Box 3

LIQUIDITY CONDITIONS AND MONETARY POLICY OPERATIONS FROM 9 NOVEMBER 2004 TO 7 FEBRUARY 2005

This box reviews the ECB's liquidity management during the three reserve maintenance periods ending on 7 December 2004, 18 January and 7 February 2005.

Liquidity needs of the banking system

Banks' liquidity needs increased substantially over the period under review as a result of the seasonal increase in banknotes in circulation (see Chart A). Banknotes, which are the largest "autonomous factor" (i.e. a factor which normally does not stem from the use of monetary policy instruments), reached a historic high of €504.6 billion on 24 December 2004. On average, autonomous factors absorbed €208.0 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 €138.4 billion. Excess reserves (i.e. current account holdings in excess of reserve requirements) were higher than normal (€0.60 billion in the first reserve maintenance period, €0.74 billion in the second and €0.75 billion in the third; see Chart B). The high value observed for the period ending on 18 January was probably related to a higher demand for liquidity buffers around the Christmas holiday period to cope with unexpected payment shocks. Regarding the maintenance period which ended on 7 February, its rather short length (only three weeks) may explain the high average value.

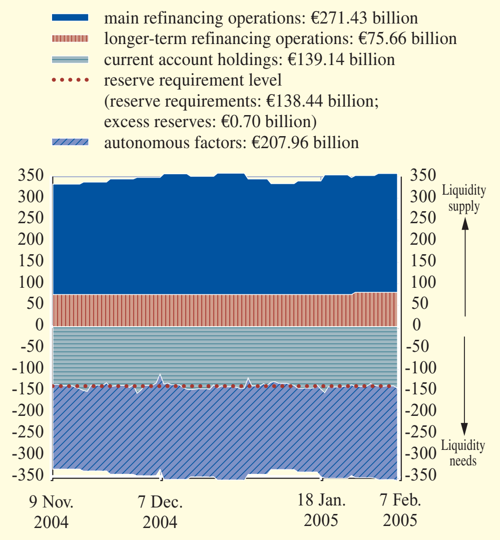
Liquidity supply and interest rates

In parallel with the growing demand for liquidity, the volume of open market operations increased (see Chart A). The allotment amount in the main refinancing operation (MRO) settled on 22 December 2004 was €283.5 billion, the highest since the introduction of the euro. Nevertheless, the ratio between bids submitted by counterparties and satisfied bids (the bid-cover ratio) remained stable at a comfortable level of 1.29 on average during the period under review.

The ECB generally applied a policy of loose allotments during this period, attempting to smooth money market conditions. Accordingly, the ECB allotted either €0.5 or 1 billion more than the benchmark amount in most of the MROs of the period. In the MROs close to the Christmas holidays and the year-end, the ECB decided to increase the

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)



Source: ECB.

allotment amounts to €4.5 billion above the benchmark amount. Thereafter, the ECB gradually returned to moderate deviations from the benchmark.

In order to restore neutral liquidity conditions, the ECB conducted a fine-tuning operation on the last day of each of the three maintenance periods under review.

The differences between the marginal and the weighted average rates in all the weekly tenders were either zero or one basis point, except for the MRO settled on 30 December where the difference reached 8 basis points.

In the longer-term refinancing operation settled on 27 January the allotment amount was increased to €30 billion, in line with the Governing Council's decision announced on 14 January 2005.

Chart B Excess reserves [1)]

(EUR billions, average level in each maintenance period)

Source: ECB.
1) Banks' current account holdings in excess of reserve requirements.

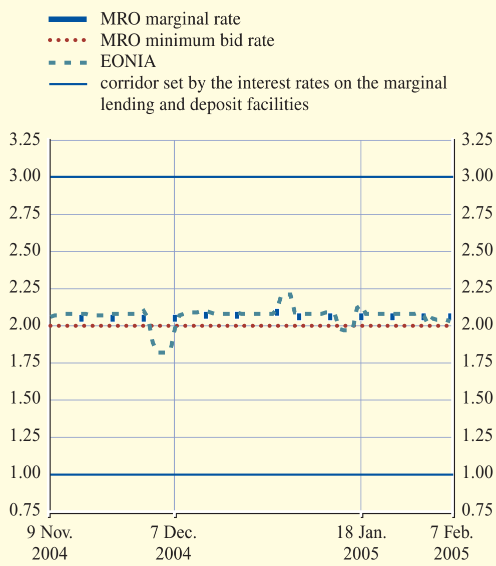
Generally, the EONIA was fairly stable during most of the period under review, although its spread versus the minimum bid rate remained somewhat higher than the historical level (see Chart C). As usual, the EONIA increased at month ends and exhibited higher volatility after the last MRO allotments and the end of the maintenance periods.

After the last MRO allotment of the maintenance period ending 7 December, the EONIA initially declined to levels well below the minimum bid rate of 2%, as market participants apparently perceived liquidity conditions to be loose. However, on 6 December the ECB announced its readiness to conduct a fine-tuning operation and the EONIA rose to 1.83%. The ECB indeed absorbed €15 billion on the last day of the maintenance period, which ended with a net recourse to the marginal lending facility of €0.5 billion and the EONIA at 1.98%.

Market expectations of loose liquidity conditions at the end of the following maintenance period emerged after the slightly loose allotment of the last main refinancing operation, settled on January 12. The EONIA thus dipped slightly below the minimum bid rate. However, liquidity absorbing errors in autonomous factors pushed the EONIA

Chart C The EONIA and the ECB interest rates

(daily interest rates in percentages)



Source: ECB.

upwards to 2.12% on 17 January. On 18 January, the last day of that maintenance period, the ECB injected €8 billion through a fine-tuning operation. In spite of this action, an unusually large autonomous factor forecast error, related to a technical failure of the German RTGS payment system, generated a net recourse to the marginal lending facility of €2.5 billion and left the EONIA at 2.14% on that day.

The EONIA remained very stable after the last allotment of the maintenance period ending on 7 February, although at a slightly lower level than observed earlier in the maintenance period. On 7 February the ECB injected €2.5 billion through a fine-tuning operation and the net recourse to the marginal lending facility on that last day was of €0.2 billion, with the EONIA at 2.03%.