

# EUROPEAN ECONOMY

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## Supplement A

Economic trends

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*In this number:  
The ECU markets*

### SUMMARY

*This report is made up of two sections. The first is an in depth commentary on developments during 1996 and the first half of 1997 in the various ECU markets in addition to some comparisons with the performance of other major currencies. The second section provides a comprehensive analysis of ECU market evolution over a longer time frame.*

*In general activity in the ECU markets was low during 1996 and picked up slightly in the first half of 1997.*

*In 1996 bond issues were lower than in 1995, itself a poor year, and reimbursements remained at historically high levels. Issuance activity accelerated in 1997 with new issues reaching levels not seen since 1994; however, the stock of outstanding ECU-denominated debt continued to contract due to the high level of reimbursements.*

*A number of innovative issues were brought to the market in 1997 reflecting growth in issuer and investor interest in the possibilities presented by the euro. In particular the EIB launched a Eurobond denominated in euro with a nominal value of 1 000 mn. All monetary rights and obligations in respect of these notes will be performed in ECU, at one-to-one, until the introduction of the euro at the start of Stage Three.*

*Liquidity remained limited though turnover in the secondary market was relatively stable, due largely to professional curve trading and swap market activity.*

*The ECU appreciated against the DEM during 1996 and the first half of 1997. The spread between the market exchange rate of the ECU and that of the basket, which had widened to unprecedented levels in 1995, gradually narrowed to around 50 basis points for much of the second half of 1996, and below 50 basis points during the majority of the first half of 1997.*

*Interest rate behaviour suggested the pricing in by markets of the ECU as an "in" currency. ECU rates narrowed with DEM and FRF rates as market confidence in monetary union strengthened. The presentation of regulations on the euro by the Commission further strengthened market confidence in the legal arrangements and underlined the one-to-one conversion of the ECU into the euro at the start of Stage Three of EMU.*

# **PART I : COMMENTARY ON DEVELOPMENTS IN THE ECU MARKETS DURING 1996 AND THE FIRST HALF OF 1997**

## **I. ECU BOND AND DERIVATIVE MARKETS**

### ***ECU bond issues strengthened from the second half of 1996 onwards***

Issuing activity was relatively low and fluctuated from month to month during 1996, but there was a demonstrable strengthening of the market towards the end of the year. This improvement in primary market activity was maintained and strengthened in 1997, and to a degree the optimism in the ECU reflected growing market confidence in the monetary union process. However, within a longer time perspective, it is apparent that the performance of the ECU has generally been modest, and that despite the slight strengthening of the market, the ecu's share of the market has continued to decline.

New ECU bond issues totalling ECU 13.2 bn were brought to the market in 1996, compared with ECU 15.2 bn in 1995. Total repayments of maturing bonds during 1996 came to ECU 22.2 bn. Thus the steady reduction in the total stock of ECU-denominated bonds, since the peak of the ECU bond market in 1993 (ECU 130 bn), continued in 1996. At the end of 1996 ECU 118.8 bn of bonds were outstanding down ECU 8.9 bn since the end of 1995 (ECU 127.7 bn).

During the first six months of 1997 some ECU 9.7 bn of ecu-denominated bonds were issued, compared with ECU 6.6 bn for the first half of 1996. Apart from slightly lower activity in May, bond issues during 1997 have been consistently higher, on a month-on-month basis, than in 1996. The total of ECU 9.7 bn is the highest activity recorded since 1994 (ECU 13 bn). However, with bond reimbursements of ECU 16 bn during the first six months of 1997 the stock of outstanding ecu-denominated bonds continued to fall, reaching ECU 112.2 bn by the end of June 1997.

Sovereign issues provided a source of stability for the ECU bond market in 1996. Though a number of countries, that in previous years had made relatively

small speculative issues, did not come to the ECU market, sovereigns with regular issue programmes, notably France, Italy and the United Kingdom, maintained the level of their ECU debt issues. This continuity provided the liquidity to the market, and maintained essential benchmarks.

Private issuers were sparse in the first half of 1996 with only nine issues totalling ECU 710 mn compared with eleven issues totalling ECU 825 mn over the same period in 1995. However, the second half of the year and the first half of 1997 saw a gradual but steady increase in private issues with a further ECU 4,090 mn being brought to the market. The returning interest of private issuers in the ECU market was reflected in the increase in their share of total issues to its 1994 level of 16% by the end of 1996 and 28% by the end of June 1997, compared with 10% for 1995. As has historically been the case, the timing of issues has tended to be determined by swap opportunities. This explains both the grouping together of issues at intermittent periods and the increased interest in ECU debt by issuers since the second half of last year as the spread between swap rates and bond yields became increasingly attractive, particularly in the shorter maturity band.

With retail demand firmly concentrated at the shorter end of the maturity range the majority of private issues did not exceed the 7 year maturity band. Issues aimed at retail investors tended to require additional attractions such as slightly higher coupons or step-up features compared with issues targeted at institutional investors.

Institutional issuers were slightly less well represented in 1996 than in 1995, with the share of total issues falling from 8% to 6.4%. In 1997 institutional issuers returned to the ECU market accounting for 16% of total issues.

As table 3 below shows, in terms of market share of the international bond issues the ECU continued to cede ground to DEM and FRF issues as it did during 1995.

While the value of total non-domestic issues in most currencies included in the table increased in 1996 and 1997 compared with 1995, ECU issues were down just over ECU 2 bn. As a result, the share of ECU fell from 1.4% to 0.6% for 1996.

TABLE 1: ECU bonds issued during 1996

Cat. of issuer	Date of payment	Issuer	Nat.	Amount (ecu mn)	Maturity	Coupon
Sov.	23.01.96	UNITED KINGDOM T-NOTE	UK	500.0	26.01.99	5.000%
Sov.	25.01.96	FRANCE (BTAN)	FR	815.0	16.03.01	6.000%
Sov.	22.02.96	ITALY CTE	IT	500.0	22.02.01	6.500%
Sov.	22.02.96	ITALY CTE	IT	500.0	22.02.99	5.750%
Sov.	22.02.96	FRANCE (OAT)	FR	168.0	25.04.05	7.500%
Sov.	22.02.96	FRANCE (BTAN)	FR	200.0	16.03.99	5.000%
Sov.	28.03.96	FRANCE (BTAN)	FR	165.0	15.04.01	6.500%
Sov.	28.03.96	FRANCE (OAT)	FR	174.0	25.04.05	7.500%
Sov.	09.04.96	KINGDOM OF SWEDEN	SE	55	09.04.02	STEP-UP
Sov.	19.04.96	UNITED KINGDOM T-NOTE	UK	500	15.04.99	5.000%
Sov.	25.04.96	FRANCE (BTAN)	FR	225	15.04.01	6.500%
Sov.	25.04.96	FRANCE (OAT)	FR	238	25.04.05	7.500%
Sov.	23.05.96	FRANCE (OAT)	FR	771	25.04.06	7.000%
Sov.	29.05.96	WESTDEUTSCHE LANDESBANKEN	GE	55	29.05.02	STEP-UP
Sov.	27.06.96	FRANCE (OAT)	FR	210	25.04.06	7.000%
Sov.	27.06.96	FRANCE (BTAN)	FR	200	16.03.01	6.000%
Sov.	22.08.96	FRANCE OAT	FR	284	25.04.06	7.000%
Sov.	25.07.96	FRANCE OAT	FR	532	25.04.06	7.000%
Sov.	19.07.96	UK T-NOTE	UK	500	26.01.99	5.000%
Sov.	16.07.96	ITALY CTE	IT	1000	16.07.01	6.250%
Sov.	26.09.96	FRANCE OAT	FR	232	25.04.06	7.000%
Sov.	26.09.96	FRANCE BTAN	FR	360	16.03.99	5.000%
Sov.	15.10.96	UNITED KINGDOM T-NOTE	UK	500	15.04.99	5.000%
Sov.	22.10.96	MUNICIPALITY FINANCE HELSINKI	FI	60	22.10.98	5.125%
Sov.	26.10.96	FRANCE OAT	FR	325	25.04.06	7.000%
Sov.	26.10.96	FRANCE BTAN	FR	314	16.03.01	6.000%
Sov.	28.11.96	FRANCE OAT	FR	182	25.04.04	6.000%
Sov.	28.11.96	FRANCE OAT	FR	335	25.04.06	7.000%
Sov.	26.12.96	FRANCE OAT	FR	190	25.04.06	7.000%
Sov.	26.12.96	FRANCE BTAN	FR	145	16.03.01	5.000%
<b>TOTAL SOVEREIGN</b>				<b>10235</b>		
Priv.	15.01.96	DSL FINANCE	GE	55	29.12.99	6.250%
Priv.	26.01.96	CAISSE CENTRAL DU CREDIT IMMOBILIER DE FRANCE	FE	150	26.01.98	FRN
Priv.	21.02.96	KB INTERNATIONAL	BE	55	21.02.05	6.000%
Priv.	21.02.96	KB INTERNATIONAL	BE	45	21.02.05	6.000%
Priv.	28.02.96	COMMERTZETBANK	GE	100	28.02.05	6.000%
Priv.	12.03.96	LANDESBANK SCHLESWIG HOLSTEIN	GE	100	12.03.99	5.250%
Priv.	18.03.96	BAYERISCHE HYPOBANK	GE	100	18.03.05	STEP-UP
Priv.	04.04.96	CREDIT LOCAL DE FRANCE	FE	50	29.12.99	5.250%
Priv.	25.04.96	LW RENTENBANK	GE	55	25.04.02	5.750%
Priv.	17.06.96	FINANCE FOR DANISH INDUSTRY	DA	55	17.06.02	STEP-UP
Priv.	28.06.96	KB INTERNATIONAL	BE	100	28.06.02	5.250%
Priv.	29.07.96	CREDIT LOCAL DE FRANCE	FR	45	29.12.99	5.250%
Priv.	30.07.96	BAYERISCHE VEREINSBANK	GE	110	30.07.02	STEP-UP
Priv.	08.08.96	OESTERREICHISCHE KONTROLLBANK	AT	250	08.08.01	5.750%
Priv.	14.08.96	CREDIT LOCAL DE FRANCE	FR	55	14.08.02	5.000%
Priv.	30.08.96	NORDDEUTSCHE LANDESBANK GIROZENTRALE	GE	55	30.08.02	5.250%
Priv.	30.08.96	BAYERISCHE HYPOTHEKEN UND WECHSELBANK	GE	60	30.10.01	6.250%
Priv.	24.09.96	CREDIT LOCAL DE FRANCE	FR	400	24.09.01	6.000%
Priv.	27.09.96	DE NATIONALE INVESTERINGS BANK	NL	55	27.09.04	5.625%
Priv.	15.10.96	ABBEY NATIONAL	BE	55	15.10.04	STEP-UP
Priv.	22.11.96	KB INTERNATIONAL	BE	55	22.11.04	STEP-UP
Priv.	06.12.96	KB INTERNATIONAL	BE	55	06.12.04	STEP-UP
Priv.	12.12.96	ABBEY NATIONAL	UK	100	12.12.00	5.000%
<b>TOTAL PRIVATE</b>				<b>2160</b>		
Int.Inst.	15.04.96	EIB	EO	500	15.04.01	6.000%
Int.Inst.	02.08.96	EIB	EO	150	04.04.01	6.000%
Int.Inst.	13.09.96	EBRD	IO	150	13.09.01	5.750%
Int.Inst.	30.10.96	EEC	IO	50	30.10.06	FRN
<b>TOTAL INSTITUTIONAL</b>				<b>850</b>		
<b>TOTAL</b>				<b>13245</b>		

Source: Commission Services.



**Market sentiment towards the ECU is improving  
but limited liquidity remains a problem**

A large part of primary issuing in ECU exploits the opportunities provided by the large amount of maturing paper. The level of maturing paper in 1997, at ECU 22.2 bn, was only slightly down on the total for 1995, ECU 23.8 bn. With some ECU 19.1 bn of ECU paper maturing during 1997 these opportunities will persist. Clearly in these circumstances the ECU market has become reliant on re-investment flows and cannot attract fresh capital.

Though in general the bond markets performed strongly in 1996 and 1997, and the European markets

demonstrated a positive trend, led by the German Bund market, the ECU failed to live up to its traditional out performance of its component markets during an upswing in market sentiment. The under performance of the ECU is particularly explicit if one considers that given the size of the re-investment flows available in ECU the potential for progress in the ECU market is considerable. The main obstacle to any improvement is the poor state of liquidity in the ECU market. Generally speaking the ECU bond market cannot compete against the government bond markets, this in part reflects the absence of a domestic investor base and the relatively modest size of individual issue lines compared with Bunds or OATs. These factors are not likely to change before the conversion of the ECU at one-to-one in to the euro at the start of Stage Three.

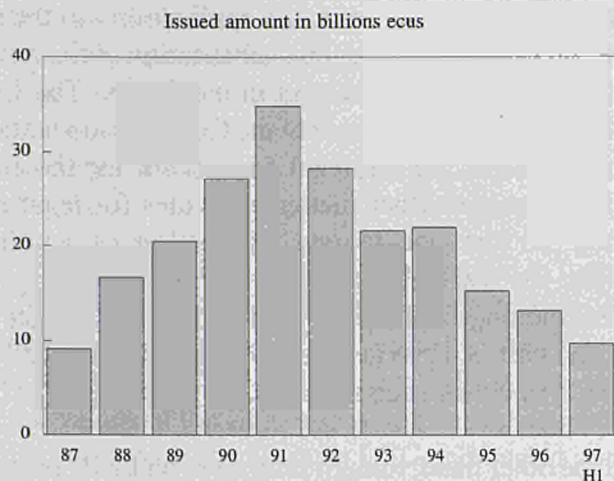
**TABLE 2 : ECU bonds issued during 1997 H1**

Cat. of issuer	Date of payment	Issuer	Nat.	Amount (ecu mn)	Maturity	Coupon
Sov.	21.01.97	UNITED KINGDOM T-NOTE	UK	550	28.01.00	4.000%
Sov.	23.01.97	FRANCE OAT	FR	910	25.04.07	6.000%
Sov.	20.02.97	FRANCE OAT	FR	738	05.04.07	5.500%
Sov.	27.03.97	FRANCE OAT	FR	426	05.04.07	5.500%
Sov.	02.04.97	REPUBLIC OF ITALY	IT	1000	02.04.04	6.000%
Sov.	18.04.97	UNITED KINGDOM T-NOTE	UK	500	28.01.00	4.000%
Sov.	27.04.97	FRANCE OAT	FR	265	25.04.02	6.750%
Sov.	27.04.97	FRANCE OAT	FR	275	25.04.07	6.750%
Sov.	21.05.97	FRANCE OAT	FR	566	25.04.07	5.500%
<b>TOTAL SOVEREIGN</b>				<b>5230</b>		
Private	10.01.97	CAISSE NATIONALE DU CREDIT AGRICOLE	FR	100	10.01.03	ZERO-B.
Private	15.01.97	KB INTERNATIONAL	BE	55	20.01.05	STEP-UP
Private	15.01.97	BAYERISCHE HYPOBANK	GE	200	15.01.01	5.000%
Private	15.01.97	CREDIT LOCAL DE FRANCE	FR	100	15.01.03	5.750%
Private	16.01.97	CREDIT LOCAL DE FRANCE	FR	100	16.12.02	5.500%
Private	20.01.97	KB INTERNATIONAL	BE	15	20.01.05	STEP-UP
Private	29.01.97	ABBAY NATIONAL	UK	100	12.12.00	5.000%
Private	04.02.97	CREDIT LOCAL DE FRANCE	FR	50	31.12.03	5.750%
Private	19.02.97	ABN AMRO	NL	200	25.04.07	6.375%
Private	24.02.97	BAYERISCHE VEREINSBANK	GE	100	31.12.03	5.375%
Private	04.03.97	DE NATIONALE INVESTERINGS BANK	NL	75	04.03.05	STEP-UP
Private	05.03.97	CAISSE CENTRAL DU CREDIT IMMOBILIER DE FRANCE	FR	300	10.12.01	FRN
Private	11.03.97	CREDIT LOCAL DE FRANCE	FR	100	11.06.03	5.250%
Private	11.03.97	CREDIT LOCAL DE FRANCE	FR	50	11.06.03	5.250%
Private	13.03.97	ABBAY NATIONAL	UK	100	02.12.00	5.000%
Private	17.03.97	BAYERISCHE HYPOBANK und WECHSELBANK	GE	100	17.12.04	5.750%
Private	09.04.97	COMPAGNIE BANCAIRE	FR	200	09.04.04	5.875%
Private	15.04.97	CREDIT LOCAL DE FRANCE	FR	100	15.04.02	5.375%
Private	30.04.97	BANQUE INTERNATIONALE A LUXEMBOURG	LU	150	30.04.03	5.500%
Private	06.05.97	CREDIT LOCAL DE FRANCE	FR	120	23.12.02	5.625%
Private	06.06.97	CERABANK BELGIUM	BE	60	06.12.02	5.000%
Private	06.06.97	CERINVEST	BE	40	06.12.02	5.500%
Private	10.06.97	GENERAL ELECTRIC CAP. CORP.	US	150	10.06.02	5.125%
Private	27.06.97	BANQUE GENERALE DU LUXEMBOURG	LU	75	27.06.03	5.500%
<b>TOTAL PRIVATE</b>				<b>2640</b>		
Inst.	14.02.97	EIB <sup>(1)</sup>	EO	1000	15.04.04	5.250%
Inst.	05.03.97	EIB	EO	300	05.04.04	5.250%
Inst.	11.03.97	EUTELSAT	EO	150	12.03.01	4.750%
Inst.	27.03.97	EBRD	IO	100	27.03.07	FRN
<b>TOTAL INSTITUTIONAL</b>				<b>1550</b>		
<b>TOTAL</b>				<b>9420</b>		

(1) Issued in euro with all monetary rights and obligations in respect of the notes performed in ECU, at one-to-one, until the introduction of the euro at the start of Stage Three of EMU.

Source: Commission Services.

GRAPH 1 : ECU bond historical view



Source: Cedel, Euroclear, Commission Services.

Though it is unlikely that a significant improvement in the liquidity position of the ECU will occur between now and the start of Stage Three, the prospects are good for the liquidity of bonds originally denominated in ECU after the start of Stage Three. With the introduction of the euro liquidity across the entire yield curve of old ECU bonds will improve, because, in very broad terms debt originally denominated in ECU will gain the entire euro area as its domestic base, with domestic investors and an end use for euro/ECU. Moreover, with a number of potential members of the euro area likely to redenominate outstanding national currency unit debt into euro certain ECU bond issues may become fungible with such redenominated debt. This is for example true of French OAT issues in FRF and ECU with the same characteristics. All future BTAN and OATs ECU issues are to have coupon and maturity dates identical to issues in FRF to ensure fungibility after the introduction of the euro. Moreover, existent ECU strips will be fungible with FRF strips.

### Market turnover

In terms of internationally traded ECU denominated securities, based on data collected by Euroclear and Cedel, turnover in the primary and secondary markets taken together decreased in 1996, reflecting the reduced demand, at least in the short term, for ECU assets, and the longer term effects of a relatively low and decreasing level of debt outstanding denominated in ECU. With an increase in total turnover the ECU's share in volume terms fell from 7% in 1995 to 4.6% in 1996.

TABLE 3: Currency composition of international bond issues, % of total.

	1990	1991	1992	1993	1994	1995	1996	1997 H1
<b>USD</b>	32.9	32.7	36.7	35.5	33.8	39.2	46.2	51.3
<b>Yen</b>	12.3	12.4	12.7	11.9	17.8	18.3	13.5	8.5
<b>DM</b>	12.4	6.8	10.2	11.4	9.1	13.8	10.6	7.4
<b>SFR</b>	9.0	6.3	5.4	5.6	4.8	6.1	3.3	2.7
<b>STG</b>	8.6	8.6	7.0	8.6	6.8	4.3	6.8	8.7
<b>ECU</b>	7.8	10.0	7.4	4.1	4.9	1.4	0.6	1.2
<b>FRF</b>	4.0	5.7	7.2	8.6	6.6	2.7	5.4	4.5
<b>ITL</b>	2.3	2.8	2.3	2.5	3.9	2.4	4.6	4.4
<b>Other</b>	8.1	7.1	6.7	5.8	9.1	11.8	8.9	11.3

Source: Bank of England, ICMS database.

Taking secondary turnover by itself, measured through Euroclear and Cedel systems as a monthly average, there was a decline in value terms from ECU 95.24 bn at the start of 1996 to ECU 86.43 bn at the end of the year, with a low of ECU 76 bn being recorded in August (ECU 98 bn August 1995). However, taking 1996 as a whole average turnover increased slightly from ECU 88 bn in 1995 to ECU 91 bn in 1996. Table 4 shows the evolution of secondary turnover in ECU assets during 1994 through 1996.

A large portion of secondary market activity reflected professional operators switching between benchmarks as they pursued curve trading strategies, and movements out of less liquid issues into newer benchmark issues. Investors remained cautious in terms of increasing ECU exposure and tended to limit duration to under five years. Little or no fresh capital entered the ECU market from other currencies.

TABLE 4: Secondary bond market turnover through Euroclear & Cedel (monthly average ECU bn<sup>1</sup>)

	1994		1995		1996	
	value	%	value	%	value	%
<b>DM</b>	783	64	945	21	1404	48
<b>USD</b>	154	16	164	7	253	54
<b>DKK</b>	91	22	137	50	190	38
<b>NLG</b>	121	11	134	11	235	75
<b>ECU</b>	81	15	88	8	91	3
<b>FRF</b>	105	-24	65	-39	71	9
<b>PTA</b>	50	-21	22	-55	28	27
<b>UKL</b>	25	-14	22	-13	35	59
<b>LIT</b>	29	23	17	-41	29	58

<sup>1</sup> % change is defined as year-on-year.

Source: CEDEL and EUROCLEAR.



## II. EXCHANGE AND INTEREST RATES

### *Foreign exchange*

During the first half of 1996 the European currency markets were characterised by the strength of the DEM. Weakness in the dollar and political concerns in a number of European countries, saw investors moving into the DEM and Swiss Franc and out of other European currencies. This situation changed in the second half of the year and continued in the first half of 1997. Concerns over German economic performance undermined the value of the DEM and the ECU and other European currencies gained ground. This coupled with a strengthening of the dollar saw the ECU and other European currencies appreciate against the DEM. For the period as a whole the ECU moved from DEM 1.88 at end December 1995 to DEM 1.95 at end December 1996 and to DEM 1.97 at end June 1997, an appreciation of 4.7%.

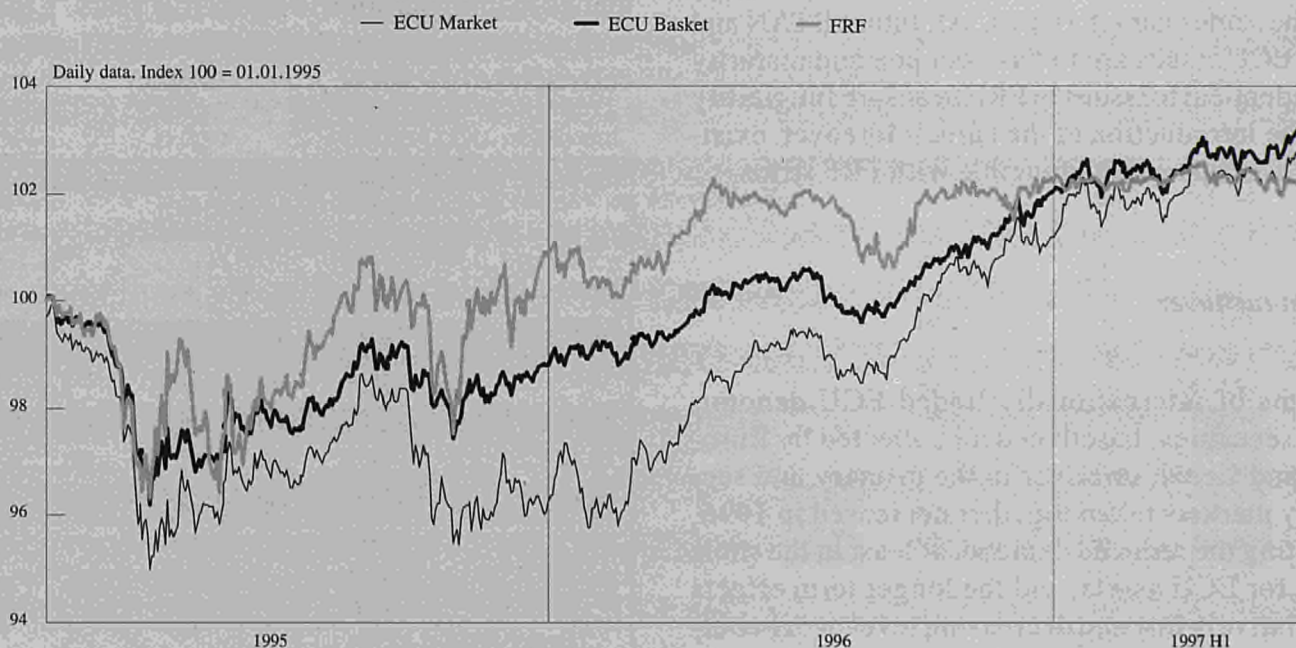
### *ECU market/theoretical exchange rate spread*

From the second half of 1995 and into the first half of 1996 the spread between the exchange rate of the basket and of the market rate of the ECU grew to unprecedented levels (+300 bp). This occurred against stable European and international foreign exchange markets. Thus the development of the spread could not be discounted as flowing from volatile foreign ex-

change markets or, as in the past, reflecting transient tensions in the ERM. Some observers pointed to market uncertainties over the applicability to the private ECU of the one-to-one substitution of the basket ECU for the euro, as set out in the Treaty. The ECU benefited from the release of the Commission texts, in October 1996, on the legal framework for the euro, which amongst other matters provides for legal certainty on the one-to-one conversion of anything called an ECU into the euro. Moreover, the strengthening of member confidence in EMU in the second half of 1996 and in 1997 further enhanced the growth in confidence in the ECU.

On the other hand, though sentiment on EMU remains positive the significant reduction in the size of the spread, over the second half of 1996, went into temporary reverse in December 1996. The spread grew to 94 bp on 19 December, but since the start of 1997 the ECU has returned to trade spot with the basket at around 50 bp, still a significant discount. During the first half of 1997 the spread generally remained below 50 bp. Given the positive developments for EMU coming from the Dublin summit in December, market operators were surprised by the blip in December. Many had anticipated a further contraction of the spread rather than the reverse. This underscores the perils of attempting to predict how the spread will behave in the short term based on past behaviour. It is this uncertainty of short term behaviour that continues to concern to the market, despite the clear linkage of the ECU at one-to-one with the euro, coupled with the thinness of the market.

GRAPH 2 : ECU (basket and market) and French franc : Exchange rate evolution against the German mark



Source: Commission Services.



Given the relatively small number of players in the market, the lack of liquidity and such technical difficulties as the limited number of business days compared with other currencies<sup>1</sup>, there is a general concern that the reversing of even a modest position in ECU can be difficult and can move the market. In such circumstances the running of positions is perceived as high risk.

Although in the short term it is impossible to forecast the behaviour of the delta, in the longer term there does appear to be a link between the values of the ECU and that of the basket. If one compares the development of the values of the ECU and of the basket against the DEM (see graph above) both ECU and basket appear often to appreciate or depreciate at the same point in time and to a similar degree. For example, during the first quarter of 1995 and the last quarter of 1996. In comparison the FRF reveals a quite different performance against the DEM. It is also worth noting that the expansion of the delta in December 1996 could be explained by the appreciation of basket, as measured against the DEM, which was not immediately matched by the ECU.

### Interest rate behaviour suggests the markets are beginning to view the ECU as an "in" currency

According to the Treaty, the value of the ECU is known in the future to be equal to that of the basket, because all ECUs will convert at one-to-one with the euro on 1 January 1999 and, as specified by the Treaty (Art. 109l(4)), the introduction of the euro will not change the external value of the ECU. At that point the

value of the ECU and of the basket must be at parity. Therefore one way of looking at the ECU is as a definite "in" currency which will be converted in to the euro at one-to-one. If the markets view the ECU as an 'in' currency then it might be assumed that this should have been discounted in future rates. The evidence is not conclusive but does reveal a clear, but far from complete, convergence of ECU interest rates with those of DEM and FRF. As graph 4 shows there has been a narrowing of spreads between the ECU short term rates and other core currencies over the last twelve months.

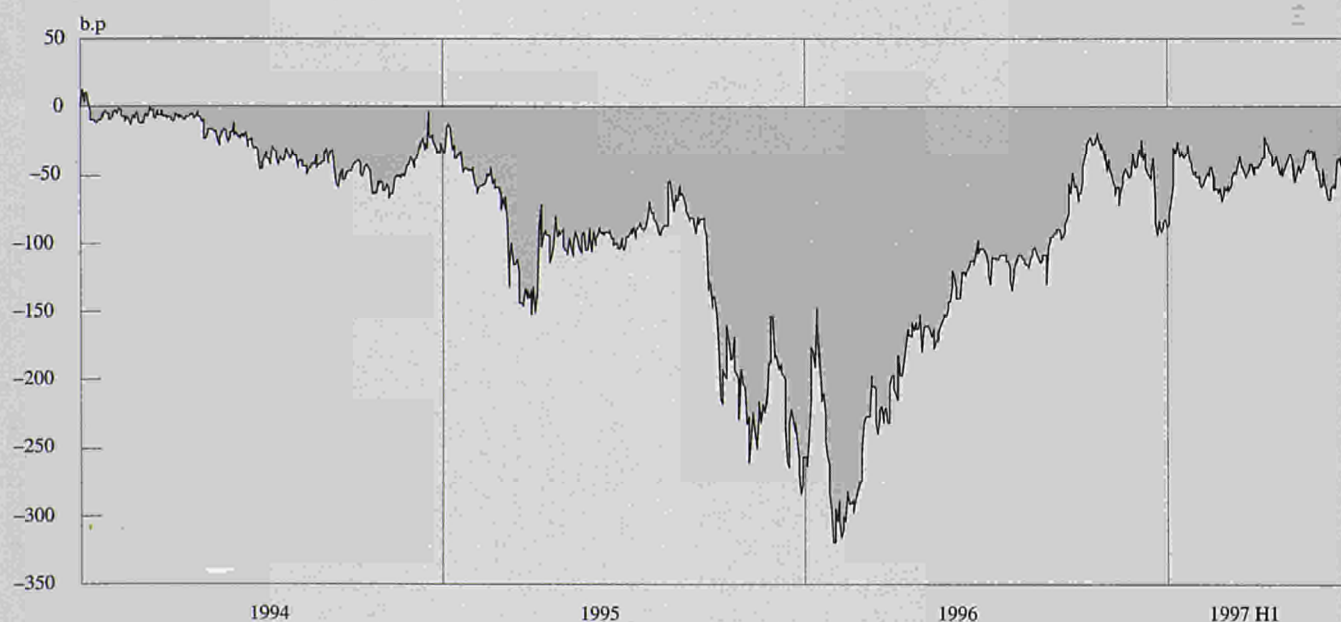
Nevertheless, ECU short term rates remain almost one percentage point above FRF (80 bp 30.06.97) and DEM (102 bp 30.06.97) rates, but against the DEM this is a narrowing of 38 bp since end-December 1995. Long term rates reveal a greater convergence, as might be anticipated. The spread between the ECU and DEM has narrowed from 96 bp on 29.12.95 to 29 bp on 30.06.97.

Of course, the ECU differs from other currencies in that it is not the currency of a country and therefore there can be no economic fundamentals to underpin expectations and no central bank to determine monetary policy. The ECU rates are set by the interest rate mechanism of the EBA clearing system.<sup>2</sup> Thus whilst

1 The ECU Banking Association produces a calendar of business days for the ECU. Its calculation is complicated but in broad terms only permits settlement of ECU on days in which a large number of financial centres are open in the EU.

2 The methodology of this mechanism is that clearing members submit two-way overnight rates and the BIS takes the average of these to determine the ECU bid and offer rates (EIBID & EIBOR). The selection of which rate, or an average of the two, depends on the willingness of clearing members to exchange ECU for the basket at par. If offers to sell ECU for the basket exceed offers to buy by ECU100 mn then EIBOR is selected if the reverse then EIBID. If the offers are below ECU100 mn then EIMEAN is set.

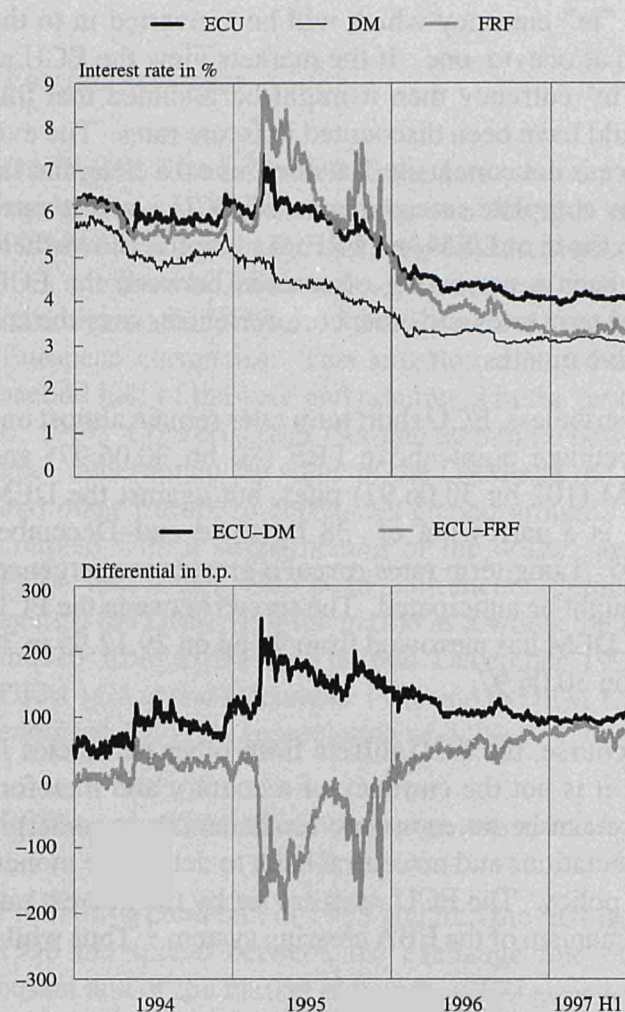
GRAPH 3 : ECU exchange rate spread (daily data)



Source: Commission Services.



GRAPH 4 : Short term (3month) interest rates (daily data)



Source: Commission services.

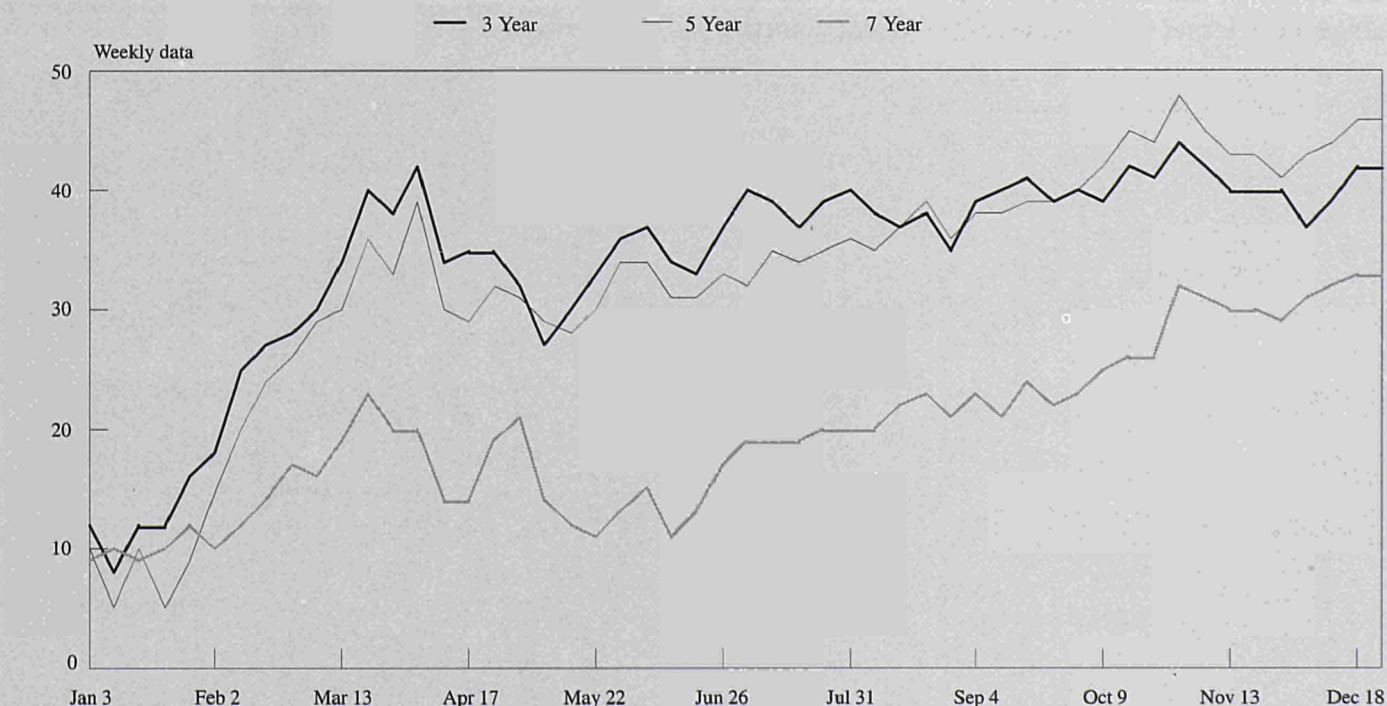
economic convergence explains the convergence of "in" currencies the sole explanation for the convergence of the ECU must be its link to the euro.

### *ECU swap activity*

Few corporate issuers have an actual need for ECU. Thus the raising of debt in the ECU primary market depends to a large extent on opportunities provided by the swap market. The attractiveness of a swap transaction for an issuer rests on the size of the spread between the swap and bond rates. When the size of the spread becomes attractive enough issuers can be tempted to raise ECU debt because it provides cheaper funding than the currency they actually require. For the issuer there is no currency risk because the swap is matched. If ECU bonds are cheap compared with the swap market then investors can buy ECU AAA debt and swap at Libor or Libor +, which represents excellent value as Libor corresponds to average quality names, not AAA.

A second source of activity in the ECU bond market is provided by opportunities for asset-swap investors to earn a profit. For such investors speculative positions are taken when ECU bonds are cheap with the intention to trade out when the price of the bonds returns to higher price against the swap.

GRAPH 5 : Swap rates and bond yields : ECU swap rates and yield spread in 1996



Source: Paribas Bank.



TABLE 5 : ECU bond maturity profile

maturity	Amount ECU bn	Issues	% of total
0 - 3	3.370	10	17
3 - 5	5.124	18	18
5 - 7	7.220	11	11
> 7	4.029	20	34

Source: Commission Services.

As the table above demonstrates, the higher the yield/swap spread the higher the volume of issues at that maturity. This reflects the greater benefits accruing.

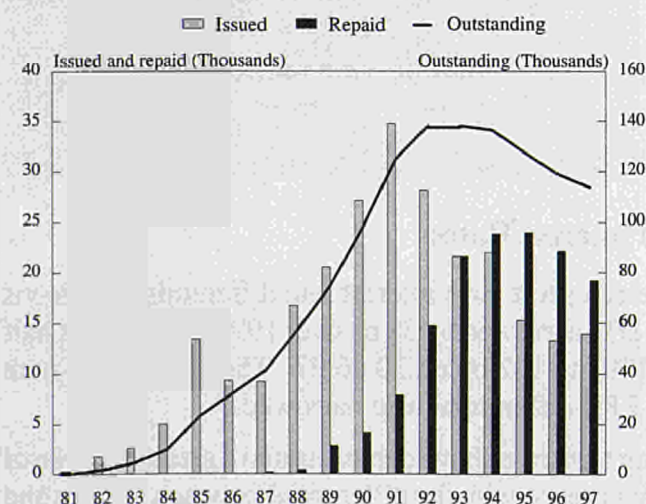
## PART II : STATISTICAL REVIEW AND ASSESSMENT

### (A) Financial Markets

#### (i) Primary Bond Market

##### *Recent Evolution*

From the 1991 issuing activity in the primary bond market has been on a downward trend. Though activity stabilised briefly in 1994, the amount issued fell by around 30% in 1995 and 13% in 1996. During the first half of 1997 issuance activity picked up with the amount of new issues brought to the market increasing by 46% over the same period in 1996. Nonetheless, with historically high levels of maturing bonds during 1996 and 1997, the stock of outstanding ecu-denominated bonds fell to ECU 118.8 bn at the end of 1996 and ECU 112.2 bn by the end of June 1997, compared with ECU 127.7 bn at the end of 1995.

GRAPH 6 : ECU primary bond market  
End of year situation (ECU billions)

Source: European Commission (DG II).

### *Issuing activity by type of issuer*

In the whole of 1996 there were three issues by EU institutions amounting to ECU 800 mn.

For the year as a whole the EU institutions' share was just over 5% of the total compared with 4% for 1995. During the first six months of 1997 the share of total issues remained constant at 5% with three issues being brought to the market by EU institutions totaling ECU 1,450 mn.

EU Member State Governments accounted for ECU 10 bn in 1996 down some 21% on 1995 and some ECU 5 bn in H1 1997. The share of total issues fell from 84% in 1995 to 77% in 1996 and to 55% in H1 1997.

There was only one non-Member State Government or institutional issue during 1996 (the EBRD for ECU 150 mn) and one more in H1 1997 (again the EBRD for ECU 100 mn).

For 1996 and 1997, the UK continued its quarterly 3-year Treasury Note Programme with four quarterly offerings, of ECU 500 mn each, bringing the total issued during 1996 to ECU 2 bn and ECU 1 bn for H1 1997.

Total issues of Italian Treasury issued CTEs was ECU 1bn in H1 1997 and 2bn in 1996, compared with ECU 3.2 bn in 1995 and ECU 9.2 bn in 1994.

The French Treasury issued ECU 3.2 bn of OATs in H1 1997. In 1996, ECU 3.6 bn of 9 year OATs and ECU 2.3 bn of BTANs were issued. Whilst issuing activity in BTAN was largely unchanged from 1995 there was a large increase (just over 75% increase) in OATs.

The Greek Government did not issue any ELB during 1996 and H1 1997.

#### (ii) Secondary Bond Market

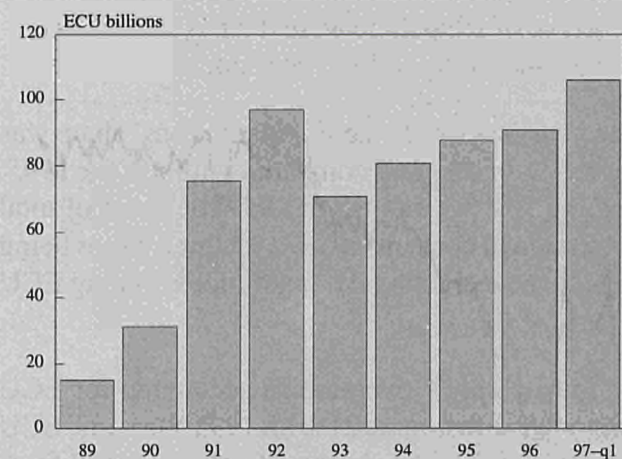
After a peak of almost ECU 100 bn in 1992 the market decreased in 1993 to ECU 70 bn but since then has steadily increased, recording a turnover of ECU 88 bn in 1995 and ECU 91 bn in 1996.

The ecu share of total bonds cleared through Euroclear and Cedel has however fallen from 5% in 1995 to just under 4% in 1996.

The monthly secondary turnover in ecu bonds cleared through Euroclear and Cedel remained relatively stable in 1996 and 1997 compared with 1995.



**GRAPH 7 : ECU secondary bond market**  
Monthly average turnover per year



Source: Cedel, Euroclear, Commission Services.

### (iii) Treasury Bills and Euro Notes (short-term issues)

The UK continued to pursue its monthly Treasury bill borrowing programme.

Under the programme ECU 1 bn is issued each month, with ECU 200 mn at one month maturity, ECU 500 mn at six months maturity and ECU 300 mn at one year maturity.

Monthly average secondary turnover remained at around ECU 2 bn.

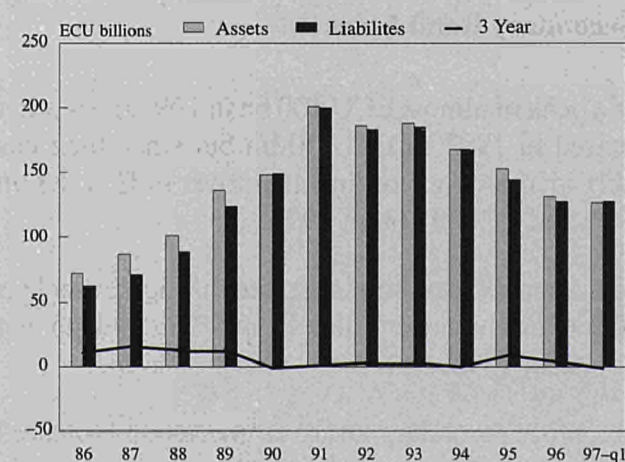
The Italian Treasury has not issued bills since the end of 1993.

## (B) Banking Market

### (i) Assets and Liabilities

Ecu assets and liabilities of the banking sector vis-à-vis all sectors have remain relatively static since the end of 1996.

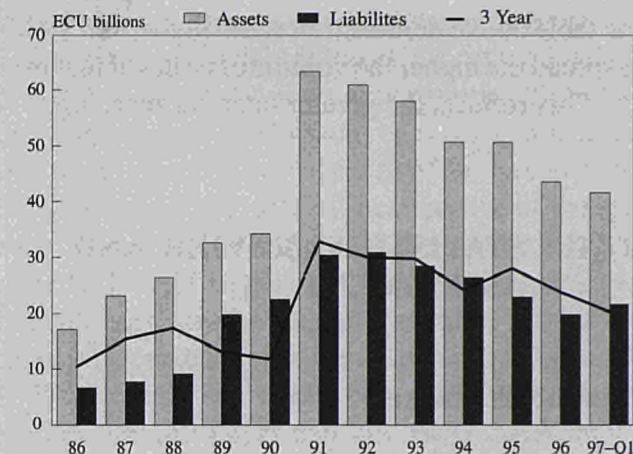
**GRAPH 8 : Banking market – all sectors**  
Assets and liabilities (ECU billions)



Source: B.I.S.

Ecu assets of the banking sector vis-à-vis the non-banking sector fell very slightly from ECU 51 bn at the end of 1995 to ECU 42 bn at the end of the first quarter of 1997 (latest available data). In contrast liabilities remained virtually unchanged.

**GRAPH 9 : Banking market – non-bank sector**  
Assets and liabilities (ECU billions)

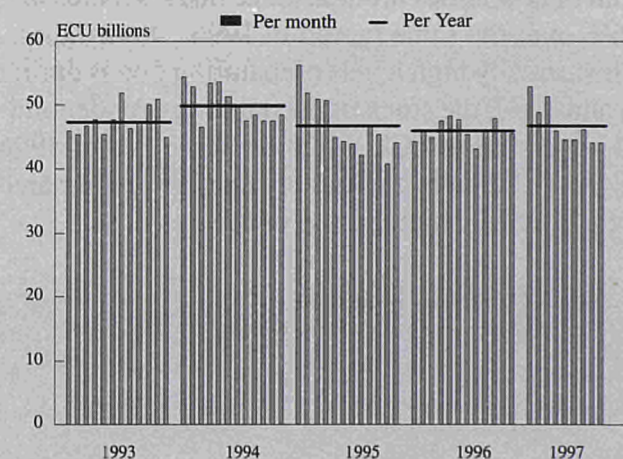


Source: B.I.S.

### (ii) EBA ECU Clearing and Settlement System

Daily average turnover in the EBA clearing system, on a yearly basis, decreased from ECU 46.82 in 1995 to ECU 46.03 in 1996, but increased during 1997 to ECU 47.90 bn for the first six months.

**GRAPH 10 : ECU clearing through S.W.I.F.T**  
Average daily turnover



Source: B.I.S.

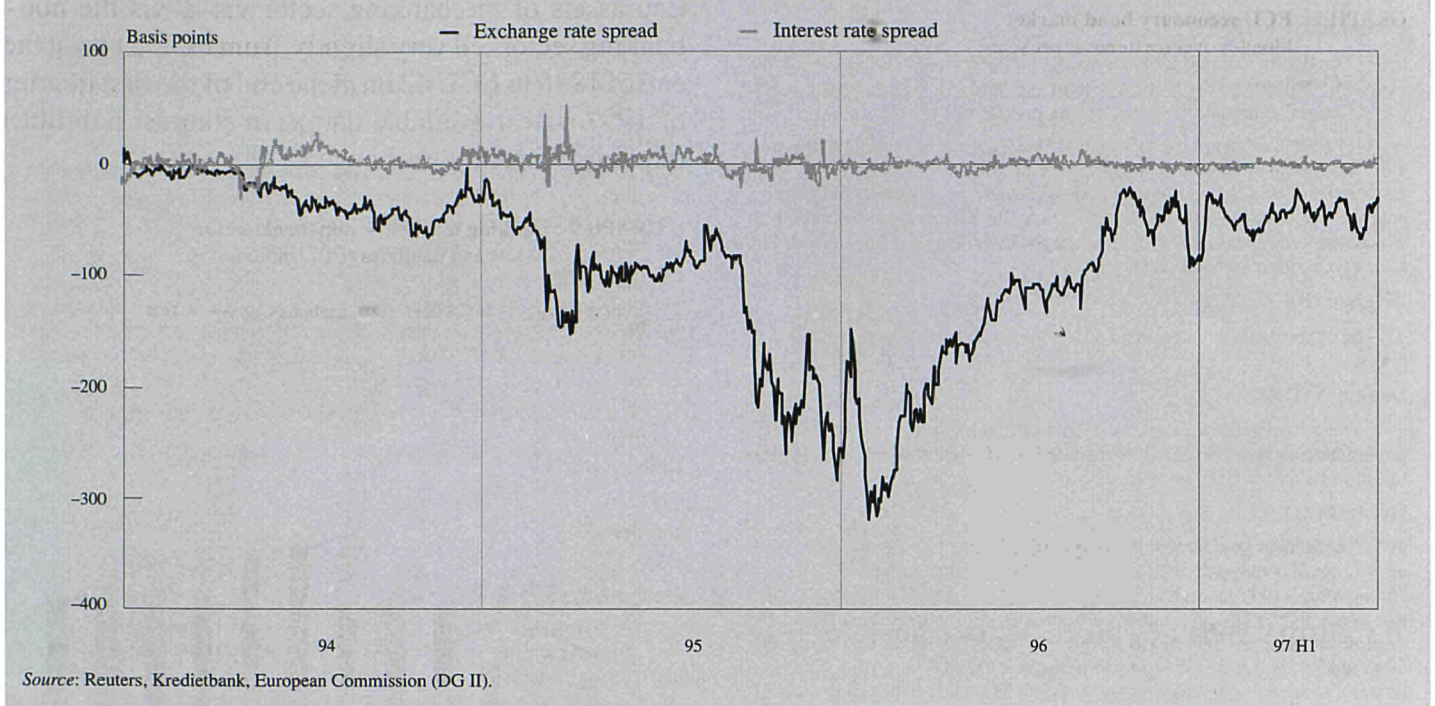
## (C) Interest Rates

The ecu short term interest rate differential vis-à-vis the DM narrowed by 38 bp over 1996 and the first half of 1997 to 102 bp on 30.06.97. The differential with the FFR differential also narrowed.

Long term rates have demonstrated a greater degree of convergence with the differential between the ecu and DM falling from 96 bp on 29.12.95 to 29 bp on 30.06.97.



GRAPH 11 : Theoretical versus market interest and exchange rates spreads



During the first two months of 1996 the spread reached low levels, within a longer-term perspective, but subsequently widened to attractive levels, par-

ticularly at the 3 and 5 year maturity bands, which were sustained throughout the remainder of the year and the first half of 1997.

26 September 1997

## Principal economic policy measures – July/August 1997

## Community (EUR-15)

07.07 The Ecofin Council formally adopts the 1997 Broad Guidelines of the Economic Policies of the Member States and the Community. Furthermore, the Council examines the convergence programme of Italy.

16.07 President Santer presents "Agenda 2000", a communication which provides perspectives for the development of the EU and its policies, enlargement and the financial set-up after 2000. Furthermore, President Santer presents the Commission's view on applications for membership, according to which negotiations could start with six applicants (Hungary, Poland, Estonia, Czech Republic, Slovenia and Cyprus).

## Belgium (B)

4.7 The government decides on measures to create jobs by reducing working hours.

## Denmark (DK)

26.8 The government presents the 1998 draft budget proposal. The general government surplus is expected to reach 0.8% of GDP and the gross debt ratio to fall to 63.5% of GDP in 1998.

## Germany (D)

11.7 The German government increases the deficit ceiling for this year's federal budget and adopts its official proposals for the 1998 budget bill. The new ceiling for the 1997 federal budget is put at DEM 71.2 billion (DEM 53.3 billion previously). The government reiterates that, on a Maastricht basis, the general government deficit will be 3.0% of GDP despite this overrun. The 1998 federal deficit is planned to be reduced to DEM 57.8 billion, thanks to restraint in spending (growing only by 0.5%) and new privatisation receipts.

## Greece (GR)

None.

## Spain (E)

None.

## France (F)

10.7 The government adopts by decree (*décret d'avance*) its package of immediate measures to boost consumption and employment. The measures, costing some FRF 10 billion (0.1% of GDP), are financed by the spending cuts already decided by the previous government.

21.7 The public finance audit carried out on the government's behalf by two independent magistrates puts the general government deficit at between 3.5% and 3.7% of GDP at the end of 1997.

21.7 On publishing the public finance audit, the government announces a programme of measures costing FRF 32 billion in 1997. The government's deficit target for 1998 is 3% of GDP.

## Ireland (IRL)

17.7 The Minister for Finance announces a change in the eligibility threshold for the cash basis of accounting for VAT in order to help small businesses. The threshold is increased to IEP 500 000 from IEP 250 000.

## Italy (I)

None.

## Luxembourg (L)

30.7 The government presents its budget for 1998, giving a central government deficit of LFR 200 million, equal to 0.03% of GDP.

## Netherlands (NL)

10.7 The central bank raises its special rate on advances from 2.90% to 3.00%, bringing the most important capital market rate into line with the equivalent rate in Germany.

## Austria (A)

24.7 The Council of Ministers approves the budget proposal for 1998 and a first draft for 1999. In both years the federal government budget is targeting a deficit of 2.6% of GDP. The budget proposal for 1998 will be presented to Parliament in mid-September.

## Portugal (P)

2.7 The coverage of the income maintenance programme is extended to the entire country. This programme includes, for each person with an income below a threshold of PTE 21 000, a minimum income, a negative income tax, and an integration and training agreement.

11.7 The Bank of Portugal cuts its key official rates by 30 basis points. The repo rate is cut to 5.7%.

## Finland (FIN)

None.

## Sweden (S)

None.

## United Kingdom (UK)

2.7 The Chancellor of the Exchequer presents the budget. The measures tighten fiscal policy by around ¾% of GDP in both 1997/98 and 1998/99. The authorities expect a general government deficit of 2% of GDP in 1997. Among the main measures introduced are the following:

- A windfall tax levied on privatised utilities to finance a GBP 5 billion "Welfare-to-Work" programme, which, among other things, encourages the reintegration of young and long-term unemployed; to be paid in two instalments, in December 1997 and in 1998.
- Corporation tax cut from 33% to 31%; effective April 1997.
- Small company corporation tax cut from 23% to 21%; effective April 1997.
- Abolition of tax credits on dividends to pension funds and companies; effective immediately.
- Enhanced capital allowances for SMEs; effective immediately.
- Allowing local government to invest proceeds from the sale of public housing in new housing projects.
- VAT on domestic fuel and power cut from 8% to 5%; effective September 1997.
- Abolition of income tax relief on private medical insurance contributions for the over-60s; effective immediately.
- Introduction of a new 10% income tax rate; to be implemented "when prudent to do so".
- Road fuel duties to be increased by 1% per year over and above the already existing 5% per year real rate of increase; effective immediately.
- Tobacco duties to be increased by 2% per year over and above the already existing 3% per year real rate of increase; effective November 1997.
- Alcohol duties to be increased in line with retail price inflation; effective January 1998.
- Gas levy on domestic consumers to be cut to zero; effective April 1998.
- Stamp duty to be increased from 1% to 1½% for property sales in excess of GBP 0.25 million and to 2% for property sales in excess of GBP 0.50 million; effective after acceptance of the budget by the House of Commons.
- Mortgage interest tax relief cut from 15% to 10%; effective April 1998.
- 10.7 The Bank of England raises the base interest rate to 6¾% from 6½%.
- 7.8 The Bank of England raises the base interest rate to 7% from 6¾%.

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