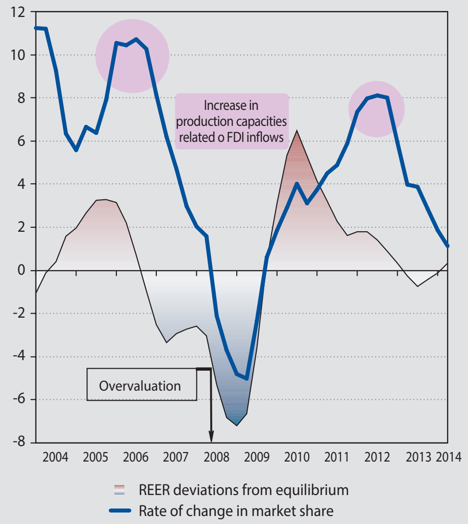
Nominal and real effective exchange rates[2]

The nominal effective exchange rate (NEER) index appreciated year-on-year by an average of 1.2% in 2014. The largest positive contribution to that figure was made by appreciation against the Czech koruna (0.8 p.p.), since the Czech central bank, Česká národní banka, used weakening of the exchange rate (close to CZK 27 to the euro) as a further instrument for easing monetary conditions. Weakening of the Russian rouble, related to the conflict in Ukraine, added 0.6 p.p. to the NEER's appreciation. There were negative contributions to the NEER from depreciation against the South Korean won (-0.3 p.p.) and against the pound sterling (-0.2 p.p.).

Despite the NEER's appreciation, the real effective exchange rate (REER) index based on unit labour costs in manufacturing depreciated by 0.1% (after appreciating by 1.1% in 2013). This was caused by the negative inflation differential against Slovakia's most significant trading partners. The most negative differentials were against Russia (-7.3 p.p.), the Czech Republic (-2.8 p.p.), the United States (-2.6 p.p.) and Hungary (-2.3 p.p.). Taking into account the weights of the trading partners, the differentials that had the largest impact on the REER's depreciation were those against the Czech Republic and Germany (in each case -0.4 p.p.), and Russia (-0.3 p.p.). The price competitiveness of domestic firms in 2014 may have continued to be supported by an undervalued REER, since equilibrium growth of labour productivity was higher in Slovakia than abroad, creating scope for sustainable moderate appreciation of the real exchange rate. The trend of increasing REER undervaluation observed in previous years came to a halt in 2014, as did the improving trend in Slovakia's trade balance. This may partly explain the decelerating rise in the share of Slovakia's exports in world trade.

Chart 11 Annual changes in the ULCM-based REER's deviation from equilibrium and the annual growth rate of market share (centred moving average for five quarters, p.p., and per cent)



Source: ECB, Eurostat, and NBS calculations.
Note: FDI – foreign direct investment.

2 Eurosystem monetary policy

2.1 Monetary policy operations

The European Central Bank (ECB) implements euro area monetary policy through national central banks (NCBs) using several standard monetary policy instruments: open market operations, standing facilities, and minimum reserve requirements. Open market operations consist of main refinancing operations (MROs), longer-term refinancing operations (LTROs), fine-tuning operations (FTOs), and structural operations (SOs). The standing facilities comprise the deposit facility (DF) and the marginal lending facility (MTF).

The divergence between the monetary policies of major world central banks became more pronounced during 2014. In the United States, the Federal Reserve concluded its asset purchase programme and sent signals of its intention to tighten monetary policy, whereas the ECB, amid falling prices and a lack of progress in boosting

2 The methodology of the effective exchange rate calculation is published on the NBS website at: http://www.nbs.sk/_img/Documents/_Statistika/VybrMakroUkaz/EER/NEER_REER_Metodika.pdf economic growth indicated its intention to further ease monetary policy.

The ECB was conducting open market operations throughout 2014 using the fixed rate full allotment policy. It decided to continue with this policy for as long as necessary, and at least until the end of the Eurosystem's reserve maintenance period ending in December 2016. The objective, as in previous years, was to ensure the stability of the euro area banking sector, with banks being able, as required, to utilise the ECB's liquidity-providing operations.

At its monetary policy meeting in June, the Governing Council (GC) of the ECB reduced the bank's key interest rates and, in addition, decided on a number of other measures. These included suspending the weekly fine-tuning operation sterilising the liquidity injected under the Securities Markets Programme (SMP), and stepping up preparatory work for outright purchases of euro-denominated assets. Furthermore, the GC decided to discontinue the Eurosystem's special-term refinancing operations (STROs) with a maturity of one maintenance period.

In pursuing the ECB's price stability mandate, the GC announced measures that would improve the monetary policy transmission mechanism by supporting lending to the real economy. At the June meeting, it decided to proceed with a series of targeted longer-term refinancing operations (TLTROs), in order to support bank lending to the euro area non-financial private sector, excluding loans to households for house purchase. The TLTROs are designed to ensure that the funding obtained is passed on, via bank lending activity, to end users, i.e. the final borrowers.

Under the first two LTROs, counterparties – commercial banks – were able to borrow, initially, 7% of the total amount of their loans to the euro area non-financial private sector, excluding loans to households for house purchase, outstanding on 30 April 2014. In these two initial tenders, conducted in September and December 2014, banks took up a cumulative €212 billion. In addition, in a further six TLTROs to be conducted over the course of 2015 and 2016, counterparties will be able to borrow, quarterly, up to three times the amount of their net lending to the euro area non-financial private sector, excluding loans to households for house purchase, provided between 30 April and the respective allotment reference date. Counterparties may participate in TLTROs either individually or as part of a group.

The interest rate on the TLTROs was fixed over the life of each operation, at the MRO rate prevailing at the time of take-up, plus a fixed spread of 10 basis points. Those counterparties that have not fulfilled certain conditions regarding the volume of their net lending to the real economy will be required to pay back borrowings in 2016, two years before the TLTROs mature.

The ECB decided to conduct, from October, a third euro-denominated covered bond purchase programme (CBPP3) – two years after the previous one – and, from November, an asset-backed securities purchase programme (ABSPP). By the year-end the purchases made under these two programmes, within euro area primary and secondary markets, amounted to €31 billion. The ABSPP is being conducted by external firms.

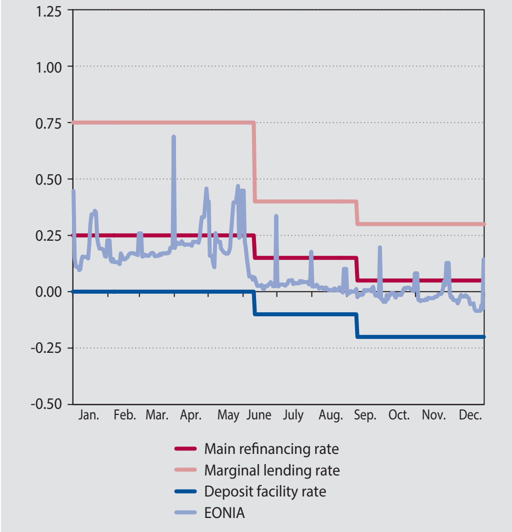
The two purchase programmes and the TLTROs are aimed at enhancing transmission of monetary policy and to support the provision of credit to the euro area economy. At the same time, they are expected to steer the ECB's balance sheet towards the dimensions it had at the beginning of 2012 and to return inflation to levels nearer the ECB's inflation target.

The banks that participated in two three-year LTROs in 2011 and 2012, each maturing in the first quarter of 2015, continued their gradual early repayment of these operations, and by the year-end 79% of the overall borrowings had been repaid (out of a total take-up of €1 trillion).

The euro area banking sector minimised its participation in US dollar liquidity-providing operations dating back to 2008. The ECB, in cooperation with the Bank of England, Bank of Japan and the Swiss National Bank, decided to cease conducting three-month US dollar liquidity-providing operations. The same operation with a one-week maturity continued to be conducted, and the ECB indicated that it would periodically assess the need for it.

In response to falling prices and weak economic recovery in the euro area, the ECB reduced its key interest rates on two occasions in 2014. At its monetary policy meeting in June, the Governing Council lowered the rate on the main refinancing operations by 10 basis points, to 0.15%, the rate on the marginal lending facility by 35 basis points, to 0.40%, and the rate on the deposit facility by 10 basis points, to -0.10%. For the first time in the history of the euro area, the ECB set a negative deposit facility rate. At September's meeting, the GC further reduced each of the three key rates by 10 basis points, setting the MRO rate at 0.05%, the MLF rate at 0.30%, and the DF rate at -0.20%.

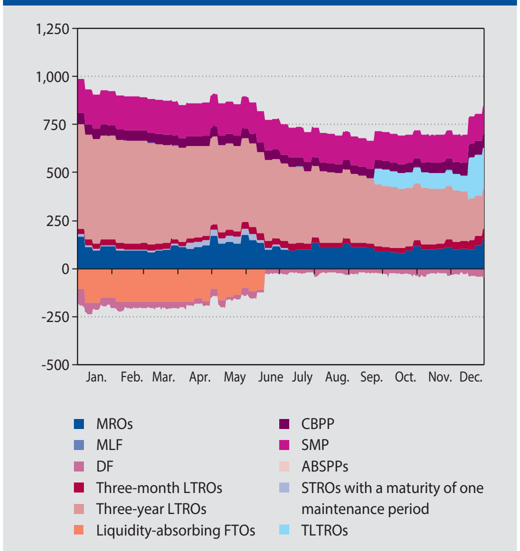
Chart 13 Key ECB interest rates and the EONIA (per cent per annum)



Source: Bloomberg.

The rate-cutting decision had a downward effect on unsecured money market rates in the euro area. In August the overnight EONIA rate moved to negative territory for the first time ever, and mostly remained there until the end of the year, when it stood at an all-time low of -0.085%. One-week and two-week EURIBOR rates also turned negative. The average size of overnight transactions fell in comparison with the previous year.

Chart 12 Eurosystem monetary policy operation in 2014 (EUR billions)

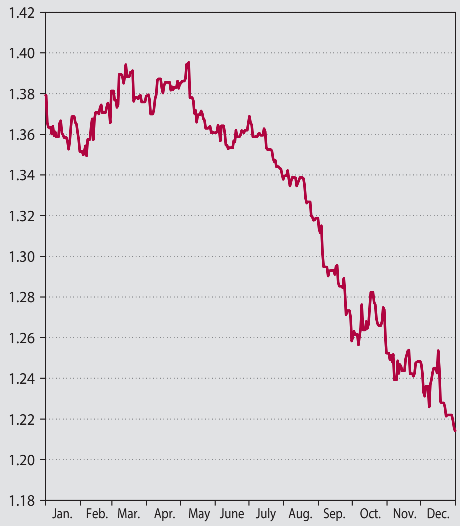


Source: ECB.
Note: MP STRO – special-term refinancing operation with a maturity of one maintenance period.

2.2 EURO DEVELOPMENTS

The euro was affected by several factors in the euro area, as well as by developments in the global economy and the monetary policy stances of major central banks. The situation was therefore heavily conditioned by the euro area's economic performance, as well as by oil price movements and tensions between Russia and Ukraine. The depreciation of the euro's exchange rate against the US dollar stemmed from ECB measures taken during the course of the year, the reduction of the deposit facility rate to negative levels, projections of slower economic growth in the euro area, expectations of quantitative easing in the euro area, political unrest in Greece, and geopolitical tensions associated with the crisis in Ukraine. Another contributing factor was the improving labour market situation in the United States, the outlook for accelerating US economic growth, and expectations of monetary policy

Chart 14 USD/EUR exchange rate in 2014



Source: Bloomberg.

tightening by the Federal Reserve. By the end of 2014 the euro was trading at USD 1.2141, its lowest level for 2.5 years and 12% weaker year-on-year.

3 Financial market developments

Developments in the external environment are important to the stability of the financial sector in Slovakia. Although the euro area economy improved moderately during 2014, it did so with limited impact on financial stability risks. The labour market situation picked up only slightly, while the euro area's disinflationary trend continued throughout the year. In response, the ECB has decided to embark on an asset purchase programme (also known as quantitative easing), which in conjunction with low oil prices and depreciation of the euro exchange rate is expected to benefit the economy going forward. The environment of weak economic growth and subdued inflation remains a significant risk, one that complicates the position of highly indebted countries. A second sizeable risk is the persisting search for yield, especially with regard to how increases in risk premia would affect the global financial system. These could be triggered by political developments in particular euro area countries, mounting geopolitical tensions, or movements in key US interest rates. On the positive side, Slovakia's economic growth was stable and relatively strong in 2014; nevertheless, a continuation of this trend will be contingent on stability in the euro area.

The potential for such adverse external risks to impair the stability of the Slovak financial sector remains mitigated by the strong position of its main pillar – the banking sector. In terms of solvency, profitability and access to funding, the banking sector in Slovakia is reporting better results than are its counterparts in most other EU countries. The sector's aggregate profit for 2014 was moderately higher year-on-year, at €560 million. Although a sharp drop in interest rates, mainly on loans to households, had a negative impact on profits, this was offset by lending growth and falling deposit costs. The aggregate capital ratio increased only slightly from the previous year, to 17.3%. It should be noted, however, that this stabilisation followed several years in which the capital ratio rose substantially.

The lending activity of domestic banks in 2014 remained marked by heterogeneity between the household and corporate sectors. Lending to the corporate sector recovered slightly after a long downward period, particularly in the second half