

Box 2

LIQUIDITY CONDITIONS AND MONETARY POLICY OPERATIONS FROM 24 NOVEMBER 2003 TO 23 JANUARY 2004

This box reviews the ECB’s liquidity management during the reserve maintenance periods ending on 23 December 2003 and 23 January 2004. Chart A summarises the development of liquidity factors over the period considered.

Liquidity needs of the banking system

Banks’ liquidity needs increased substantially over the period as a result of a seasonal increase in banknotes in circulation. Banknotes, which are the largest “autonomous factor” (i.e. a factor which normally does not stem from the use of monetary policy instruments), reached an historic high of €439.2 billion on 26 December 2003. On a daily average, autonomous factors absorbed €146.3 billion of liquidity in the period under review, which is more than in any other period since the introduction of the euro. By contrast, reserve requirements, which are the other major source of banks’ liquidity needs, remained stable at around €132.3 billion. Excess reserves (i.e. current account holdings with the Eurosystem in excess of reserve requirements) were higher than normal (€0.79 billion in the first reserve maintenance period and €0.88 billion in the second). This was probably related to the low level of the key ECB interest rates (implying low opportunity costs of holding excess reserves) and a higher demand for liquidity buffers around the Christmas holiday period to cope with unexpected payment shocks.

Chart A Liquidity needs of the banking system and liquidity supply

(EUR billions; daily averages for the whole period are shown next to each item)

- main refinancing operations: EUR 234.07 billion
- longer-term refinancing operations: EUR 45.00 billion
- current account holdings: EUR 133.11 billion
- reserve requirement level: EUR 132.27 billion
- autonomous factors: EUR 146.29 billion

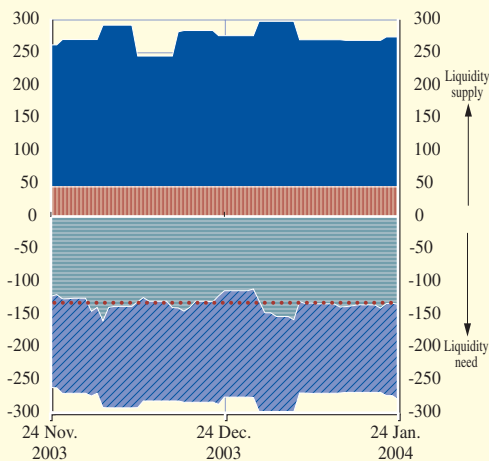
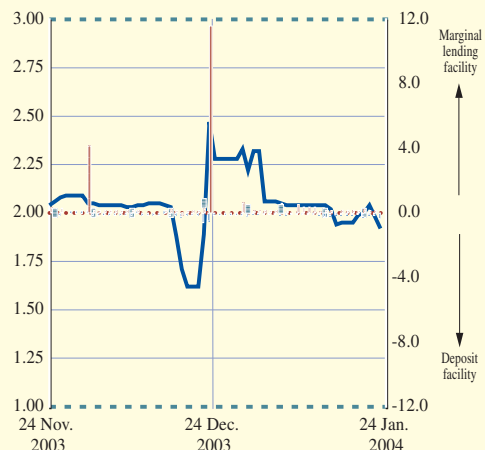


Chart B The EONIA and the recourse to the standing facilities

(left-hand scale: daily interest rates in percentages; right-hand scale: daily use of the standing facilities in EUR billions)

- deposit facility
- marginal lending facility
- EONIA
- MRO marginal rate
- MRO minimum bid rate
- corridor set by the interest rates on the marginal lending and deposit facilities



Liquidity supply and interest rates

In the first main refinancing operation (MRO) of the review period, settled on 26 November 2003, there was a minor episode of underbidding, i.e. participating banks asked for slightly less liquidity than the banking system as a whole needed for a smooth fulfilment of reserve requirements. The EONIA (euro overnight index average) temporarily increased after the underbidding episode but returned quickly to a level slightly above the minimum bid rate (see Chart B). In the next three MROs, bidding remained subdued and the marginal rate was equal to the minimum bid rate on all three occasions.

In mid-December, the EONIA fell below the minimum bid rate as market participants appeared to anticipate loose liquidity conditions at the end of the maintenance period despite the fact that one MRO was still to be settled on 23 December 2003. However, the ECB aimed in this operation to ensure neutral liquidity conditions at the end of the maintenance period. In fact, as a result of unexpected developments in the autonomous factors and demand for excess reserves in the last two days of the maintenance period, there was a net recourse to the marginal lending facility of EUR 11.1 billion on 23 December and the EONIA increased to 2.46% on that day.

As in past years, bidding was relatively high in the two MROs spanning the turn of the year as a result of the higher demand for liquidity. In the MRO settled on 23 December, the ratio between submitted bids and satisfied bids (the bid-cover ratio) increased substantially to 1.43. The dispersion of bids also increased, with the marginal rate rising to 2.05% and the weighted average rate to 2.08%. Bids were even more widely dispersed in the first MRO of the following maintenance period, settled on 30 December 2003, resulting in a marginal rate of 2.02% and a weighted average rate of 2.09%. As usual, the EONIA was also relatively high in late December, reflecting banks' desire for additional liquidity for their year-end balance sheets.

In the remaining part of the maintenance period ending on 23 January 2004, the dispersion of bid rates decreased again and the marginal rates returned to 2.00% and 2.01%. After the New Year, the EONIA returned to levels around 2.04%. In the last week of the maintenance period, it was generally slightly below the minimum bid rate as market participants again appeared to expect loose liquidity conditions at the end of the period. However, the ECB aimed at neutral liquidity conditions in the last MRO allotment of the maintenance period, which was settled on 21 January 2004. The fact that the period ended with a net recourse to the marginal lending facility of EUR 5.2 billion was almost exclusively owing to unexpected developments in the autonomous factors after the last MRO. As liquidity conditions were not perceived by market participants as tight until late in the afternoon of 23 January, the EONIA (which is a daily average) was no more than 1.92% on that day.