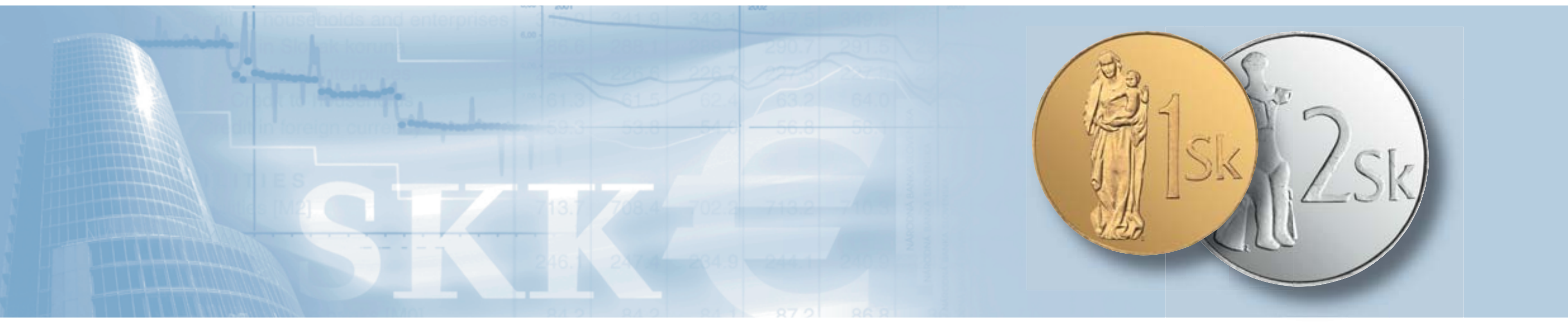
NBS Monetary Operations



3 NBS Monetary Operations, Foreign Exchange Operations and Investment Activities in Foreign Reserve Management

3.1 Monetary policy operations

The implementation of NBS monetary policy in 2006 was related to decisions taken by the NBS Bank Board in the previous year. The essential framework of NBS instruments comprised operations with banking institutions, namely operations on the open market (including the issuance of short-term securities) and standing facilities, the size and structure of which were subject to current developments in the liquidity of the Slovak banking sector. An anti-inflationary approach was accentuated, and had the most important effect on the NBS monetary policy decisions. Concerning foreign exchange operations, the NBS was looking to correct incidents of emerging and inappropriate volatility in the exchange rate of the Slovak koruna against the euro. It also sought to correct speculation-driven exchange rate movements, representing a deviation from the expected equilibrium level.

Liquidity management in the banking sector

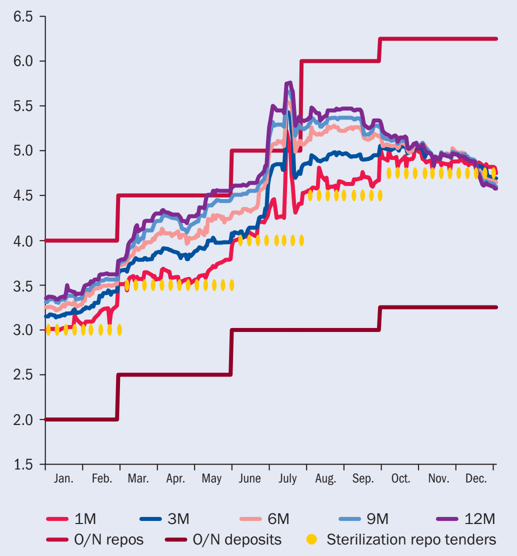
As in previous years, the banking sector's liquidity was quite ample during 2006. The average daily amount sterilized through monetary policy operations fell by SKK 53.1 billion in comparison with 2005, to stand at SKK 346.1 billion, and the conduct of monetary policy continued to have the same sterilization character. The overall liquidity surplus fluctuated during the year, largely due to foreign exchange interventions performed. Sales of euros in June and July, made against Slovak currency weakening, had the effect of reducing the average monthly sterilization position – from SKK 390.1 billion in January, the figure was down to SKK 288.2 billion in August and shrank further by the end of the year to stand at SKK 279.7 billion in December.

Main monetary policy operations

In 2006, standard sterilization repo tenders continued to be the main monetary policy operations. This instrument's share of total sterilization positions fluctuated above 90% for most of the year. As in the previous period, sterilization repo tenders were held on a regular weekly basis and their 14-day maturity period likewise remained unchanged. A total of 52 sterilization repo tenders were held during the year, and in each of them the NBS accepted the full demand. In all cases, the average interest rate matched the NBS current interest rate limit for repo tenders. Amid monetary policy tightening, this key rate was raised by the NBS Bank Board several times during the course of the year. After starting out at 3%, it underwent four adjustments to stand at 4.75%. The banking sector automatically passed on the key rate increments to money market rates. Under the effect of interest rate movements, as well as persisting expectations for further rate hikes, the money market curve was steadily moving up, except at the year-end. The appearance of an inversion curve at the end of

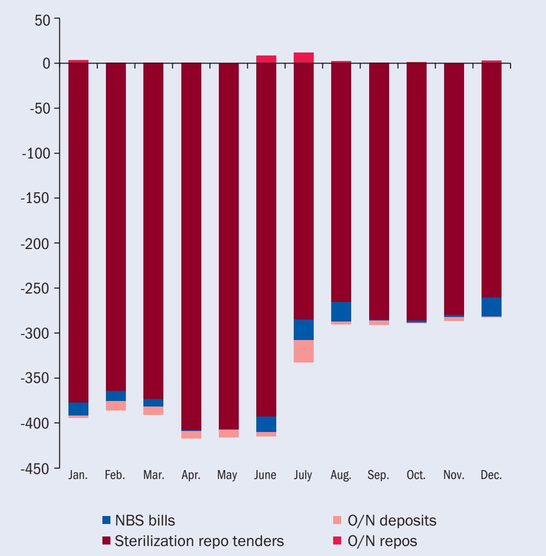
Chart 63 **BRIBOR in 2006**

(% p. a.)



Source: NBS.

Chart 64 **Open market operations in 2006 by type (monthly average) (SKK billion)**



Source: NBS.

the year reflected shifting anticipation of the further development of interest rate expectations.

Longer-term operations

Regular auctions of NBS bills were a supplementary monetary instrument that NBS also used during the course of 2006. There were a total of 13 auctions with a standard 84-day maturity. Demand in the auctions was affected by expectations for a gradual rise in NBS key rates. The application of the same limit rate to this three-month monetary instrument as to two-week sterilization repo tenders was reflected in the relatively low interest as well as in the demand accepted. That was why this type of longer-term sterilization of funds declined as a proportion over the year, to below one per cent. By the end of the year, the banking sector had reviewed and adjusted its expectations for the NBS key rates to reflect current macroeconomic developments as well as the continuing appreciation trend of the Slovak koruna. While it was expected to see the NBS key rates unchanged in the near term, the banking sector counted on rate cuts in the long run. As a result, the last auction of 2006 attracted higher interest, but although the accepted demand exceeded SKK 36 billion, it did not materially affect the share of NBS bills in the overall sterilization position in 2006.

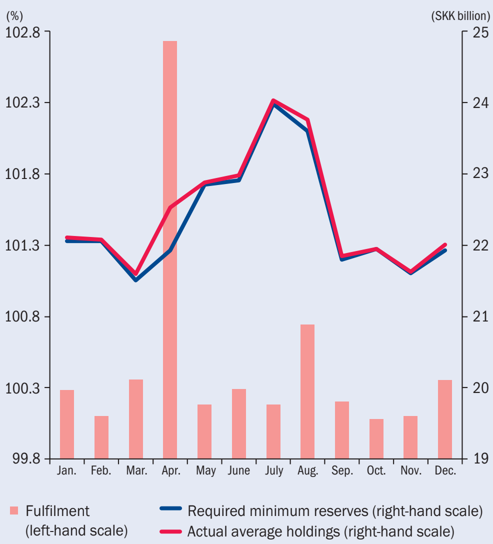
Standing facilities

Standing facilities, which take the form of deposits with the NBS, if there is excess liquidity, or repo transactions, if liquidity is insufficient, were used by banks in 2006 to adjust their current liquidity position. Both forms were applied in a standard way with a one-day maturity. Standing facilities were typically used at times when the banking sector, participating in main monetary operations, incorrectly estimated its total available funds. Towards the end of months, especially on the last days, banks's recourse to these facilities accelerated, in the effort to adjust their positions so as to meet the minimum reserve requirements. Since sterilization was a principal feature of monetary policy, it was also predominant within standing facilities. Nevertheless, the banking sector found itself at several times making more intensive use of overnight credit. Banks were also drawing intra-day credit during the course of the year. In comparison with standing facilities, this method was used only to ensure smooth operation of the payment system and did not have any monetary effects.

Minimum reserve system

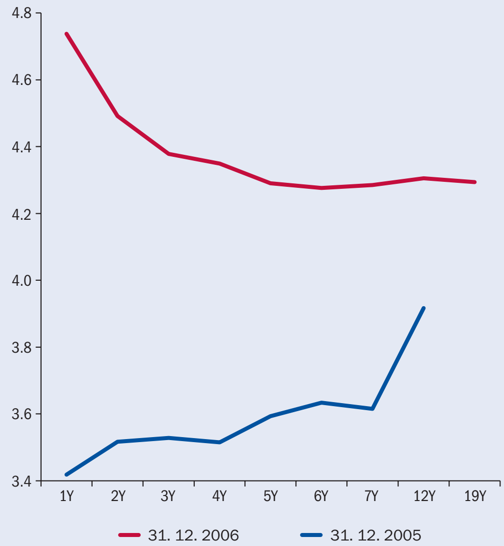
In Slovakia, the requirement to create and maintain minimum reserves applies to banks, branches of foreign banks and electronic money institutions. Besides influencing interest rates on the domestic money market, required minimum reserves also provide for the short-term liquidity of banking entities. A total of 17 banks and 7 branches of foreign banks held minimum reserves in 2006. Among the branches of foreign banks, one conducted banking activities under a licence issued by the NBS and six did so under a single banking licence applicable throughout the European Union and issued in the home Member State of the parent company. The conditions for minimum reserve system remained unchanged in 2006: a minimum reserve ratio of 2% of specific liability items, a period of one calendar month, and interest at a fixed rate of 1.5%. Ahead of euro area entry, the NBS is required to bring the national minimum reserve system into line with that applied in the euro area. Changes will concern, for example, the monitoring period for minimum reserve maintenance, with the length to be determined according to the meetings schedule of the ECB General Council. Moreover, the fixed interest on minimum reserves (remuneration) will be replaced with a variable rate derived from the ECB's interest rate. The value of required minimum reserves showed a rising trend during the first half of 2006 and increased by an average of SKK 1.9 billion. The trend reversed in the second half of the year and the value of required reserves decreased on average by SKK 2 billion. The actual fulfilment of the minimum reserve requirement for the banking sector as a whole was balanced in 2006, with the exception of April. Amid a marked excess of liquidity in the banking sector and continuing absorption of liquidity by NBS interventions, the total minimum reserve requirement was met in each month of the year.

Chart 65 **Required minimum reserves in 2006**



Source: NBS.

Chart 66 **Benchmark yield curve of government bonds** **(in % p. a.)**



Source: NBS.

Risk management

In 2006 NBS continued to apply the risk management system which it had introduced in 2005. It is still in the process of harmonizing this system with the principles applied in the euro area, prior to entry into the same. That is why the conditions for selecting counterparties, and for selecting financial assets, which the NBS accepts in monetary policy operations are set out in NBS decisions. These eligible financial assets are valued at market or theoretical prices on a daily basis. The system of financial asset valuation also includes haircuts, monitored and adjusted by the NBS on the basis of developments in financial asset prices in domestic financial markets. Since the conditions for using the "Single List" (of assets eligible for Eurosystem monetary policy operations) in its entirety require not only the mentioned selection of assets but also supplementation of the legal framework related to financial assets, as well as intensive communication between the NBS and ECB or other central banks, the NBS at the end of 2006 began to work on targeted preparations for these needs, including the automation of the respective procedures. Banks and other financial institutions are to be informed about these conditions by the NBS in the run up to euro area entry.

Benchmark bond yield curve

In 2006 the NBS continued to coordinate the quotation of prices for benchmark government bond portfolios traded by banks and to create the related yield curve. The NBS monitored the benchmark portfolio structure on a continuous basis and updated it in cooperation with the banks. The benchmark portfolio of securities was last updated in November 2006, the aim being to broaden the term structure of the quoted government bonds. One of the criteria for the inclusion of a bond in the benchmark portfolio is a minimum issue amount of SKK 5.0 billion. At present, the portfolio includes bonds with a maturity of 1 to 7 years as well as 12-year and 19-year bonds. The prices are set by the daily processing of quotations given by eight banks active in the market, and they are published on the Reuters system. Like banks, the NBS uses indicative benchmark curve prices for the theoretical valuation of financial assets.

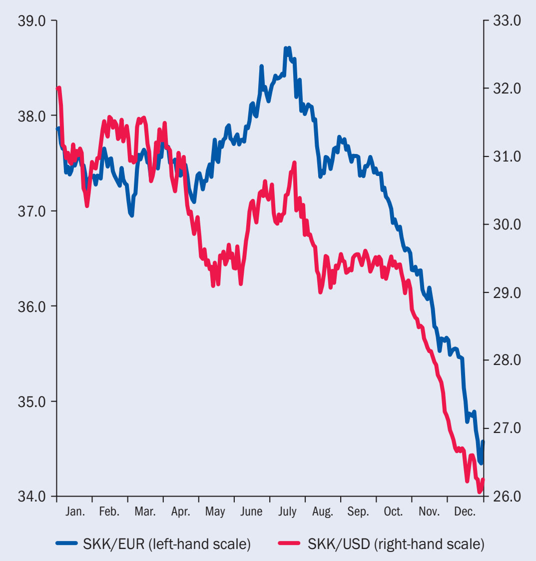
Government bond yields in 2006 were affected mainly by changes in the NBS key interest rate, expectations for these changes, and the exchange rate of the Slovak koruna. After the parliamentary elections, however, these yields were briefly, but markedly, influenced by the domestic political situation. It was mainly the yields on shorter maturities that were affected when the NBS raised key rates four times, as a result of which the yield curve's standard slope flattened out or evened. Following the last of the key rate increases, the yield curve acquired a distinct inversion.

3.2 Foreign exchange operations

Foreign exchange market operations

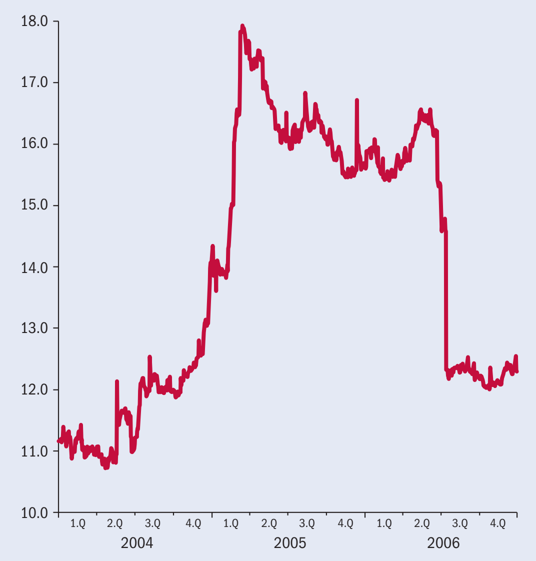
During 2006, the exchange rate of the Slovak koruna against the euro appreciated by 8.65% (from SKK/EUR 37.848 at 31 December 2005, to SKK/EUR 34.573

Chart 67 **Exchange rates of the Slovak koruna against the euro and dollar in 2006**



Source: NBS.

Chart 68 **Foreign reserve assets managed by the NBS (USD billion)**



Source: NBS.

at 31 December 2006). The average exchange rate was SKK/EUR 37.248, representing an appreciation of 3.5% in comparison with 2005. Against the US dollar in 2006, the koruna's exchange rate strengthened by 17.85% (from SKK/USD 31.948 at 31 December 2005, to SKK/USD 26.246 at 31 December 2006). The average exchange rate was SKK/USD 29.724, representing an appreciation of 4.2% year-on-year. The exchange rate of the Slovak koruna against the Czech koruna strengthened by 4%.

In regard to the Slovak koruna's strong volatility, the NBS made several foreign exchange interventions in 2006. As a result of the premature demise of the coalition-led government, and especially the pre-election uncertainty which this gave rise to, as well as the increased aversion of investors to the currencies of emerging markets, the Slovak koruna lost value and the NBS reacted with foreign exchange interventions aimed against its weakening. During the interventions on 21 June, 29 June and 12 July, the NBS sold EUR 3,085 million. The last of these was the largest single-day intervention in Slovakia's history, with the NBS selling EUR 1,750 million. In view of the relatively high amount of foreign exchange funds sold from the NBS foreign reserve assets, there was speculation about whether the central bank had the ability to defend the koruna against any further depreciation. In the second half of the year, however, investors returned to emerging market currencies and the koruna began to show stable appreciation, gaining an average of 2 percentage points per month and finishing the year at its strongest ever level. The koruna appreciated most sharply during December, when it deviated by 11.43% from its central parity. In order to dampen the koruna's volatility, the NBS made another intervention on 29 December, entering the market when the currency was at its strongest level of the year: SKK/EUR 34.060. The NBS purchased EUR 495 million to curb the koruna's appreciation, and so in the net balance of foreign exchange interventions in 2006 it sold EUR 2.59 billion.

Investment activities in foreign reserve management

In 2006, as in the previous two years, the NBS conducted investment policy for foreign reserve management in accordance with the rules set out in the long-term investment strategy that it approved in 2004. Last year, as part of an active approach to foreign reserve management, the NBS began trading in futures contracts, both for the dollar investment portfolio and for the euro investment portfolio. In regard to the Slovak koruna's considerable exchange rate volatility against the euro during 2006, the corrective interventions made in response affected both the total value of foreign reserve assets and the values of individual portfolios. The value of foreign reserve assets at the respective exchange rates and market prices fell from USD 15.5 billion at the end of 2005 to USD 13.4 billion at the end of 2006. The return on foreign reserves represented 1.8% for the euro investment portfolio and 4.4% for the dollar investment portfolio. The total interest income from foreign reserve management in 2006 was approximately SKK 9.6 billion.