

Box 2

LIQUIDITY CONDITIONS AND MONETARY POLICY OPERATIONS FROM 10 MAY 2006 TO 8 AUGUST 2006

This box reviews the ECB's liquidity management in the three reserve maintenance periods ending on 14 June, 11 July and 8 August 2006.

Liquidity needs of the banking system

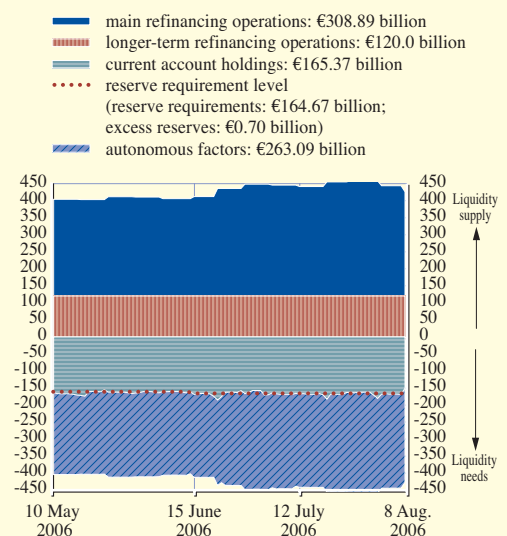
Over the period under review, banks' liquidity needs increased by €22.2 billion as a result of a greater impact of autonomous factors (€16.5 billion) and higher reserve requirements (€5.7 billion) (see Chart A). Banknotes in circulation, the largest autonomous factor, reached a historical high of €593.9 billion on 4 August. Overall, autonomous factors contributed €263.1 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 €5.7 billion to €164.7 billion over the same period. On average, daily average excess reserves (i.e. the daily average of current account holdings in excess of reserve requirements) contributed €0.70 billion to the liquidity deficit in the Eurosystem. Average excess reserves reached €0.73 and €0.74 billion in the reserve maintenance periods ending on 14 June and 11 July respectively, before decreasing to €0.61 billion in the maintenance period ending on 8 August (see Chart B).

Liquidity supply and interest rates

In parallel with the increase in the demand for liquidity, the volume of open market operations rose gradually (see Chart A). On average, 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.

liquidity provided via main refinancing operations (MROs) amounted to €308.9 billion. The ratio between bids submitted by counterparties and satisfied bids (the bid-cover ratio) varied between 1.06 and 1.33, with an average bid-cover ratio of 1.19 over the period.

The liquidity provided by longer-term refinancing operations (LTROs) remained constant at €120 billion in the period under review.

On 3 May the ECB announced that, if needed to counter an elevated spread between the EONIA (euro overnight index average) and the minimum bid rate in the Eurosystem's MROs, it would consider continuing to allot more than the benchmark amount in all MROs (including the last MRO of the maintenance period), while still aiming at balanced liquidity conditions on the last day of the maintenance period. In line with its announcement, the ECB allotted €2 billion more than the benchmark amounts in all MROs in the period under review.

Maintenance period ending on 14 June

The period started with marginal and weighted average MRO rates at 2.58% and 2.59% respectively, while the EONIA stood at 2.60%, i.e. 10 basis points above the minimum bid rate. The two tender rates remained unchanged for the three subsequent MROs. On 31 May the EONIA rose to 2.62%, due to the end-of-month effect. Over the next few days, the EONIA then declined to 2.57% as a result of growing expectations among market participants that the ECB would also allot more than the benchmark amount in the final MRO. As this was the case, the EONIA declined further to 2.55% on the last MRO allotment day, and the marginal and weighted average MRO rates decreased by 3 and 2 basis points respectively. On that and the subsequent day, the EONIA fell to 2.47%, remaining below or very close to the minimum bid rates on the following days as well. On the last day of the reserve maintenance period, the ECB had intended to absorb an expected liquidity surplus of €5 billion via a fine-tuning operation. However, the operation attracted bids for only €4.91 billion. Nevertheless, the maintenance period ended with a net recourse of €0.84 billion to the marginal lending facility and the EONIA came out in line with the minimum bid rate, i.e. 2.50%.

Maintenance period ending on 11 July

On 8 June, the Governing Council of the ECB decided to increase the key ECB interest rates (the minimum bid rate and the rates on the deposit and marginal lending facilities) by 25 basis points to 2.75%, 1.75% and 3.75% respectively. The change became effective on 15 June, i.e. the start of the subsequent maintenance period.

In the first two weeks of the maintenance period, the marginal and weighted average MRO rates came out at 2.82% and 2.83% respectively, while the EONIA was stable at 2.83-2.84%,

Chart B Excess reserves¹⁾

(EUR billions, average level in each maintenance period)



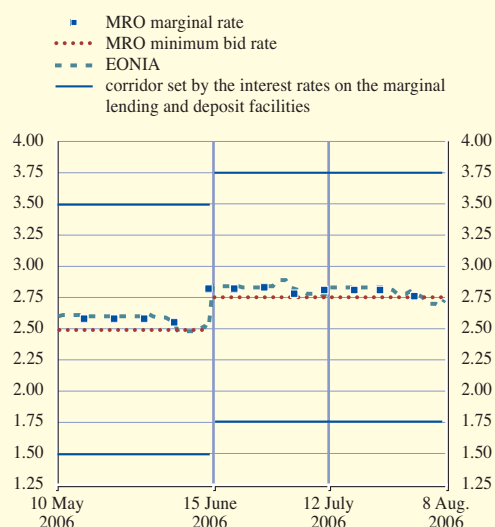
Source: ECB.

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

i.e. between 8 and 9 basis points above the new level of the minimum bid rate. The penultimate MRO allotment saw both the marginal and weighted average MRO rates 1 basis point higher, while the EONIA remained stable at 2.84%. On 30 June the EONIA rose to 2.89% as a result of the usual end-of-quarter effect, returning to 2.83% on the next day. Ahead of the allotment of the last MRO in the maintenance period, the EONIA declined in anticipation that the ECB would continue its policy of allotting €2 billion above the benchmark amount also in the last MRO of the period. The marginal and weighted average rates in the last MRO came out at 2.78% and 2.81% respectively. Given the comfortable liquidity conditions, the EONIA declined further in the following days, reaching 2.78% on 10 July. On the final day of the maintenance period, the ECB conducted a liquidity-absorbing fine-tuning operation of €8.5 billion. The maintenance period ended with a net recourse of €0.84 billion to the marginal lending facility, and the EONIA at 2.76%.

Chart C The EONIA and the ECB interest rates

(daily interest rates in percentages)



Source: ECB.

Maintenance period ending on 8 August

The maintenance period started with the EONIA at 2.83%, i.e. 8 basis points above the minimum bid rate. The EONIA remained unchanged for the first two weeks. Ahead of the last MRO allotment, the EONIA started to decline, reaching 2.78% on 28 July and rising to 2.80% on 31 July, due to the usual end-of-month effect. On 1 August, the allotment day of the last MRO of the period, the EONIA reverted back to 2.78%. The EONIA continued to decrease and reached 2.68% on the penultimate day of the maintenance period. On the last day of the maintenance period, the ECB launched a fine-tuning operation in order to absorb excess liquidity of €18 billion. The maintenance period ended with a net recourse of €1.2 billion to the marginal lending facility, and the EONIA at 2.73%.