NÁRODNÁ BANKA SLOVENSKA
EUROSYSTÉM

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

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2 Implementation of Eurosystem monetary policy, foreign exchange operations, and investment activities in foreign reserve management

2.1 MONETARY POLICY OPERATIONS

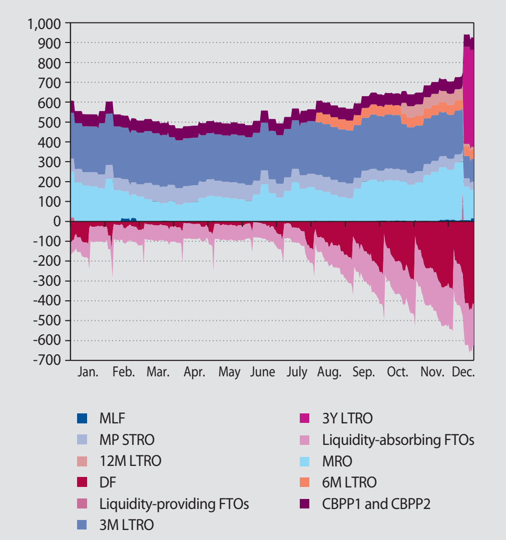
The European Central Bank implements monetary policy through the national central banks of the Eurosystem by means of various monetary policy instruments. The most widely used of these instruments are the main refinancing operations (MROs), longer-term refinancing operations (LTROs), fine-tuning operations (FTOs), and standing facilities, which include the deposit facility (DF) and marginal lending facility (MLF). In response to the deepening financial crisis in the euro area, the ECB continued to conduct operations as fixed rate tender procedures with full allotment and it expanded the use of longer-term operations by introducing extraordinary LTROs of six months and two years. In order to mitigate the mounting pressures in the euro area market, the ECB decided towards the end of the year to replace two planned 12-month LTROs with two LTROs that have a maturity of 36 months and may be repaid after one year. European banks that had already drawn funds under a 12-month LTRO had the option of switching their participation to the three year LTRO. This was partially used by the European banks.

Although the ECB maintained US dollar liquidity swap arrangements with the Federal Reserve System, there was minimal use of this swap line in the euro area banking sector. Participation in US dollar liquidity swap arrangements did not pick up until the end of the year, after the ECB announced a lowering of the prices on these operations.

Given the persisting problem of euro area countries' excessive indebtedness, the Eurosystem decided to continue the Securities Markets Programme (SMP), which began in 2010 and involves national central banks purchasing government bonds of selected countries. Several countries found that their excessive indebtedness made it difficult for them to obtain financing through the capital market, since the supply of their bonds far exceeded the demand for them. In August 2011, the ECB decided that the SMP, which had originally been used to purchase government bonds issued by the "peripheral countries" of Ireland, Greece and Portugal would be extended for the purchase of Spanish and Italian sovereign debt. By the end of 2011, ECB purchases under the SMP amounted to €211 billion. In order to mitigate the effect of these interventions, the ECB conducted liquidity-absorbing operations and thereby neutralised the programme's impact on the monetary stance.

Also as part of its non-standard measures, the ECB launched a new covered bond purchase programme (CBPP2) to run from November 2011 until October 2012, the aim being to revive activities in the covered bond market. Under the programme, purchases will be made for an intended amount of €40 billion and will be carried out in the primary and secondary markets. Národná banka Slovenska is not taking part in CBPP2. The programme was first implemented in 2009, when it was used to purchase bonds that had a total nominal value of €60 billion.

Chart 10 Eurosystem operations in 2011 (EUR billions)



Source: ECB.
Note: MP STRO – Special-term refinancing operation with a maturity matching the length of the maintenance period.

The ECB changed its key interest rates on four occasions in 2011. It raised them by 25 basis points in April and by the same amount in July. Following the second hike, the interest rate on the main refinancing operations stood at 1.50%. As instability in the euro area market mounted, the ECB responded by cutting the key rates by 25 basis points in November and by a further 25 points in December, thus bringing the main refinancing rate back down to 1.00%. The width of the standing facilities corridor remained unchanged throughout the year, at ± 75 basis points. The first half of 2011 was marked by improving sentiment in the global market and by a decline in the liquidity surplus of the euro area banking sector. The ECB had to some extent contributed to that surplus due to the exit strategy it adopted in 2010; its decision to conduct supplementary operations caused a substantial rise in the cumulative liquidity surplus of European banks in the second half of the year. The overnight market rate (EONIA) also reacted to the surplus by moving towards the lower end of the corridor in which it can fluctuate (defined by the standing facility rates). In 2011, the ECB continued to absorb the excess liquidity appearing regularly before the end of each maintenance period by conducting overnight fine-tuning operations. This was reflected in short-term increases in the EONIA rate at the end of each period.

Minimum reserves

Under Eurosystem rules, all credit institutions operating in the euro area are required to hold a minimum amount of reserves with their respective national central bank (NCB). In 2011, a total of 29 credit institutions operating in Slovakia were subject to minimum reserve requirements; they comprised 14 banks that had their registered office in Slovakia (including three home savings banks) and 15 branches of foreign credit institutions (including credit cooperatives).

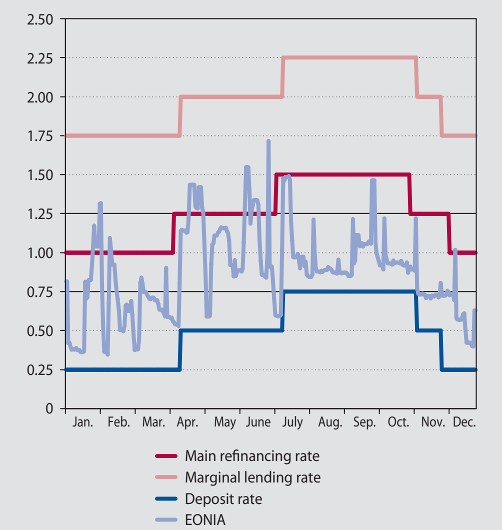
In 2011, the reserve ratio remained unchanged at 2% of the reserve base (selected types of deposits and debt securities issued). The ECB Governing Council decided at its meeting on 8 December 2011 to reduce the reserve ratio for 2012 to 1% in order to support money market activity.

The average amount of required reserves in 2011 stood at €702.34 million, which was around 1.02% higher than the average in 2010. The increase reflected to some extent the increase in deposits from households and the issuing activity of the banks under review.

Eligible assets

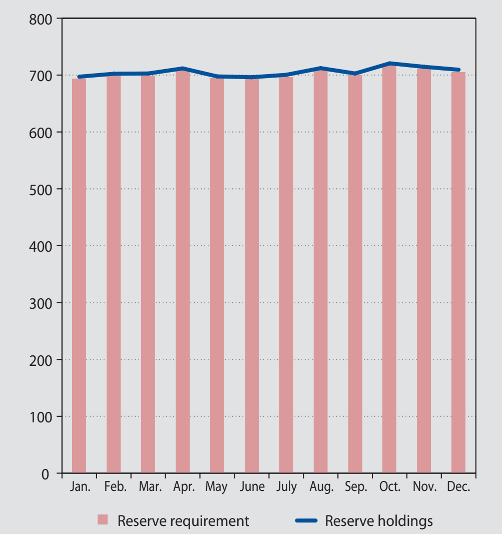
The conduct of Eurosystem monetary policy operations in 2011 was affected mainly by the repercussions of both the debt crisis of certain euro area countries and the financial crisis of

Chart 11 Key ECB interest rates and the EONIA rate (% p.a.)



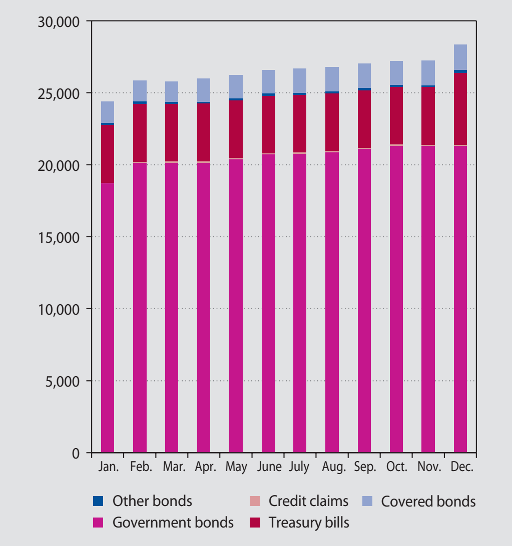
Source: ECB and Bloomberg.

Chart 12 Minimum reserves in 2011 (EUR millions)



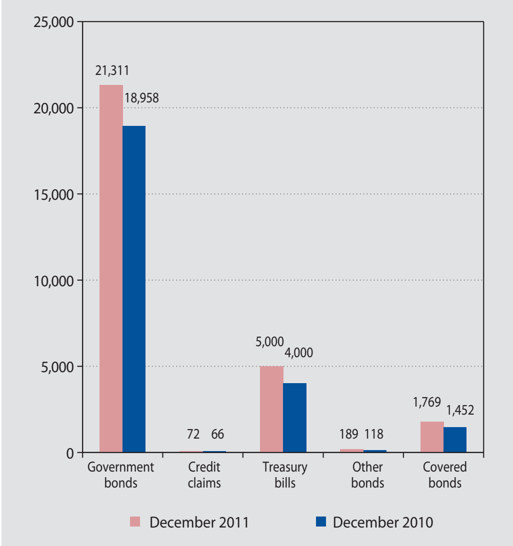
Source: NBS.

Chart 13 Composition of Slovak eligible assets in 2011 (EUR millions)



Source: NBS.

Chart 14 Changes in the composition of Slovak eligible assets in 2011 (EUR millions)



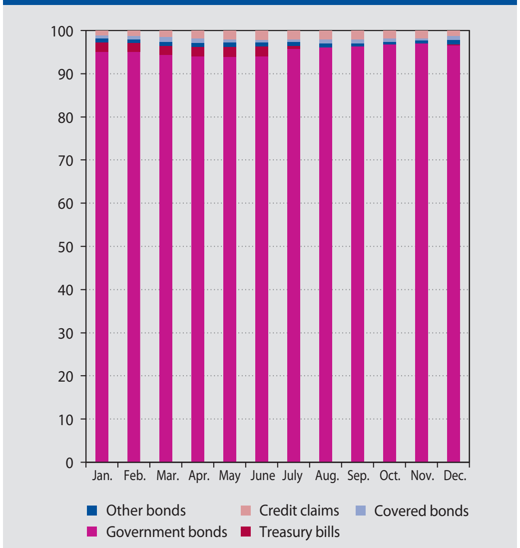
Source: NBS.

2008. These were reflected in the availability of assets eligible as collateral in Eurosystem credit operations. Over the year, the eligibility criteria were tightened for asset-backed securities and structured covered bonds, while at the same time they were eased for certain other assets, particularly those of countries included in the EU/IMF programme. Towards the year-end, as the need for liquidity among Eurosystem counterparties became more pressing, there was a prevailing tendency to ease the eligibility criteria, particularly in regard to the use of credit claims. In the end, the Governing Council decided for a temporary reversion to a two-tier system of eligible assets.

Eligible assets issued and held in Slovakia had an overall value of €28,341 million at the end of last year, representing an increase of 15% in comparison with the previous year. The largest share of that total, approximately 93%, consisted of bonds and Treasury bills issued by the Slovak government. Besides the increase in government debt securities, there was a gradual rise in the value of covered bonds issued according to UCITS directive and other bonds. The use of credit claims almost doubled during 2011, but by the year-end it had returned to its 2010 level.

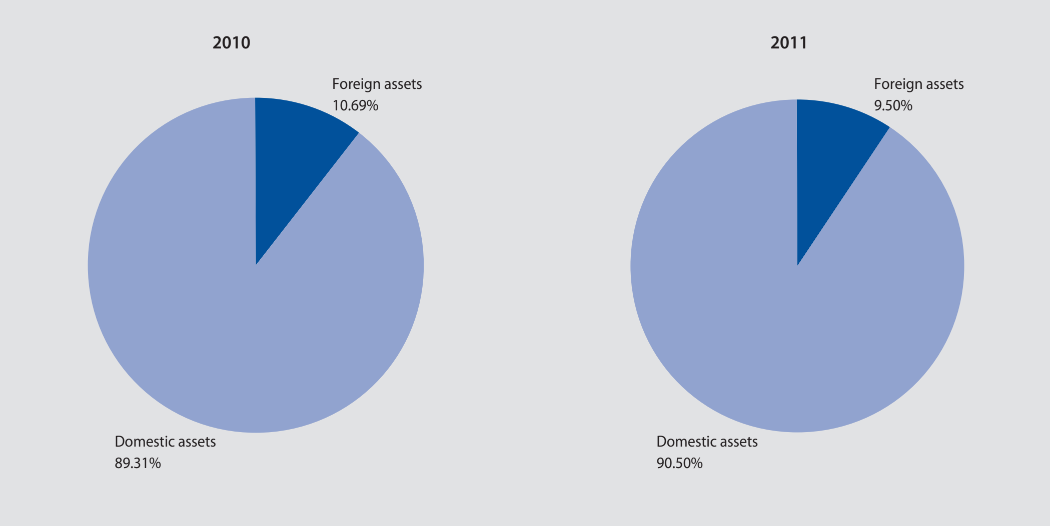
The activity of Slovak counterparties in Eurosystem monetary policy operations declined in 2011 in comparison with the previous year, while, by contrast, there was increased use of daylight credit in the TARGET-2SK payment system. The lower activity was reflected in the value of the collateral that Slovak banks pledged with Národná banka Slovenska. The assets most frequently used as collateral were those issued in Slovakia, which accounted for 90.5% of the total collateral value; assets issued in other euro

Chart 15 Use of eligible assets in 2011 (%)



Source: NBS.

Chart 16 Use of domestic and foreign eligible assets (%)



Source: NBS.

area countries saw their share of the total drop slightly from the levels of the previous two years. Government debt securities accounted for the vast majority (97%) of the collateral held in Slovakia, and the share of other asset types did not change significantly from the previous year. Slovak counterparties used a collateral pool to manage their collateral for monetary policy operations.

2.2 FOREIGN EXCHANGE OPERATIONS

Foreign exchange market operations

The euro was significantly more volatile in 2011 as a consequence of the public finance difficulties in several European countries and the United States. The euro appreciated markedly against the US dollar in the first half of 2011, rising from 1.30 USD/EUR in January to

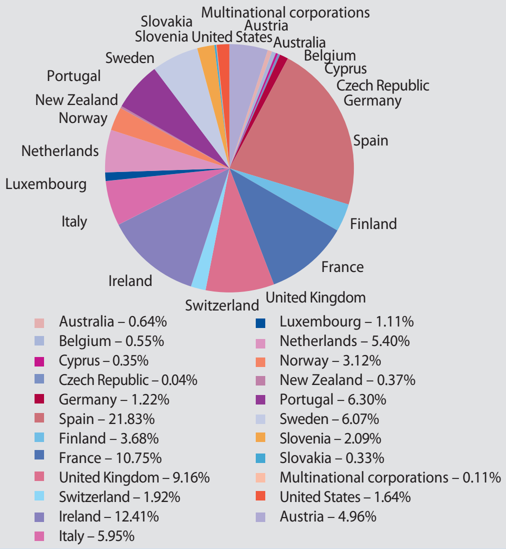
Chart 17 EUR/USD exchange rate in 2011

Source: Bloomberg.

Chart 18 Euro investment reserves managed by NBS in 2011 (EUR billions)

Source: NBS.

Chart 19 Euro investment portfolio – breakdown of investments by country of issuer



Source: NBS.

1.48 USD/EUR in May, its strongest level of the year. As problems mounted in the euro area, however, the exchange rate depreciated in the second half of 2011 and it ended December at 1.2939 USD/EUR.

Investment activities under investment reserves management

Národná banka Slovenska manages its investment reserves with the aim of ensuring that they make a positive contribution to its overall financial result. The total value of investment assets, at corresponding exchange rates and market prices, increased by 5.4% between the end of 2010 and the end of 2011 – from €12.9 billion to €13.6 billion. The NBS reserves are managed in accordance with the principles laid down in the NBS Investment Strategy approved in 2008. This means that interest rate risk in the euro investment portfolio is managed in a standard way through interest rate swaps and futures contracts. The return on this portfolio in 2011, after taking into account interest expenses and hedging, stood at 0.063% for 2011. As for the central bank's US dollar investment portfolio, it ended 2011 with a total value of €206.5 million, which, compared with the respective benchmark, represented a negative return of 0.42%.