NÁRODNÁ BANKA SLOVENSKA
EUROSYSTÉM

IMPLEMENTATION OF EUROSYSTEM MONETARY POLICY, FOREIGN EXCHANGE OPERATIONS AND INVESTMENT ACTIVITIES IN FOREIGN RESERVE MANAGEMENT

3

3 Implementation of Eurosystem Monetary Policy, Foreign Exchange Operations and Investment Activities in Foreign Reserve Management

3.1 MONETARY POLICY OPERATIONS

Once Slovakia became fully integrated into the euro area, Národná banka Slovenska began to implement the monetary policy set by the European Central Bank. As at 31 December 2008, NBS ceased using monetary policy instruments as a means of absorbing the liquidity surplus in the Slovak banking sector (approximately €13 billion). The systemic liquidity deficit that is a permanent feature of the European banking sector requires liquidity-providing operations. On 1 January 2009 Slovakia became the 16th member of the euro area, where the monetary policy operations conducted at the national level are those of the Eurosystem.

The European Central Bank implements a qualitative monetary policy through setting the key interest rates that serve as the rates for main refinancing operations and for the marginal lending and deposit facilities. The ECB manages the banking sector's liquidity so that the reference rate for the euro interbank overnight market (EONIA) remains close to the main refinancing rate. The interest rates for the marginal lending and deposit facilities serve as a corridor within which the EONIA may fluctuate.

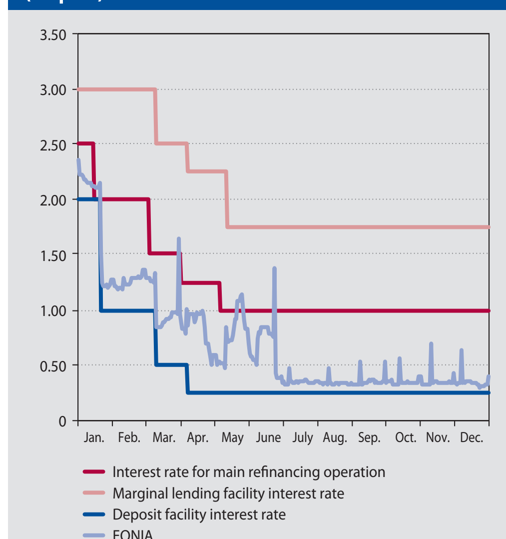
The Eurosystem's standard set of monetary policy instruments includes main refinancing operations with a maturity of one week, longer-term refinancing operations with a maturity of three months, overnight fine-tuning operations of a liquidity-providing or liquidity-absorbing character, and standing facilities. The other monetary policy instruments that the ECB has at its disposal are not used in normal circumstances,[8] but they did come into play during 2009 as part of the response to the financial crisis.

Key interest rates in the euro area were cut fourfold during the course of 2009, by 150 basis points in cumulative terms, with the main refinancing rate ending the year at an all-time low of 1.00%. Whereas before the financial crisis the EONIA overnight rate had been close to the main refinancing rate, in 2009 it remained almost constantly below this rate and at the same time close to the lower end of the corridor. This was due to the liquidity surplus that banks accumulated after the ECB switched the way in which funds are allotted in Eurosystem liquidity-providing operations – from basing the allotment on a calculated benchmark, to applying the full allotment procedure. During this period, however, the ECB did not abandon the standard practice of smoothing the effect of excess liquidity at the end of the reserve maintenance period, which was absorbed through fine-tuning operations. This was reflected in short-term rises in the EONIA overnight rate.

Liquidity of the banking sector

With Slovakia's adoption of the euro, Slovak banks became fully integrated into the Europe-

Chart 31 Key ECB interest rates in 2009 (% p.a.)



Source: ECB.

8 *For further details, see the ECB publication "The implementation of monetary policy in the euro area", the Slovak version of which is published on the NBS website at http://www.nbs.sk/_img/Documents/ecbpub/ump/mp200811.pdf.*

an financial sector and their liquidity surplus was absorbed by the systemic deficit of the European banking sector. Slovak banks placed part of their surplus funds with their respective parent companies and invested a further part of these funds in the European interbank market.

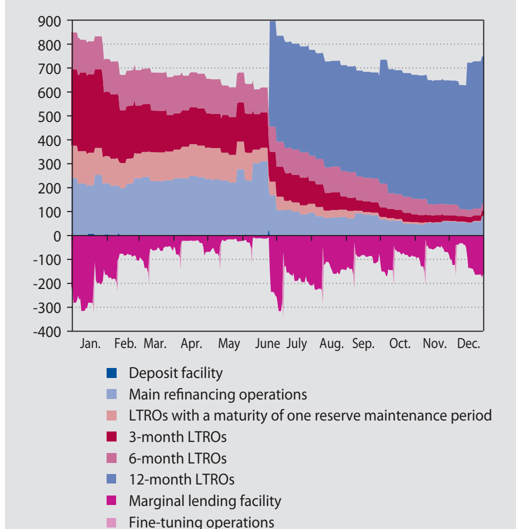
In 2009, the European Central Bank continued with the non-standard full allotment procedure through its liquidity-providing operations. Since liquidity remained tight in the interbank market, banks were obtaining the funds they required almost exclusively from the ECB. With banks requesting far more funds than they actually needed, there was a substantial surplus in the amount of funds lent by the ECB. The lack of confidence in the interbank market and the need to accumulate funds was reflected in the higher number of longer-maturity borrowings. This in turn saw the share of longer-term refinancing operations in the total amount of outstanding refinancing increase to a majority of 75% in the first half of 2009, having already risen in the previous period by the addition of operations with a maturity of one reserve maintenance period and with a maturity of six months. Unlike in normal circumstances, main refinancing operations accounted for only 35% of the total amount of outstanding refinancing in the first half of 2009. The introduction of 12-month operations in mid-2009 further squeezed the use of main refinancing operations as a means of providing liquidity to banks. Banks gradually reduced the amount of funding they obtained through all other operations, until 12-month operations became almost their only source (with a share of 86%).

In July 2009, after the Eurosystem had carried out its first one-year LTRO, the total amount of the Eurosystem's outstanding refinancing stood at a record €900 billion. The new LTROs allowed banks to obtain credit from the ECB for one year at an all-time low rate of 1.00%. These operations appreciably squeezed main refinancing operations as a share of the total outstanding amount, represented only around 10% by the end of 2009.

Standing facilities

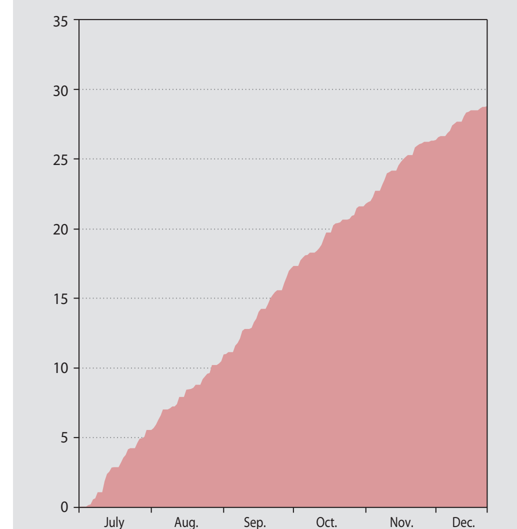
Since banks were responding to counterparty credit risk by not investing their temporary surplus funds in the interbank market, they placed large volumes with the Eurosystem's marginal deposit facility. Usage of the facility doubled during 2009, and its highest-ever levels of around €300 billion were recorded in January and July. The fact that banks experiencing a liquidity shortage obtained credit from the ECB at the main refinancing rate and that banks with a surplus of funds accessed the deposit facility at rates of 100 and 75 basis points, respectively, below the main refinancing rate indicates that the interbank market was still not functioning efficiently in 2009.

Chart 32 Eurosystem operations in 2009 (EUR billions)



Source: ECB.

Chart 33 Purchase of covered bonds in 2009 (EUR billions)



Source: ECB.

Covered bond purchase programme
In July 2009, the Eurosystem introduced another non-standard instrument – the covered bond purchase programme – the aim of which was to revive the market in these securities. Under the programme, covered bonds with a total nominal amount of €60 billion should be purchased within a period of one year, i.e. by June 2010. The purchases are carried out through the ECB and national central banks, their share being determined on the basis of their capital key. By the end of 2009, the Eurosystem's portfolio of covered bonds amounted to almost €30 billion, a half of the targeted amount.

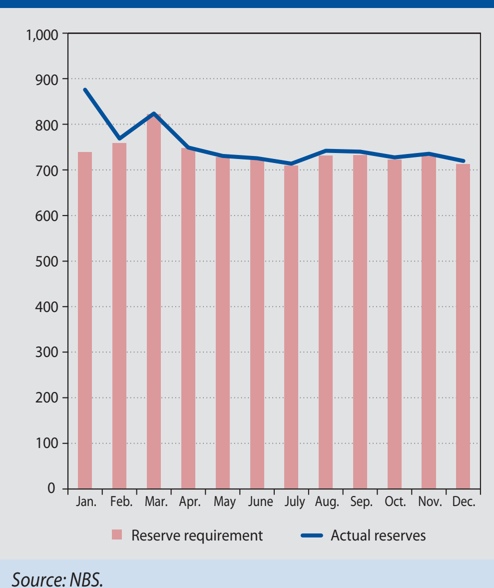
Minimum reserves

In the area of minimum reserves, the principal changes introduced to the system applied in previous years concerned the reserve base of credit institutions. Under Eurosystem rules, the reserve base consists only of primary deposits and debt securities issued with an agreed maturity of up to two years; it does not include deposits taken from other credit institutions in the Eurosystem. In 2009, as in previous years, the reserve ratio stood at 2% of the reserve base. Each credit institution may deduct a lump-sum allowance of €100,000 from its reserve requirement. The reserve maintenance period is around one month on average, and typically starts on the Wednesday following the meeting of the ECB Governing Council at which monetary policy parameters are set. There were also changes in regard to the remuneration of minimum reserves; the fixed remuneration rate was superseded by a variable rate equal to the average marginal rate for the Eurosystem's main refinancing operations over the respective maintenance period.

Credit institutions operating in Slovakia are required to hold minimum reserves either on their own account or on an intermediary's account with Národná banka Slovenska. In 2009, a total of 26 credit institutions were subject to minimum reserve requirements, and one of them held its reserves on an intermediary's account.

The average value of the reserve requirement in 2009 was €734.5 million; its value fell by 3.5% over the course of the year, from €739.5 million in January to €713.3 million in December. None of the credit institutions established in Slovakia failed to comply with the reserve requirement.

Chart 34 Minimum reserves in 2009 (EUR millions)



Source: NBS.

The minimum reserve system fulfils an important role in the framework of monetary policy implementation. Since reserves need to comply with the reserve requirement only on average over the whole maintenance period, the system supports stability in short-term money market rates. It smoothes the effects of unexpected liquidity fluctuations and, in regard to non-cash payment requirements, it maintains the minimum liquidity of financial institutions that are subject to minimum reserve requirements.

Eligible assets

In January 2009, Národná banka Slovenska began implementing the Eurosystem's common monetary policy. The common rules concern the conduct of monetary policy operations, as well as the management of the risks associated with them. NBS started to conduct Eurosystem operations at the national level with eligible credit institutions that perform banking activities in Slovakia. Under the ESCB and ECB Statute, all Eurosystem credit operations must be collateralised with eligible collateral. Consequently, the Eurosystem has put in place a set of criteria by which to assess the eligibility of particular types of financial assets. Assets meeting these eligibility criteria may be used as collateral for liquidity-providing operations (including intraday credit in the TARGET2 payment system), or they may be the subject of outright transactions. The asset

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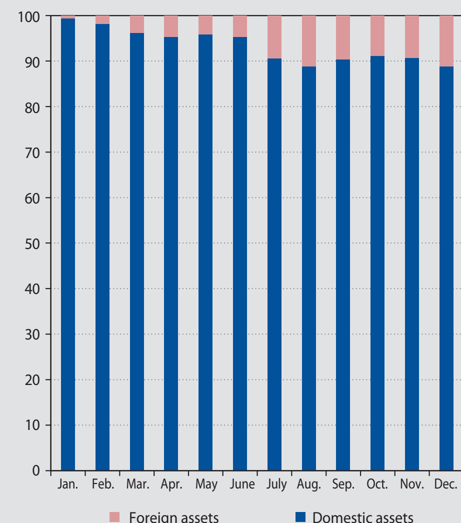
eligibility criteria are applied at the national level in the euro area countries. Therefore all financial assets issued or provided in Slovakia are included in the Single List of Eligible assets, provided that they met the eligibility criteria in the previous year and continue to meet them.

Regarding the use of financial assets in Eurosystem operations, another important aspect, apart from their eligibility, is the collateralisation techniques for depositing assets and how these assets are managed in the creditor national central bank. For eligible credit institutions in Slovakia, Národná banka Slovenska began to manage pool accounts for pooled collateral. These assets may be deposited for the collateralisation of operations either through the repo technique or the pledge technique. NBS established the same conditions for the use of domestic assets and for the use of assets on the cross-border principle. Where eligible financial assets were used, they were also valued at either their market value or on the basis of a theoretical price, including application of the corresponding haircut.

In 2008, before Slovakia joined the euro area, the assets most commonly used in monetary operations were government securities and NBS bills, but in 2009 eligible credit institutions in Slovakia had the opportunity to use various types of underlying financial assets. The category of eligible assets was extended to include various debt securities, as well as credit claims. These assets could be domestic assets or foreign financial assets held by eligible credit institutions in Slovakia. As of the beginning of 2009, NBS started to accept as collateral, in addition to maturing NBS bills, other domestic financial assets up to the amount of €17.6 billion. During the course of 2009, these assets were supplemented with new assets held in Slovakia, up to a total value of €19.1 billion. In accordance with the use of assets held in Slovakia, counterparties also started to apply foreign eligible financial assets that were denominated in euros and held in euro area countries. In Slovakia, however, the actual use of foreign assets was less significant, and by the year-end it represented only 11% of the total amount of collateral used for Eurosystem operations conducted through NBS. The largest shares of the assets used in 2009 were represented by covered bank bonds issued in accordance with the UCITS Directive (which in Slovakia means mortgage bonds), followed by Slovak government bonds, Slovak Treasury bills, and bonds issued by bank and non-bank entities in Slovakia. As for foreign assets used as eligible collateral by credit institutions in Slovakia, they mainly comprised government bonds of EEA countries and covered bank bonds issued by credit institutions in EEA countries. In 2009, no credit claims were used as collateral in Slovakia.

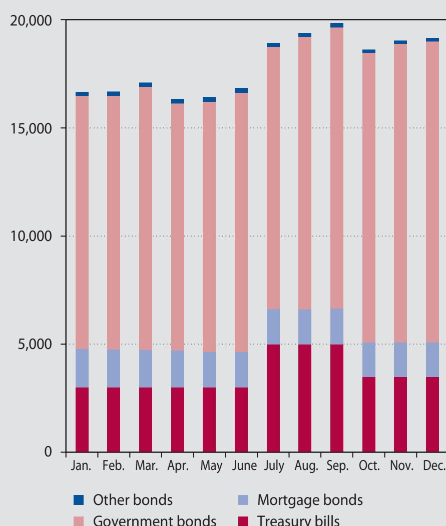
In 2009, the Eurosystem opened the way for extending the range of financial assets eligible for use during the financial and economic crisis, and, as a result, the asset eligibility criteria were amended. This new group of assets is identified as "temporary collateral" held in euro area countries; the debt securities may be denominated not only in euro, but also in US dollars, pounds sterling and Japanese yen. They may be accepted as eligible collateral until the end of 2010, or no later than the maturity of the last 12-month liquidity-providing operation undertaken with the Eurosystem before the end of 2010. This opportunity could and can be taken up also by eligible credit institutions in Slovakia. Another group of assets that the Eurosystem has recognised as eligible since the beginning of 2009 (in the context of exceptional crisis conditions) are assets issued by selected governments of G-10 countries (in their domestic currency). These assets are identified as "special collateral" and their

Chart 35 Use of domestic and foreign eligible assets in 2009 (%)



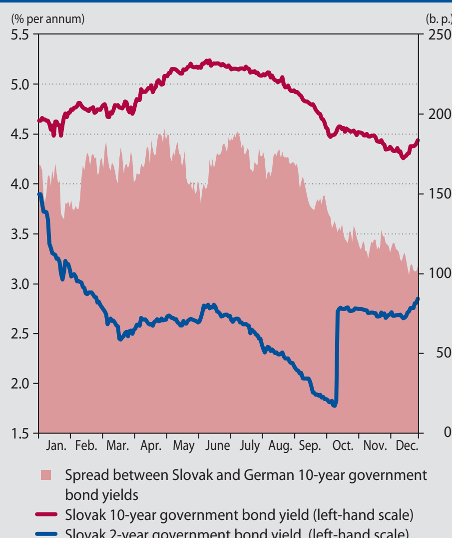
Source NBS.

Chart 36 Structure of Slovak eligible assets in 2009 (EUR millions)



Source NBS.

Chart 37 Benchmark government bonds in 2009



Source NBS.

eligibility is judged by the ECB, taking into account the mobilisation of assets for the requirements of particular euro area NCBs.

As from January 2009, Národná banka Slovenska began using a proprietary information system for conducting Eurosystem operations (including settlement operations) in the given area of processes and procedures. This includes communicating with eligible credit institutions in Slovakia and with external systems, such as the Bratislava Stock Exchange and Centrálny depozitár cenných papierov SR, a.s. (the central securities depository). This system is directly connected to the TARGET2-SK payment system and allows NBS to communicate with the ECB and other euro area NCBs in regard to, inter alia, eligible assets for Eurosystem monetary operations.

Benchmark bond yield curve

Yields on two-year Slovak government bonds fell markedly in 2009, and thus partially converged to the European level. The conspicuous upward shift towards the end of October was caused by revised figures for Slovak benchmark bonds. The long end of the yield curve approached European yields only to a slight extent, where spreads between Slovak and German 10-year benchmark bonds narrowed from almost 200 basis points to 100 basis points.

Chart 38 Euro-dollar exchange rate in 2009

Source: ECB.

3.2 FOREIGN EXCHANGE OPERATIONS

Foreign exchange market operations

With the adoption of the single European currency in Slovakia, the Slovak koruna was as the domestic currency replaced by the euro in a floating exchange-rate regime. At the beginning of 2009, the euro's exchange rate against the US dollar was high-

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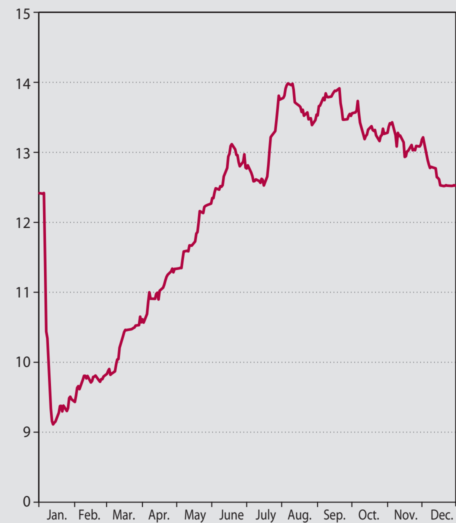
Chart 39 NBS foreign reserves in 2009 (USD millions)

Source: NBS.

Chart 40 Investment reserves under NBS management (EUR billions)



Source: NBS.

ly volatile as a consequence of investors' persisting risk-aversion. The euro recorded its lowest level of 1.25 USD/EUR in March, but as the year wore on it gained almost 21% against the dollar. Between its peak, at 1.51 USD/EUR, and the end of the year, the euro weakened slightly, and it ended 2009 at 1.44 USD/EUR. The European Central Bank did not undertake any currency interventions in 2009.

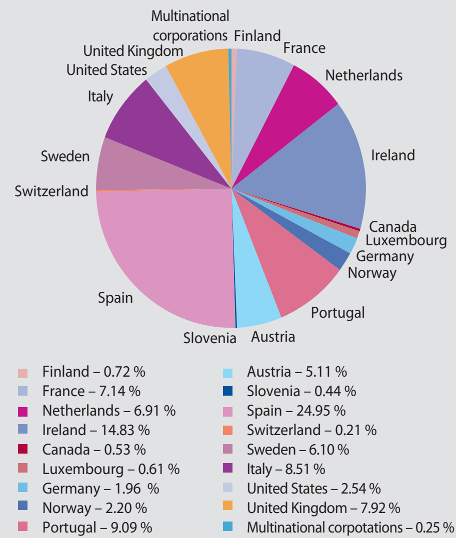
Investment activities in foreign reserve management

The changeover to the single currency brought about changes in foreign reserve management in the area of investment strategy. In previous years, NBS had managed foreign reserves in the form of US dollars, euros and gold. From the beginning of 2009, however, its foreign reserves comprised only US dollars and gold. The amount of foreign reserves was determined mainly by the price of gold, since gold comprised the main part of the foreign reserves. The value of the foreign reserves at the corresponding exchange rates and market prices rose from USD 1.28 billion at the beginning of 2009, to USD 1.8 billion at the end of 2009. The amount of foreign reserves denominated in US dollars was affected largely by the exchange rate between gold and the dollar.

Investment activities in investment reserves management

For Slovakia, 2009 was its first year of euro area membership. NBS adapted to the new framework of investment reserves management and followed the new rules set out in the investment strategy approved at the end of 2008. The character of investment reserves management has changed from the investment of net assets to the management of assets and liabilities. In the wake of the euro changeover, the focus of investment reserves management has been on achievement adequate net returns by comply-

Chart 41 Euro investment portfolio – breakdown by country



Source: NBS.

ing with the pre-determined constraints. The moderate easing of credit restrictions on investments was accompanied by tightening of portfolio diversification conditions that limit the concentration of credit exposure vis-à-vis a single issuer or country. Another change was the restriction of exposure to interest rate risk and foreign exchange risk. In order to manage interest rate risk effectively, interest rate swaps started to be traded in the euro investment portfolio during 2009. By 31 December 2009, the nominal value of interest rate swaps had reached €12.3 billion and the total value of investment assets came to €12.5 billion. The effective net return on investment reserves represented 2.3% for the euro investment portfolio and 3.1% for the dollar investment portfolio. The overall return on investment reserves on the basis of portfolio performance measurement was around €280 million.