

### Box 3

#### THE IMPACT OF THE FIRST ONE-YEAR LONGER-TERM REFINANCING OPERATION

On 24 June 2009, in the context of its enhanced credit support, the Eurosystem conducted its first liquidity-providing longer-term refinancing operation with a maturity of one year. This measure is designed to improve banks' liquidity positions on a longer-term basis, further promoting the reduction of term spreads in the money market while encouraging banks to maintain and increase their provision of credit to the real economy. This measure is fully in line with those undertaken since October 2008, which have focused primarily on banks as the main source of credit in the euro area economy. That first one-year LTRO resulted in a record €442 billion being allotted to the euro area banking system at a fixed rate of 1%. This exceptional amount represents around 1.4% of the total assets of euro area credit institutions as at June 2009 and mainly reflects banks' current demand for liquidity available at longer horizons. This one-year operation, by further alleviating the liquidity risk faced by banks, fulfils one of the conditions necessary in order for banks to increase their provision of credit.

The one-year operation created a large liquidity surplus at the time of its allotment, which should, in turn, encourage the expansion of credit by reducing the liquidity risks faced by banks. Having peaked in January 2009, banks' liquidity surplus – i.e. the difference between total outstanding

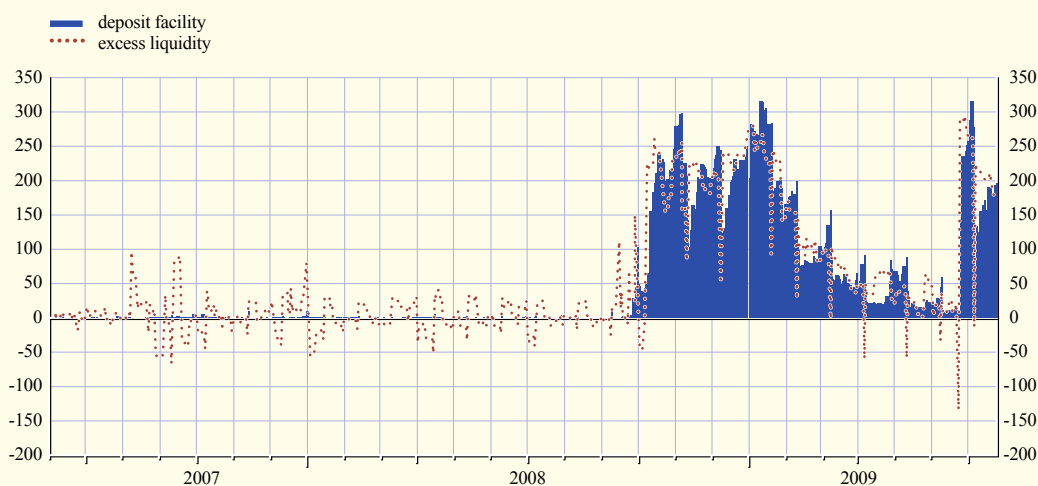
liquidity and the actual liquidity needs of the system (calculated as the sum of net autonomous factors and reserve requirements) – almost disappeared in the first half of this year, before increasing again to stand at a new record high following the one-year operation on 24 June. Providing banks with large amounts of liquidity for one year at a favourable rate allows them to build up liquidity buffers in case negative liquidity shocks occur over the maturity of the operation. This, in turn, helps to enhance confidence, thereby increasing banks' willingness to lend to the real economy.

The fact that this liquidity buffer is largely held in the deposit facility does not affect its confidence-enhancing impact in the presence of heightened liquidity risks. Recourse to the deposit facility is mechanically linked to the liquidity surplus, as long as the deposit facility is remunerated at more than 0%.<sup>1</sup> Directly after the operation, given the duration of credit approval processes and the lagged nature of reserve requirements, credit institutions deposited the surplus liquidity in the deposit facility. The use of the deposit facility to accommodate variations in surplus liquidity is naturally much more immediate than the process of initiating credit expansion. Even if banks use these extra funds to increase credit to the real economy promptly, as long as those funds end up in banks somewhere within the euro area banking system, surplus liquidity will remain and the funds will still need to be deposited with the Eurosystem on a daily basis. In the longer term, by contrast, banks can be expected to grant credit to the economy and, at the same time, create deposits that are subject to reserve requirements. Thus, the reserve base will gradually increase and lead to a decline in the liquidity surplus, all other things being equal. However, this hinges on a broad set of economic determinants, as well as banks' business considerations. Just as an increase in lending does not necessarily imply a reduction in the use of

1 Instead of having recourse to the deposit facility, banks could place these funds in their current accounts, thereby either fulfilling their reserve requirements or increasing their excess reserves. Funds placed in the deposit facility are currently remunerated at a rate of 0.25%, and funds used for the fulfilment of minimum reserve requirements are remunerated at the rate on the main refinancing operations (currently 1%). By contrast, excess reserves on banks' current accounts are not remunerated at all.

### Recourse to the deposit facility and excess liquidity

(EUR billions)



Sources: ECB and ECB calculations.

Note: Excess liquidity is calculated as the difference between outstanding liquidity provided through Eurosystem operations and liquidity needs (measured as the sum of autonomous factors and reserve requirements).

the deposit facility, conversely, a reduction in recourse to the deposit facility does not necessarily imply increased lending to firms and households, as it may reflect other adjustments to banks' liquidity positions.

Thus, banks' balance sheet developments need to be monitored carefully in order to obtain indications as to the utilisation of the liquidity provided by the Eurosystem. What has been observed so far is that the amounts deposited with the Eurosystem through the deposit facility have developed in line with the size of the liquidity surplus in the period following Lehman Brothers' collapse and have increased markedly following the one-year operation carried out in June (see chart).

To summarise, banks' propensity to lend to the real economy does not follow from the amount of surplus liquidity; rather, it depends on the extent to which there is an associated reduction in liquidity risk, with markets assured that liquidity will be available in abundance over the maturity of the operation in question. In this sense, the one-year operation conducted on 24 June should help banks to increase their loans to the real economy, despite the fact that, at an aggregate level, the excess liquidity generated by means of this operation is, for the time being, apparently being absorbed by the deposit facility on a daily basis.