Comparison of the current performance of NBS monetary policy with the performance after the euro adoption in Slovakia

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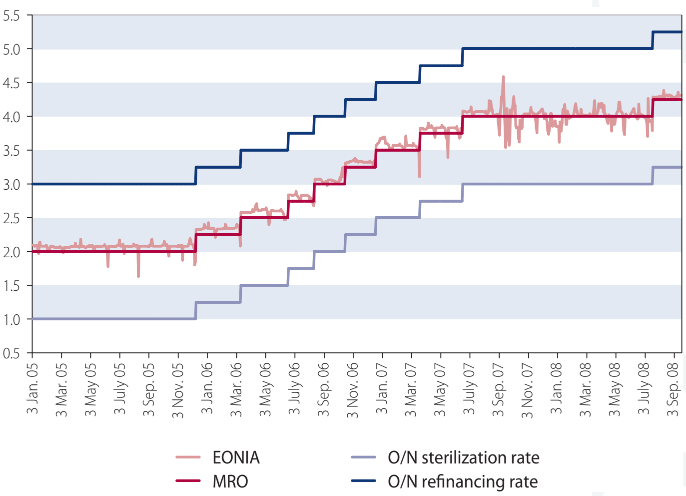
A positive rating by European institutions concluded a long-term process of fulfilling the criteria of Slovakia's eligibility for entering the euro area. The subsequent fixing of the conversion rate of Slovak koruna against the euro commenced the final stage of preparations for the euro changeover. Although the adoption of a single currency will be the most tangible change for the public, changes also await the financial sector as a whole, including the National Bank of Slovakia. As we all know, national central banks lose their competences in the monetary policy decision making at the time of entering a monetary union. In the case of the euro area, all competences in the monetary policy will be transferred to the European Central Bank and the National Bank of Slovakia will remain the local executor of monetary policy.

The National Bank of Slovakia (NBS) has been determining and executing the monetary policy in Slovakia since 1993. It will carry out an independent monetary policy until 31 December 2008 and since this time it will start executing monetary policy determined by the European Central Bank. NBS will thus conduct tasks set by Europe's central bank. Although the currently defined target of the NBS is the same as that of the ECB, i.e. shortly said to maintain the price stability close to 2% in the medium-term horizon, there are some different views as to how to reach that target.

The NBS has currently no set operational target of the monetary policy. On the contrary, the ECB applies its instruments and procedures for liquidity management, aiming at stabilizing interest rates of the financial market. Its operational target is EONIA, an overnight interest rate of the European money market. The ECB tries to minimize its volatility by managing liquidity in the banking sector. Thus its relative stability not only acts as a stabilizer for other maturities but also lowers the risk of a fluctuation in the price of overnight deposits, making the market more efficient. The National Bank of Slovakia does not manage liquidity (the volume of liquid funds available to banks) as a part of its monetary policy procedures and banks are left to evaluate their liquidity needs using their own estimates. This procedure is justified due to the fact that the Slovak banking sector has a continuous surplus of liquidity compared to the European banking sector whose liquidity is insufficient in the long term. From this point of view, the Slovak banking sector has a more favourable position than the European sector. However, it is often the case that domestic banks have either too many or too little funds in the short term, which automatically causes significant fluctuations in the overnight (O/N) BRIBOR. In spite of that, the NBS managed to fulfil the inflation Maastricht criterion and to significantly lower the inflation in Slovakia. The maintenance of price stability is most likely a result of several agents, implying the absence of an operational framework in Slovakia is not an important factor.

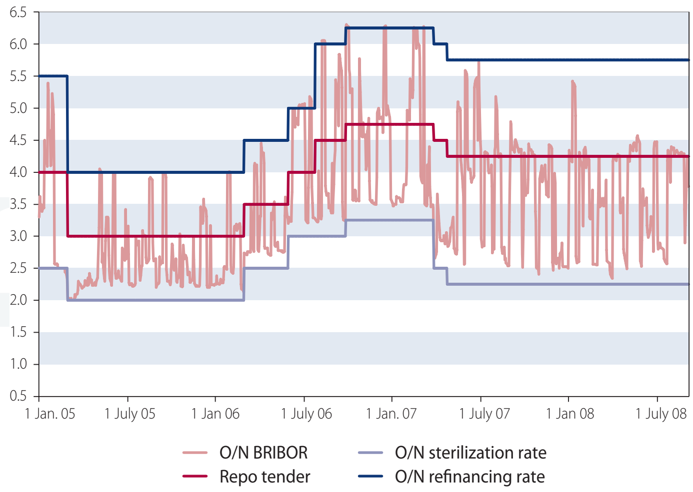
The fundamental difference between Slovakia and the euro area is that while the Slovak banking

Chart 1 EONIA (% p. a.)



Source: www.euribor.org, ECB.

Chart 2 BRIBOR (% p. a.)



Source: NBS.

sector has a long-term structural liquidity surplus and the NBS absorbs these funds from the sector, the euro area banking sector has a long-term structural liquidity deficit and the ECB refinances it using its instruments. The NBS sterilization position is currently amounting to about SKK 370 billion, roughly equivalent to EUR 12 billion.

The ECB provides the European banks with the funds in the amount of approximately EUR 470 billion. Since the European market rates are currently at higher levels compared to Slovak market rates, it is assumed that after the adoption of euro in Slovakia, banks will place their surplus of funds in the euro area very fast and very easily, thus dissolving the Slovak surplus.

Both the National Bank of Slovakia and the European Central Bank are currently using official rates, open market operations, automatic operations and minimum reserves to achieve their monetary policy targets, however, in different system environments.

Official rates

The NBS sets three key rates in its transactions, namely the limit rate for two-week REPO tenders that absorb the most of the liquidity surplus from the sector, together with the interest rate for overnight refinancing and sterilization transactions. The spread between these overnight rates is currently asymmetrical, at the level of 3.5%. In other words, the bottom limit of the corridor may be calculated as the REPO limit rate less 2 percentage points and the top limit of the corridor as the REPO limit rate plus 1.5 percentage points.

The ECB has a similar structure of key rates, with the most important one being the minimum rate for the main one-week refinancing operations. The aim is to bring the EONIA overnight market rate close to this reference rate. The top and bottom limits for the fluctuation of EONIA constitute the interest rate for overnight marginal lending facility and deposits facility, respectively. The spread between these two rates is symmetrical, 2%, i.e. one percentage point above and one percentage point below the key rate for one-week refinancing operations. However, the EONIA has not yet come near these limits due to its relatively high stability near the level of the key one-week rate.

As at 1 January 2009, NBS key rates will be replaced by ECB key rates.

Open market operations

Open market operations are based on central bank's initiative in the conditions of both the NBS and the ECB. The structure of the open market operations is also similar in both banks, differing, however, in their essence. The NBS uses these operations to absorb liquidity surplus and the ECB provides loans in order to refinance the banking sector's liquidity needs.

The main instrument of the NBS is a standard REPO tender carried out every Tuesday[1], while the settlement takes place on Wednesday with a two-week maturity. It is conducted in the form of an American auction with maximum interest rates for two-week REPO tenders. Each financial institution eligible for trading with the NBS is allowed to submit no more than three bids, specifying three interest rate levels and the volume for each interest rate level. The National Bank of Slovakia provides collateral for such trades, currently in the form of the NBS bills (PP NBS).

The issuance of PP NBS is the NBS's long-term means of absorbing liquidity from the sector, taking place once a month under standard conditions, on Thursday, while settlement takes place on Friday and has a three-month maturity. In practice, these transactions are also carried out using the key rate for two-week REPO tenders. The auction of PP NBS is conducted in a similar manner as REPO tenders. NBS currently absorbs approximately 78% of liquidity surplus by means of two-week REPO tenders, while the remaining 21% are placed in the PP NBS.

The ECB open market operations include the main refinancing operations (MRO[2]). They are carried out according to an indicative calendar[3], normally every Tuesday with settlement on Wednesday and a one-week maturity. Since this is a refinancing transaction, the minimum interest rate is the key ECB's rate for main refinancing operations. Each counterparty may submit a maximum of ten bids whereas one bid represents a certain level of the interest rate and the volume which the counterparty intends to acquire for this rate.

For an additional provision of liquidity, the ECB uses long-term refinancing operations (LTRO[4]) that are carried out in a similar manner as the MROs. They are likewise conducted on the basis of an indicative calendar, i.e. each Wednesday of the last week of the calendar month, with settlement on Thursday and a three-month maturity. Counterparties are allowed to submit ten bids, with no limitations to the interest rate.

Prior to August 2007, i.e. when the problems on mortgage markets had arisen, ECB had been placing around 70% of funds via MRO into the

1 Under standard circumstances. In case of a public holiday, the realization of trades is postponed to the first business day before Tuesday.
2 Main Refinancing Operation.
3 Published in advance by the ECB on www.ecb.int.
4 Long-Term Refinancing Operation.

banking sector, while the remaining 30% were refinanced using the LTRO. Due to the transfer of disturbances into the European market, banks became reluctant to lend money each other, causing an increase in the rates of all maturities on the European money market. For this reason, in an effort to prevent growth in market rates around a three-month maturity, the ECB increased the frequency of conducting LTROs to twice a month. Consequently, the structure of the refinancing position has changed and the LTROs acquired a higher, around 60% share of delivering funds into the sector. The European Central Bank currently uses the MRO to inject around 40% of funds to the banking sector.

The ECB, in order to limit an increase in market rates with longer maturities, also introduced further supplementary operations such as LTROs with a six-month maturity as well as the provision of USD-denominated funds with a maturity of 28 or 84 days.

Another currently used instrument are fine-tuning operations conducted with non-standardized periodicity and with non-standardized maturities. They are used to smooth any unexpected fluctuations of liquidity that cause higher deviation of EONIA from the key rate for MRO.

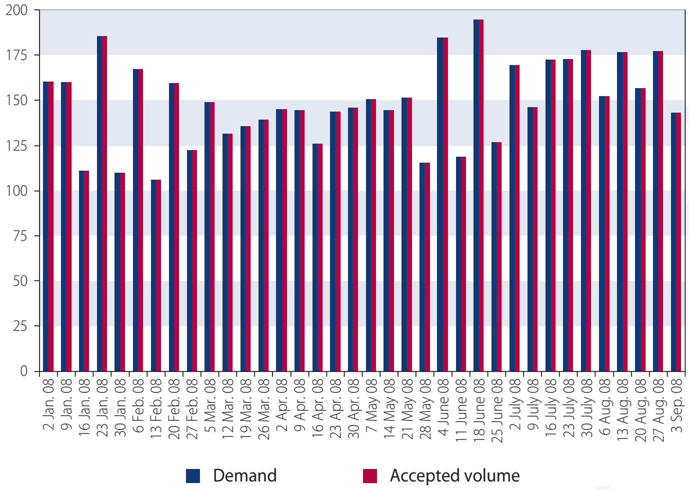
Every refinancing operation that the ECB provides to the counterparty has to be collateralized by acceptable assets. As a standard, transactions are carried out as reverse transactions, either as a purchase or sale of acceptable securities with a repurchase agreement or as provision of a loan with a securing transfer of acceptable securities. The particular technical specifications are determined by national central banks, i.e. the means by which these transactions are carried out in Slovakia are specified by the National Bank of Slovakia.

It is important to point out that each counterparty eligible to participate in open market operations may use them only through the national central bank of the country of its registered office. In other words, a bank based in Slovakia may not sign up for a tender through e.g. the Austrian central bank but only through the National Bank of Slovakia. In order to participate in open market operations, an institution must be subject to a minimum reserve requirement system, moreover it must be financially strong and meet all operational requirements.

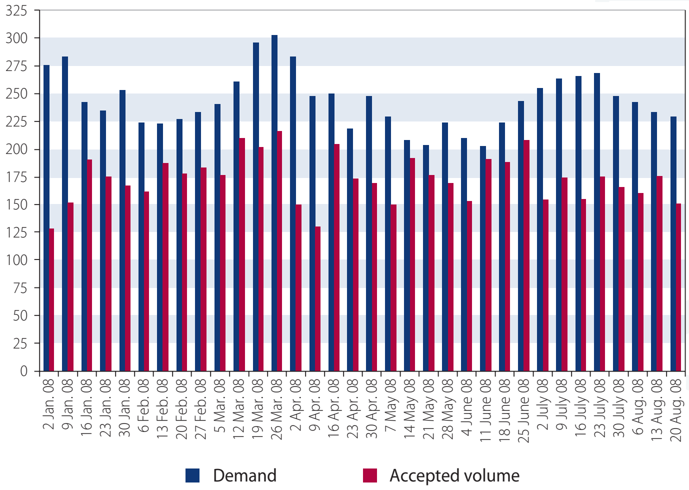
The following example demonstrates the actual allocation within the tenders. A commercial bank with its registered office in Slovakia sends its bids to the National Bank of Slovakia. The NBS sums up the total volume requested by all banks and reports it to the ECB. The European Central Bank sums up the total requested volume of funds of the individual national central banks of the Eurosystem. Using its own forecast, it determines the amount of liquidity that the banking sector will need during the upcoming week after taking into account minimum reserves requirements and autonomous factors. Then it decides on the total volume of funds provided to the

Chart 3 Comparison of demand and acceptable volume in major operations of the NBS and the ECB

Two-week NBS sterilisation tenders (SKK billion)



One-week ECB refinancing tenders (EUR billion)



Source: NBS, ECB.

market. Once the requested volume exceeds the volume that the ECB intends to place in the market, demand will be satisfied only partially. As the auctions are normally conducted in the form of an American auction, the first demands to be satisfied are those with the highest interest rates up to the interest rates where the cut occurs. This rate is simultaneously the marginal rate for the given operation. The allocation of funds to counterparties that were successful in the auction, takes place at the national level. In other words, the National Bank of Slovakia provides liquidity to the Slovak banking sector as per the instructions it receives from the ECB.

At present, under standard conditions, the NBS accepts the entire bids of counterparties in standard REPO tenders. Since they know that most likely they will succeed with the full demand, they have to consider for themselves the demand they present. On the contrary, the ECB predicts the liquidity that the banking sector will need in the coming week and on the basis of this forecast decides on the volume of funds it will place in the market so as to keep the EONIA at a stable level. Where the forecast is not accurate and the sector has a surplus or shortage of resources and is putting noticeable pressure on fluctuations in the EONIA, the ECB may conduct fine-tuning operations. These operations add liquidity where it is the lack and absorb excess liquidity from the banking sector, both of which stabilizes the EONIA.

The Eurosystem currently uses the above instruments. Apart from these it has other instruments in its portfolio[5], the structural transactions, which together with the fine-tuning operations may be carried out by another type of transactions such as reverse transactions, foreign exchange swaps, outright transactions, issuance of debt certificates and collection of fixed-term deposits. However, the ECB uses these instruments very rarely and some of them have not been used at all yet. When carrying out certain transactions it may use three types of procedures, namely standard tenders (whose duration is maximum 24 hours from their announcement until the result publishing), quick tenders (max. 90 minutes) or bilateral procedures (unspecified). The ECB has full power of decision as to the type of operation, type of transaction, maturity and procedures – local national central banks act only as executors of its decisions.

5 For more information on the monetary policy operations of the Eurosystem see the ECB publication Execution of Monetary Policy in the Euro Area, September2006. www.nbs.sk.

Automatic operations

If a commercial bank has shortage or surplus of funds on a daily basis, it may use automatic operations. These transactions have a very similar characteristic in both central banks. They are carried out on the initiative of a commercial bank, have a one-day maturity and are used either as refinancing or sterilisation transactions. Refinancing transactions have to be collateralized by the commercial bank. Automatic operations are conducted in a way where the commercial bank arranges the transaction directly with the NBS. The procedure of these transactions will remain similar after entering the euro area – a commercial bank based in Slovakia will continue to contact the NBS which will either provide it with a loan or accept a deposit. NBS will do this without any consultation with the ECB, which means that automatic operations will continue to be carried out at the national level. There are no limits to the execution of automatic operations. The only condition in providing with the refinancing transaction is that the commercial bank has sufficient amount of eligible assets to serve as collateral.

When carrying out one-day refinancing transactions, commercial banks based in Slovakia will contact the NBS directly with their request for a transaction. Alternatively, if the bank is to draw an intraday credit during the day and this credit is not paid back until the end of the same day, this will be automatically considered as a request for a refinancing transaction and this transaction will be carried out. If a counterparty based in the Slovak Republic is interested in an overnight sterilisation transaction, it is to deposit funds in its account with the NBS. This will be automatically considered as a request for an overnight deposit. Overnight deposits in the NBS will be renumerated using the overnight rate for ECB deposits and overnight credits will be charged with the overnight rate for ECB credits.

Minimum reserve system

The National Bank of Slovakia currently uses the minimum reserve system. The European Central Bank similarly requires that credit institutions keep minimum reserves (MR) in their accounts with national central banks within the MR system. The difference between these two systems lies especially in the period of maintaining the MR. While in the SR this is one calendar month, in the euro area the period begins on the settlement date of major refinancing operations following a session of the ECB Governing Council where the setting of monetary policy for the following month is decided. MR account funds up to the limit of set MR are paid interest at the average marginal interest rate of the last main refinancing operation.

The Eurosystem applies in the MR system a deductible item of up to EUR 100,000. This means that if the bank has set MR for the given period at a lower value than EUR 100,000, it is not obliged to fill the MR and the balances on its accounts are not subject to interest.

The NBS uses a similar structure of instruments and procedures in its exercise of monetary policy and this factor will make it easier for banks to adapt to the euro area system. The most important difference remains the fact that the Slovak banking sector has a surplus of liquidity absorbed by the National Bank of Slovakia, while the European banking sector has a shortage of liquidity refinanced by the European Central Bank. For this reason, monetary instruments are adapted to the requirements arising from the differing structural positions. After the euro has been adopted, in Slovakia it is expected that the Slovak liquidity surplus will be dissolved in the euro area, mainly owing to a higher level of the European market rates. At the turn of the years 2008 and 2009, all instruments and competences of the National Bank of Slovakia in determining its monetary policy will cease to exist and the NBS will become the national executor of the monetary policy of the European Central Bank.