

EUROPEAN ECONOMY

EUROPEAN COMMISSION
DIRECTORATE-GENERAL FOR ECONOMIC AND FINANCIAL AFFAIRS

Supplement A

Economic trends

No 8/9 – August/September 1995



*In this number :
The Ecu Markets*

SUMMARY

This report is divided into two sections. The first discusses the development of the ecu financial markets in the first half of 1995 and the second offers a statistical presentation of the ecu financial markets, highlighting key developments during the first half of 1995.

The first half of 1995 has seen progressive growth in demand for ecu from institutional investors. In general this demand reflects professional curve trading and secondary swap activity. The demand has not been generated by an increase in end demand for ecu. Ecu issuing activity has been very irregular with bursts of activity followed by lean stretches. Continuing perception by markets of uncertainty over aspects of EMU, perhaps exacerbated by currency market volatility, has tended to limit demand to the shorter end of the maturity band, with most ecu issues brought to the market in the first half of 1995 having a maturity of under five years.

The spread between the ecu market and theoretical exchange rates widened significantly during the first quarter of 1995. The spread at the end of March was the third widest observed after those seen in 1992 and 1993 during the ERM crisis. In the second quarter of 1995 the spread decreased significantly and stabilised at approximately 100 basis points. The persistence of the spread at ± 20 basis points suggests the possibility of a change in the strategy of the ecu basket makers. They appear to be less willing than before to maintain open positions even though such positions would realise a profit when closed at the end of stage two of EMU.

During 1994 it was decided that the European Commission, in agreement with the EMI, would undertake a study of the ecu flows passing through the Ecu Banking Association's private Ecu Clearing System. The result of the survey suggest that commercial ecu payments were in the range of ECU 50 bn to ECU 70 bn. These results demonstrate that earlier estimates of the use of the ecu were overly cautious.

PART I: COMMENTARY ON DEVELOPMENTS IN THE ECU MARKETS DURING THE FIRST HALF OF 1995

I. ECU BOND AND DERIVATIVES MARKETS

New ecu bond issues totalling ECU 8.2 bn were brought to the market during the first half of 1995 compared with ECU 13.4 bn during the first half of 1994 and ECU 8.0 bn during the second half.¹ Nevertheless, ECU 13.4 bn of ecu bonds matured during the same period, meaning that the stock of outstanding ecu-denominated bonds declined by 3.8% during the first half of this year (to ECU 129.9 bn). At the peak of the market, during the first half of 1993, approximately ECU 140 bn of bonds were outstanding.

The share of total new issues pertaining to EU Member States increased during the first half of 1995 compared

with the 1994 average (to 82% from 76%). The private sector remained well represented in the market; however, its share decreased slightly (from 16% to 10%); the share of institutional issuers recovered from 7% to 8%.

As in 1994, weakness in the primary bond market during the first quarter (the latest data period available) was a factor common to other currency sectors as well as ecu. Table 2 highlights the position. Currency instability was one of a range of contributory factors. During the first three months of 1995 the ecu achieved further increases in market share, following on from those in 1994. Turning to other currencies, the significant increase in the market share of the DM is unsurprising. The fall in the relative position of UKL could reflect increased political risk, during the period. Similar factors could have impacted on the FFR.

¹ All figures exclude Greek Ecu-Linked Bonds.

TABLE 1 : ECU bond issues during 1995 H1

Type	Cat. of Issuer	Date of Payment	Date of Issue	Issuer	Nat.	Amount (ecu mn)	Maturity	Coupon
Euro	Sov.	24.01.95	17.01.95	UK (T-note)	UK	1000.0	27.01.98	8.062%
Euro	Sov.	24.01.95	20.01.95	Italy (CTE)	IT	750.0	24.01.00	8.500%
Euro	Sov.	25.01.95	11.01.95	France (OAT)	IT	295.0	25.04.04	6.000%
Euro	Sov.	25.01.95	11.01.95	France (BTAN)	FR	221.0	16.03.98	7.250%
Euro	Sov.	16.03.95	23.02.95	France (BTAN)	FR	1200.0	16.03.97	7.500%
Euro	Sov.	20.03.95	20.02.95	Austria	AT	400.0	20.03.98	7.750%
Euro	Sov.	21.03.95	24.02.95	Denmark	DK	500.0	21.03.96	6.750%
Euro	Sov.	15.03.95	08.03.95	France (OAT)	FR	221.0	15.03.02	6.750%
Euro	Sov.	25.04.95	18.04.95	UK (T-Note)	UK	499.0	27.01.98	7.410%
Euro	Sov.	24.05.95	10.05.95	France (OAT)	FR	253.0	25.04.02	6.750%
Euro	Sov.	24.05.95	10.05.95	France (BTAN)	FR	322.0	13.03.98	7.250%
Euro	Sov.	29.05.95	22.05.95	Italy (CTE)	IT	500.0	29.05.98	7.500%
Euro	Sov.	29.05.95	25.05.95	Italy (CTE)	IT	500.0	24.05.00	8.250%
TOTAL SOVEREIGN						6661.0		
Euro	Int.	28.02.95	26.01.95	EIB	EU	400.0	28.02.00	8.250%
Euro	Int.	03.03.95	02.02.95	Eurofima	EU	50.0	20.12.99	8.125%
Euro	Int.	23.03.95	24.02.95	Council of Europe	IO	200.0	23.03.96	6.875%
TOTAL INSTITUTIONAL						650.0		
Euro	Private	25.01.95	05.01.95	General Electric Cap Corp	US	150.0	25.01.99	8.250%
Euro	Private	03.02.95	05.01.95	BNG	NL	50.0	08.12.98	8.125%
Euro	Private	22.02.95	25.01.95	Bayerische Hypobank	D	125.0	23.02.99	8.250%
Euro	Private	24.02.95	24.01.95	General Electric Cap Corp	US	100.0	24.02.00	8.250%
Euro	Private	28.02.95	11.01.95	DSL Finance	D	100.0	28.08.98	8.250%
Euro	Private	01.03.95	27.01.95	Crédit Local de France	FR	150.0	23.12.98	8.125%
Euro	Private	01.03.95	27.01.95	Sudwest LB Cap. Market	NL	100.0	01.03.00	8.250%
Euro	Private	02.03.95	15.02.95	General Electric Cap Corp	US	50.0	17.11.98	8.000%
Euro	Private	23.04.95	21.04.95	Itochu Unit	JP	45.0	23.04.96	6.600%
Euro	Private	26.04.95	19.04.95	Bank of Tokyo	JP	45.0	26.04.96	6.500%
Euro	Private	16.05.95	06.04.95	Samsung Electronics	KR	80.0	16.05.00	na
TOTAL PRIVATE						825.0		
TOTAL						8146.0		

Source: Commission Services.

TABLE 2 : Currency composition of international bond issues, %

	1990	1991	1992	1993	1994	1995 Q1
USD	32.9	32.7	36.7	35.5	33.8	30.2
DM	12.4	6.8	10.2	11.4	9.1	14.1
YEN	12.3	12.4	12.7	11.9	17.8	13.4
UKL	8.6	8.6	7.0	8.6	6.8	6.4
ECU	7.8	10.0	7.4	4.1	4.9	6.0
ITL	2.3	2.8	2.3	2.5	3.9	5.8
SFR	9.0	6.3	5.4	5.6	4.8	5.6
FRF	4.0	5.7	7.2	8.6	6.6	4.7
Other	8.1	7.1	6.7	5.8	9.1	13.8

Source: Bank of England ICNS Database.

Ecu issuing activity during the first half of 1995 was very irregular. Periodic bursts of activity were followed by very lean stretches; such as June during which there were no issues. Furthermore, in line with the increase in uncertainty generated by currency market volatility (during February and March in particular), and facilitated by strong redemption flows, demand remained firm only at the short end of the yield curve (1–3 years). The majority of issues were thus targeted at the short end, with none of the private issues brought to the market so far in 1995 having a maturity in excess of five years. Moreover, ecu primary bond issue activity was further constrained by historically tight swap spreads (see below).

The level of institutional demand for ecu assets has increased progressively during the first half of 1995; however, this demand has not been generated by an increase in end-demand for ecu, but reflects primarily professional curve trading and secondary swap activity. Part of the reason for this lack of institutional interest in the ecu, as a long-term investment vehicle, is the persistent market perception of uncertainty concerning (economic, technical and political) aspects of Economic and Monetary Union (EMU).

Investors have been discouraged by the lack of new benchmark issues along the curve, as well as the decay of many existing benchmarks. The appearance of a stripped bond facility² in January 1994 via French OAT issues in principle introduced a homogenous yield curve in ecu right out to 27 years (29 new maturities were created via this facility), but liquidity in this market has remained poor. The lack of market-maker facilities and of outstanding in some of the issues (and despite the fungibility of the coupon strips) is part of the reason. Consequently, traded volumes have been light, for instance compared to volumes traded in French

² Bond stripping involves turning an original bond into a principal certificate and simultaneously into as many coupon certificates as there remain annuities to run. Conversely, reconstituting the original bond means that equal numbers of principal and coupon certificates are exchanged with the central clearing institution (Euroclear and CEDEL for the ecu) for an equal amount of original bonds (De Clermont-Tonnerre, A. & M-A. Lévy (1995), Zero-Coupon Bonds. IFR).

TABLE 3.a : Outstanding amounts of ECU strips as at 31 May 1995

Strippable bonds	Amount stripped (ECU mn)	Total outstanding (ECU mn)	% of total stripped
9.50% 25/04/00	66	2174	3.03
6.75% 24/04/02	1	2175	0.04
8.00% 25/04/03	10	1260	0.79
6.00% 25/04/04	46	3954	1.17
8.25% 25/04/22	157	2000	7.87
Total	280	11562	2.42

Source: Sicovam.

TABLE 3.b : Outstanding amounts of French franc strips as at 31 May 1995

Strippable bonds	Amount stripped (FFR mn)	Total outstanding (FFR mn)	% of total stripped
8.50% 25/04/03	4368	99103	4.41
6.75% 25/10/03	5987	101706	5.89
5.50% 25/04/04	430	101121	0.43
6.75% 25/10/04	6890	70711	9.74
7.50% 25/10/05	12912	108157	11.94
7.75% 25/10/05	600	37147	1.62
8.50% 25/10/08	3773	57398	6.57
8.50% 25/10/19	41797	61328	68.15
8.50% 25/04/23	48115	87952	54.71
6.00% 25/10/25	3222	33581	9.6
Total	128093	758204	16.89

Source: Sicovam.

franc strips (see Table 3). Nevertheless, this innovation clearly could half importance in the context of Stage Three of EMU and the development of a liquid, continuous single currency ecu yield curve.

Though in value terms ecu secondary turnover increased marginally in the first half of 1995, turnover remained modest, reflecting the relative lack of demand for ecu assets. Over the same period, the ecu's share of total secondary turnover settled through the Euroclear and Cedel systems, measured as a monthly average, declined further to 4.6% at the end of June from 5.2% during 1994 as a whole (and 5.6% during 1993).

As Table 4 highlights, the evolution of secondary turnover in ecu assets during recent years has been less spectacular than that of some other currencies, notably the French franc and sterling. For these two currencies the sharp falls in turnover in 1994 and the first half of 1995 appear primarily to have reflected a correction to more sustainable levels following the pricking of the bond market bubble at the beginning of 1994 (and despite the recovery of world bond markets generally during 1995). In contrast, the ecu, having ridden out the 1994 bear market better than these two currencies (although much less impressively than the DM, which attracted the lion's share of flight capital) has not regained much of the activity lost as a result of ERM crises

TABLE 4 : Secondary bond market turnover through Euroclear & Cedel (monthly average ECU bn¹)

	1993		1994		1995 H1	
	value	%	value	%	value	%
DM	477	+143	784	+64	883	+13
USD	133	+34	154	+16	160	+4
NLG	108	+96	121	+12	123	+2
FRF	139	+72	105	-24	67	-36
DKK	75	+233	91	+22	125	+37
ECU	70	-28	81	+16	83	+3
UKL	29	+34	25	-14	21	-16

¹ % change is defined as year-on-year.

Source: Euroclear, Cedel.

in 1992 and 1993 (secondary ecu turnover is still 20% lower compared to end 1992).

In line with the approximate evolution of yields in other developed bond markets, ecu yields have declined along the curve during the first half of 1995 as a whole. Thus, at ten years yields declined by 78 bps, to end the period at 7.94%; this compares with a local peak in January 1995 of 8.83%. However there was a minor upwards correction in ecu yields (20 bps at ten years) during June, in common with other bond markets. In other European bond markets this correction in yields was

triggered primarily by an upward spike in US yields on the back of concerted central bank intervention on the foreign exchange markets to support the dollar (although market specific factors, such as an increase in political risk in the UK, were relevant also). In the ecu

GRAPH 1 : Evolution of MATIF bond future

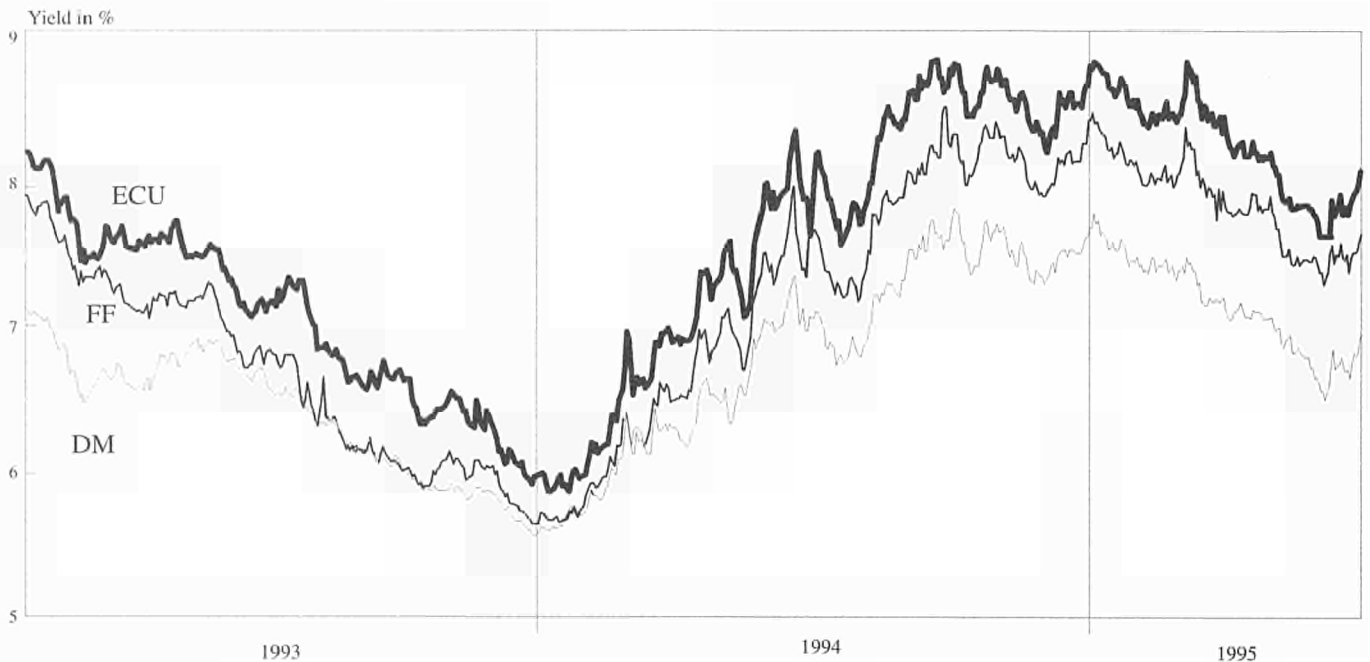


Source : MATIF.

sector this correction was due primarily to the lack of bond market liquidity.

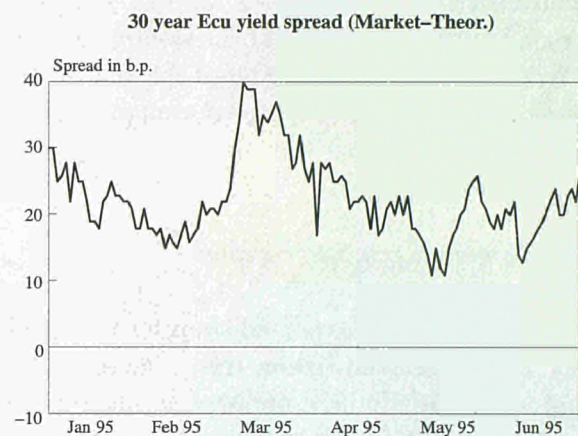
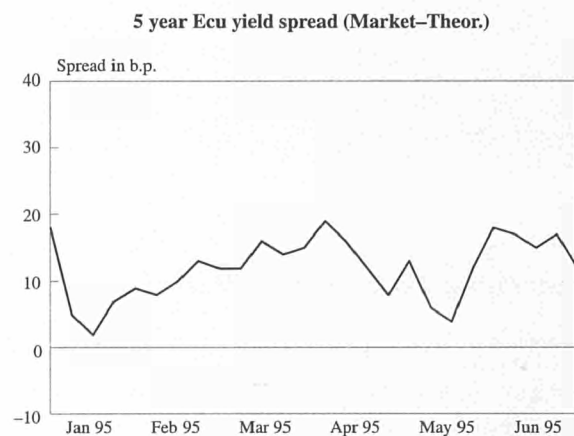
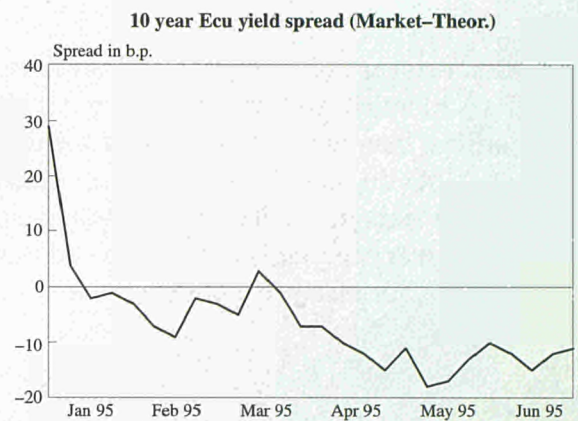
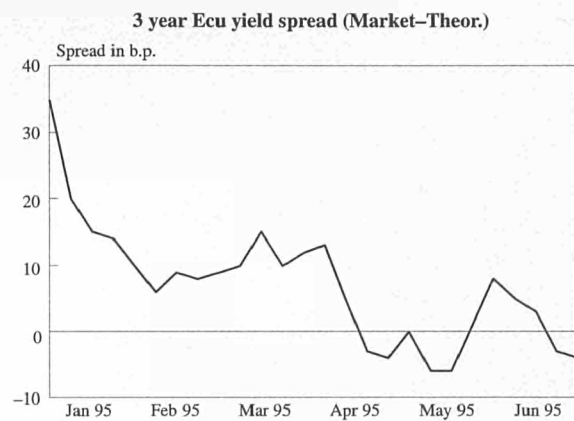
Consistent with yield evolution during the first half, the MATIF ecu long bond futures contract price trended up over the period as a whole, although it underwent a small correction during June (from a high for 1995 marginally in excess of 87 to below 85).

GRAPH 2 : 10 year yields-benchmark



Source: Commission Services.

GRAPH 3 : Ecu yield spreads



Source: Deutsche Bank AG London, UBS (Luxembourg).

Mixed performance of ecu assets against comparable component markets...

Ecu assets were unable to make significant progress against DM equivalents over the first half of 1995 as a whole. This is indicated by the slight increase in the ecu/DM yield spread at ten years, from 107 bps over DM bunds at the beginning of January to 110 bps over at the end of June. At mid-period this spread widened frequently, to as much as 139 bps, before tightening thereafter, while the spread tightened below 100 bps on only three occasions during the first half. The period low was 96 bps (in May). These spreads demonstrate the importance of the DM as a safe-haven currency during periods of high market volatility. It also reflects negatively upon the ecu, given its erstwhile tendency to outperform component currencies, including the DM, during the initial phases of a bond market rally.

In contrast, against the FRF the yield premium on ecu assets, at ten years, remained stable, generally trading in a range 20-55 bps. It began 1995 at a premium of 55 bps and ended the first half at 44 bps. The close correlation at present between ecu and FFR yields derives from the predominance of French OAT and BTAN issues within the ecu bond market.

In addition, differential behaviour of ecu/DM and ecu/FRF yield spreads confirms the central role in the markets of the DM during the early months of this year. Similarly, the brief periods of outperformance by ecu assets over comparable DM assets during May, noted above, were encouraged by the good performance of French franc assets in the wake of this year's presidential elections.

Modest outturn for market ecu assets versus their theoretical...

The performance of the yields on market ecu assets vis-à-vis their theoretical equivalent was less strong than historic trends would suggest. The market ecu has historically outperformed its components at the beginning of an upswing in bond markets, as has occurred during the first half of 1995, so that yields attached to market ecu assets move to a premium against their theoretical equivalents. In a relatively modest way this has occurred at 3 and 10 years maturities.

At 5 and 30 years maturities the market ecu made no sustained gains against its theoretical. It has continued to trade at a significant discount throughout the first half of 1995; consequently market ecu assets offer investors significant opportunities at these maturities.

The ecu yield curve flattened during the first half of 1995...

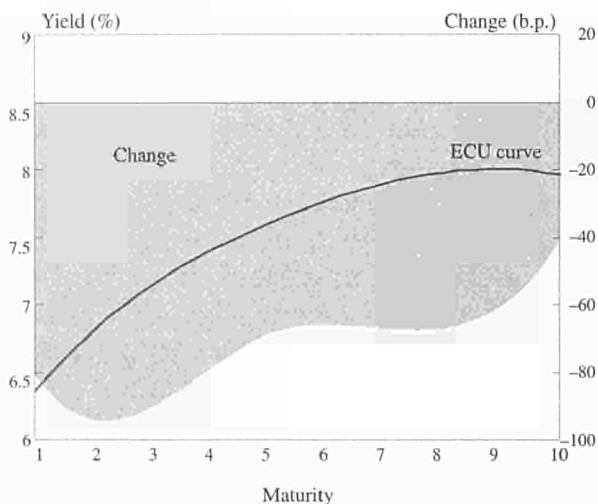
With a modest decrease of 6 bps to 6.19% in short interest rates (3 months) and sharply lower yields at longer maturities, there was a flattening of the market ecu yield curve. As discussed above, the poor liquidity conditions in ecu market, resulted in a modest upwards correction in market ecu yields at the long end during June (at ten years, for instance, yields increased by 20 bps, to 7.94%).

Furthermore, from the above it is clear that the slope of the yield curve (measured as a ratio of ten years to three months) continued to fall back during the first half 1995, from 1.39 at the beginning of the year to 1.28 at end-June. On a historic basis it remains relatively steep.

Implied one month ecu interest rates

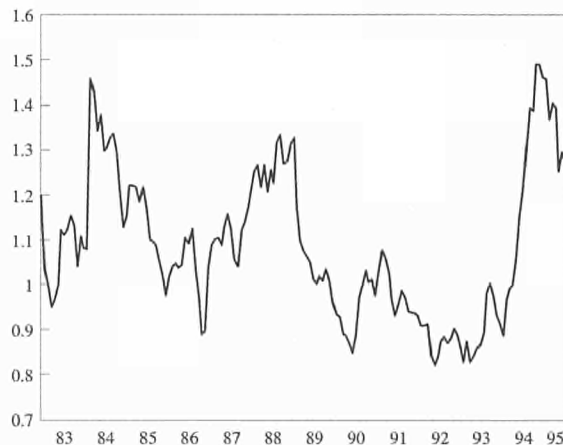
Given the evolution of expected short term market ecu interest rates (derived from the settlement prices quoted for the LIFFE three month ecu interest rate futures contract), it is apparent that, in line with EuroDM rates, market participants anticipate further increases in ecu short rates throughout the period to mid-1997, driven primarily by cyclical factors. However, it is also apparent that investors have revised their interest rate expectations (in terms of levels, rather than trend) downwards during the first half of 1995, primarily in response to slower growth in the US and Germany.

GRAPH 4 : Ecu yield curve as at 30.06.95 and change from 31.12.94



Source: EUROSTAT.

GRAPH 5 : ECU yield curve slope (10 y/3 Mth)



Source: Commission Services, EUROSTAT.

A one-year forward ecu interest rate curve...

EUROSTAT, the Statistical Office of the European Commission, has constructed an ecu forward yield curve from the market prices of sovereign and supranational bonds in the market³. As is well-known, the forward yield curve is a plot of one-year forward rates against term to maturity. Similarly, the relationship between spot and forward yield curves is widely understood. Thus, the forward curve is a plot of marginal interest rates, that is the marginal reward for lengthening the maturity of a given investment by one year, while the spot rate measures an investment's average return from today to maturity. Spot rates are thus geometric averages of one or more forward rates.⁴

The two curves therefore contain the same information. However, on the basis of the Expectations Hypothesis of the yield curve, one can more easily extrapolate conclusions from the forward curve concerning investor expectations vis-à-vis the path of future interest rates than from the spot curve. Expectations so derived will be subject to a degree of noise, depending upon the extent of risk premia and convexity bias implicit within yields.

³ This curve will be updated weekly. Requests for additional information should be addressed directly to EUROSTAT. The following formulae summarise the essential elements of the forward curve.

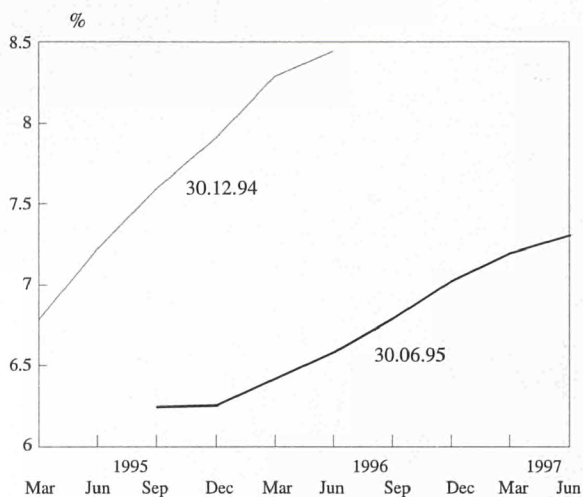
Discount function : $D(M) = 1 + K_1M + K_3M^2 + K_5M^3 + K_6\max(0, M-5)^3$ $M \in [0,10]$
 Spot: $S(M) = [D(M)]^{-1/M}$ $M \in [0,10]$
 Forward: $F(M) = D(M)/D(M+1)^{-1}$ $M \in [0,9]$

with M : Maturity, K_n : coefficients of the regression

The behaviour of the forward curve beyond 8 years is not considered reliable, given the lack of benchmark issues beyond 10 years and the curve's construction.

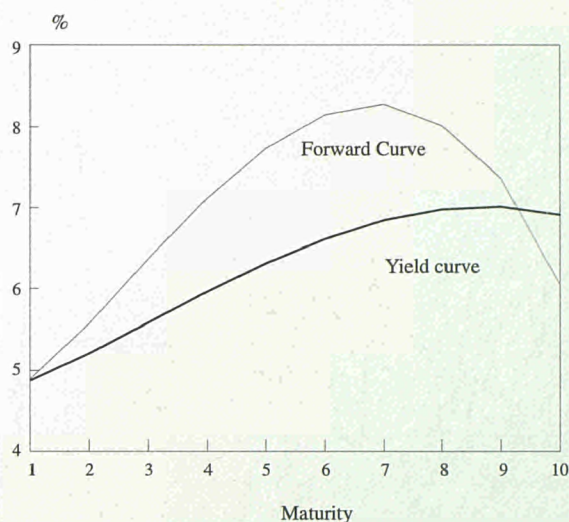
⁴ A. Ilmanen (1995), Overview of Forward Rate Analysis. Salomon Brothers. May.

GRAPH 6 : Implied future ecu 3 month interest rate



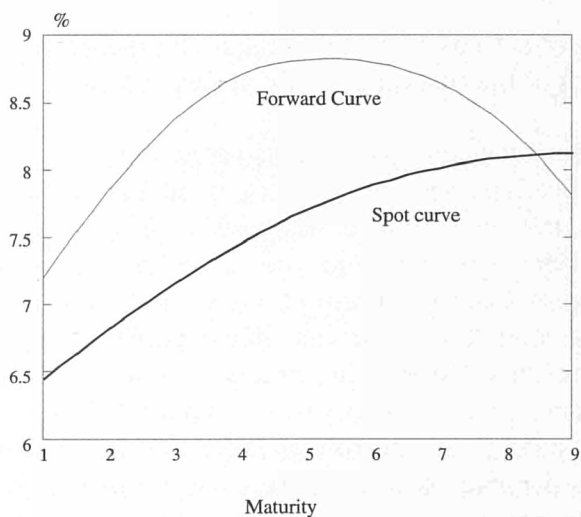
Source: LIFFE.

GRAPH 8 : Forward yield curve



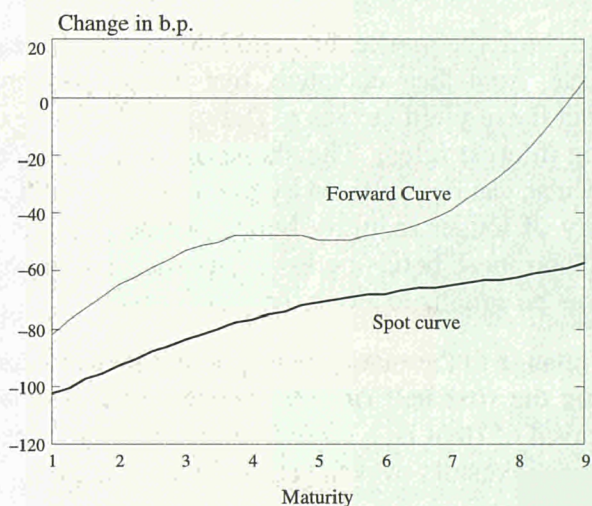
Source: Commission Services.

GRAPH 7 : Ecu 1 year forward curve as 30.06.95



Source: EUROSTAT.

GRAPH 9 : Change from 31.12.94 of ecu 1 year forward curve



Source: EUROSTAT.

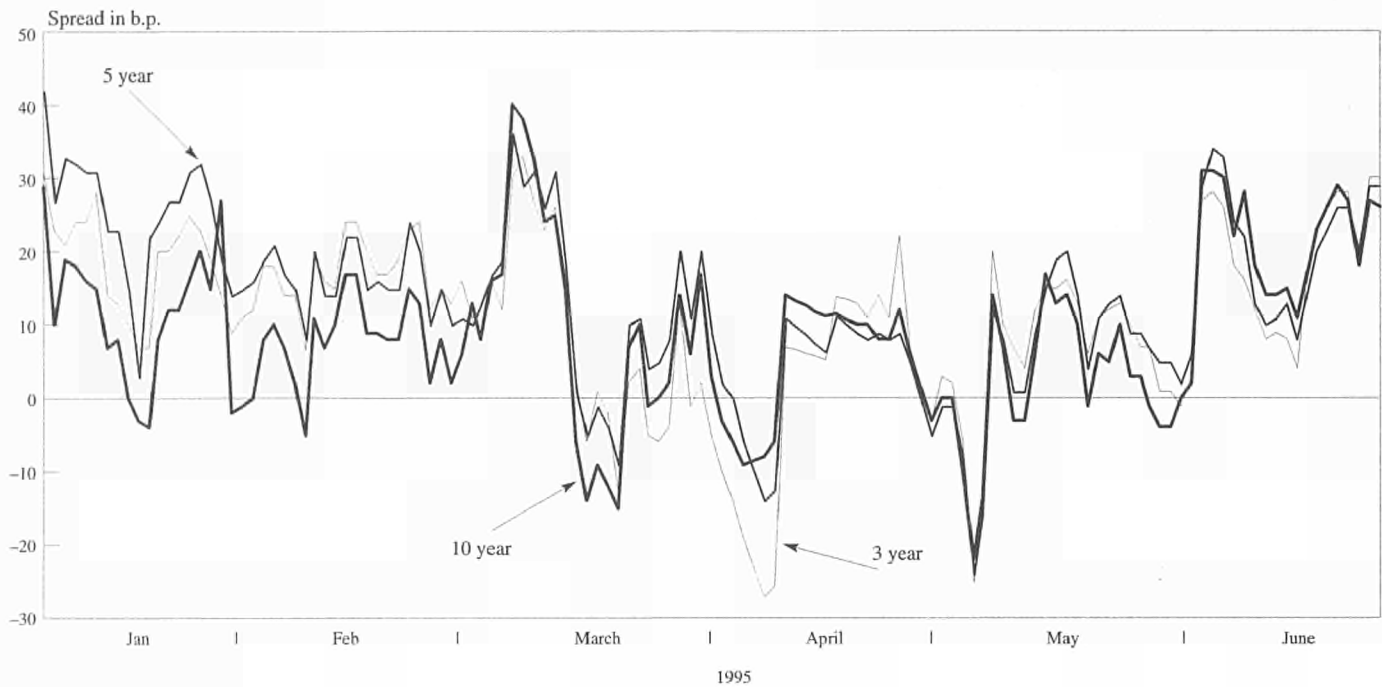
There are a number of factors which, to a lesser or greater degree, appear at present to underlie the expected evolution of one year forward market ecu interest rates.

First, the expected evolution of market ecu interest rates appears compatible with the introduction of EMU at the beginning of 1999, given that single currency ecu interest rates, quoted from the beginning of Stage Three of EMU, including one year rates, will likely fall relative to basket ecu rates, quoted immediately prior to this date. This is because the single currency ecu interest rates will not be based upon a weighed average of low and high yielding component currencies, as are current basket ecu yields.

Pursuing this argument further, it is probable that the decline in forward rates from 1999 onwards will become more distinct as the start date of Stage Three approaches, with active position-taking and portfolio adjustment. Furthermore, the risk premium at present priced into basket ecu forward rates, due to the persistence of market uncertainty concerning EMU, will tend to zero as the start date for Stage Three approaches. Assuming other factors remain equal, the whole ecu forward curve can be thus expected to shift lower relative to the DM curve.

Second, the expected evolution of market ecu forward rates indicates an important cyclical component. This is clear also from the DM one year forward curve.

GRAPH 10 : ECU swap spreads



Source: Commission Services.

Third, both the market ecu and DM curves appear to indicate, from their curvature, that market participants expect these yield curves to flatten in the context of rising interest rates. The shape of the ecu curve, in particular, can be explained by the relatively high convexity of longer maturity bonds, which requires that yields on these bonds be lower in order that expected returns be equalized along the yield curve.

The change in the market ecu spot and forward curves during the first half of 1995 appears to reflect a reappraisal of (that is, a reduction in) inflation expectations by investors over the current business cycle.

Ecu swap spreads are very tight within an historical perspective...

A characteristic of the ecu bond market is its high dependence on the swap market. How attractive a swap transaction is for an issuer depends on the difference between offered swap and bond rates. During the first five months of 1995, this spread reached very low levels within a longer-term perspective, before subsequently widening modestly.

From the ecu yield curve, implied future ecu three month rates and forward ecu interest rate curve, it is clear that expectations are indicative of higher interest rates in most Member States (the significant exception is the UK, where official rates are close to, if not at, their local peak). In turn, this has encouraged borrowers to lock into current low funding costs by swapping their floating rate liabilities into fixed rate debt. Given the limited supply of fixed rate ecu bonds, this

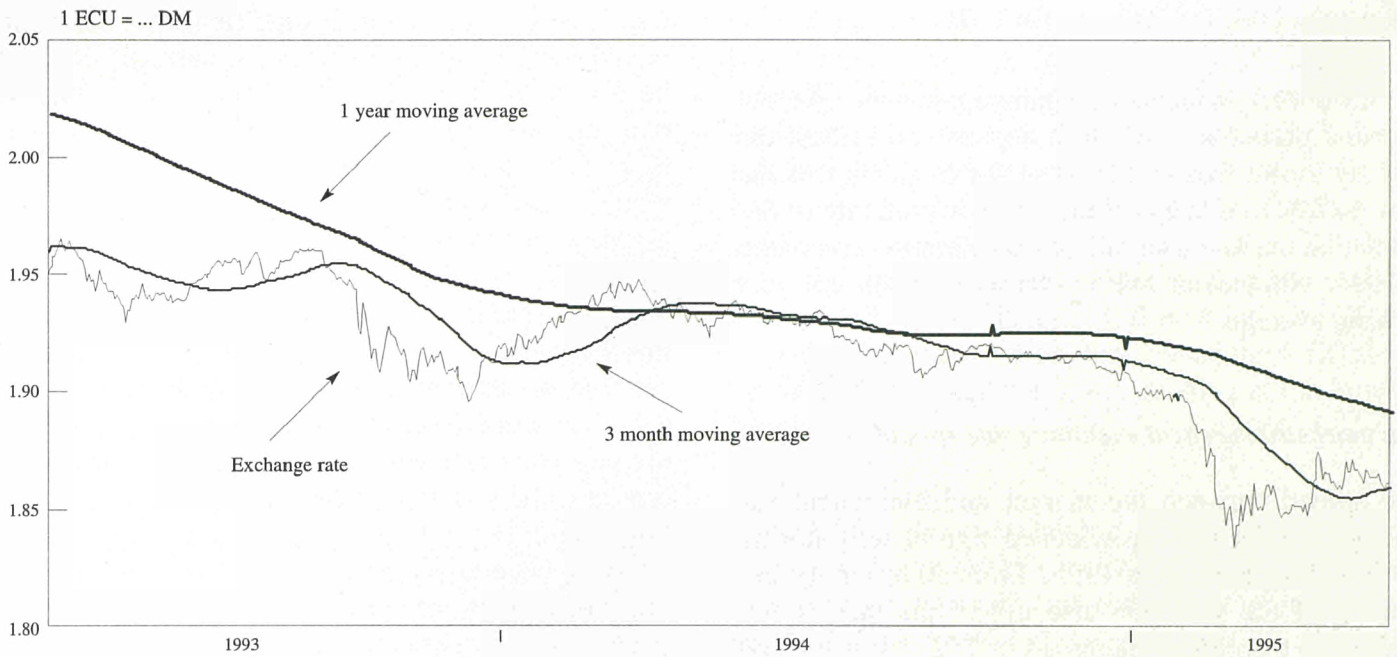
type of activity may well explain the reduction during much of the first quarter of ecu swap spreads.

Lower swap spreads have, as noted above, significant implications for ecu primary bond market activity; thus, the low volume of new issues during the first half of 1995, compared to the same period of 1994, suggests that some borrowers have postponed new ecu issues until later in the year, due to poor swap opportunities (the effect on ecu primary bond market liquidity of these postponements was compounded by the fact that 'natural' ecu borrowers failed, for the reasons discussed above, to take the slack created by the absence of swappers). A similar effect was observed in the second half of 1987, when new issues fell from ECU 4.3 bn, during the first half of the year, to ECU 1.7 bn, during the second half.

On the other hand, diminishing swap spreads have a positive effect on the secondary market. Market participants can pay into swaps at low rates and receive the interest on the bond. The lower the swap rate is, the more profitable these transactions become. The majority of secondary activity in the ecu bond market during the first half of the year was motivated by this type of transaction.

Low swap rates also indicate that some holders of ecu bonds are willing to sell interest flows on bonds for a very low price. This might suggest that some holders of ecu paper desire to switch out of this market. For example, institutional investors who had their portfolios frozen during the decline in the bond market in

GRAPH 11 : DM/ECU exchange rate



Source: Eurobrokers Capital Markets, Commission Services.

1994, because of the need to avoid reporting on balance sheet losses, might fall into this category. With a pick-up in the bond market, a traditional way of achieving any such reduction would be via asset swaps, given relative transaction size available, as compared to an outright sale.

II. EXCHANGE AND INTEREST RATES

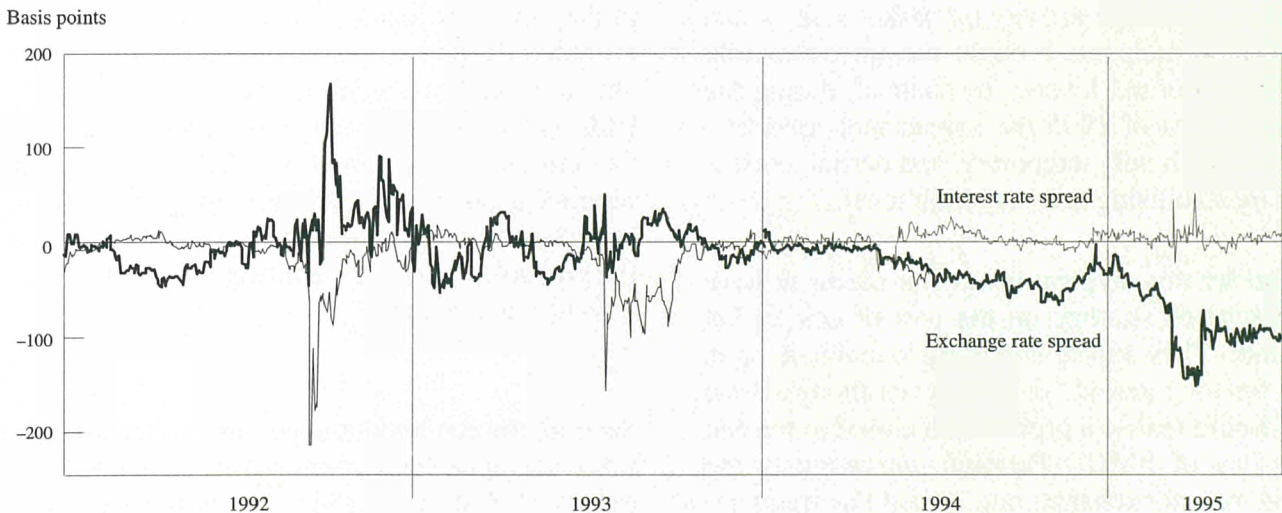
Foreign Exchange

During the first half of 1995 the key characteristic of the European currency markets was the strength of the

DM. A weak dollar and political and structural difficulties in a number of European countries moved investors to choose the DM as a key safe-haven, with a consequent flight of capital from other component currencies of the ecu basket. As a result, the ecu and many other European currencies (other than the guilder, schilling, Danish krone and Belgian franc) were generally weak against the DM, and bilateral exchange rates were volatile.

Beginning in April, the DM lost a little of its lustre. Expected real interest rate developments during the remainder of 1995 and concerted central bank intervention

GRAPH 12 : Theoretical versus market interest and exchange rates spreads



Source : Reuters, Kredietbank, European Commission (DG II).

in favour of the US\$ weakened the DM against the former. In Europe a number of currencies made gains against the DM; for instance, the FFR.

In May the ecu made modest gains against the DM, but over the period as a whole it depreciated against the DM by 2.6%, from DM1.91 at the beginning of the year, to DM1.86 at end-June. This overall rate of depreciation marked a significant acceleration compared to 1994, with the rate falling sharply below its one year moving average.

Ecu market/theoretical exchange rate spread

The spread between the market and theoretical exchange rates of the ecu widened significantly during the first three months of 1995. From 30 bps at the beginning of the year, the discount of the market ecu against its theoretical increased to 152 bps at the end of March. This was the third widest spread ever observed, behind only those seen during the ERM crises of 1992 and 1993. However, on 7 April 1995 it decreased significantly from 152 bps to 94 bps (i.e. 38 %), apparently as a result of central bank activity in the foreign exchange market. Subsequently, the spread has stabilised at approximately 100 bps.

The persistence of a spread wider than ± 20 bps (considered to be a normal trading range within an historical context), as was observed throughout the first half of 1995, contradicts the experience during the ERM crises.

Furthermore, during the ERM crises in 1992 and 1993, the ecu market/theoretical spread jumped immediately to its peak, due primarily to interventions by central banks on the currency markets rather than outright sales of ecu by institutional and retail investors. Subsequently, arbitrage activity by basket makers and other market participants brought the spread rapidly down to more normal levels. In contrast, during the first three months of 1995 the spread increased in a ratchet effect with only temporary, and partial, corrections, before stabilising at a very high level.

One reason for this atypical behaviour seems to have been a change of strategy on the part of ecu basket maker banks. They appear unwilling to maintain open positions for long periods of time, even though these positions would realise a profit when closed at the end of Stage Two of EMU. Periodic narrowing in the market/theoretical exchange rate spread has frequently been used by basket makers to close positions. This caps the recovery of the market ecu against its theoretical.

Basket maker banks performed arbitrage between the market ecu and the respective basket currencies on the basis of two main assumptions: first, that ecu claims would be exchanged into the single currency ecu at the beginning of Stage Three of EMU at parity and, second, on the basis of a "general" perception in the market that the market and theoretical values of the ecu would trade in a tight range. However, while the first assumption remains valid today, psychological factors appear to be working against the second. Growing market awareness of the lack of an institutionalised link between these two values, juxtaposed with the practice of marking positions to market, appears to have increased the tolerance of market participants to the persistence of wide spreads. Basket making has ceased to be riskless. It has become similar to position-taking in the foreign exchange market, with the inherent uncertainty and risks. Thus the relatively high volatility in the currency markets (especially during February and March 1995) further discouraged ecu arbitrage. In addition, causality feeds back from the persistence of spreads to market awareness of this apparent lack of a formal mechanism, potentially leading to a vicious circle.

Two other factors have been important in the evolution of the ecu market/theoretical spread. First, ecu market players are troubled by the continuing uncertainty over EMU. This may account for fluctuations of the spread around a trend evolution. Though the market has broadly accepted the prospect of EMU there remains a lack of clarity, for example, as to which countries will take part and how strictly the convergence criteria will be applied. Mixed results from opinion polls concerning EMU reinforce these uncertainty.

It is worth emphasising, that the existence of a discount in the value of the market ecu to its theoretical is consistent with the likely situation at the time of official announcements concerning the move to Stage Three of EMU (Phase A, in the language of the recent European Commission Green Book on the Introduction of the Single Currency). The current discount of the market ecu to its theoretical appears to have emerged despite the probable effects of the introduction of EMU, rather than because of them.

Second, the ecu bond market has exerted an important influence upon the currency market. Thus, the recent excess of maturing paper over new issues has weakened the market exchange rate against its theoretical. Funds so released are generally not being held on deposit in ecu.

III. THE COMMERCIAL USE OF THE ECU

During 1994, it was decided, in agreement with the EMI within the framework of an ad hoc working group created by the CMFB (Comité monétaire de finance et de balances de paiement), that the European Commission would undertake a study of ecu flows passing through the Ecu Banking Association's (EBA) private Ecu Clearing System, in order to improve the quality of data on the commercial use of the ecu. Until this time, incomplete Balance of Payments data had offered the best available estimates.

Accordingly, DG II launched a survey, which took place between 14 November 1994 and 12 December 1994, with the participation of 14 EBA clearing banks (out of a total of 45) from seven different countries. The survey covered approximately 50% of total payments netted by the EBA Clearing System by volume and by value (total payments per clearing day in November 1994 were 6,118 in number and ECU 47.5 bn in value).

On the basis of the study's findings, it is possible to estimate commercial and European Institution payments by value and volume for the whole ECU Clearing System.

Thus, on the basis of these estimates, the total value of commercial transactions in ecu within the ECU Clearing System was approximately ECU 75 bn for 1994 (the number of commercial payments was estimated at 132,000). However, allowing for remaining uncer-

ainties, such as potential seasonality in commercial ecu payments, it appears safer to assume that commercial ecu payments in 1994 were in the range of ECU 50 bn to ECU 75 bn, i.e. approximately 6% to 11% of intra-EU trade between the 12 Member States existing at the time of the survey. These results clearly indicate that previous estimates of the commercial use of the ecu were overly cautious (for instance, Commission services previously estimated this use at ECU 35 bn annually, while estimates based on Balance of Payments data indicated that it could be as low as ECU 6.5 bn annually, i.e. approximately 1% of intra-EU trade between the 12 Member States existing at the time of the survey).

Payments by European Institutions were approximately ECU 17 bn in 1994. Due to seasonality and certain other technical aspects, the estimated figure for total annual European Institution payments (of which the European Commission is the principal) should be interpreted cautiously.

Concerning payment flows, the main countries based on location of paying bank which made ECU payments were Belgium (4 banks, 46%) and the UK (4 banks, 32%). Five country destinations (F 26%, NL 19%, ES 17.7%, B 14.3%, UK 13.8%) accounted for over 90% of commercial payments. However, as above, these results should be interpreted with a degree of caution as payment instructions may not necessarily reveal the precise flow of trade. Participating banks were also not evenly distributed across the EU area.

TABLE 5 : Commercial use of the ECU
Estimate of annual flows for the ECU Clearing System

Destination Country	Survey result			% of total
	10 days	Estimate for 1 year	Whole Clearing System estimate for 1 year	
in ECU mn				
F	394.5	9947.4	19764.2	26.1
NL	291.8	7353.4	14619.0	19.3
E	267.6	6743.5	13406.6	17.7
B	216.1	5445.7	10826.5	14.3
UK	209.3	5274.4	10485.8	13.8
L	41.2	1038.2	2064.1	2.7
D	35.1	884.5	1758.5	2.3
I	15.7	395.6	786.6	1.0
P	5.8	146.2	290.6	0.4
DK	4.7	118.4	235.5	0.3
IRL	4.6	115.9	230.5	0.3
GR	0.4	10.1	20.2	0.0
Rest of world	27.0	680.4	1352.7	1.8
Total	1513.8	38147.8	75840.5	100.0

* Slight Discrepancies are due to rounding.

Source: Commission Services.

PART II : STATISTICAL ANNEXES

(A) Financial Markets

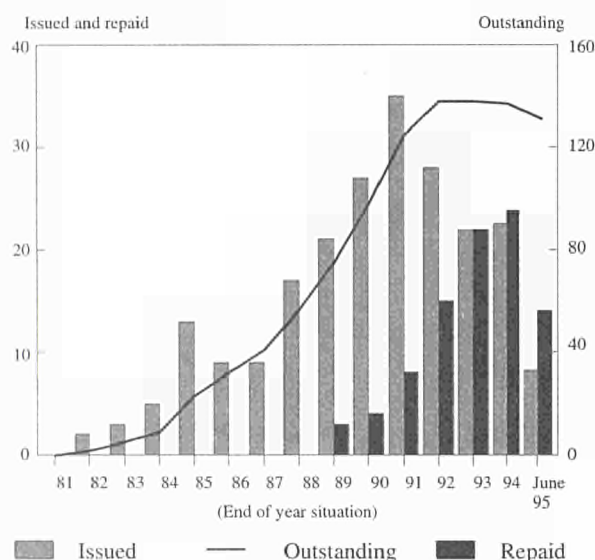
(i) Primary Bond Market

Recent Evolution

The ecu bond market continued to contract during the first half of 1995 (by 3.8%), following on from a fall in the stock outstanding during 1994 as a whole of 0.7%.

However, in contrast to 1994, this contraction has been due both to the large value of maturing paper during the period and a relatively low level of new issues (in 1994, the principal factor was the amount of maturing paper). The reasons behind the relative decline in issuing activity were discussed in the first section of this report.

GRAPH 13 : Ecu primary bond market — Historical evolution (Ecu Billions)



Source: Commission Services.

Issuing activity by Type of Issuer

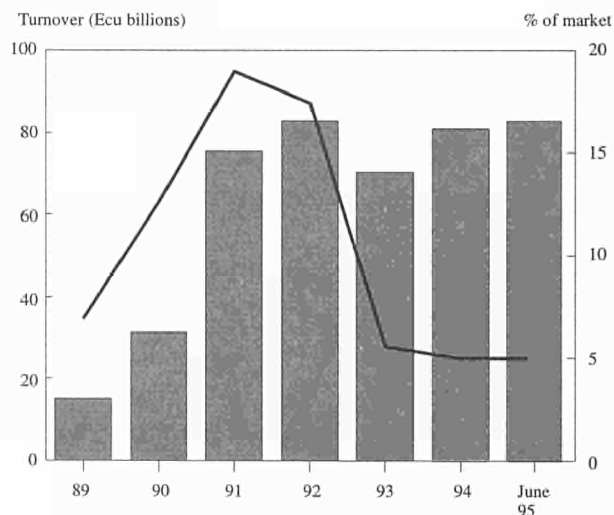
- Two issues by **EU institutions**, the **EIB** and **Eurofi-ma**, were brought to the market during the first half of 1995, representing 6% of total issuing activity. During the same period of 1994, EU institutions were not represented in the ecu primary bond market.
- **EU Member State governments** accounted for 82% (ECU 6.7 bn) of new ecu issues during the first half of 1995, compared to 76% during the same period of 1994.
- No **non-EU Member State governments** utilised the ecu bond market during the first half of 1995.

However, the **Council of Europe**, with an issue of ECU 200 mn, and six **non-EU private sector** issues were present in the market.

- **Private sector** issuing activity in ecu during the first half of 1995 (ECU 825 mn) decreased by 41% compared to the same period of 1994. Consequently, the private sector represented 10% of total issuing activity during the first half of 1995, compared to 15% during the same period of 1994.
- The **United Kingdom** continued its quarterly **3-year ecu Treasury Note programme** with two issues to a total value of ECU 1.5 bn. At the end of the first half of 1995, the stock outstanding was ECU 6.0 bn, compared to ECU 6.5 bn at the end of 1994.
- In accordance with its announced ecu borrowing programme (issues every two months, to a minimum value of ECU 100 mn) the **French Treasury** issued ECU 769 mn of 7- and 9-year ecu **OAT's** and ECU 1.7 bn of 2- and 3-year ecu **BTAN's**. At the end of the first half of 1995, ECU 15.5 bn of OAT's and ECU 5.4 bn of BTAN's was outstanding. This compares with ECU 14.7 bn and ECU 3.6 bn, respectively, at the end of 1994.
- The **Italian Treasury** issued ECU 1.8 bn of CTE's during the first half of 1995. The stock outstanding of CTE's at the end of the first half was EU 25.8 bn, compared to ECU 27.8 bn at the end of 1994.
- No **Greek Ecu-Linked bonds (ELBs)** were issued during the first half of 1995. The stock outstanding at end June 1995 was ECU 0.8 bn, compared to ECU 1.5 bn at the end of 1994.

(ii) Secondary Bond Market

GRAPH 14 : Ecu secondary bond market — Historical evolution (Monthly average turnover per year)

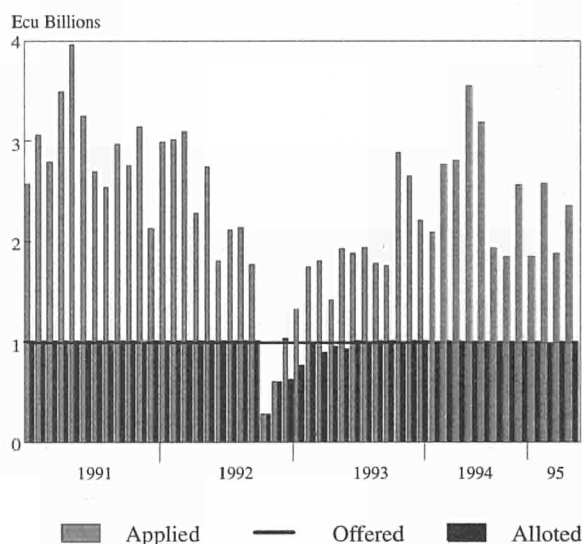


Source: Cedel, Euroclear, Commission Services.

Average monthly turnover in ecu bonds cleared through Euroclear and Cedel, in value terms, increased during the first half of 1995 (ECU 83 bn) by 3%, compared to the average for the whole of 1994. However, the ecu's market share of total turnover cleared through these systems nonetheless decreased during the first half, to 4.6% from 5.2% during the whole of 1994 (and 5.6% during 1993).

(iii) Treasury Bills and Euro Notes (Short-Term Issues)

GRAPH 15 : UK Treasury bills



Source : Bank of England.

The **United Kingdom** continued to pursue its monthly **ecu Treasury Bill programme**. Under this programme ECU 1 bn is issued each month ((ECU 200 mn with a maturity of on month, ECU 500 mn at six months, and ECU 300 mn at one year). Debt outstanding is approximately ECU 3.5 bn.

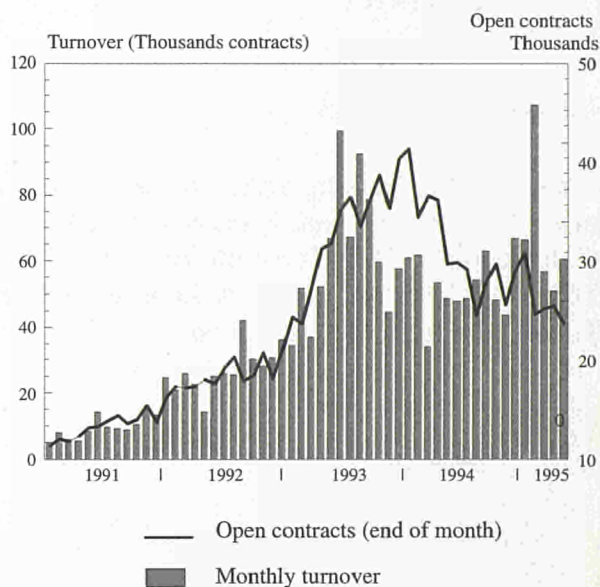
The total amount of outstanding Euro paper denominated in ecu increased to ECU 8.7 bn at the end of the first quarter of 1995 (the latest data period available), from ECU 6.6 bn at the end of last year. The ecu's share of the total market increased during this period to 2.4% from 2.02% at the end of 1994. On a disaggregated basis, while the stock outstanding in ecu of Other Short Term paper decreased (to ECU 0.9 bn from ECU 1.6 bn), the stock outstanding of ecu Medium Term paper

increased during the first quarter of 1995 (to ECU 6.4 bn from ECU 4.6 bn at end-1994), as did the stock outstanding of ecu Euro-commercial paper (to ECU 1.4 bn from ECU 0.8 bn at the end of 1994).

(iv) Derivatives Markets

Average monthly turnover in the LIFFE ecu three month interest rate futures contract increased by 30% during the first half of 1995, to 68,000 contracts compared to 52,000 during 1994 as a whole. This is consistent with the increase in market volatility observed (during the first three months of the year in particular), and therefore an increase in demand for hedging instruments. At the end of June there were 17,000 open contracts, compared to 20,000 at the end of 1994.

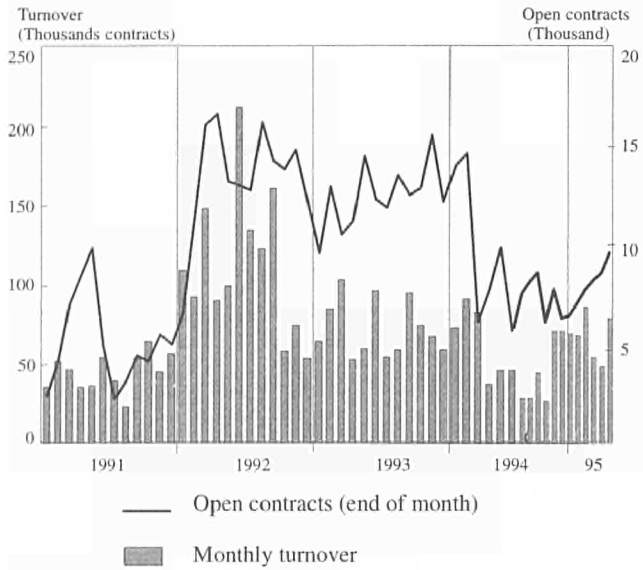
GRAPH 16 : LIFFE future contracts



Source :LIFFE.

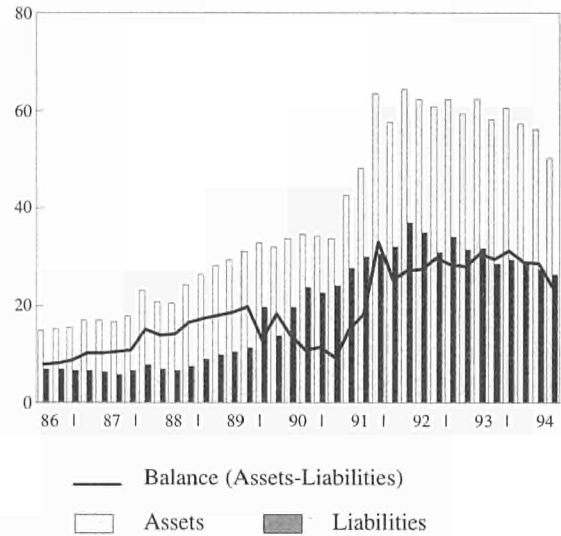
The MATIF ecu bond futures contract has also seen an increase in average monthly turnover during the first half of 1995 compared to the whole of 1994, of 17% (to 60,600 during the first half of 1995 from 51,600 during 1994). In this case, the increase in turnover has been due primarily to the introduction in 1994 of an effective market-maker scheme to this contract, which thereby guaranteed an adequate level of liquidity for market participants. At the end of June there were 10,000 open contracts, compared to 7,000 at the end of 1994.

GRAPH 17 : MATIF future contracts



Source : MATIF.

GRAPH 19 : Banking market – Assets and liabilities — Non-bank sector



Source : B.I.S.

(B) Banking Market

(i) Assets and Liabilities

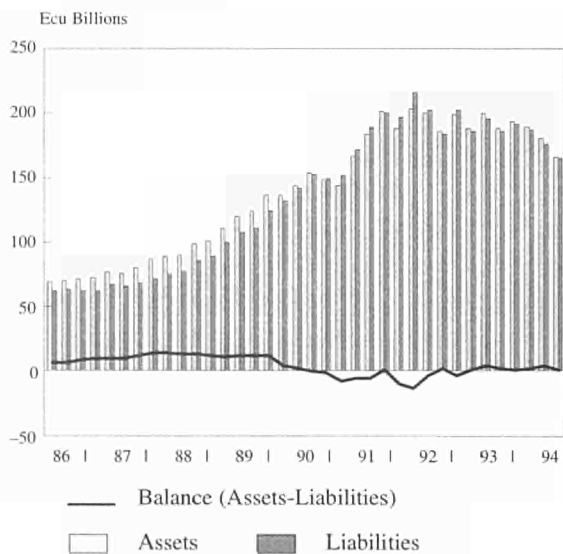
Ecu assets of the banking sector vis-à-vis all sectors decreased during the fourth quarter of 1994 (latest available data), to ECU 166.6 bn from ECU 180.3 bn at the end of the third quarter, as did ecu liabilities, to ECU 165.1 bn from ECU 175.9 bn.

Ecu assets of the banking sector vis-à-vis the non-bank private sector also decreased during the fourth quarter of 1994 (latest available data), to ECU 50.3 bn from ECU 56.0 bn at the end of the third quarter, as did ecu liabilities, to ECU 26.3 bn from ECU 27.3 bn.

(ii) EBA Ecu Clearing and Settlement System

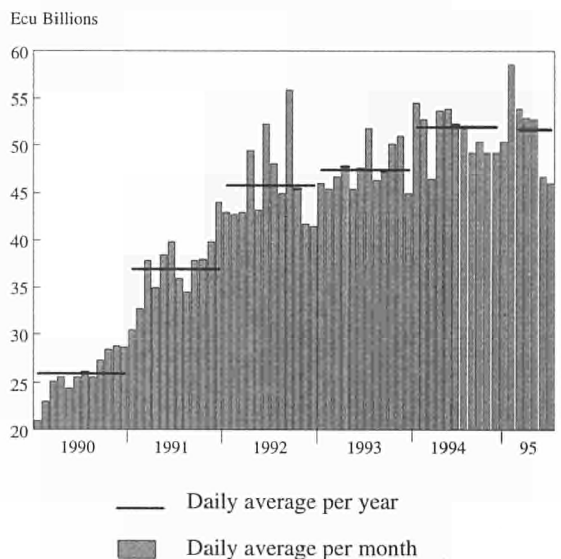
Daily average turnover in this system during the first half of 1995, measured on a monthly basis (ECU 49.8 bn), increased by 3% compared to the second half of 1994 (ECU 48.19 bn).

GRAPH 18 : Banking market – Assets and liabilities — All sectors



Source : B.I.S.

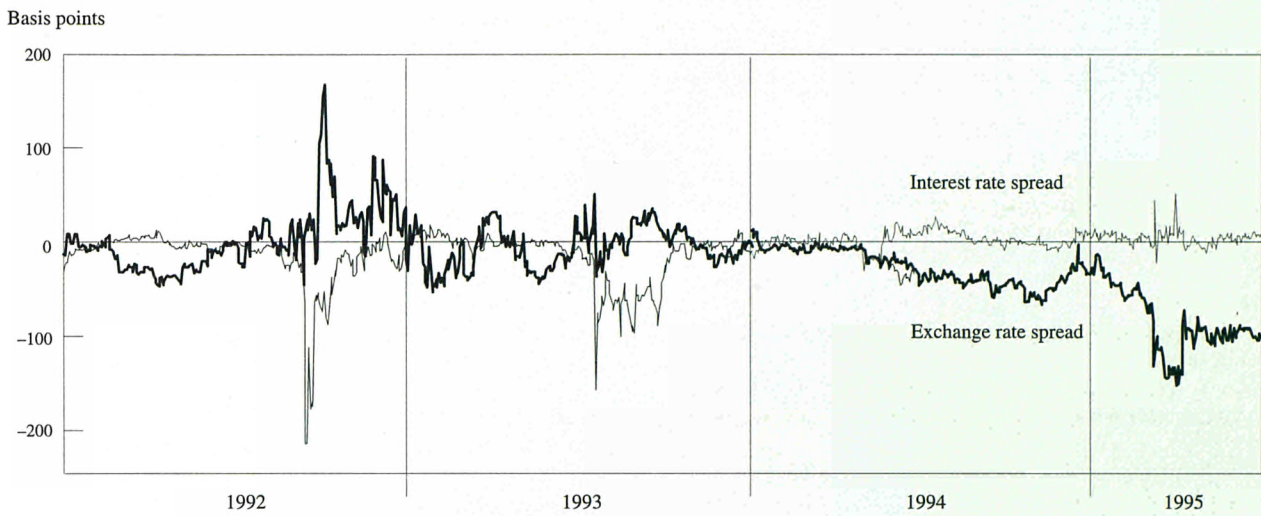
GRAPH 20 : Ecu Clearing through S.W.I.F.T. — Average daily turnover per month



Source: Ecu Banking Association.

(C) Interest Rates

GRAPH 21 : Theoretical versus market interest and exchange rates spreads



Source : Reuters, Kredietbank, European Commission (DG II).

For an analysis of interest rates see Part I. The interest rate spread remained within its ± 20 bps normal trading range throughout the period.

25 July 1995

Principal economic policy measures -- June 1995

Community (EUR-15)

19.6 EcoFin Council decides that Germany, as with Ireland and Luxembourg, is no longer in an excessive deficit situation.

26-27/6 Cannes European Council stresses the priority to be given both to employment creation and to proposals for a timetable for the introduction of the single currency.

Belgium (B)

8.6 The central bank cuts two of its key interest rates. It reduces the rate on advances within the ceiling from 6% to 5.75% and the rate on advances outside the ceiling from 9% to 8.75%. The central rate and the discount rate remain unchanged at 4.50% and 4% respectively.

Denmark (DK)

21.6 Parliament approves local tax increases in 1996. The main points of the agreement are:

- discretionary increases in local taxes in 1996 of DKR 3 billion, equivalent to an increase in the overall tax burden from 50.1% of GDP to 50.3% of GDP;
- transfers from central to local government down by DKR 1.5 billion, equivalent to 0.1% of GDP;
- marginal rate of personal income tax now to be cut from 63.5% to 62% by 1996, instead of 61%.

Germany (D)

None.

Greece (GR)

None.

Spain (E)

2.6 The Banco de España raises its 10-day key intervention rate by 75 basis points to 9.25%.

France (F)

22.6 The Bank of France reintroduces its 5-day to 10-day emergency lending rate at 7.50%. It had been suspended on 8 March at 6.40% and replaced by an 8.0% overnight facility which was cut to 7.75% on 6 April.

22.6 The Prime Minister presents the revised budget for 1995, which includes FF 19 billion in spending cuts and FF 30.3 billion in new taxes with a view to reducing the deficit to about 5% of GDP. Without these measures, the 1995 budget would have been FF 48.8 billion above the deficit target, which remains unchanged at FF 322 billion excluding FF 47 billion of privatization receipts. New spending on job creation and housing amounts to FF 14.6 billion.

28.6 The government approved the revised budget for 1995, which maintains the central government deficit at 4.1% of GDP. It provides for the following tax increases:

- the standard rate of VAT goes up from 18.6% to 20.6% on 10 August;
- the corporate tax rate goes up from 33.3% to 36.6%;
- the wealth tax is increased by 10%.

The revised budget includes the following measures to promote employment:

- subsidies and welfare tax exemptions for companies hiring long-term unemployed people and young people;
- reductions in welfare charges on low wages;
- 4% increase in the minimum wage from 1 July;
- 0.5% increase in state pensions from 1 July;
- 2.8% increase in the minimum allowance for elderly people from 1 July;
- increase in the education allowance for low-income families;
- measures to boost housing;
- reduction of red tape for small businesses.

Ireland (IRL)

None.

Italy (I)

None.

Luxembourg (L)

None.

Netherlands (NL)

8.6 The central bank cuts its rate on special advances by 0.1 percentage point, from 4.20% to 4.10%. The central rate is also cut from 4% to 3.75%.

Austria (A)

None.

Portugal (P)

14.6 The Council of Ministers approves the legislation allowing the start of a derivatives market, to be opened in November, on the Porto Stock Exchange.

Finland (FIN)

9.6 The Finnish central bank increases the tender rate from 5.75% to 6.0%

Sweden (S)

29.6 The central bank raises two key rates by 50 basis points with effect from 5 July. The deposit and the lending rates are increased to 8.00% and 9.50% respectively.

United Kingdom (UK)

14.6 The Chancellor announces that the government has made its aim of achieving underlying inflation within a 1-2½% range more durable by extending its time-scale from beyond the end of the current parliament (mid-1997 at the latest) into the foreseeable future. The formal target range of 1-4% has been retained to allow for deviations from the aim as a result of temporary shocks.

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