

2007-12-13

PRESS RELEASE

The liquidity management of the Eurosystem during the period of financial turmoil (Article published in the Economic Review, December 2007)

Since 9 August 2007, as a result of the backwash caused by the problems on the American sub-prime mortgage market, the Eurosystem has regularly faced very strong demand for liquidity from the resident banking sector, as the banks have become reluctant to pass on liquidity to one another on the interbank market, causing a surge in demand for reserves at the central bank. This article describes the way in which the Eurosystem responded to this greatly increased demand for liquidity via its open market operations during the period up to the end of the tenth reserve maintenance period of 2007, namely 13 November. It also shows how the function of the short-term interest rate as an indicator of the monetary policy stance was safeguarded.

The liquidity management of the Eurosystem is aimed at keeping the very short-term interest rate at a stable level close to the minimum bid rate of the main refinancing operations. This minimum bid rate is a clear indicator of the monetary policy stance. The supply of liquidity is therefore geared to the demand prevailing at that interest rate. This means that the provision of liquidity and the structure of the central bank balance sheet become endogenous and therefore no longer provide information on the monetary policy stance (in this connection, cf. another article in this Review¹).

By making flexible use of the operational framework, which did not change in itself, the Eurosystem was successful in keeping the short-term interest rates sufficiently stable over the period of financial market turmoil. However, the practical implementation of monetary policy did differ in three respects from the usual practice under normal market conditions. For instance, the main refinancing operations at the start of the reserve maintenance periods did not adhere so closely to the pre-announced benchmark volumes as the guide for the amounts allotted. By allotting more liquidity than the benchmark amounts, the Eurosystem satisfies the demand from credit institutions, enabling them to meet the reserve requirements more than proportionately at the start of the reserve maintenance period. That gives them a substantial liquidity buffer during the remainder of the reserve maintenance period. In addition, greater use was made of fine-tuning operations. Both the number and volume of fine-tuning operations increased. Third, the amount allotted in the longer-term refinancing operations was increased considerably on two occasions, to provide the credit institutions with a larger volume of liquidity secured for three months – always against high-quality collateral.

Despite the relative success in stabilising interest rates in the shortest segment of the money market, rates for unsecured loans at the longer end of the market increased sharply during the period of financial turmoil. The central bank has no control over these developments since it can only influence the very short-term interest rate by adjusting the supply of liquidity. These large fluctuations indicate that the banks are demanding higher compensation from one another for the risk of default. However, these fluctuations may also have repercussions outside the interbank market, since the three-month Euribor is generally used as the benchmark for a wide range of interest rates applicable to lending to individuals and to non-financial corporations. This potential tightening of credit conditions is therefore a factor which is taken into account in determination of the monetary policy stance by the ECB Governing Council. The financial turmoil has heightened the uncertainty concerning the outlook for growth and inflation. In view of this, following the September, October and November meetings, the Governing Council chose to wait for more information to become available before making any further decisions on policy.

¹ Aucremanne L, J. Boeckx en O. Vergote (2007), "Interest rate policy or monetary base policy: impact on a central bank's balance sheet", *Economic Review of the National Bank of Belgium*, III, 17-27.