

Box 3

**LIQUIDITY CONDITIONS AND MONETARY POLICY OPERATIONS IN THE PERIOD FROM 13 AUGUST TO 11 NOVEMBER 2008**

This box describes the ECB's liquidity management during the three reserve maintenance periods ending on 9 September, 7 October and 11 November 2008. In the aftermath of the failure of Lehman Brothers in mid-September 2008 the financial market turbulence intensified further. This led to additional disruption in the functioning of the money markets. Accordingly, the Eurosystem adopted further measures to ensure that solvent banks continued to have access to liquidity and were therefore able to pursue their activities.

In the second half of September the ECB increased the frontloading of liquidity in the main refinancing operations (MROs) by allotting even larger amounts in excess of the benchmark amount. On 8 October it announced, on the basis of a decision by the Governing Council, that MROs would henceforth be carried out through fixed rate tender procedures with full allotment, and that the width of the corridor formed by the two standing facilities (i.e. the marginal lending facility and the deposit facility) would be narrowed symmetrically from 200 to 100 basis points. Both of these measures will remain in place for as long as is necessary, and at least until the end of the first maintenance period of 2009.

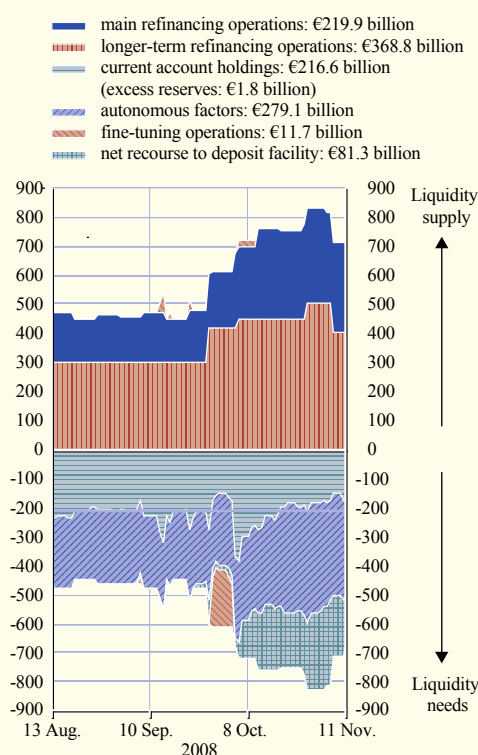
Moreover, on 15 October the Governing Council of the ECB decided to carry out all longer-term refinancing operations (LTROs) through fixed rate tender procedures with full allotment until the end of March 2009. At the same time, the Governing Council also decided to increase the frequency of such operations, with two three-month operations, one six-month operation and one operation with a maturity corresponding to the length of the relevant maintenance period to be carried out every month until the end of March 2009. This enhanced provision of longer-term refinancing was complemented by the decision – announced on the same day – to extend the list of eligible collateral. The ECB also enlarged its swap line with the Federal Reserve in order to increase its provision of US dollar funding to counterparties by offering full allotment at various maturities for both EUR/USD foreign exchange swaps and repurchase agreements.

**Liquidity needs of the banking system**

In the three maintenance periods under review banks' daily liquidity needs – defined as the sum of autonomous factors, reserve

**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)

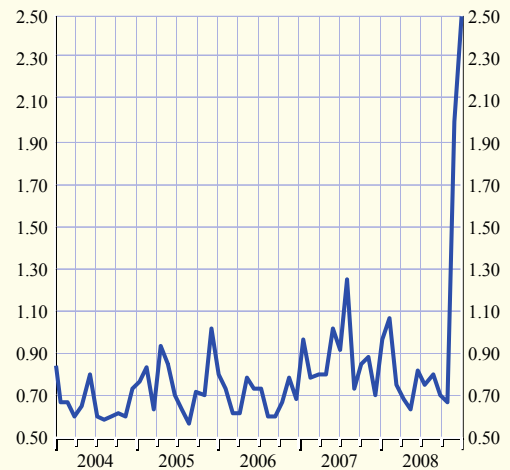


Source: ECB.

requirements and excess reserves (i.e. current account holdings in excess of reserve requirements) – averaged €495.7 billion, an increase of €33.8 billion by comparison with the €461.9 billion recorded for the previous three periods. This reflects a €29.3 billion increase in autonomous factors, a €3.5 billion increase in reserve requirements and a €1.0 billion increase in excess reserves. Average daily liquidity needs resulting from reserve requirements stood at €214.8 billion, while daily liquidity needs resulting from autonomous factors averaged €279.1 billion. Autonomous factors also include the liquidity effect stemming from the foreign exchange swaps currently being conducted through the swap lines between the ECB and other central banks (see Chart A). Daily excess reserves averaged €1.8 billion (see Chart B).

**Chart B Excess reserves**

(EUR billions; average level in each maintenance period)



Source: ECB.

Owing to the tensions in the money markets and the decline in interbank transactions, the demand for liquidity to cover net interbank positions increased as banks sought liquidity to cover their gross interbank positions. In view of the dysfunctional nature of the interbank market, the ECB decided to increase its intermediation role by satisfying 100% of counterparties' bids in all refinancing operations from 15 October 2008. This resulted in excess liquidity and heavy use of both standing facilities, particularly in the last maintenance period under review. Overall, net recourse to the deposit facility averaged €81.3 billion over the three periods under review, compared with a negligible amount for the previous three periods (see Chart A).

### Liquidity supply and interest rates

The use of fixed rate tender procedures with full allotment for all refinancing operations from 15 October 2008 significantly increased the total volume of outstanding euro-denominated open market operations. However, this did not affect the shares of LTROs and MROs in that total volume, which remained broadly unchanged at around 60% and 40% respectively.

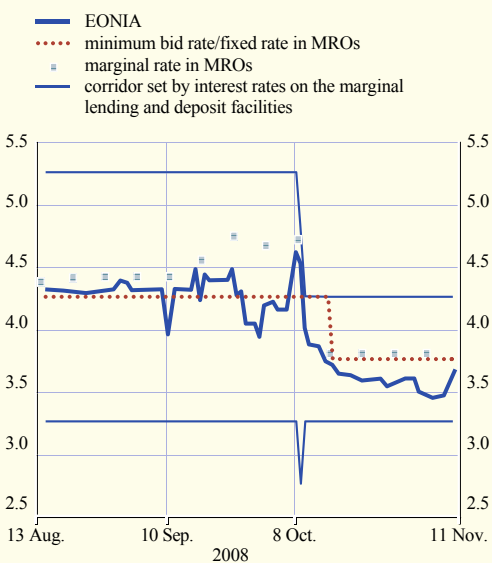
On 8 October the Governing Council of the ECB decided to reduce the main policy rate (i.e. currently the fixed rate applied in MROs) by 50 basis points to 3.75%, with effect from 15 October. Correspondingly, the interest rates on the marginal lending facility and the deposit facility were reduced by the same amount, with immediate effect.

In the maintenance period which ended on 9 September (i.e. before market tensions intensified) the EONIA was stable around the minimum bid rate, despite exhibiting the usual volatility around the end of the month and spiking towards the end of the period (see Chart C). In the maintenance period ending on 7 October the EONIA showed pronounced volatility owing to the severe disruption in the functioning of the money markets that began around the time that

the market turmoil intensified. The EONIA initially rose above the minimum bid rate, before drifting below it following the ECB's provision of significant amounts of additional liquidity. However, the absorption of some liquidity through fine-tuning operations led to the EONIA rising above the minimum bid rate in the last couple of days of that maintenance period. Liquidity was abundant in the maintenance period ending on 11 November as a result of banks' increased demand for liquidity and the implementation of the ECB's policy of full allotment. However, in this period the surplus liquidity was mainly reabsorbed through banks' recourse to the deposit facility, the interest rate on which was only 50 basis points below the policy rate (rather than 100 basis points, as had previously been the case). Accordingly, the EONIA stood moderately below the rate on the main refinancing operations.

Chart C The EONIA and the ECB interest rates

(daily interest rates in percentages)



Source: ECB.