NÁRODNÁ BANKA SLOVENSKA
EUROSYSTÉM

CHAPTER 2

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

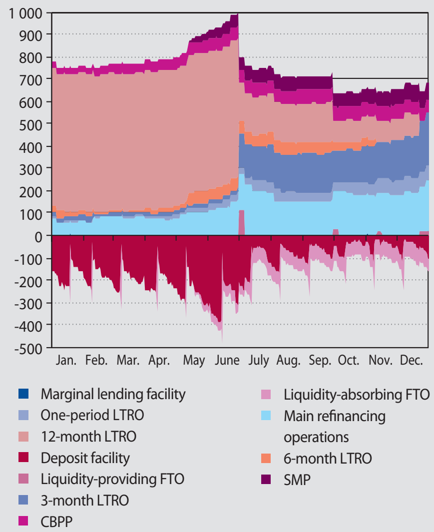
The European Central Bank (ECB) implements monetary policy through the respective national central banks (NCBs) of the Eurosystem. In doing so, it employs a range of instruments of which the most frequently used are the main refinancing operations (MRO), longer-term refinancing operations (LTROs), fine-tuning operations (FTOs), and standing facilities comprising the marginal deposit facility and marginal lending facility. During the financial crisis, the standard conduct of these operations was partly modified, in particular by the ECB broadening the maturity spectrum at which it offers refinancing operations and by introducing a fixed-rate tender procedure with full allotment. In 2010, the ECB gradually began to implement an exit strategy from these non-standard measures, firstly by discontinuing or not renewing six- and twelve-month LTROs and reducing the number of three-month operations to one per month.

The ECB's response to the financial crisis was not confined to euro liquidity-providing operations, but also included the introduction of liquidity-providing operations in US dollars and Swiss francs conducted through swap lines with, respectively, the Federal Reserve System and the Swiss National Bank. The swap line in Swiss francs was discontinued at the beginning of 2010 owing to the lack of demand from market participants, while the US dollar liquidity-providing swap line was conducted by the Eurosystem throughout 2010, even though the banking sector used it for only minimal amounts of refinancing.

In 2009, the Eurosystem sought to revive the securities market by using another non-standard instrument: the Covered Bond Purchase Programme (CBPP). Under the programme, the ECB together with the national central banks purchased bonds in the nominal value of €60 billion within a period of one year, i.e. by June 2010.

The beginning of 2010 saw the emergence of a new kind of problem in the European financial market, namely the excessive debt of certain euro area countries and the fact that these countries had difficulty to borrow in the capital market. Trading in government bonds issued by certain peripheral countries came to almost a complete standstill, as the supply of sovereign debt far exceeded the demand due to the higher borrowers' credit risk. This situation represented a threat to the financial stability of the euro area. In order to ease pressure on the capital market, the ECB in June 2010 introduced the Securities Markets Programme (SMP), under which it acts in cooperation with national central banks to purchase government bonds of selected countries. By the end of 2010, the value of securities purchases made under the programme amounted to €74 billion. To sterilise the liquidity provided through the SMP, a number of liquidity-absorbing operations were carried out. These ensured that the SMP had a neutral effect on the Eurosystem's monetary policy stance.

Chart 12 Eurosystem operations in 2010 (EUR billions)



Source: ECB.

The ECB did not make any changes to the monetary policy rate in 2010, maintaining it at the historically lowest level of 1.00%. Before the financial crisis, the EONIA moved very close to the key interest rate, but last year it remained below that rate and at the same time very close to lower bound of the corridor. This was due to the surplus liquidity that the banks had accumulated following the ECB's switch to a full-allotment procedure. During this period, however, the ECB did not discontinue the standard overnight fine-tuning operation conducted at the end of the reserve maintenance period to absorb excess liquidity. As a consequence there were short-term rises in the EONIA overnight interest rate at the end of each reserve maintenance period. As non-standard LTROs gradually matured, thereby reducing the excess liquidity in the banking sector, the overnight market rate became more volatile and more frequently approached the main monetary policy interest rate.

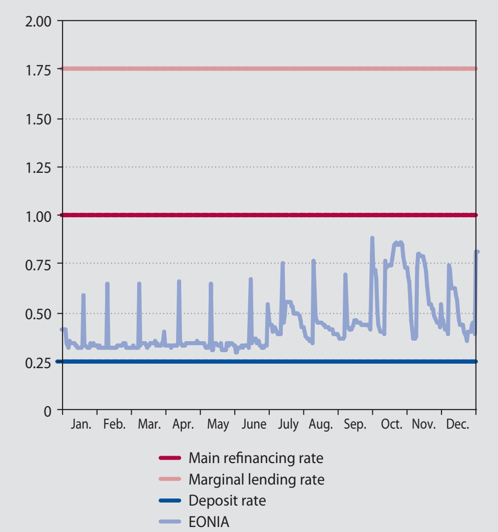
Minimum reserves

Under Eurosystem rules, all credit institutions operating in the euro area are required to hold a minimum amount of reserves with the respective national central bank (NCB). In 2010, 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. In 2010, the reserve ratio remained unchanged at 2% of the reserve base (a selected group of deposits and issued debt securities) and the average value of the reserve requirement was €686.34 million, which was around 7% lower than the average for 2009.

Eligible assets

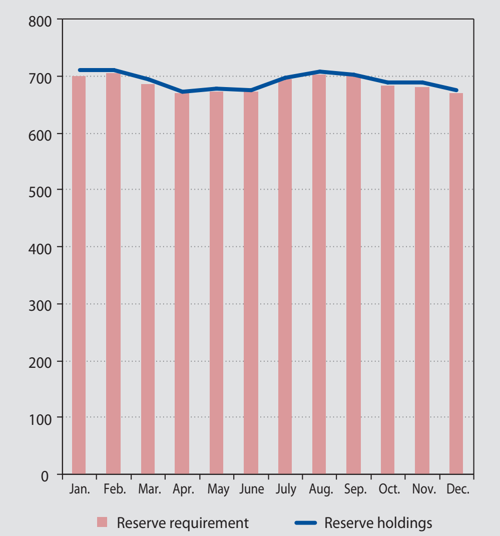
The conduct of Eurosystem monetary policy operations in 2010 continued to be marked by the consequences of the financial crisis, with the ECB and NCBs applying several non-standard measures concerning the eligibility assessment of assets which are accepted as collateral in Eurosystem credit operations or the subject of outright transactions. Certain temporary measures that had been introduced in the previous year and remained in force in 2010 had significant influence on the eligibility of assets used in Eurosystem monetary policy operations. Temporary measures pertaining to the eligible assets were: the acceptance of a lower credit rating in the credit risk assessment of assets, issuers or borrowers; the decision to accept non-euro denominated assets registered in EEA countries; to accept specific government bonds issued by G10 countries and registered outside the EEA, and the recognition of counterparties' deposit operations as collateral, although under the conditions of the Single List the assets in question comprise main-

Chart 13 Key ECB interest rates and the EONIA rate in 2010 (% p.a.)



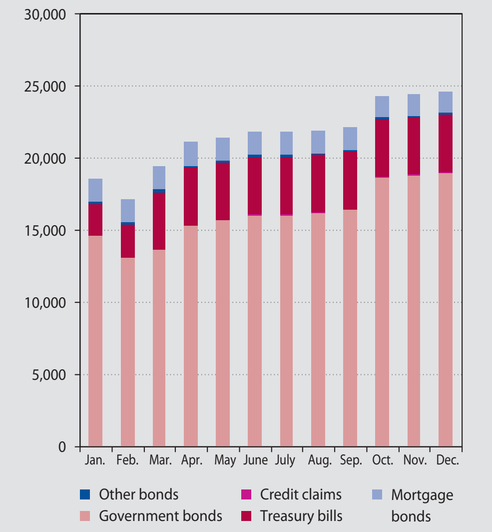
Source: ECB and Bloomberg.

Chart 14 Minimum reserves of Slovak banks in 2010 (EUR millions)



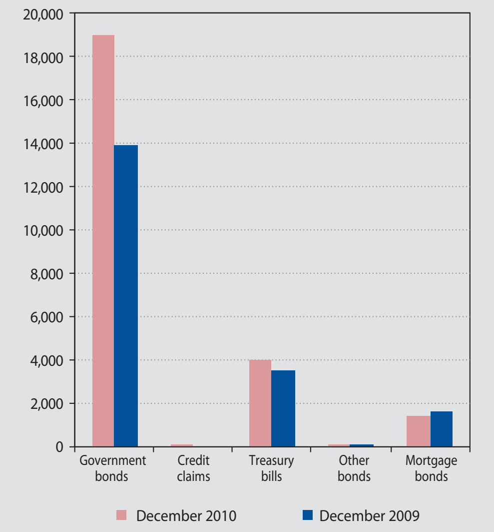
Source: NBS.

Chart 15 Structure of Slovak eligible assets in 2010 (EUR millions)



Source: NBS.

Chart 16 Slovak eligible assets – development of structure (EUR millions)



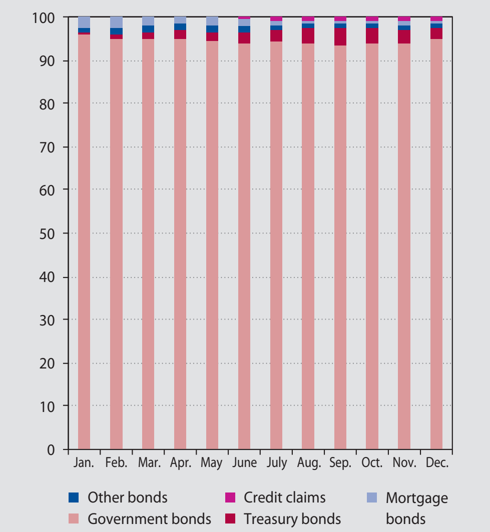
Source: NBS.

ly debt securities and credit claims. In response to financial markets being less liquid and to the unavailability of market prices of assets, it was decided to change the Eurosystem rules concerning the theoretical valuation of assets. The new system of valuation haircuts has been in force since January 2011.

Eligible debt securities issued and held in Slovakia and included in the Eurosystem's Single List had an overall value of €24,594 million at the end of last year. The structure of eligible assets was dominated by government securities, which represented approximately 94% of all debt instruments issued in Slovakia, followed by mortgage bonds issued by credit institutions. The rest of these securities comprised other types of bonds and credit claims of credit institutions on the non-financial sector of the economy.

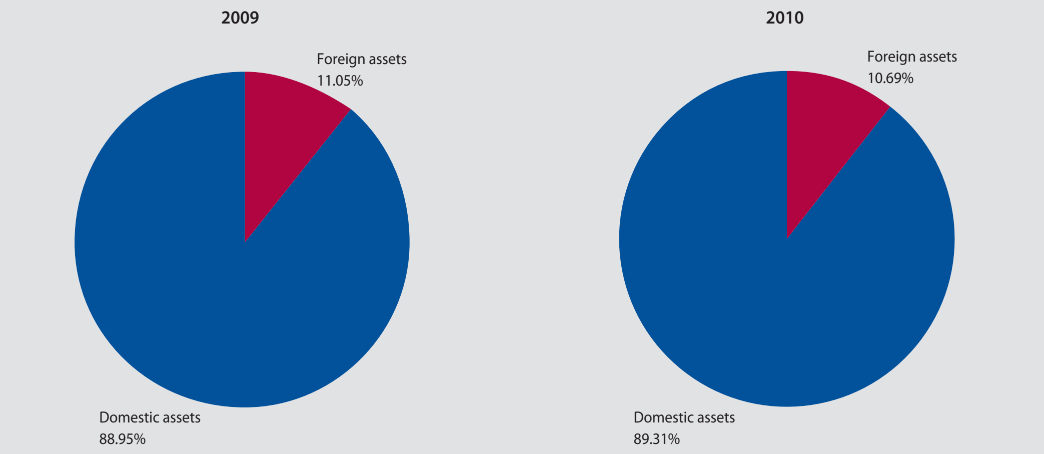
The value of collateral pledged by counterparties to pool accounts held by Národná banka Slovenska increased in 2010 due to the more active participation of Slovak counterparties in monetary operations, but also to the use of intraday credit in the TARGET-2SK payment system. In the previous year, as in 2009, the first year of Slovakia's membership of the Eurosystem, the pledged collateral consisted mainly of domestic debt securities; the assets issued in other euro area countries accounted only for 10.7 % of the pledged collateral. The assets most frequently used as collateral were government bonds, Treasury bills, covered bank bonds issued in accordance with the UCITS Directive, and other bonds issued by non-financial institutions. In contrast to 2009, credit claims were also used as collateral. In the monetary policy operations, Slovak counterparties used their collateral in a coordinated way, within the collateral pooling system.

Chart 17 Use of eligible assets in 2010 (%)



Source: NBS.

Chart 18 Use of domestic and foreign eligible assets (%)



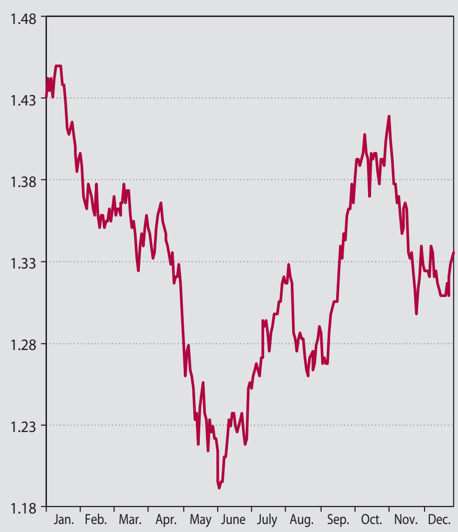
Source: NBS.

2.2 FOREIGN EXCHANGE OPERATIONS

Foreign exchange market operations

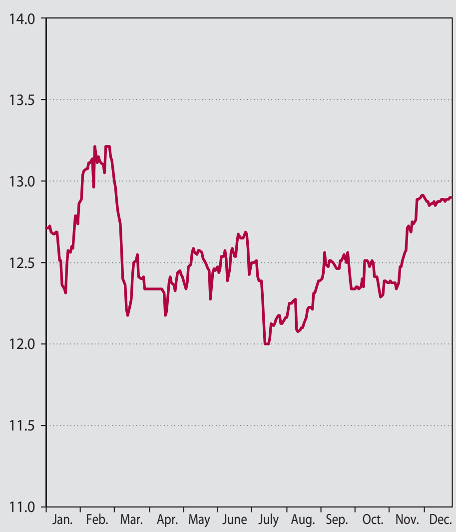
The euro showed greater volatility in 2010, as it reacted to the public finance problems facing certain European countries. The currency depreciated significantly in the first half of 2010, from its strongest level of the year in January (1.45 USD/EUR) to its weakest level of the year in June (1.19 USD/EUR). In the second half of the year, the euro fluctuated within this corridor with an appreciating tendency. The euro ended 2010 at 1.3362 USD/EUR, which in year-on-year terms represented a depreciation of 7% against the US dollar. The European Central Bank did not intervene on the foreign exchange market in 2010.

Chart 19 Euro-US dollar exchange rate in 2010



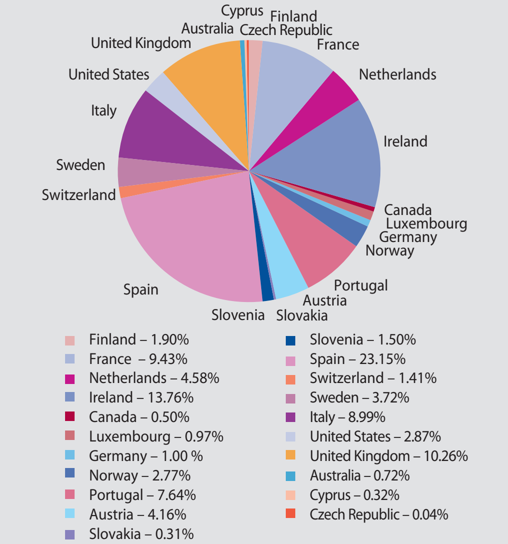
Source: Bloomberg.

Chart 20 Investment reserves under NBS management in 2010 (EUR billions)



Source: NBS.

Chart 21 Euro investment portfolio – breakdown by country



Source: NBS.

Investment activities under investment reserves management

In managing investment assets in 2010 (the second year of Slovakia's euro area membership), NBS continued, as in 2009, to apply the principles laid down in the NBS Investment Strategy approved in 2008. Following the euro adoption, the management of investment reserves at NBS consists of managing assets and liabilities so as to ensure that the balance makes a positive contribution to the central bank's performance over the long-term. The total value of investment assets, at the corresponding exchange rates and market prices, increased from €12.7 billion at the end of 2009 to €12.9 billion at the end of 2010. For the euro investment portfolio, the effective net return on investment reserves, less interest expenses, represented minus 4.0%, while for the US dollar investment portfolio it was 0.5%. Interest rate risk in the investment portfolios is managed in a standard way through interest rate swaps and futures contracts. In 2010, the overall return on investment reserves as calculated from the performance of individual portfolios was around minus €483 million.