HRVATSKA NARODNA BANKA

Open market operations

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The central bank uses open market operations to affect the liquidity of the banking system and interest rate movements on the money market. Open market operations refer to the purchase or sale of assets (securities, foreign exchange, etc.) on the financial market, i.e. to the granting of loans to the banks and collecting of deposits from the banks. The central bank defines in advance the assets eligible for open market operations and usually publishes information on such assets.

The central bank conducts open market operations at its own initiative, following a previously published schedule or at any moment it deems suitable, with the voluntary participation of credit institutions. By open market operations, the central bank affects the liquidity of the banking system and interest rate trends on the money market, thus controlling the price and/or the supply of reserve money (money in the banks' accounts with the central bank). By purchasing assets from the banks or granting loans to the banks, the central bank increases the liquidity in the system and prompts a decrease of interest rates on the market, while by selling assets to the banks or collecting deposits from the banks, it achieves the opposite effect.

Open market operations may be performed as:

1. Reverse operations, i.e. transactions with a pre-arranged maturity, such as the granting of loans to the banks or repo transactions where transactions of asset purchase (sale) at the current date and the transactions of resale (repurchase) of same assets at a prearranged future date are arranged simultaneously. The interest rate in the case of granting of loans or the repo rate in the case of repo transactions affects the trends in other interest rates on the market;
2. Outright operations, meaning that a transaction of purchase (sale) of assets is arranged without the obligation of resale (repurchase), i.e. the transaction is final after the initial settlement. In that case, no interest rate is defined, but it is affected by the amount of purchased (sold) assets.

In terms of frequency and purpose, open market operations may be:

- regular, meaning that their frequency is scheduled in advance and known;
- fine-tuning operations, meaning that they are conducted as required;
- structural, meaning that they are conducted in situations in which it is necessary to act due to structural changes in liquidity.

The Croatian National Bank mostly uses outright operations, notably foreign exchange purchase and sale operations, i.e. foreign exchange auctions. The aforementioned operations may be considered fine-tuning operations, but on certain occasions they are also structural. Foreign exchange auctions are performed in order to ensure the stability of the domestic currency and maintain payment liquidity both in the country and abroad. Using foreign exchange auctions, the CNB seeks to affect the exchange rate of the domestic currency relative to a reference foreign currency. The Croatian National Bank conducts foreign exchange auctions when it considers it necessary to mitigate exchange rate movements of the kuna against the euro. By purchasing foreign currency, the central bank provides domestic currency, increasing the amount of domestic currency in circulation and simultaneously withdrawing foreign currency from circulation. As a result, it causes the domestic currency to depreciate. In the opposite case, by selling foreign currency, the central bank withdraws domestic currency from circulation, causing it to appreciate relative to the reference foreign currency.

In addition to foreign exchange interventions, as fine-tuning operations, the Croatian National Bank also conducts securities purchase operations. In contrast to other monetary policy operations, due to the specific features of the domestic capital market, in addition to banks, other financial institutions may also participate in securities purchase auctions. By purchasing securities on the open market, the Croatian National Bank not only increases banking system liquidity but also affects the stabilisation of the market in securities it purchases (e.g. government bonds market) and thus contributes to financial system stability. The sale of securities by the central bank would lead to a withdrawal of liquidity from the banking system.

The Croatian National Bank conducts reverse transactions in the form of granting of loans as regular and structural operations. In the process, the central bank initially increases the liquidity of the banking system, which then decreases on the date of loan repayment at maturity. For the period of liquidity use, banks pay an agreed interest rate. Reverse transactions differ in terms of the applied collateral system, which may be the earmarking system, with each claim being secured by a specific security, usual for repo transactions, or the pooling system, common for granting of loans, with the total value of all securities transferred to the central bank representing the ceiling for all borrowing.

Reverse transactions also include so-called FX swaps. FX swaps are transactions in which the central bank initially increases (reduces) liquidity by purchasing (selling) foreign currency at the so-called market spot exchange rate and simultaneously arranges the purchase (sale) of foreign currency at a future date and at a future, so-called forward exchange rate, thus reducing (increasing) the liquidity of the banking system. The future, or forward exchange rate equals the sum of the spot exchange rate and the interest differential of currencies calculated for the period of FX swap duration. The interest differential may be positive (in case the foreign currency has a lower interest rate than the domestic currency) or negative (in case the foreign currency has a higher interest rate than the domestic currency). In economic terms, the FX swap in which the central bank initially purchases foreign currency may be considered a reverse repo transaction as described above.

Other reverse transactions include the issuance of central bank bills, whereby the central bank initially reduces the liquidity of the banking system by selling central bank bills with defined maturity to banks, after which it repurchases the bills from banks, again boosting the liquidity of the banking system. In that case, the central bank pays an interest rate on issued central bank bills to the banks.