

Recent changes in Austrian monetary policy instruments and procedures

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1. Basic goals of Austrian monetary policy

The basic long-term goal of monetary policy as laid down in the National Bank Act and pursued by the Oesterreichische Nationalbank (OeNB) is price stability. With a view to achieving this primary goal, the OeNB uses the exchange rate as an intermediate target and tries to keep the Austrian schilling stable against the currencies of the stable-currency countries, in particular, against the Deutsche mark. With this strategy the OeNB fulfils the requirements of the National Bank Act, ensuring "... that the value of the Austrian currency is maintained with regard both to its domestic purchasing power and to its relationship with stable foreign currencies" (Article 2, paragraph 3). Since 1995 Austria has been a member of the European Exchange Rate Mechanism (ERM), which, however, left the basic strategy of Austrian monetary policy unchanged.

The essential qualitative elements which have evolved from the economic policy environment since the 1970s are the import of price stability (exchange-rate-price spiral as a virtuous circle) and, later on, the stabilisation of expectations with regard to both the intermediate and the final target. Credibility in the context of a fixed exchange rate regime requires interest rate policy to be subordinated to the exchange rate objective. This implies an endogenously determined money supply. The alternatives available to the central bank consist of influencing the structure of money supply, i.e. the domestic and foreign source components.

Since domestic and foreign financial assets are not perfectly substitutable, the Austrian yield curves are not identical with the German ones. However, as the credibility of Austria's exchange rate policy increased, the originally positive interest differential to the anchor currency area narrowed, not only at the short end (where the overnight rates repeatedly even fell below the German ones), but also at the long end of the interest curve. The (current) options for a – moderately – autonomous interest rate policy are the result of comparatively favourable fundamentals and of the high degree of monetary policy credibility.

As far as practical implementation is concerned, the daily determination of exchange rates – the so-called exchange rate fixing – forms an integral part of this policy and is performed autonomously by the OeNB.

The operational target of the OeNB is to minimise fluctuations of short-term money market rates. This task is greatly facilitated by the imposition of minimum reserve requirements imposed on the banking sector.

The changes in the types of accommodation of the demand for central bank money and of the OeNB's options of fine-tuning the money market have to be seen in the broader context of the liberalisation of financial markets and the resulting call for greater flexibility. Therefore, in line with other industrial countries and given harmonisation efforts due to the envisaged operational framework of the European System of Central Banks (ESCB), the OeNB has adapted its operational framework. The predominance of standing facilities has been ended and open market operations have gained crucial importance.

This paper provides a short summary of the development of the operational system of monetary policy in Austria. First, the traditional instruments and the prevailing money market conditions are described. It is shown why this system has been successful and why, nevertheless, there

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were reasons for reform. Second, the new measures taken and their rationale are presented as well as the main features of the current system. Finally, a few remarks on the potential need for further harmonisation measures are added since Austria wants to participate in Stage III of Monetary Union from the very beginning.

2. The old framework of the refinancing system

2.1 Standing facilities

Central bank money was predominantly provided to the Austrian banking sector by means of "standing facilities" (demand-oriented facilities at the initiative of the commercial banks). About 60 banks had a permanent refinancing volume (refinancing ceiling) at their disposal. Although there was no formal link, there was a loose connection between the total refinancing limit and the amount of central bank money necessary for the banks to fulfil their minimum reserve requirements. Within this framework, there existed basically three refinancing possibilities:

- Rediscount of bills of exchange;
- Securities repurchase deals;
- Lombard loans.

2.1.1 *Rediscount of bills of exchange*

The discount facility was restricted to providing a 40% maximum of the total refinancing ceiling. This restriction was necessary because the discount was offered at an interest rate below market. If banks had expected interest rates to increase, they could have used this facility too extensively and thus would have undermined the effectiveness of increases of the GOMEX rate.

The importance of the discount of trade bills decreased in the last few years, especially at times when the interest rate differential between the GOMEX and the discount rate narrowed (the discount facility involves rather high handling fees). Other reasons were expectations of falling interest rates, which, at times, made the discount less attractive due to the maximum maturity of 3 months (which meant that banks' positions would be locked in for a rather long period of time).

However the discount rate continued to play an important role in signalling the broad monetary policy stance of the OeNB.

2.1.2 *Securities repurchase deals*

The largest part of refinancing was effected by means of securities repurchase deals or so-called GOMEX transactions between the central bank and commercial banks pursuant to Article 54 National Bank Act, which regulates open market operations.² These transactions were carried out at a due-at-call basis. The majority of large banks used them as a de-facto overnight facility. The GOMEX rate was one of the interest rates of the OeNB that conveyed the monetary policy stance to the money market and functioned as an effective peg for overnight rates.

Moreover, there was a so-called special open market facility with a limit on the amount of repos (and/or FX swaps) within which the OeNB could offer additional funds to cover temporary liquidity shortages in the money market. In a few specific situations the OeNB offered one-week repos (with the opportunity of prolongation if necessary). This facility was the first to be offered in the form of tenders.

² The international definition of open market operations rather refers to transactions conducted at a central bank's discretion; the GOMEX is therefore to be subsumed under standing facilities.

Besides, a rather limited – in terms of disposable volume – restrictive facility called REGOM was available which was based on the issue of central bank certificates.

2.1.3 *Lombard loans*

A lombard loan under the old system denoted the possibility of granting a short-term loan (maximum: 3 months) against securities as collateral, as laid down in Article 51 National Bank Act. Until the adaptation of refinancing facilities of the OeNB in October 1995, the lombard was included in the refinancing ceiling. Since the lombard rate, which is also set by the Bank's Generalrat, was fixed above market rates, this facility was hardly used in the past.

2.2 Minimum reserves

Minimum reserve requirements have been an important instrument to stabilise money market rate fluctuations in Austria and to create or enlarge a money market liquidity shortage; i. e. a stable demand for central bank money. This is predominantly important for countries that face a structural liquidity surplus. Reserve ratios have been chosen to be sufficiently high to guarantee reserve requirements that are clearly higher than the working balances of banks.

In spite of the fact that the OeNB adapted its reserve requirement system, several key elements have remained unchanged. The averaging provision with a maintenance period of one month helps to buffer a good deal of liquidity fluctuations and therefore acts as a stabiliser for short-term money market rates. In addition, there are no limits on deviations of daily reserve holdings from the required average (however, there is no overdraft facility). These features contribute to an increase in the interest elasticity of the demand for liquidity and consequently help to reduce volatility in money market rates – the only exception being the end of the maintenance period when volatility in the overnight rate tends to increase ("ultimo" effect).

As regards the fulfilment of reserve requirements, there existed some specific features that have been abolished in the course of the implementation of EU legislation. Certain banks were allowed to use Treasury certificates as a fixed part of their required holdings, which implied a low-level interest rate for this part of their reserve requirements. Moreover, up to 25% of the individual requirements could be fulfilled through vault cash.

2.3 The Austrian money market

Generally speaking, the major features of the money market in the old system are still valid. Potential future changes due to the adjustment of monetary policy instruments and procedures are briefly discussed in Section 5.

The Austrian money market has been characterised by an oligopolistic structure with relatively low market depth and a lack of classic money market papers like commercial paper or certificates of deposit. Of course, all kinds of derivative instruments are used by Austria's large banks, although the market is still somewhat under-developed. A few large commercial banks, the central institutions of sectoral banks and especially the Postal Savings Bank (the fiscal agent of the Treasury) are the key market players.

In the Austrian money market, the call money rate predominates. Given the minimum reserve maintenance period of one month, there is some liquidity in the segment including maturities up to one month, but there are rather modest activities in the longer money market maturities, i.e. up to one year.

The lack of money market papers was partly traceable to the stock exchange turnover tax, which was abolished in 1994. As a kind of substitute, a special type of short-term credit (especially

vis-à-vis industrial enterprises), "Barvorlagen", was developed. These short-term credits with maturities of up to 6 months were frequently used and had near money-market qualities.

In 1995 the Austrian government – in coordination with the OeNB – started issuing short-term papers known as "Geldmarkt-Bundesschatzscheine" on a regular basis (current volume: Sch 100 billion) in order to increase money market liquidity.

Another specific feature of the Austrian money market results from the multi-tier banking system, where the sectoral banks have access to the refinancing facilities via their central institutions. Liquidity management within the sector often causes the central institutions to use the money market primarily for balancing their peaks.

2.3.1 Volatility in the money market

The OeNB has been very successful in minimising fluctuations of the overnight rate. This has increased money market efficiency and retained the central bank's signalling capacity. Any fluctuations occur towards the end of the minimum reserve period.

2.4 Summary of features of the old refinancing system

The old refinancing system provided an efficient liquidity framework:

- It ensured a high degree of stability, which means the system was very efficient in minimising fluctuations in the money market (only exception: the aforementioned "ultimo" effect).
- It provided a flexible solution for the commercial banks (they were in a position to manage their liquidity position on a daily basis according to their individual needs) as well as for the OeNB, which did not face the necessity of intervening regularly or very often.
- To a great extent, the banks themselves had to assume responsibility for their own liquidity management. This favoured a cautious demand-oriented use of central bank facilities.

More generally, the minimum reserve system along with standing facilities that could be used by banks in a highly flexible way provided an efficient framework for decades, enabling the Österreichische Nationalbank to reach its intermediate and final goal (exchange rate stability and price stability) as well as its operational goal (minimising the volatility of the overnight rate).

2.5 Reasons for reform

- There was clearly a need for harmonisation with international requirements.³ As the tender was to be the predominant liquidity-providing instrument of the ESCB, any country that envisaged participating in Stage III from the very beginning had to adapt its monetary policy instruments. This entails the preparation of the necessary

³ Refinancing conditions in Austria can potentially also be influenced during the fixing. Under normal circumstances, a policy of the "smallest net position" is pursued. This means that efforts are focused on keeping the repercussions of foreign currency flows to a minimum. On the other hand, occasional deviations from this policy are taken into account to engineer changes in the domestic liquidity situation and to help stabilize confidence in the DM/Sch parity. Moreover, the OeNB has always aimed at keeping the DM/Sch fluctuations at a low level in order to pave the way for more or less risk-free DM/Sch interest rate arbitrage in the call money segment. This implies that banks can make use of the German money market to fine tune their liquidity position. Moreover, it explains why the OeNB has rarely intervened in the money market in the past.

instruments in time to give the banks – and the central bank itself – some leeway to gain experience before entering into Monetary Union.

- The quota system might have distorting effects on the money market, since the calculation and adjustment of refinancing ceilings for individual banks may not always fully reflect their dynamic development. During the previous decades, the calculation base of the individual refinancing ceilings was changed several times. Until the beginning of the 1970s, only equity capital was used as a basis. Later primary deposits were also taken into account. In the mid-80s, growth of the consolidated liable capital served as the base. At the beginning of this decade, the respective share of domestic business (balance sheet total minus interbank and foreign transactions) was used to calculate refinancing ceilings. This development might explain why some distortions regarding individual refinancing ceilings of banks may have been hard to prevent.
- In a system that is based exclusively on standing facilities, exceptional circumstances may restrict the central bank's room for manoeuvre (with standing facilities not fully used; e. g., the restrictive measures of the central bank may have a relatively weak impact in its effort to combat currency speculations).
- There was some need to bring reserve requirement ratios more in line with those of other European countries to improve the competitive position of Austrian intermediation.

3 The current refinancing framework

As has been pointed out, one of the main driving forces for restructuring the Austrian refinancing system was certainly the need to harmonise Austria's monetary policy instruments and procedures with those of the key EU countries. The OeNB saw the need to give the Austrian banks and itself the opportunity to get used to techniques which had been used only occasionally in the past and which the OeNB clearly recognised will be the dominant ones in a new system of European central banks.

3.1 Tender facility

- A regular tender facility with a frequency and maturity of one week was introduced in 1996 (there will be a change to a maturity of two weeks in early 1997). Up to now it has been implemented as a fixed-rate tender, in order to establish a clear margin between the GOMEX and the tender rate and clearly signal to the market that the tender facility is thought to outbid the attractiveness of the GOMEX as a basic refinancing facility. The relatively short maturity chosen was due to the fact that neither the banks nor the OeNB had sufficient experience with regular tender operations and thus both sides would be able to correct imprecise liquidity estimates.

Clearly, a more active engineering of market conditions implies a higher degree of responsibility for the central bank to provide accurate liquidity forecasts within shorter periods. The counterparts of the OeNB as well as the central bank have to get used to the fact that the regular tender will be the main liquidity-providing facility.

- It was considered a reasonable "package" to reduce reserve ratios on the one hand and to lower the refinancing ceiling by more than the amount of central bank money set free through the reduction of the reserve ratios on the other hand.

With these measures, the OeNB could – theoretically – create an artificial demand for money sufficiently high to supply liquidity via the tender facility to be newly installed.

In practice, however, during the last few years, the OeNB has been repeatedly faced with the situation of a huge general liquidity surplus in the money market due to massive foreign exchange inflows, which substantially reduced the refinancing needs of the banks and led to a significant reduction in the average use of standing facilities.

Given that situation, a further incentive had to be created in order to win the banks over to use the new system.

- Thus, while the OeNB had to reduce central bank key rates in line with the requirements of its exchange rate target, the GOMEX was kept at an artificially high level, whereas the tender rate was reduced.

3.2 Remaining (modified) standing facilities

The measures described above have led to an almost unutilised GOMEX facility during the last months, so that the GOMEX as the basic refinancing instrument has de-facto been replaced by the regular tender facility, and the only standing facility which is still of some importance is the discount facility. In principle, the discount window and the GOMEX transactions are still covered in a reduced refinancing ceiling, although, as a result of the aforementioned practice, their importance has waned. Through this more active way of influencing liquidity in the money market, the fixing mechanism potentially lost importance in liquidity management.⁴

The reformed lombard facility serves as a kind of standing facility outside the refinancing ceiling (which means that access to this facility is only limited by the amount of the available collateral). It is designed to function as an emergency lending facility which should not be used for structural refinancing purposes. This implies that it is a very short-term facility, in fact an overnight facility for individual liquidity problems predominantly at the end of the day, and definitely not for liquidity shortages across the market. Therefore the rate provides a ceiling for the market rates. This facility has not yet been used by the banks as the money market is very liquid and there have been no unexpected liquidity management problems so far. This is bound to change next year when the RTGS, which is currently in preparation, starts operating. This system will provide intraday liquidity to participants on a collateralised basis. A provision like this implies that the central bank might face a potential spillover into overnight credits which have to be covered.⁵ The overnight credits have to be provided at a rate sufficiently above market rates to, as much as possible, prevent participants from speculative abuse. Most of the EU central banks – as well as the OeNB – envisage to cover such overdrafts (as far as participants from the euro area are concerned) via the marginal lending (lombard-) facility.

3.3 Restrictive instruments

For the purpose of structural as well as fine-tuning liquidity-absorbing transactions, a long-term OeNB paper with a maturity of 10 years was issued already in 1994. This issue can be used

⁴ Refinancing conditions in Austria can potentially also be influenced during the fixing. Under normal circumstances, a policy of the "smallest net position" is pursued. This means that efforts are focused on keeping the repercussions of foreign currency flows to a minimum. On the other hand, occasional deviations from this policy are taken into account to engineer changes in the domestic liquidity situation and to help stabilize confidence in the DM/Sch parity. Moreover, the OeNB has always aimed at keeping the DM/Sch fluctuations at a low level in order to pave the way for more or less risk-free DM/Sch interest rate arbitrage in the call money segment. This implies that banks can make use of the German money market to fine tune their liquidity position. Moreover, it explains why the OeNB has rarely intervened in the money market in the past.

⁵ This refers to situations which trigger the use of an overnight emergency lending facility, such as the unforeseen default on an expected payment by a counterparty of a bank.

in a two-fold way. On the one hand, as a standing facility (practically the liquidity-absorbing counterpart of a GOMEX deal, but with own issues of the central bank) for fine-tuning transactions of the banks themselves; on the other hand as an open market facility for the central bank. This facility was used by the banks in the first half of this year and provided a floor to market rates. This "floor-function" is also supported by the fact that it might be more efficient for banks to deposit excess money at the OeNB rather than to risk an exchange rate loss (of course this is – due to the small band of the Sch/DM parity – only true for huge volumes) via the fixing.

In addition, many of the short-term credits ("Barvorlagen") described above are indexed to the VIBOR (Vienna Interbank Offered Rate). Therefore, it seems more favourable for banks if money market rates are kept a bit higher than necessary in terms of liquidity in order to avoid losses due to indexation.

4

Information policy and predictability of interest rates

As mentioned above, the OeNB considers the stabilisation of the overnight rate to be of utmost importance, not only for increasing money market efficiency by keeping refinancing costs stable and low, but also for retaining the central bank's capacity to signal its monetary policy stance and to convey information to or get information from the market.

- The OeNB, in general, tries to pursue a very transparent liquidity policy vis-à-vis the banks taking part in the refinancing process. In practical terms, this means that the OeNB publishes – on a daily basis – the current amount of reserves at the OeNB and the average counting towards minimum reserve fulfilment.
- Moreover, the use of the individual refinancing instruments is published. This enables banks to make a rather accurate estimate of the liquidity need in the market. They know the reserve requirements of the system of the previous month and they can make use of estimates of liquidity-influencing factors like historical patterns concerning the probable development of the banknote circulation.
- As the Postal Savings Bank (PSK) is a major player in the money market and acts as a fiscal agent for the Treasury, there is also satisfactory information about liquidity movements due to government payments and receipts (e.g. tax dates, social security payments, etc.). At times, this bank exercises central bank functions in distributing liquidity among other money market participants or dominating the pricing policy in the market.

Because of the PSK's important role in the market, the OeNB closely watches rate movements at this bank (also in different maturities which give indications of interest rate expectations) and thoroughly analyses developments in order to find out if they reflect distribution in the market or signal a general shortage or surplus.

- In addition, there are regular (daily) telephone contacts with the most important players in the money market, where – if necessary – additional information, e.g. about government transactions that result in foreign exchange in- or outflows, can be spread.

Overall, this transparency favours a moderate volatility of money market rates, just as it did in the old system of predominant GOMEX transactions. In a more market-oriented world, it will also ensure the predictability of monetary policy transactions by market participants with an adequate degree of accuracy. The predictability of interest rate movements is facilitated by the Bank's strict commitment to the stability-oriented exchange rate target and by the consistency of policies and policy signals that could be observed generally in the past.

Transparency and a high degree of credibility resulting from an impressive track record of monetary policy and from solid fundamentals and political stability can provide some room for

manoeuvre for independent interest rate policies which has been proved during and after the EMS crisis in 1992.

For more than 15 years, the OeNB has faced practically no speculative attacks against the Schilling (with one minor exception). On the contrary, it temporarily gave up the more or less fixed positive spread against the DM because of permanent currency inflows. At times, the OeNB had to apply interest rates involving a negative spread to contain inflows. Otherwise the Sch/DM exchange rate would have exceeded the informally fixed band, and the use of the standing facilities would have converged to zero.

5 Prospects

By making the above mentioned adaptations of the system of monetary policy instruments and procedures, the OeNB took the necessary measures in the face of the challenges of the European Monetary Union.

Further changes may arise, e.g., in the field of counterparts. The question of whether any eligible counterpart of the ESCB must have direct access to the ESCB refinancing facilities is still open. At any rate, the definitive solution might lead to an increase of counterparts for the OeNB.

Another issue with a potential impact for the future might be the specification of eligible collateral. The proposed distinction between Tier One and Tier Two instruments implies some room for manoeuvre for national central banks. This might lead to considerations whether, for example, the use of different kinds of money market paper (like CDs and CPs) should be promoted by making them eligible for certain types of central bank refinancing. Positive effects on the liquidity and depth of the money market could result in this case.

**Chart 1
Reserves and spreads between overnight rates of Austria and Germany**

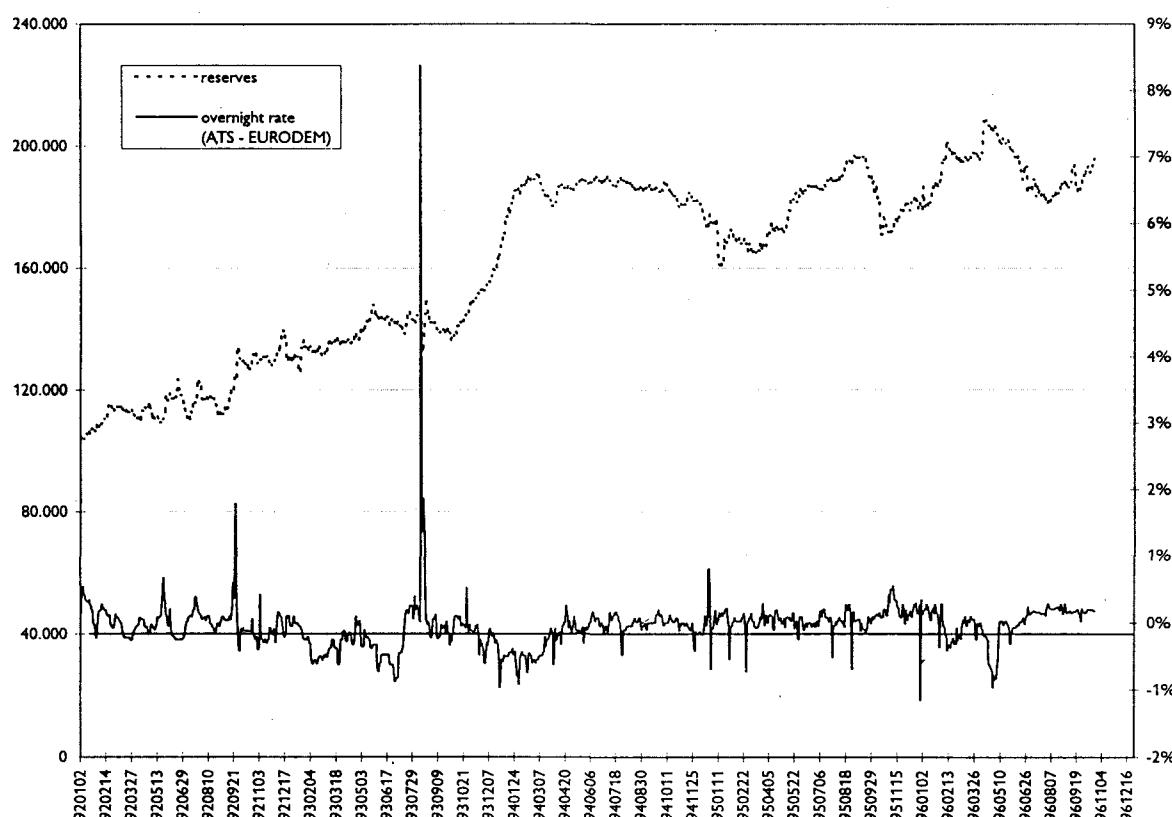


Chart 2
Spread between overnight rates of Austria and Germany

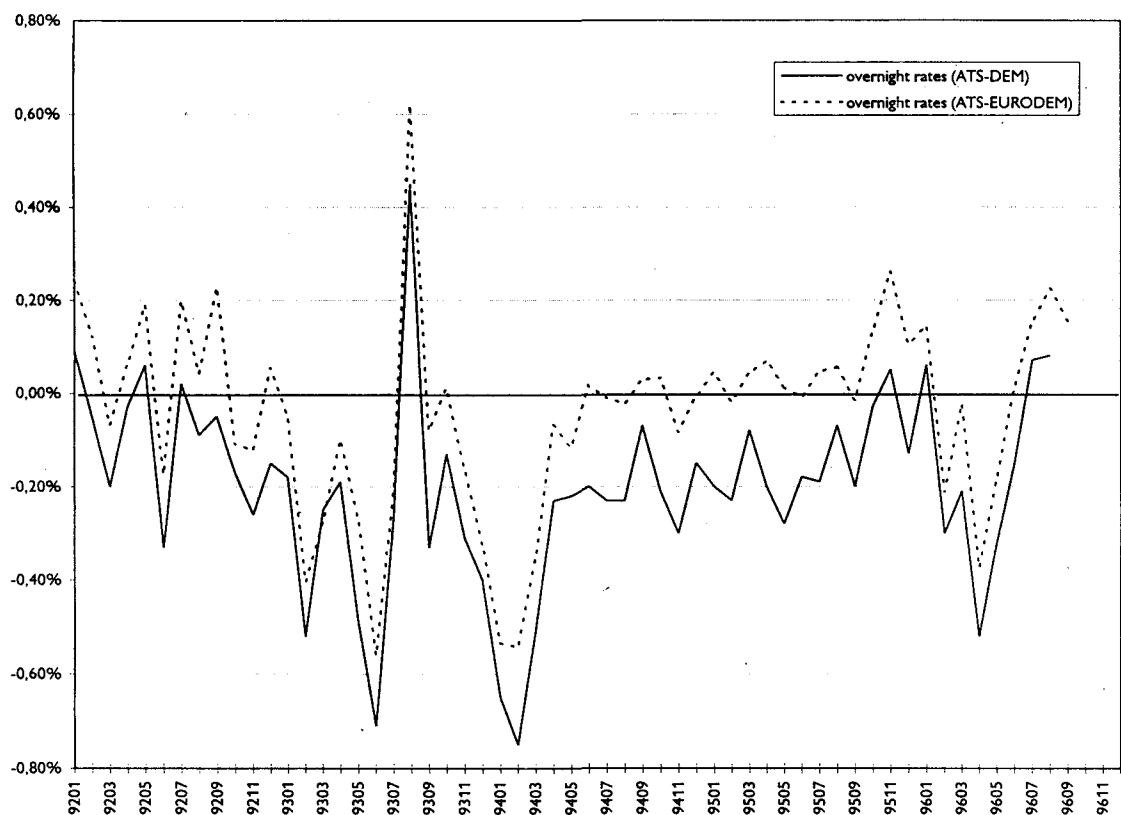


Chart 3
Austrian discount and overnight rates
1992 - October 1996

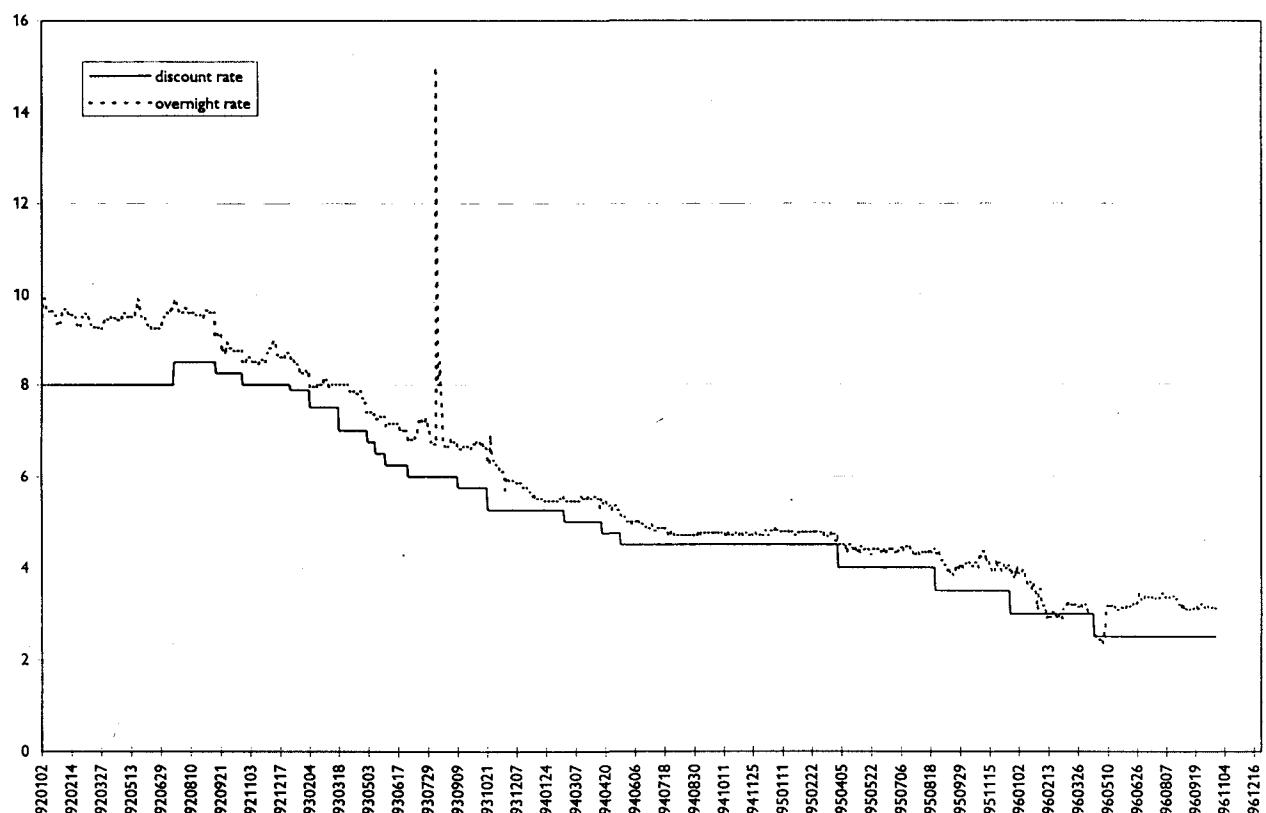


Chart 4
Volatility of the Austrian overnight rate
 30-day average

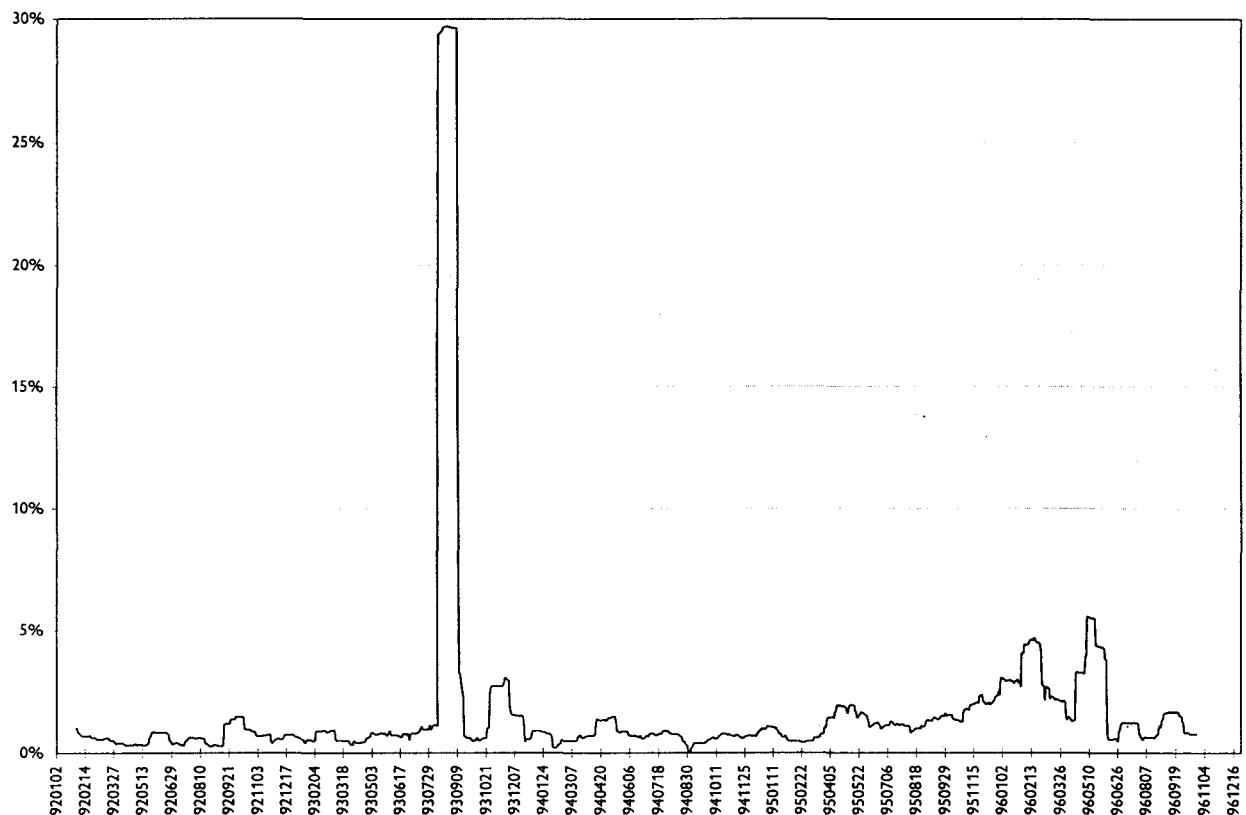


Chart 5
Austrian and German discount rates
 1992 - October 1996

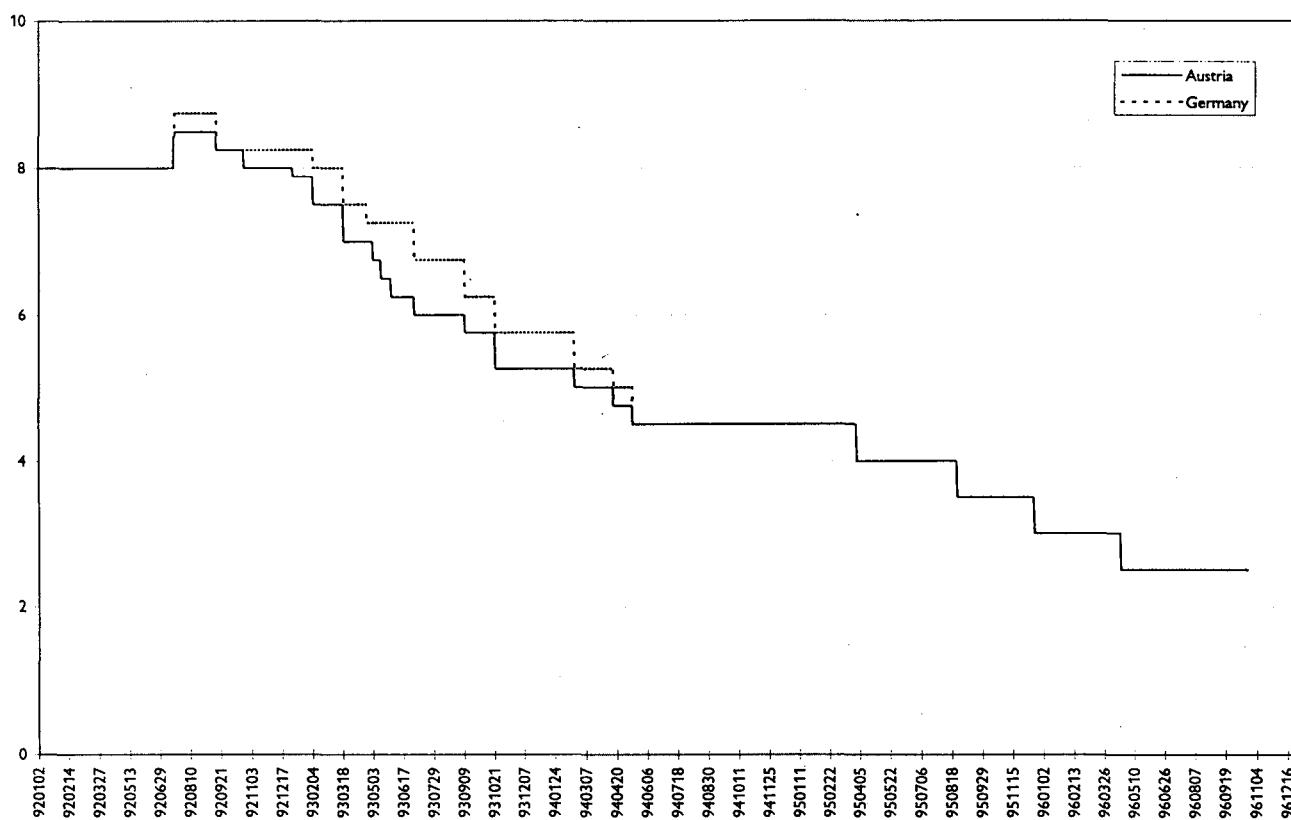


Chart 6
Austrian and German long-term interest rates

