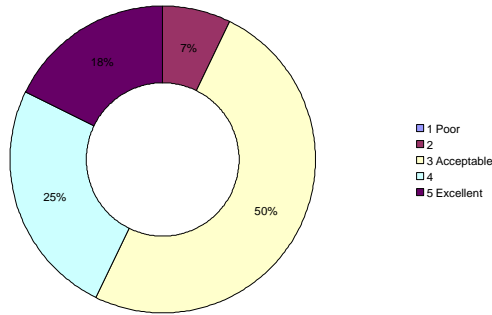
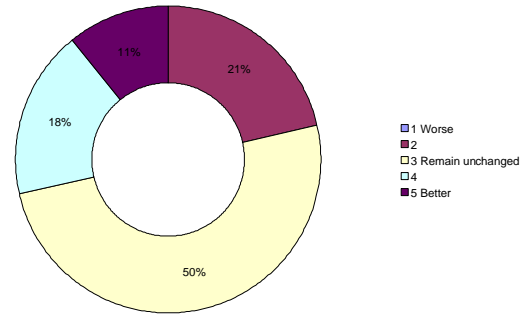


Figure 31. What is your view of liquidity regarding forwards (SEK/USD) in relation to 2006?



Liquidity in the *FRA market in SEK* showed similar patterns as the forward market in SEK/USD in the year 2007, according to the survey responses. Almost all of the participants gave liquidity an acceptable grade or higher, but slightly fewer stated that it was excellent compared with the liquidity in the market for forwards in SEK/USD. Almost seven out of ten consider that liquidity was unchanged in 2007. Two out of ten participants consider that this market functioned more poorly than in 2006 (see Figure 33).

Figure 32. What is your view of liquidity regarding FRA (in SEK) in 2007?

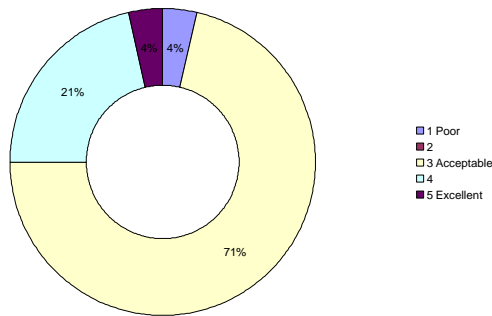
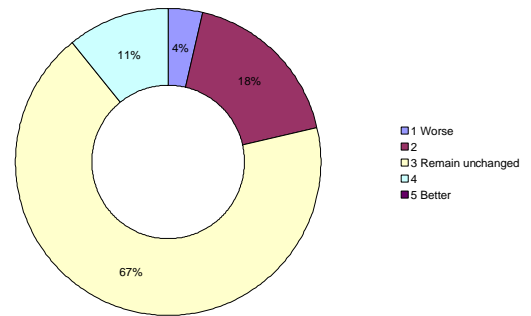


Figure 33. What is your view of liquidity regarding FRA (in SEK) in relation to 2006?



Just over nine out of ten participants give liquidity in the *market for swap/STINA in SEK* an acceptable grade or higher for the year 2007 (see Figure 34). Almost seven out of ten consider that the market functioning was unchanged in 2007 compared with 2006. There are slightly more who considered that market functioning deteriorated in 2007 than considered that it improved (see Figure 35).

Figure 34. What is your view of liquidity regarding swap/STINA (in SEK) in 2007?

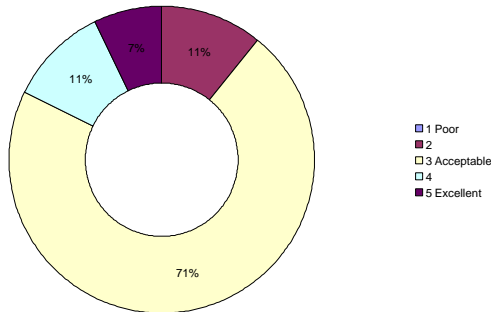
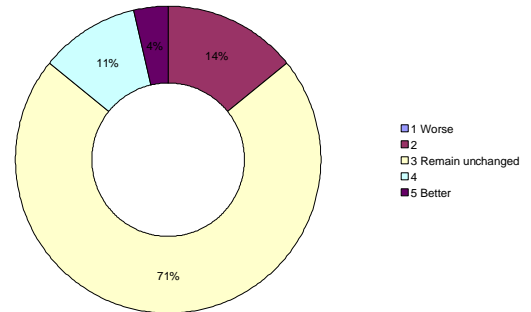


Figure 35. What is your view of liquidity regarding swap/STINA (in SEK) in relation to 2006?



As with the previous market, nine out of ten foreign exchange market participants in the *market for O/N and T/N in SEK* state that liquidity was satisfactory or better during the year 2007 (see Figure 36). Almost six out of ten considered that the functioning of the market was the same as in 2006, while more than two out of ten considered it had improved (see Figure 37).

Figure 36. What is your view of liquidity regarding O/N and T/N (in SEK) in 2007?

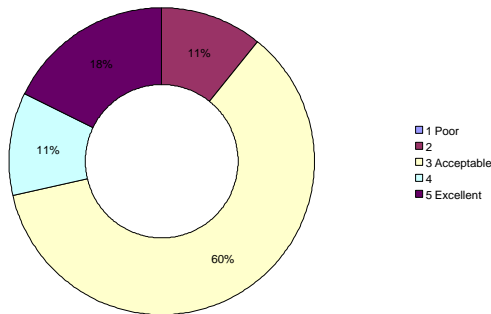
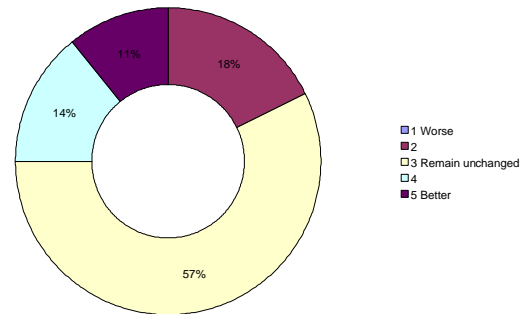


Figure 37. What is your view of liquidity regarding O/N and T/N (in SEK) in relation to 2006?



The liquidity in the *SEK/EUR spot* in 2007 is given high marks by the market participants. Almost two out of three give the market functioning a higher grade than acceptable, while only four per cent considered the market functioning to be poorer (see Figure 38). Two out of three respondents consider that liquidity has remained unchanged, while the remainder considers it better than in the previous year (see Figure 39).

Figure 38. What is your view of liquidity regarding spot (SEK/EUR) in 2007?

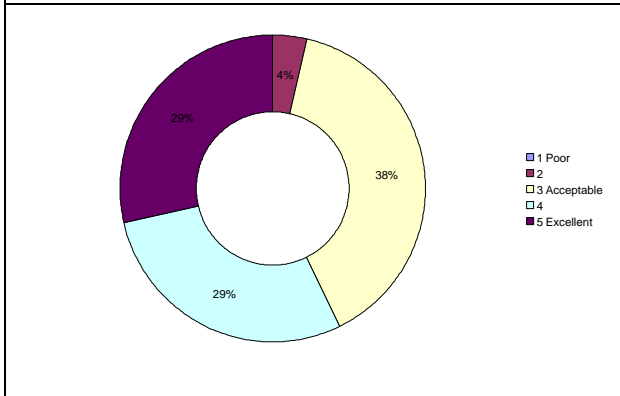
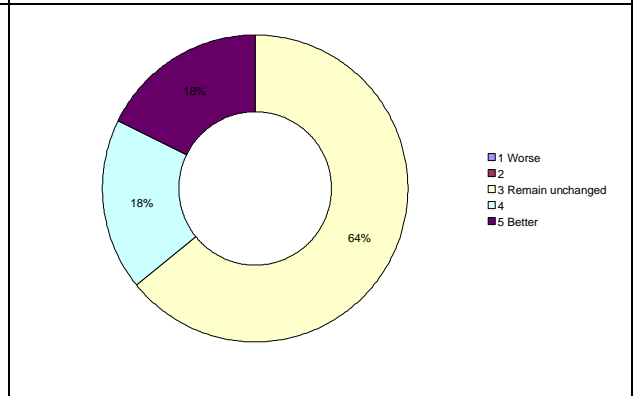


Figure 39. What is your view of liquidity regarding spot (SEK/EUR) in 2007?



On the basis of the survey responses, liquidity in *currency options in SEK* functioned well in 2007. Most participants in the market give liquidity an acceptable grade or higher (see Figure 40). As with liquidity in SEK/EUR spot only four per cent of the participants considered that the function of this market was poor. Nine out of ten participants assess that liquidity was unchanged or better in 2007 than in the previous year (see Figure 41).

Figure 40. What is your view of liquidity regarding currency options (in SEK) in 2007?

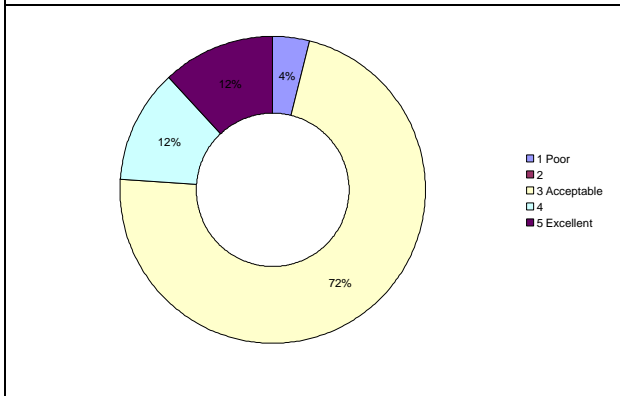
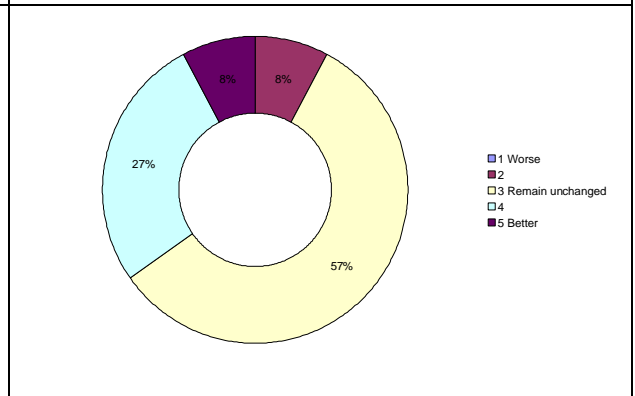


Figure 41. What is your view of liquidity regarding currency options (in SEK) in relation to 2006?



Comments on instruments in individual foreign exchange markets

In response to the question of what the respondents consider has functioned well/poorly in the spot (SEK/EUR) market in 2007, many reply that "everything has functioned well/fairly well". However, a couple of participants in the foreign exchange market mention that liquidity has been a problem. In response to the corresponding question regarding the foreign exchange instruments FRA (in SEK), swap/STINA in SEK, forward SEK/USD, O/N and T/N in SEK several participants consider that "everything has functioned well/fairly well". However, some participants mention occasions when pricing has been affected by liquidity problems and high risk premiums.

The effects of the financial turmoil on the Swedish financial markets and their future development

Lasting effects of the recent financial turmoil

A general impression of participants in the Swedish fixed income and foreign exchange markets is that the recent financial turbulence has changed views and prices of risk. A higher risk awareness provides the conditions for better risk management, partly through changes in regulations. Most participants assess that the price of risk will be both higher and more diversified, with the price rise ultimately affecting bank customers.

Some fixed income market participants consider that the financial turmoil has made securitisation more difficult and that the credit rating agencies have lost credibility. Investors will look for products that are transparent and liquid, something that applies both to the way the products function and their pricing.

Opinions are divided among fixed income market participants and foreign exchange market participants as to whether or not the financial market turbulence will soon be over.

The focus on the Swedish financial markets over the coming six months

Several market participants take up the issue that over the coming six months focus will be on the credit turmoil and its secondary effects, for instance on the banks' results and financing. Economic activity in Sweden and how this is affected by developments in the United States will also be important. A further common area considered important by the participants in the short term is inflation and developments in the short-term interest rate. Some market participants, primarily in the fixed income market, also take up the fact that there will be a focus on liquidity in the financial markets in the future.

Risks for the Swedish financial markets over the coming six months

Participants in the fixed income and foreign exchange markets point to some common risks over the coming six months. Several participants mention continued liquidity risks as a consequence of the credit turmoil. They say that continued high interest rates may make borrowing more expensive for companies and households. A further risk mentioned by several participants is that Swedish banks will not be able to meet their commitments in the Baltic countries.

Risks for the Swedish financial markets in the longer term

One common risk for the Swedish financial markets in the longer term, which was mentioned by several responding participants in the survey, is the economic activity in Sweden and abroad combined with the development in inflation. Some fixed income market participants also state that the liquidity shortage may continue to be a threat to the markets. Several fixed income market participants also point out that confidence in the Swedish financial sector may be damaged if the markets are perceived as unpredictable.

Other comments

The survey respondents gave few other comments regarding the functioning of the fixed income and foreign exchange markets. Some participants pointed to the Riksbank's role in the Swedish financial markets, mainly to a need for improvement in the Riksbank's communication to avoid surprising the market.



Financial Stability Department
Sveriges riksbank, 2008