

### LIQUIDITY CONDITIONS AND MONETARY POLICY OPERATIONS FROM 24 JANUARY 2004 TO 11 MAY 2004

This box reviews the ECB's liquidity management during the three reserve maintenance periods ending on 9 March, 6 April and 11 May 2004. The reserve maintenance period ending on 6 April 2004 was the first under the amended operational framework for monetary policy<sup>1</sup>.

#### Liquidity needs of the banking system

Banks' liquidity needs increased over the period under review (see Chart A), mainly owing to larger net autonomous factors (i.e. the liquidity factors which do not normally stem from the use of monetary policy instruments), which on average absorbed €147.5 billion, more than in any other period since the start of 1999. This increase was mainly related to the continued growth in banknotes in circulation, which reached a historic high of €441.4 billion over the Easter holidays. Reserve requirements and excess reserves (i.e. current account holdings in excess of reserve requirements) were relatively stable. The former increased by €1 billion between the first and third maintenance periods under review, while the latter fluctuated moderately around an average value of €0.64 billion per day.

#### Liquidity supply and interest rates

In line with growing liquidity demand, the volume of open market operations also increased over the period under review. Counterparties' bidding behaviour adapted smoothly to the adjusted operational framework, which, from 9 March onwards, led to a doubling of the average size of the allotment in the main refinancing operations (MROs) because of the shortening of the maturity of these operations from two weeks to one week. The smooth adaptation is confirmed by the continued high concentration of bids as reflected in the small difference between the marginal and average MRO rate, which remained within one basis point in the period under review. Moreover, counterparties quickly adjusted their bid volumes to the increased allotment amounts. The ratio of submitted bids to satisfied bids (the bid-cover ratio) stabilised at a level of around 1.25 after the first two MROs with a one-week maturity. Only in the second of these MROs, which was allotted on 23 March with a then historic high benchmark allotment amount of € 224.5 billion, did bids fall marginally short of the benchmark allotment amount.

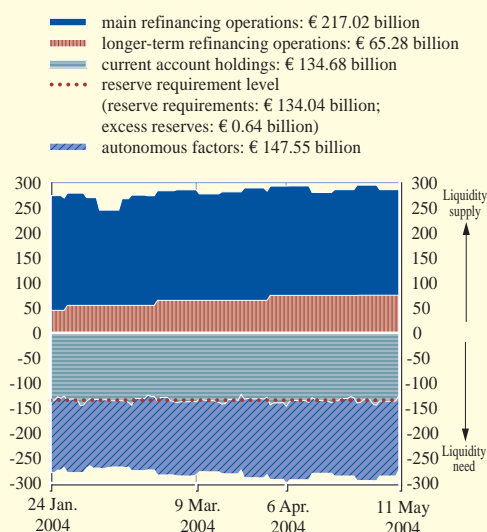
The amount of outstanding longer-term refinancing operations increased from €45 to €75 billion in the course of the period under review, reflecting the Governing Council's decision of 8 January 2004 to increase the pre-announced allotment amount in each of these operations from €15 to €25 billion. This decision took into consideration the higher liquidity needs of the euro area banking system anticipated for the year 2004.

In the first weeks of the reserve maintenance period which ended on 9 March, the EONIA (euro overnight index average) hovered slightly above the minimum bid rate of 2.00% (see Chart B). A minor underbidding episode took place in the MRO allotted on Friday 20 February. This was probably related to the unusual allotment day (MROs are normally allotted on Tuesdays), to the

<sup>1</sup> See the article entitled "Changes to the Eurosystem's operational framework for monetary policy" in the August 2003 issue of the Monthly Bulletin and the box entitled "Publication of the benchmark allotment in the main refinancing operations" in the April 2004 issue of the Monthly Bulletin.

**Chart A Liquidity needs of the banking system and liquidity supply**

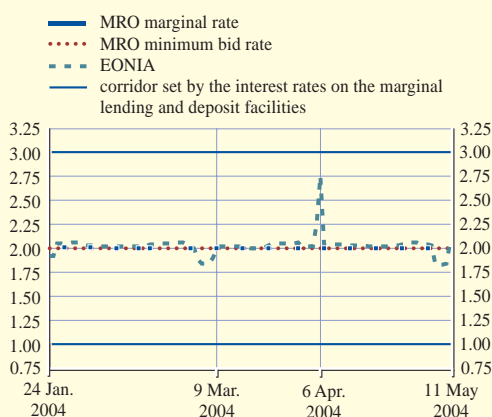
(EUR billions; daily averages for the whole period are shown next to each item)



marginal temporary increase in the EONIA. Second, on the penultimate day of the reserve maintenance period, when market participants started to perceive the liquidity conditions as being tight, the EONIA moved sharply upwards. On the last day of the reserve maintenance period a net recourse to the marginal lending facility of €8.2 billion was recorded and the EONIA rose to 2.75%.

**Chart B The EONIA and the ECB interest rates**

(daily interest rates in percentages)



operation took the form of a collection of fixed-term overnight deposits. It succeeded in re-establishing balanced liquidity conditions, and the reserve maintenance period ended with a net recourse to the marginal lending facility of only €0.1 billion and the EONIA at 2.07%.

prevailing money market rates, which were very close to the minimum bid rate, and to the increase in the benchmark allotment amount in that MRO. The underbidding triggered only a slight temporary increase in the EONIA of a couple of basis points. After the allotment of the last MRO of that reserve maintenance period, the EONIA declined, reaching a low of 1.84% on 5 March, as market participants apparently perceived the liquidity conditions to be loose. However, on 9 March, the last day of the reserve maintenance period, the EONIA rose to 1.99%, consistent with the fact that the liquidity conditions turned out to be almost balanced, with a small net recourse to the deposit facility of €2.1 billion on that day.

For most of the following reserve maintenance period ending on 6 April, the EONIA remained at a level slightly above the minimum bid rate. There were two exceptions: first, the above-mentioned underbidding event on 23 March resulted in a

In the following reserve maintenance period, the ECB again allotted its benchmark amount in all MROs and the EONIA was stable at a level slightly above that of the minimum bid rate until the last few days of the period. On 7 May, the third last trading day of the period, market participants started to discount loose liquidity conditions and the EONIA fell to 1.83%. In the morning of the following trading day, the ECB announced that its liquidity forecasts pointed towards an extreme liquidity imbalance and that it stood ready to counter this imbalance through a fine-tuning operation on the following day, should it not be reversed by other liquidity shocks. Such a reversal was not observed and, accordingly, the ECB absorbed €13.0 billion through a fine-tuning operation on 11 May, the last day of the reserve maintenance period. The