Box 2

LIQUIDITY CONDITIONS AND MONETARY POLICY OPERATIONS FROM 8 FEBRUARY TO 10 MAY 2005

This box reviews the ECB's liquidity management during the three reserve maintenance periods ending on 8 March, 12 April and 10 May 2005.

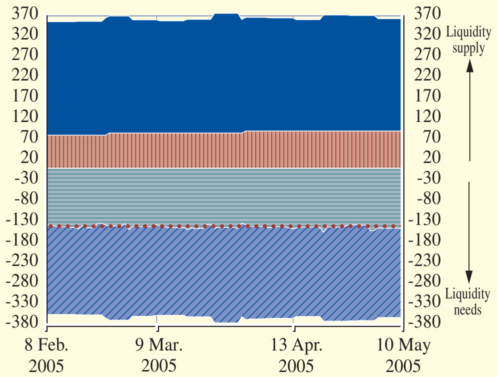
Liquidity needs of the banking system

Banks' liquidity needs increased moderately over the period under review, mainly as a result of the increase in the stock of banknotes in circulation (see Chart A). Banknotes, which are the largest "autonomous factor" (i.e. a factor which does not normally stem from the use of monetary policy instruments), reached a historic high of €512.7 billion on 6 May. On average, autonomous factors absorbed €221.1 billion of liquidity in the period under review, which is more than in any other period since the introduction of the euro. Reserve requirements, which are the other major source of banks' liquidity needs, increased to €142.1 billion. Daily average excess reserves (i.e. the daily average of current account holdings in excess of reserve requirements) remained at relatively high levels (€0.83 billion in the first reserve maintenance period, €0.64 billion in the second and €0.93 billion in the third; see Chart B). The unusually high value observed for the period ending on 10 May was in part due to relatively large excess reserve holdings concentrated around banking holidays.

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)

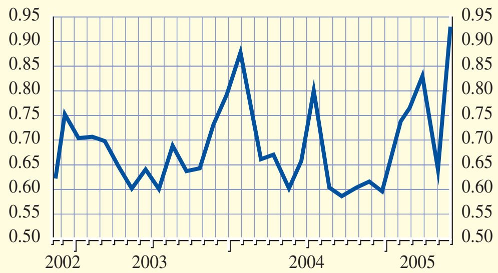
main refinancing operations: €277.60 billion
longer-term refinancing operations: €86.32 billion
current account holdings: €142.85 billion
reserve requirement level
(reserve requirements: €142.10 billion;
excess reserves: €0.82 billion)
autonomous factors: €221.08 billion



Source: ECB.

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.

Liquidity supply and interest rates

In parallel with the growing demand for liquidity, the volume of open market operations increased (see Chart A). This growth was partly accommodated by the €5 billion increase in the size of the first two longer-term refinancing operations (LTROs) allotted during the period under review. This increase, decided by the Governing Council on 14 January 2005, was aimed at reaching a volume of €30 billion for LTROs conducted during 2005. The liquidity allotted in the main refinancing operation (MRO) settled on 23 March was €291.0 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 level of around 1.18 during the period under review. This was only slightly lower than the levels observed around Christmas, when participation is usually higher.

During the first of the three reserve maintenance periods under review, the ECB phased out its policy – introduced in October 2004 – of slightly loose MRO allotments. This policy was undertaken to prevent the occurrence of episodes of increased volatility in the overnight rate at the end of reserve maintenance periods, with a view to smoothing conditions in the money market ahead of the Christmas period. In line with this policy, the ECB allotted €0.5 billion more than the benchmark amount in the first three MROs of the reserve maintenance period that ended on 8 March, while in the last two MROs of the period, the benchmark amount was allotted. In the next two maintenance periods, the ECB provided the benchmark amount in all MROs. The difference between the marginal and weighted average rates was either zero or one basis point in all the weekly tenders, with the marginal rate at 2.05%.

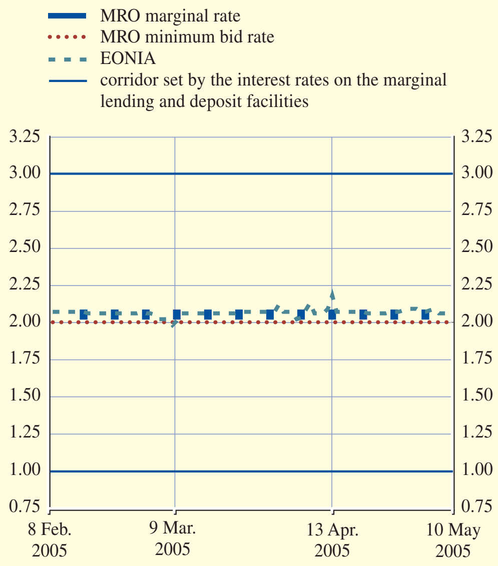
Generally, the EONIA (euro overnight index average) was fairly stable during most of the period under review, although its spread versus the minimum bid rate remained at a slightly high level (see Chart C). As usual, the EONIA increased at month-end and in the days between the last MRO and the end of the maintenance period, when the EONIA also exhibited somewhat higher levels of volatility. However, the end-of-period fine-tuning operations carried out since November 2004 have brought about a noticeable reduction in the level of volatility at the end of the maintenance period and have reinforced market expectations of neutral liquidity conditions at the end of the maintenance period.

After the last MRO allotment of the maintenance period ending on 8 March, the EONIA initially declined to levels slightly below the minimum bid rate of 2%, as market participants perceived liquidity conditions to be loose. On 8 March, the last day of the maintenance period, the ECB absorbed €3.5 billion in a fine-tuning operation. The period ended with a net recourse to the marginal lending facility of €1 billion and the EONIA at 2.01%.

In the following maintenance period, liquidity conditions gradually tightened after the last MRO allotment on 5 April. However, this had a muted impact on the overnight rate owing to widespread expectations that the ECB would restore neutral liquidity conditions on the last day. The EONIA thus stood at 2.06% and 2.09% on 8 and 11 April respectively. However, on 12 April, the last day of that maintenance period, the

Chart C The EONIA and the ECB interest rates

(daily interest rates in percentages)



Source: ECB.

Eurosystem's updated forecasts indicated that the expected imbalance was too small to warrant a fine-tuning operation. The net recourse to the marginal lending facility on that last day was ultimately €0.9 billion, with the EONIA finishing the day at 2.18%.

The EONIA remained stable after the last MRO allotment of the maintenance period ending on 10 May. The ECB decided not to conduct a fine-tuning operation after the revision in the average excess reserves on the last day of the maintenance period, which gave rise to very balanced liquidity conditions. The net recourse to the marginal lending facility on that last day amounted to €0.3 billion, with the EONIA standing at 1.99%.