

# BELGIAN PRIME NEWS

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## Special topic :

*Swaps : a complementary benchmark curve for OLOs ?*

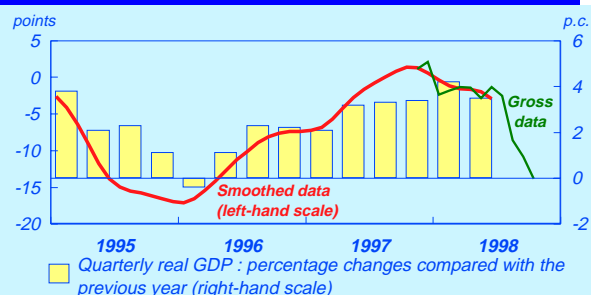
## CONSENSUS FORECAST

	1997		1998 p			1999 p		
	Belgium	Eur 11 <sup>3</sup>	Belgium		Eur 11 <sup>3</sup>	Belgium		Eur 11 <sup>3</sup>
			Consensus	Previous consensus		Consensus	Previous consensus	
<b>Real GDP<sup>1</sup></b>	3.0	2.5	<b>3.0</b>	2.8	3.0	<b>2.0</b>	2.6	2.6
<b>Employment<sup>1</sup></b>	0.3	0.2	<b>0.9</b>	1.0	1.1	<b>0.8</b>	1.0	1.0
<b>Consumer prices<sup>1</sup></b>	1.5	1.6	<b>1.0</b>	1.2	1.3	<b>1.3</b>	1.5	1.5
<b>Current account<sup>2</sup></b>	5.4	1.7	<b>5.7</b>	5.5	1.9	<b>5.9</b>	5.4	1.9
<b>General government balance<sup>2</sup></b>	-1.9	-2.5	<b>-1.4</b>	-1.4	-2.3	<b>-1.3</b>	-1.3	-1.9
<b>Primary balance<sup>2</sup></b>	6.0	2.6	<b>6.1</b>	6.1	2.4	<b>6.0</b>	6.0	2.5
<b>Public debt<sup>2</sup></b>	121.9	75.0	<b>117.8</b>	117.6	73.8	<b>114.5</b>	113.9	72.5

<sup>1</sup> P.c. change. <sup>2</sup> In p.c. of GDP. <sup>3</sup> Forecast from the European Commission (available since October 1998; next publication in spring 1999).

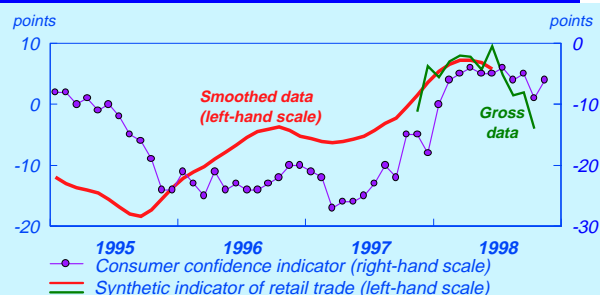
## MACROECONOMIC DEVELOPMENTS

### BUSINESS CYCLE INDICATOR AND GDP



Following strong GDP growth of 3.8 p.c. in the first half of 1998, economic activity cooled down in the second half of the year. This is confirmed by the significant decline of the NBB business climate indicator from -1.3 in June to -13.8, the lowest level since the beginning of 1996, in October. Business confidence in manufacturing industry suffered most, reflecting the adverse impact of the crisis in emerging countries on foreign orders and on real export growth. Gloomy export prospects, declining profit growth and a slight decrease in the capacity utilisation rate could delay investment plans of manufacturers and lead to less dynamic business investment.

### PRIVATE CONSUMPTION



Private consumption remains the main engine behind economic growth. Car sales, an important component of household consumption, increased by 14.3 p.c. during the first 11 months of the year. Although conditions for household spending are good (improving labour market, low interest rates, neutral fiscal policy), some hesitation is becoming apparent. Consumer confidence and the NBB retail trade indicator have deteriorated somewhat in recent months. A key element is the labour market : fear of rising unemployment (a consequence of the fall in foreign demand) could undermine consumer confidence and halt the growth in private consumption. For the time being, however, unemployment is on a clearly downward course.

Inflation has resumed its downward trend, after a temporary rise in the early months of 1998, owing in particular to the steep decline in oil prices. Producer prices have fallen steadily over the last few months and were 3.2 p.c. lower in October than a year ago - the biggest drop since the early nineties. The inflation outlook for next year remains very favourable.

Thanks to low interest rates and strong economic growth in the first half of the year, the development of the government deficit is still favourable. The Federal Government net borrowing requirement for the first 11 months of 1998 amounted to BEF 204 billion, compared with BEF 326 billion in the corresponding period of 1997. The budget for 1999 is based on a real GDP growth forecast of 2.4 p.c., which is slightly more optimistic than the Belgian Prime News Consensus forecast, but the outlook for short-term interest rates (4.1 p.c. in the budget, against 3.6 p.c. at the moment) offers a certain safety margin.

## Swaps : a complementary benchmark curve for OLOs ?

Walter Van Nieuwenhove  
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In financial articles, reference is often made to the yield spread between a certain bond and another one which is used as the "benchmark bond". This is also done in this publication (cf. the chart "Benchmark 10-year bond yields" on p.3). There has been a good deal of competition earlier this year between French OATs and German bunds for the euroland status of benchmark bond. The German government bond curve seems to have emerged as the winner.

In this special article, the question is raised whether the swap curve (Interest Rate Swaps) does not deserve the status of a complementary benchmark curve.

Comparing the yield to maturity of bonds, such as OLOs, with that of bunds has some drawbacks for the following reasons :

- the maturity and coupon rate of both bonds will be different in most cases, and, as a result, durations will differ too;
- as the period to maturity decreases and new bonds are issued, the benchmark bonds have to be replaced regularly. As a result, changing bond pairs are compared.

The mere fact that a bond is considered to be a benchmark is not market-neutral : its status and the relative scarceness of a newly issued bond can cause the price of this bond to rise. As a result, its yield will drop. The bund with a remaining maturity of 10 years is the benchmark amongst the European benchmarks and is therefore relatively expensive.

To illustrate the expensiveness of the German government bonds we can compare the 10-year segment of German government bonds with the DEM interest rate swap curve over time, using a suitable algorithm. This has been done in Chart 1. Chart 2 shows the spreads of OLOs with similar maturities to swaps. OLOs have been compared to DEM swaps as the BEF swap curve has been identical with the DEM swap curve in recent months. We refer to these spreads as "swap spreads".

The German government bond maturing on 4 July, 2008 and with a coupon of 4.75 p.c. used to be the benchmark bond until very recently. It is shown in Chart 1 as a thick red curve. This bond is traded with the largest spread vis-à-vis the swaps curve. It is more expensive by several basis points (hundreds of a percent) than other bonds in the same part of the maturity range. In times of market tension, like last September, the difference in swap spread from other bonds tends to increase.

The range of swap spreads for OLOs is clearly narrower than that for bunds in the 10-year maturity segment.

The interest rate swap curve may look odd as a benchmark for government bonds : after all, these are rates quoted by banks, while the spread vis-à-vis government bonds is quite volatile. Still, the underlying quality of swaps is higher than the rating of an average bank, thanks to collateral agreements. Swaps are actively traded. Swaptions and forward swap trading ensure a smooth and efficient curve.

The DEM swap curve and the EURO-swap curve, which will soon come into being, are useful accessory benchmark curves, as they enable us to judge how expensive benchmark bonds are compared to "off the run" bonds.

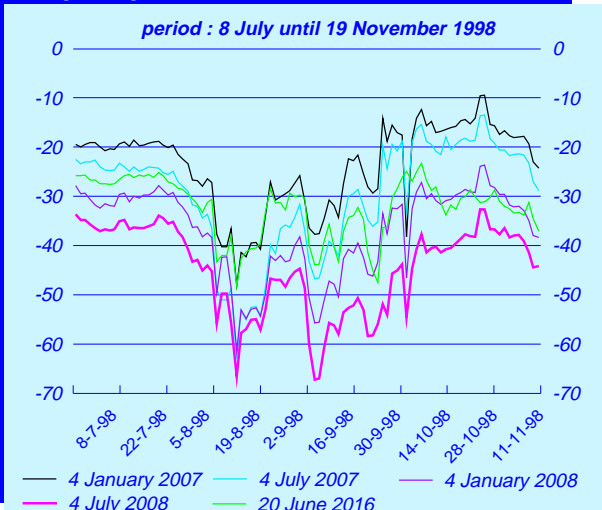
By using the swap curve as an artificial horizon, we are able to obtain a better picture of the relative cheapness or expensiveness of bonds, without recourse to concepts such as yield to maturity or duration.

The widening and tightening of swap spreads itself yields useful information on the market forces at work.

The calculation of swap spreads : Swap spreads are the annualised difference between (1) the market price of a bond and (2) the sum of the present values of the future cash flows of this bond, discounted at spot rates derived from the interest-rate swap curve.

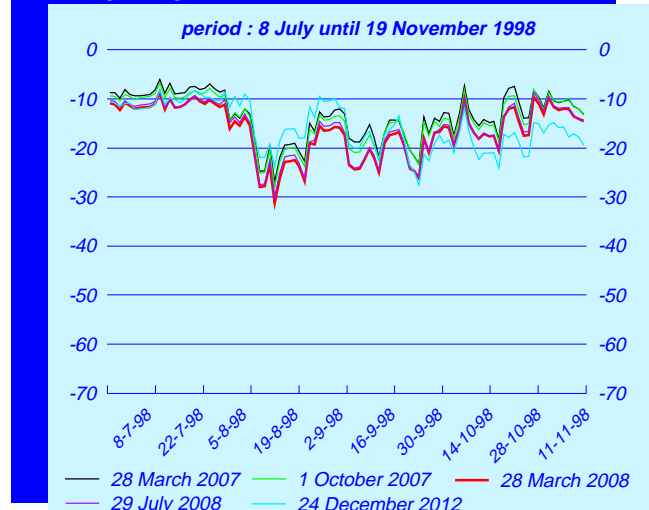
**CHART 1**

**SPREADS BETWEEN BUNDS (2007-2016) AND DEM SWAPS**



**CHART 2**

**SPREADS BETWEEN OLOs (2007-2012) AND DEM SWAPS**

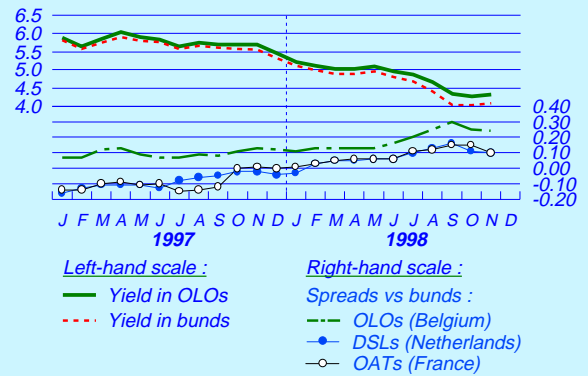


# GOVERNMENT SECURITIES MARKET

## PRIMARY MARKET (billions of BEF)

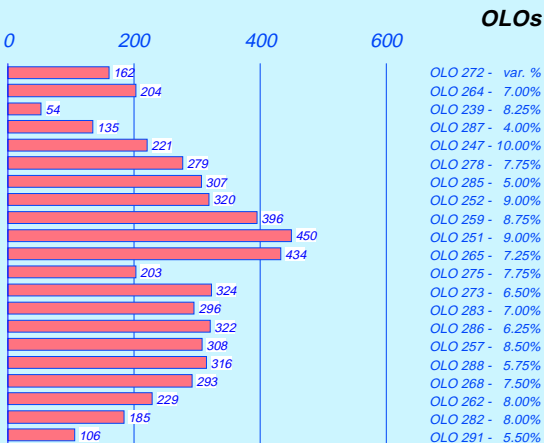
OLOs				TREASURY BILLS		
Gross issues		Net issues		Net issues		
1997	1998	1997	1998	1997	1998	
J	49.5	111.1	J - 5.9	-20.1	J 107.8	108.6
F	97.5	83.3	F 21.7	46.5	F 5.0	- 62.4
M	77.1	31.7	M 24.9	- 0.6	M 40.6	71.6
A	59.3	113.4	A 23.7	89.7	A - 71.8	-143.5
M	66.0	63.6	M -47.0	50.3	M 175.3	98.1
J	12.2	71.2	J - 0.1	- 7.9	J 3.4	36.0
J	53.7	114.1	J 53.0	-14.0	J -109.9	19.7
A	37.6	26.0	A -38.5	- 2.9	A - 12.9	25.4
S	39.9	106.3	S 29.0	51.9	S 118.1	-102.1
O	59.4	125.7	O 36.1	83.6	O - 90.0	-122.0
N	57.3	10.6	N 24.9	- 1.1	N - 65.9	-125.1
D	76.6		D 52.9		D - 77.3	

## BENCHMARK 10-YEAR BOND YIELDS (p.c.)

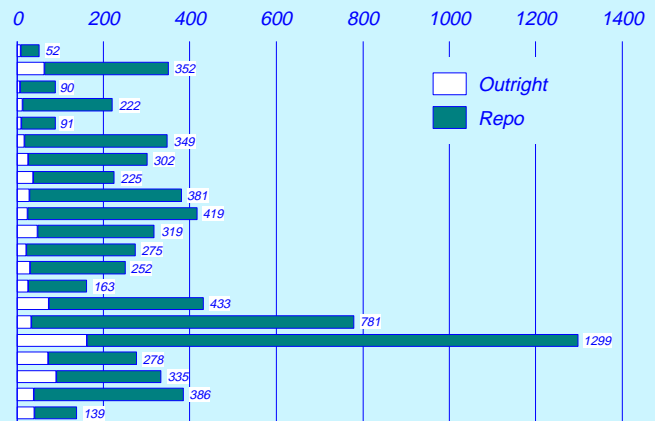


## OUTSTANDING AMOUNT AND TURNOVER (billions of BEF)

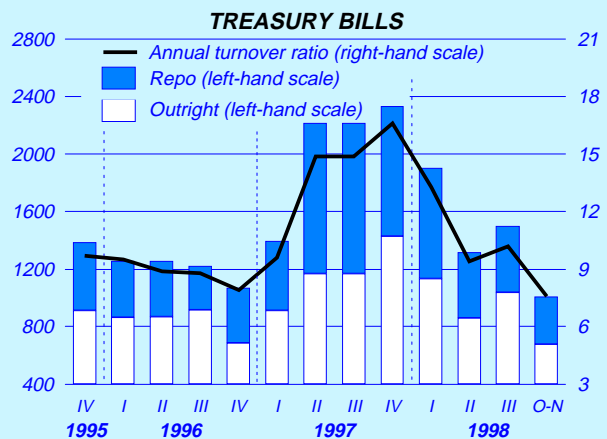
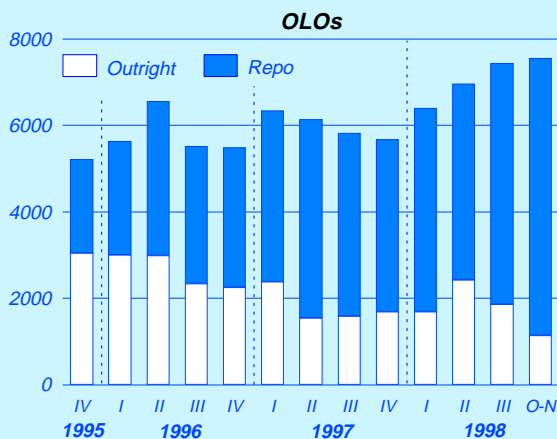
### OUTSTANDING AMOUNT AT 30 NOVEMBER 1998



### TURNOVER IN NOVEMBER 1998



## SECONDARY MARKET ACTIVITY (billions of BEF, standardised monthly averages)



## TREASURY HIGHLIGHTS

A **Debt Agency** has been operational since October. The creation of this agency reflects the Belgian Treasury's endeavour to adjust to an environment in which public debt managers are going to make increasing use of sophisticated financial tools.

The **eurolaw** of 30 October was published in the Official Journal of 11 November. The Royal Decree of 26 November, 1998 giving details of the redenomination has also been published in the Official Journal (1 December 1998). The eurolaw can be consulted (for the moment in Dutch and French only) on the web site [www.euro.fgov.be](http://www.euro.fgov.be), while excerpts concerning the redenomination of the debt can be found at <http://www.treasury.fgov.be/interdette>.

The Treasury is discussing the acceptance of **new primary dealers** and a decision will be made before the end of the year. At the same time, the articles and conditions of Primary Dealers are being revised.

## MONETARY POLICY HIGHLIGHTS

During the last months of 1998 the Governing Council of the ECB drew up the final details of the ESCB monetary policy framework.

In October it fixed the ratio of the reserve requirements at 2 p.c. In the third stage of EMU, the Belgian credit institutions will have to satisfy reserve requirements more than ten times greater than those imposed during the transitional period of September-December 1998, because of the rise in the ratio (currently 0.3 p.c.) and an enlargement of the reserve basis. On 31 December 1998 in order to enable its counterparties to satisfy these higher requirements as early as possible, the National Bank of Belgium introduced a special one-day maintenance period during which the funds made available by the maturing of the Bank's debt certificates, can be placed in reserve accounts and used during the first ESCB maintenance period.

Furthermore the Governing Council of the ECB defined the final objective of price stability as a year-on-year increase in the Harmonised Index of Consumer Prices for the euro area of less than 2 p.c. In order to maintain this price stability, it adopted a monetary policy strategy, which will consist of two key elements.

A prominent role assigned to money will be signalled by the announcement of a quantitative reference value for the growth in a broad monetary aggregate. Deviations of current monetary growth from the reference value would under normal circumstances signal risks to price stability but deviations over the short term will not be corrected automatically. The relationship between actual monetary growth and the pre-announced reference value will be regularly and thoroughly analysed by the Governing Council of the ECB; the result of this analysis and its impact on monetary policy decisions will be explained to the public.

Taking into account the quantification of the final objective, the trend growth of real output in the euro area and a medium-term decline in the velocity of circulation, the Governing Council decided to set the reference value for the chosen M3 aggregate at 4 1/2 p.c. The ESCB will monitor monetary developments against this reference value on the basis of three-month moving averages of the monthly twelve-month growth rates for M3.

In parallel with the analysis of monetary growth in relation to the reference value, a broadly-based assessment of the outlook for price developments and the risks to price stability in the euro area will play a major role in the ESCB's strategy. This assessment will be made using a wide range of economic and financial variables as indicators for future price developments.

In a context of continuous price stability but weakening growth forecasts for the euro area the National Bank of Belgium, in close cooperation with the other ESCB members, lowered the rate on its weekly tenders from 3.30 p.c. to 3 p.c. with effect from the allotment on 4 December 1998.

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