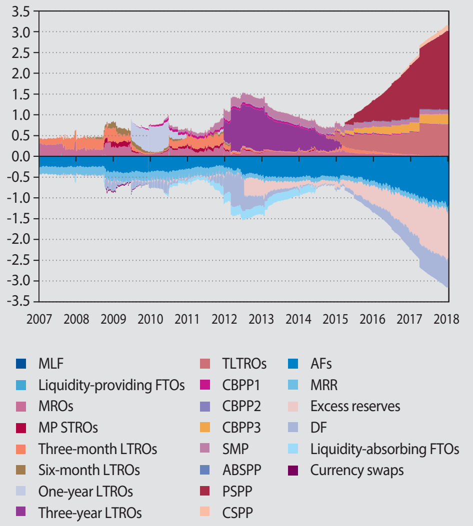
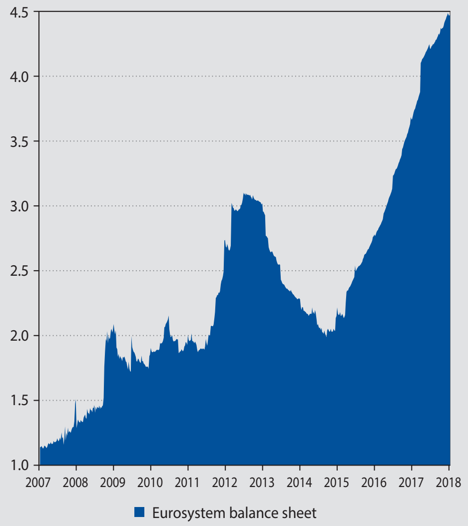
Chart 9 Liquidity position of the Eurosystem (EUR trillions)



Sources: ECB, Bloomberg and NBS calculations.
Note: MLF – marginal lending facility; FTOs – fine-tuning operations; MROs – main refinancing operations; MP STROs – special-term refinancing operations with a maturity of one maintenance period; LTROs – longer-term refinancing operation; TLTROs – targeted longer-term refinancing operation; CBPP – covered bond purchase programme; SMP – Securities Markets Programme; ABSPP – asset-backed securities purchase programme; PSPP – public sector purchase programme; CSPP – corporate sector purchase programme; AFs – autonomous factors; MRR – minimum reserve requirement; DF – deposit facility.

Chart 10 Total assets of the Eurosystem (EUR trillions)



Sources: Bloomberg, NBS calculations.

monetary policy portfolio holdings under these purchase programmes stood at around €20 billion at the end of 2017, representing a year-on-year increase of 30%.

Impact of monetary policy operations on the Eurosystem balance sheet

Total assets on the Eurosystem's balance sheet amounted to €4.5 trillion at the end of 2017, which was €0.8 trillion higher compared with the end of 2016. Since the onset of the financial crisis in 2007, when the Eurosystem's total assets stood at €1 trillion, the ECB has taken a variety of standard as well as non-standard monetary policy measures, which have had a direct impact on the size and composition of the Eurosystem balance sheet. These measures have been crucial to ensuring the smooth transmission of accommodative monetary policy.

3 Financial market developments

The global economic recovery gathered momentum during the course of 2017. A key factor behind this trend was an increase in investment demand amid improving business sentiment. A related effect was the acceleration in foreign trade growth. Euro area countries also contributed to the overall picture of robust economic activity growth. The favourable path of macroeconomic indicators is reducing the direct risks to financial stability. On the other hand, the improving economic performance is accompanied by trends whose cumulative effect is contributing to a build-up of imbalances that could be a threat to financial stability in the medium term. The most significant trend is the continuing increase in public and private sector debt at a time of relaxed lending conditions. The persisting low interest rate environment is expected to continue stoking risk appetite in the financial sector, thereby leading to an increase in financial system vulnerability. The risk of sudden asset repricing in financial markets is significant. A wave of repricing could be triggered by an unexpected course of monetary policy normalisation, a deviation of macroeconomic trends from their expected path, or an escalation of geopolitical tensions.

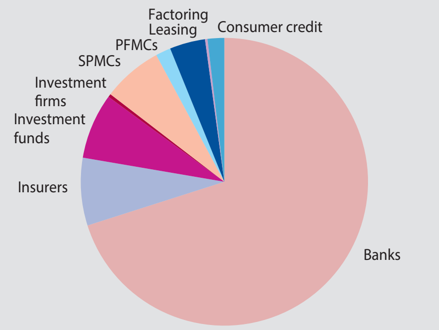
Slovakia was also experiencing an expansionary phase of the business cycle in 2017. The domestic economy maintained stable growth of 3.4%. GDP growth in the second half of the year was driven mainly by domestic demand and only to a small extent by foreign demand. The buoyancy of the Slovak labour market was reflected in domestic household consumption, which increased more than in any other year of the post-crisis period. The current outlook envisages that the economic upswing will continue and that gradual overheating of the economy could be expected. Such a scenario could pose a risk to financial stability, particularly since the exceptionally favourable labour market developments cannot be assumed to be sustainable over the long term. In some sectors of the economy, firms are already reporting shortages of skilled labour. This shortage is putting upward pressure on wage growth, which is reaching a post-crisis peak.

The banking sector's profit for 2017, net of one-off effects, was largely unchanged in year-on-year terms. Disregarding several one-off effects that had a positive impact on banks' profitability, mainly in 2016, the sector's aggregate net profit increased in 2017 by 8.1% year on year. The profit including those effects was substantially higher in 2016 than in 2017. The main drag on bank profits was the decline in net interest margins, while the largest positive contribution came from the low credit risk costs.

The banking sector strengthened its capital position in 2017, thanks largely to a marked increase in the retained earnings ratio. In 2017 banks retained 42% of their aggregate profit for 2016, while in each year from 2014 to 2016 the figure was less than 10%. The sector's total capital ratio increased in 2017, from 18.0% to 18.6%. As for the common equity Tier (CET) 1 capital ratio, it rose from 15.8% to 16.2%. At the same time, increasing capital adequacy was observed across EU banking sectors.

Household credit growth remains the most significant trend in the domestic financial sector.

Chart 11 Financial sector assets as at 31 December 2017, broken down by market segment



Source: NBS.
Note: PFMCs – pension fund management companies; SPMCs – supplementary pension management companies. The data for insurance undertakings are as at September 2017, the most recent available.

In absolute terms, year-on-year growth in the stock of retail loans maintained its upward trend in the first eight months of 2017, reaching an all-time high in August; it then remained flat or declined slightly in the final four months. In August the year-on-year increase stood at €3.55 billion, while in December it slightly declined to €3.45 billion. Annual credit growth reached a post-crisis high of 13.7% in March 2017 and then fell gradually over the rest of the year, down to a still-high 11.7% in December. Credit growth remained higher in Slovakia than in any other EU country. The favourable macroeconomic situation and low interest rates were conducive to retail loan growth, while demographic factors and gradual saturation of the market had the opposite impact. The strong growth in retail loans resulted in a further increase in household debt, to a level that was the highest in central and eastern European region. The rate of credit growth was the highest in both the region and the euro area. Thus, the most significant risk is a marked increase in the household sector's vulnerability to any economic deterioration.

As for loans to non-financial corporations (NFCs), their year-on-year growth rate was high during

2017, at 10% for the first three quarters and then a more moderate 7% for the last quarter. Furthermore, compared with other EU countries, Slovakia continued to have one of the highest rates of NFC credit growth. Demand for loans was supported by the improving situation in the corporate sectors, bright outlooks for economic growth, and the low interest rate environment. As a result, corporate credit growth was relatively broad-based across several key economic sectors and also loan categories. Most of the banks that are engaged in corporate financing reported an increase in this activity. Credit standards were eased to only a very limited extent in 2017, and then only in the form of a reduction in interest margins against a backdrop of competition from other banks and healthy economic outlooks.

NBS was responsive to developments in the domestic financial sector, most notably in regard to significant increases in private sector credit and indebtedness. In response to prolonged growth in household and corporate credit, it was decided in 2016 to raise the countercyclical capital buffer (CCyB) rate to 0.5% with effect from 1 August 2017. In view of persisting trends in the credit market and the amplification of several imbalances, the CCyB rate will be raised further, to 1.25%, with effect from 1 August 2018. NBS has also been focused on setting prudential lending requirements. An NBS decree laying down conditions for the provision of housing loans (Decree No 10/2016) entered into force on 1 January 2017. These conditions were followed by minimum requirements for consumer loans, laid down in an NBS decree that entered into force from 1 January 2018 (Decree No 10/2017).

The volume of investment in Slovak government bonds continued its downward trend in 2017. The share of these securities in the Slovak banking sector's total assets had been falling almost continuously since 2012 and ended 2017 at just under 10%, an all-time low that was similar to the pre-crisis level of 2008. The sector's holdings of foreign government bonds also declined. Among the foreign government bonds in the sector's total bond portfolio, Polish bonds had the largest share (3.6%), followed by Italian bonds (3.4%) and Czech bonds (2.3%). The share of Italian government bonds declined owing to sizeable disposals of these securities, while the shares of Polish and Czech bonds increased moderately.

In 2017 the debt servicing capacity of firms and households continued to be boosted by positive macroeconomic conditions. The non-performing loan (NPL) ratio for the banking sector's housing loan book fell from 2.3% in December 2016 to 1.9 % in December 2017, and the NPL ratio for consumer loans decreased less significantly, from 8.7% to 8.1%. The NPL ratio for loans to non-financial corporations improved markedly in 2017, from 6.5% to 5.2%. The improvement in credit quality as measured by the NPL ratio is, however, a typical feature of business cycle expansion. From the perspective of credit risk, it is necessary to follow debt indicators such as the debt-to-GDP ratio or debt burden, which provide key pointers to the vulnerability of the household and NFC sectors to any deterioration in the economic situation. All debt indicators were improving in 2017 given the economy's favourable trends and bright outlooks.

The insurance sector's net after-tax profit for the first nine months of 2017 stood at €135 million. This year-on-year increase was attributable to several factors[4], most notably one-off effects from mid-2016 (dividend payments from subsidiaries and the reversal of provisions for litigation). The gross profit unadjusted for one-off effects was higher by 3.6% year on year, while the adjusted profit rose by 30%. This result was supported by improvements in both the technical result and financial result. The net after-tax profit adjusted for one-off effects increased by a more modest 8.4%; when adjusted for one-off effects, however, it was lower by 12% (owing mainly to an increase in costs related to the special levy on the insurance sector). The insurance sector's Solvency Capital Requirement (SCR) coverage ratio remained largely unchanged in 2017, with a level of 208% at the end of the first quarter and 211% at the end of September. Compared with its level at the end of September 2016, however, the SCR coverage ratio was quite significantly lower. But despite that year-on-year decline, the insurance sector's solvency remained adequate. In life insurance, gross premiums written increased by 6% year on year, while benefits paid fell by 2%. These trends contributed to an increase in the aggregate technical result. The financial result

4 *The part of this section covering the insurance sector is based on data as at September 2017; the corresponding year-end data were not available by the cut-off date for this publication.*

for the life insurance segment also increased. The annualised return on investments in life insurance (excluding unit-linked insurance) continued to fall, and consequently the sector only just managed to cover the average guaranteed interest rate in life insurance contracts. Non-life insurance also saw an increase in gross premiums written (6% year on year). The combined ratio in non-life insurance improved in 2017, to stand at 88.6% as at September. The principal risks to the insurance sector continue to be the low interest rate environment and strong competition in motor insurance (resulting in this insurance class having a combined ratio that is close to the profit/loss threshold).

In the second pillar of the Slovak pension system, the net asset value (NAV) of old-age pension funds amounted to €7.6 billion at the end of 2017, representing a year-on-year increase of €657 million. This increase had several causes, the most important of which was the first of a series of hikes in the rate of mandatory contributions to the old-age pension scheme, from 4.0% to 4.25% of the assessment base. The amount of credited contributions was also boosted by increases in the number of savers in the scheme and in the nominal income of Slovak households. The returns on old-age pension funds accounted for just under one-quarter of the increase in their net asset value. Looking at the breakdown of the aggregate NAV by fund type, the share of index funds increased at the expense of bond funds, owing mainly to a shift in investment preferences among savers. Although changes in the core composition of old-age pension funds in 2017 were less significant, a number of long-lasting trends came to an end. The end of 2017 saw a minor outflow of bond instruments from bond pension funds, which brought to an end a multi-year trend of bond component growth in these types of pension fund. There was also a halt to the prolonged rising trend in equity exposure, as the share of equity holdings in the NAV of equity funds remained unchanged during the period under review, at just below 70%. The parameters of maturity and duration showed a stable or, in some individual funds, downward trend and appeared to reflect to some extent a gradual shift in expectations regarding the future path of interest rates. Looking at the breakdown of the bond fund portfolio by issuing sector, the share of corporate bonds increased to an all-time high and government bonds remained the largest component. The overall weighted average nominal return on old-age pension funds for 2017 was slightly lower compared with the previous year. Given the increase in inflation, the year-on-year difference in real terms was even more pronounced. The average annual nominal return on bond pension funds as at 31 December 2017 was 1.1%, and the return on the other three types of old-age pension fund ranged between 5.5% and 6.7%.

In the third pillar of the Slovak pension system, the supplementary pension scheme, the number of scheme participants recorded its highest increase in ten years and totalled 757,000 at the end of the year. The aggregate net asset value of supplementary pension funds increased by a robust 12.5%, to stand at €1.92 billion at the end of 2017. The net inflow to these funds during the period under review accounted for three-quarters of the increase in their NAV. Looking at the composition of their assets, supplementary pension funds with a balanced investment strategy saw a continuation of the trends of the previous period, most notably an increase in the equity component and fall in the bond component. As for growth-focused funds, the compositions of their portfolios did not change significantly. The weighted average residual maturity of bond securities began to fall during the year, thereby ending an unbroken upward trend. In the aggregate bond portfolio of supplementary pension funds, the share of corporate bonds increased (at the expense of government bonds). The average annual nominal return on all supplementary pension funds was 3.7% as at 31 December 2017. Growth funds earned an average return of 8.2%, balanced funds, 3.3%, and conservative funds and distribution funds together, 0.2%.

In Slovakia's investment fund sector, 2017 was marked by a surge in demand for investment fund products. The total net asset value of domestic and foreign investment funds marketed in Slovakia increased by €1.032 billion in 2017, which was close to an all-time high. The rally was concentrated in domestic investment funds, which accounted for around two-thirds of the total NAV growth. The acceleration of inflows to foreign investment funds was less significant. Household investments made up the largest share of new inflows to domestic investment funds, and insurers also made a sizeable contribution to the overall purchases of investment fund shares/units. Among other financial intermediaries, however, there were relatively high net redemptions of fund shares/units. In the breakdown of investment funds by type, mixed funds recorded the largest increase in both NAV and net inflows, followed, some way behind, by real estate funds. Bond funds, by contrast, experienced quite elevated net redemptions. Equity funds earned the highest average annual return, 7.3%, ahead of mixed funds (2.4%), real estate funds (2.4%), bond funds (0.5%) and money market funds (-1.5%).