

**Box 3**

**LIQUIDITY CONDITIONS AND MONETARY POLICY OPERATIONS FROM 8 FEBRUARY TO 9 MAY 2006**

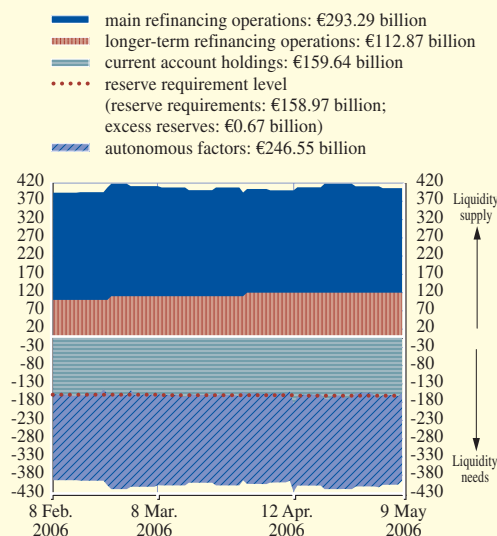
This box reviews the ECB’s liquidity management during the three reserve maintenance periods ending on 7 March, 11 April and 9 May 2006.

**Liquidity needs of the banking system**

Banks’ liquidity needs increased moderately over the period under review mainly due to an increase in reserve requirements (see Chart A). A small decline in the level of autonomous factors was observed. However, banknotes in circulation, which represent the largest “autonomous factor” (i.e. a factor which does not stem from the use of monetary policy instruments), reached a historical high of €572.7 billion on 5 May. Overall, autonomous factors contributed €246.5 billion on average to the liquidity deficit of the Eurosystem in the period under review. Reserve requirements, the other major source of liquidity needs, increased by €6.6 billion to €159.6 billion over the same period. Daily average excess reserves (i.e. the daily average of current account holdings in excess of reserve requirements) contributed €0.67 billion on average to the liquidity deficit in the Eurosystem over the period considered. Average excess reserves declined in the reserve maintenance periods ending on 7 March and 11 April to €0.63 billion and €0.62 billion respectively, before increasing again to €0.78 billion

**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.

in the last maintenance period of the period under review (see Chart B).

### Liquidity supply and interest rates

The volume of open market operations increased (see Chart A) in parallel with the moderate increase in the demand for liquidity. On average, the liquidity provided via main refinancing operations amounted to €293.3 billion. The ratio between bids submitted by counterparties and satisfied bids (the bid-cover ratio) varied between 1.20 and 1.45. The average bid-cover ratio over the period was 1.32.

In line with the decision of the Governing Council of the ECB on 16 December 2005 to increase the allotment amount of the longer-term refinancing operations (LTROs) from €30 billion to €40 billion, the liquidity provided by LTROs increased from €100 billion to €120 billion in the period under review, with all outstanding LTROs having reached the new target amount by the end of the observation period.

In October 2005 the ECB had communicated to market participants its uneasiness about the observed upward trend in the spread between the EONIA (euro overnight index average) and the minimum bid rate. Consequently, it had decided to allot €1 billion above the benchmark amount in all but the last MRO of a maintenance period. This allotment policy was prolonged during the maintenance periods ending on 7 March and 11 April, while, as explained below, it was modified in the maintenance period ending on 9 May.

#### Maintenance period ending on 7 March

The period started with marginal and weighted average MRO rates of 2.31%, while the EONIA stood at 2.34%. In the last MRO allotment, the marginal and weighted average rates increased by 1 and 3 basis points respectively, whereas the EONIA increased to 2.40% on the last day of February, before easing towards the end of the maintenance period, as the aggregate liquidity situation turned out to be slightly loose.

On the last day of the maintenance period, the ECB intended to absorb the expected liquidity surplus of €5 billion via a fine-tuning operation. However, the operation only attracted bids amounting to €2.6 billion. This was the main reason why the maintenance period ended with a net recourse to the deposit facility of €1.64 billion and the EONIA at 2.08%.

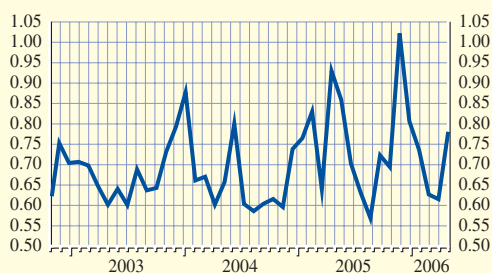
#### Maintenance period ending on 11 April

On 2 March the Governing Council decided to increase the key ECB interest rates by 25 basis points. These decisions became effective with the beginning of the new maintenance period starting on 8 March and ending on 11 April.

During the first three weeks of the maintenance period, the marginal and weighted average MRO rates stood at 2.56% and 2.57% respectively, while the EONIA was 2.58%. The last two

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.

MRO allotments in March saw both the marginal and weighted average MRO rates 1 basis point higher, with some upward pressure on the EONIA. Unusually large liquidity-absorbing forecast revisions in autonomous factors after the final MRO allotment pushed the EONIA further up to 2.71%. However, on 11 April, the final day of the maintenance period, the ECB conducted a liquidity-providing fine-tuning operation of €26 billion. The maintenance period ended with almost balanced liquidity conditions (i.e. a net recourse to the deposit facility of €0.43 billion) and the EONIA at 2.63%.

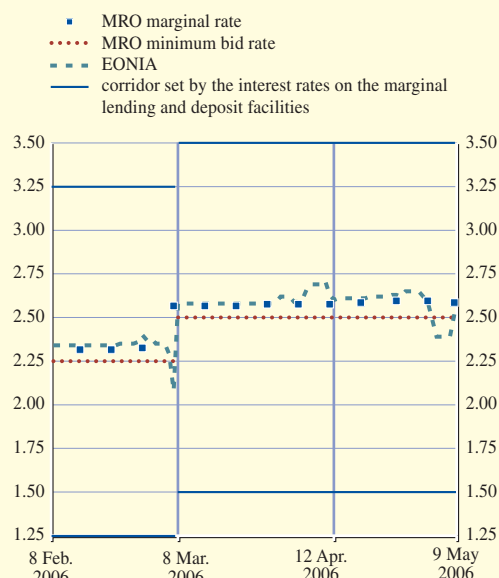
#### Maintenance period ending on 9 May

During the first three weeks of the period, the marginal and weighted average MRO rates crept up further to 2.59% and 2.60% respectively. A similar evolution was observed in the EONIA, which increased from 2.60% on the first day of the period to a level of around 2.63%. The ECB therefore increased the allotment above the benchmark amount to €2 billion in the penultimate MRO allotment of the period. In parallel, the ECB expressed its concerns about the recent developments in the spread between very short-term market rates and the minimum bid rate.

As a new measure, the ECB also allotted €2 billion more than the benchmark amount in the last MRO of the reserve maintenance period. In addition, the ECB stated that, if needed to counter an elevated spread between the EONIA and the minimum bid rate, it would consider continuing allotting more than the benchmark amount in all MROs of upcoming reserve maintenance periods (including the last MRO), but that it still aimed at balanced liquidity conditions on the last day of the maintenance period. The EONIA declined in the following days, reaching a low of 2.39% on the third to last trading day of the maintenance period. On the last day of the maintenance period, the ECB launched a fine-tuning operation in order to absorb the excess liquidity of €11.5 billion, which arose mainly as a result of the ample allotment in the previous MRO. Again, the maintenance period ended with almost balanced liquidity conditions, this time with a minimal net recourse to the marginal lending facility of €0.36 billion, and the EONIA at 2.52%.

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

(daily interest rates in percentages)



Source: ECB.