THE MONEY MARKET AND MONETARY POLICY IMPLEMENTATION IN 2002

Ing. Peter Andresič, National Bank of Slovakia

Monetary policy instruments

In 2002, monetary policy continued to be implemented with the help of the same monetary policy instruments as in the previous period. Monetary policy implementation through interest rate control focussed on two-week repo tenders and the provision of overnight refinancing and sterilisation facilities. Auctions in Central Bank (NBS) bills, held at relatively regular intervals during the year, remained a supplementary instrument. Other important monetary policy instruments, which, however, remained unused throughout the year under review, included so-called 'quick tenders', and/or individual transactions, enabling ad-hoc intervention in money market developments. In accordance with the Monetary Programme, the set of monetary policy instruments was modified to some extent, with the effect from 1 January 2002. The (unused) Lombard loan was cancelled and bills-of-exchange dealing (conducted at the discount rate with a limited amount) suspended. For the sake of continuity, the discount rate was set as an equivalent of the limit rate of NBS for two-week repo transactions with commercial banks. Among the changes, the situation on the money market was most affected by a cut in the ratio of required reserves, from 5% to 4%, and the consequent inflow of excess liquidity in the amount of Sk 5.7 billion.

Liquidity situation on the market

The excess of liquidity and the sterilisation nature of monetary policy persisted throughout the year. The volume of funds sterilised by the NBS almost doubled during the year, from roughly Sk 63 billion in January 2002 to more than Sk 135 billion at the end of the year. The greatest contribution to growth in the volume of sterilisation came from an inflow of funds from privatisation and/or increase in the holdings of foreign investors in enterprises and banks. The sterilisation position recorded a marked increase in August, due to the transfer of Sk 43 billion from the account of the National Property Fund (FNM) for debt servicing. A marked pro-liquidity effect was also exerted by the foreign exchange interventions of the NBS against undue appreciation of the Slovak currency, which increased the surplus of liquidity by Sk 24 billion in the last quarter.

Forms of individual instruments and their weights

Standard repo tenders

Of the monetary policy instruments of the NBS, standard two-week repo tenders maintained a dominant position in liquidity sterilisation throughout the year, culminating in August, with a weight exceeding 91%. During the year, 52 repo tenders were conducted in American style with a limit rate. The volume accepted at individual tenders fluctuated within a relatively wide range, from Sk 14.7 billion to Sk 61.2 billion. Interest rates achieved at the tenders fluctuated around the current limit rate, and deviated from its level by 2 to 5 base points as per normal. The NBS intervened in the results of tenders by curtailing demand only in exceptional cases, mainly when the banking sector as a whole overestimated its capacities in trying to deposit as much funds as possible at the NBS. Of the total number of tenders, the volume demanded was reduced in eight cases in accordance with the current liquidity situation in the sector.

Issues of NBS bills

The second largest share in sterilisation was maintained by issues of NBS bills, which were made at regular intervals. In total, 15 auctions were conducted for the portfolios of commercial banks. The standard maturity of this liquidity absorbing instrument was 12 weeks. Preference for longer-term sterilisation and the resulting weight of NBS bills were associated with the holdings of government securities in the portfolios of banks and, in particular, with the expectations of banks in respect of interest rate developments on the money market, and/or the financial market as a whole. This led to an increase in the contribution of NBS bills to sterilisation over the first quarter, due mainly to the limited amount of government bonds and similar securities in the portfolios of banks, to more than 26% of the applied instruments by the end of April. Subsequently, however, there were expectations of a further increase in interest rates and hence the share of this instrument fell to a level of 6% in August. A change in expectations in the second half of the year, especially in the last quarter, led to a revival of interest in long-term sterilisation, with the share of NBS bills increasing to 29% in December. At the auctions, the NBS accepted all the bids below or at the current limit rate for standard two-week repo tenders. Although the auctions were conducted without a formally set limit rate, the banking sector accepted this, and the NBS curtailed total demand only at two auctions.

Overnight facilities

Sterilisation and/or refinancing transactions with a maturity of one day, which were, in contrast with the previous two instruments, initiated by banks, represented the less significant instrument in terms of volume. Banks made use of the possibility of sterilising surplus funds by placing overnight deposits with the NBS, in the case of sudden and unpredicted inflows of liquidity, in periods between two standard tenders and/or issues of NBS bills. During a usual month, most overnight deposits are made towards the end of the month, when banks tend to replenish their minimum reserves in this way. Despite the persistence of a surplus in the banking sector throughout the year, banks also conducted overnight repo transactions for refinancing purposes on an individual basis. Such deals were conducted mainly when banks entered into longer-term investments and in the case of a short-term shortage of funds. The most intense drawing of credit from the NBS in this way may well be associated with the period of expected interest rate reduction, when banks markedly increased their participation in auctions in NBS bills, despite any need for short-term refinancing. Apart from such cases, which occurred mostly in June and October, overnight refinancing transactions were conducted only sporadically. In total, individual sterilisation and refinancing transactions accounted for less than 5.5% (the December maximum) and represented only a supplementary instrument to tenders and NBS bills. In terms of significance for the interbank market, however, overnight facilities played an essential role in the creation of a so-called 'corridor for interest rate fluctuation.'

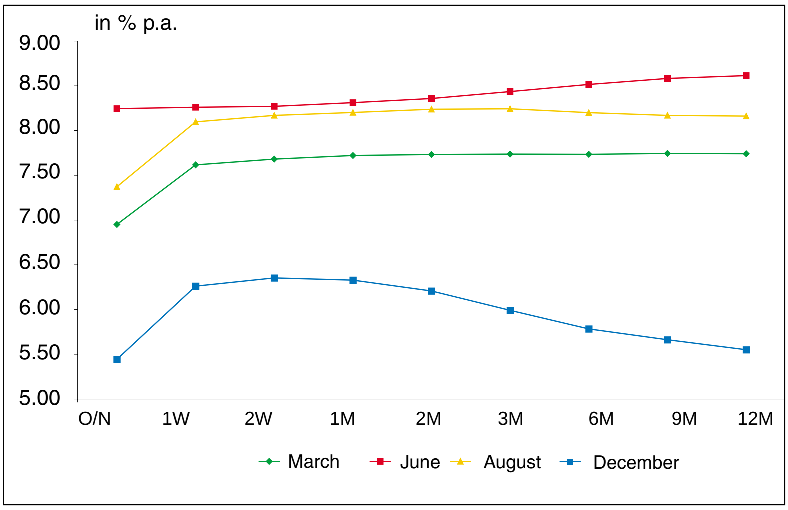
Developments in money market rates

During 2002, money market rates for maturities of up to one year fluctuated within this corridor, the upper limit of which was given by the rate for the refinancing facility and the lower by the rate for overnight deposits with the NBS. Paradoxically, an exception was represented by overnight rates, which exceeded the upper limit of the corridor on three occasions during the year. These short-term deviations (negligible in terms of interest) were caused mainly by banks lacking acceptable securities for conducting refinancing transactions with the NBS. The spread, i.e. difference between the upper and lower limits of the corridor, was left by the NBS at the level of three percent throughout the year. This relatively wide corridor for fluctuation was used mainly by short-term rates, especially rates for overnight transactions. These rates reacted most sensitively to changes in the current level of liquidity in the banking sector and still formed the most substantial part of transactions in interbank deposits. With regard to the excess of liquidity in the banking sector, interest rates fluctuated in the lower part of the corridor, close to the rate for overnight sterilisation transactions with the NBS.

Developments in rates for other maturities were determined by the limit rate for standard two-week repo tenders. Rates for one-week and two-week deposits were directly connected with the current level of the limit rate of the NBS, and/or with the results of sterilisation tenders. The level of rates exceeding the maturity of repo tenders, was affected by the expected changes in the limit rate to a greater extent than by its actual level. The anticipated developments in interest rates, which were mirrored in the shape of the money market rate curve, were derived by banks primarily from the values of basic economic indicators and the reaction of the NBS to the current trend in the exchange rate of the domestic currency. In this connection, an important part was played by the balance of trade. Other factors affecting interest levels (directly or indirectly), included developments related to the integration of Slovakia into the European and transatlantic structures, and in particular the results of elections in the current year.

With regard to the course of accession talks and the positive expectations in the post-election period (although there were no signs of improvement in the trade balance), the banking sector anticipated a gradual reduction in key interest rates during the year. These expectations were partly carried over the previous period. Due to long intra-coalition disputes affecting in the implementation of fiscal policy, banks adopted a cautious approach. The interest rate curve maintained, despite an initial fall in comparison with same period a year earlier, a balanced course over the first quarter. The risks involved in further macro-economic developments as a result of a potential loss of budget revenue and uncertainty about the use of privatisation proceeds, led to a rise in interest rates on the interbank market and the return of the interest rate curve to the initial level. The decision of the NBS to raise its key interest rates in April by 0.5% in response to these developments, had not been expected by the banking sector and caused a further rise in interest levels, to

Development of the interest rate curve in 2002



over 8%. The upward trend persisted until the middle of the year. In June, deposit rates recorded a yearly maximum and the average rates for 9-month and 1-year funds reached their highest values since the introduction of interest rate monitoring (June 2000). The interest curve followed a pronounced positive trend during that period and anticipated a further rise in interest levels.

The inflow of funds from the privatisation of SPP (Slovak Gas Industry) and their use caused a sudden increase in the surplus of liquidity at the beginning of the second half of the year. The attempt to make the best use of these funds by the banking sector brought the rise in interest rates to a halt and, during the following period, the level of interest rates was falling steadily. From August, the interest rate curve followed the opposite course, which became even more pronounced during the rest of the year. Further fall in interest levels was stimulated, first and foremost, by the results of parliamentary elections in September. The rate of fall accelerated as a result of appreciation in the domestic currency, caused by increased interest abroad in the Slovak koruna and the subsequent placement of Sk resources on the domestic market via swap operations.

Despite statements of concern by the NBS over the discrepancy between actual macro-economic developments and the appreciation of the koruna, however, the above trend continued. The growing interest in the domestic currency and the attempt to profit from the interest rate differentials between koruna and euro/dollar rates, pushed the interest level below 8% in October. The trend of further fall was supported by an improvement in the country's rating by Moody's in connection with the overall positive expectations after the general elections. This trend was also augmented by a change in the limit repo rate by the NBS, from 8.25% to 8.00%, representing the centre of the interest rate corridor formed by the rates for overnight facilities.

The trend of appreciation in the Slovak koruna with a direct downward effect on deposit rates, was not stopped by the negative trade results, nor by the verbal and subsequent direct interventions of the NBS vis-à-vis the koruna. A marked cut in all key interest rates (1.5%) in the middle of November in response to the actual developments, reduced the attractiveness of the interest rate differential between domestic and foreign rates. This change was fully reflected in interbank market rates, with the level of rates for the longest maturities falling below 6%. Interest rates remained at this level up to the end of the calendar year, while the yield curve continued to have a pronounced inverse shape, with a breaking point at funds with a maturity of three months. This shape was an indication of positive expectations of a further reduction in key NBS interest rates in the coming quarter.

Further development of the money market

The money market continued to develop positively throughout the year, especially the derivative market. A positive role was played by the connection between the domestic and foreign exchange markets as a result of a growth in faith in the domestic currency on the part of foreign entities. The market for currency swaps grew steadily and progress was also recorded in interest rate derivatives, forward rate agreements (FRA), and interest rate swaps (IRS). In line with the trend of development in these forms of trade, the share of deposit transactions (the base) decreased on the money market in percentage terms. At the beginning of the year, trading was dominated by transactions in deposits, but by the end of the year, their share had fallen below the level of 50%. This trend, which is a phenomenon accompanying money market development in the neighbouring transition economies as well, is expected to continue in the next period. A positive step towards improvement in the transparency of money market developments was also represented by the introduction of monitoring of the weighted average of overnight deposit rates, published as SKONIA (SKK OverNight Index Average) with effect from June 2002. It is highly probable that this rate, being a key indicator of the liquidity situation on the money market for central banks, will also be used in future for commercial purposes.