

Box 2

**LIQUIDITY CONDITIONS AND MONETARY POLICY OPERATIONS FROM 11 MAY TO 9 AUGUST 2005**

This box reviews the ECB's liquidity management in the three reserve maintenance periods ending on 7 June, 12 July and 9 August 2005.

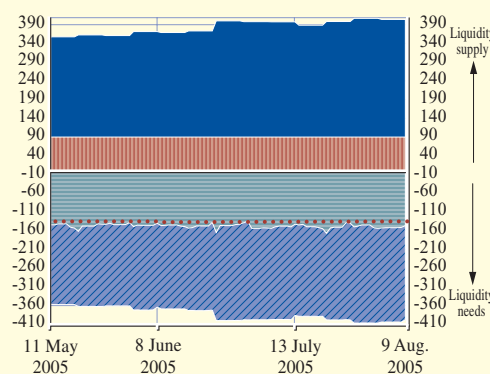
**Liquidity needs of the banking system**

Banks' liquidity needs increased further over the period, mainly as a result of the increase in the stock of banknotes in circulation (see Chart A). Banknotes in circulation, the largest "autonomous factor" (i.e. a factor that does not normally stem from the use of monetary policy instruments), reached a historic high of €537.5 billion on 5 August. On average, autonomous factors contributed €235.7 billion to the liquidity deficit of the Eurosystem in the period under review. Reserve requirements, which are the other major source of liquidity needs, increased to €147.0 billion. Daily average excess reserves (i.e. the daily average of current account holdings in excess of reserve requirements) stood at a relatively high level in the reserve maintenance period ending on 7 June (€0.86 billion), but then fell to €0.70 billion in the period ending on 12 July to reach a level of €0.63 billion in the period ending on 9 August (see Chart B). The high value observed for the period ending on 7 June 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: €293.73 billion
- longer-term refinancing operations: €90.00 billion
- current account holdings: €147.73 billion
- ..... reserve requirement level  
(reserve requirements: €147.00 billion; excess reserves: €0.73 billion)
- autonomous factors: €235.73 billion



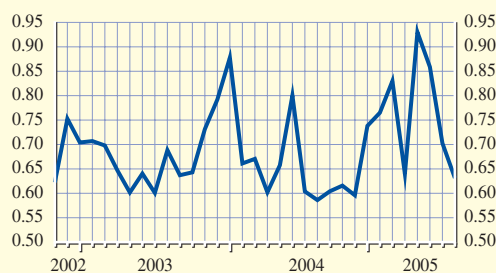
Source: ECB.

**Liquidity supply and interest rates**

In parallel with the growing demand for liquidity, the volume of open market operations increased (see Chart A). The liquidity allotted in the main refinancing operation (MRO) settled on 27 July was €317.0 billion, i.e. the highest since the introduction of the euro. Nevertheless, the ratio between bids submitted by counterparties and satisfied bids (the bid-cover ratio) increased to a level of, on average, around 1.28 during the period under review.

**Chart B Excess reserves<sup>1)</sup>**

(EUR billions, average level in each maintenance period)



Source: ECB.

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

In the three maintenance periods under review, the ECB allotted the benchmark amounts in all MROs. The differences between the marginal and the weighted average rates in all the weekly tenders were either zero or one basis point, with the marginal rate at 2.05%.

Generally, the EONIA was rather stable throughout most of the period under review, with its spread versus the minimum bid rate remaining at 7-8 basis points on most days (see Chart C). As usual, the EONIA increased at the month end and also showed some increase in volatility at the end of the maintenance periods.

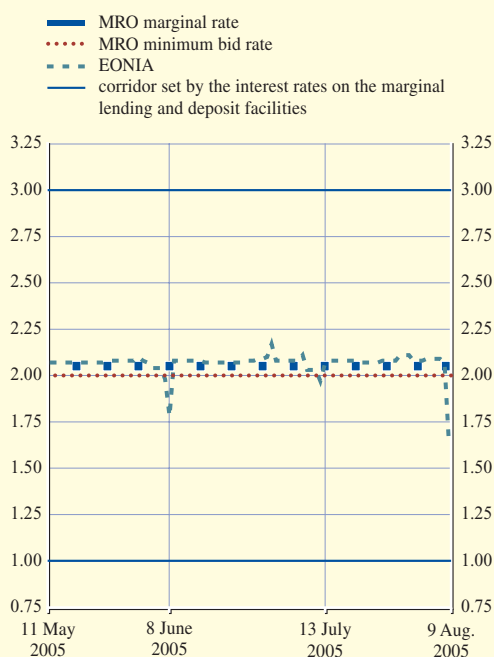
After the last MRO allotment of the maintenance period ending on 7 June, the EONIA initially declined slightly and fell below the minimum bid rate of 2% on the penultimate day of the maintenance period, as market participants perceived liquidity conditions to be loose. On 7 June, the last day of the maintenance period, the ECB conducted a fine-tuning operation to absorb an expected liquidity surplus of €7.5 billion. However, because counterparties offered less liquidity than expected in the operation, only €3.7 billion were drained from the market. The period ended with a net recourse to the deposit facility of €3.5 billion, with the EONIA declining to 1.78%.

In the following maintenance period, liquidity conditions also loosened after the last MRO allotment on 5 July. The EONIA declined to 2.03% on 8 July and to 1.97%, i.e. to slightly below the minimum bid rate, on 11 July. On 12 July, the last day of the maintenance period, the Eurosystem's updated liquidity forecasts indicated that a liquidity surplus of €10 billion was expected. A fine-tuning operation was launched, which absorbed €9.6 billion. Net recourse to the deposit facility on the last day of the maintenance period amounted to €1.4 billion, and the EONIA came out at 2.06%.

In the days following the last MRO of the maintenance period ending on 9 August, the EONIA remained stable at around 2.08% in spite of increasingly loose liquidity conditions. On 9 August, the ECB announced a liquidity-absorbing fine-tuning operation for an amount of €6.5 billion. However, only €0.5 billion were absorbed. At the end of the day, net recourse to the deposit facility totalled €5.4 billion, and the EONIA stood at 1.63%.

Chart C The EONIA and ECB interest rates

(Daily interest rates in percentages)



Source: ECB.