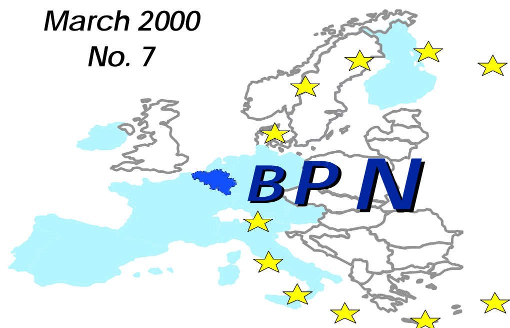
BELGIAN PRIME NEWS

March 2000
No. 7



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Special topic :
Reduced vulnerability of public finances to rises in interest rates

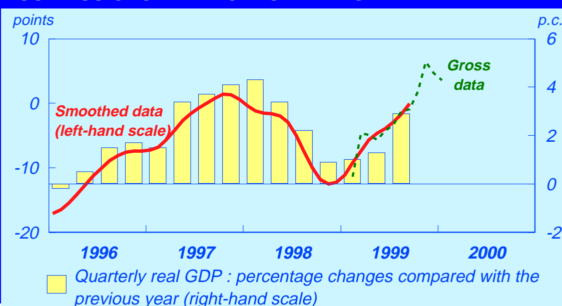
CONSENSUS FORECAST

	1998		1999 p			2000 p		
	Belgium	Eur 11[3]	Belgium		Eur 11[3]	Belgium		Eur 11[3]
			Preliminary results	Previous consensus		**Consensus**	Previous consensus	
Real GDP [1]	2.7	2.7	**2.3**	2.1	2.1	**3.4**	3.1	2.9
Employment [1]	1.2	1.3	**1.0**	0.9	1.2	**1.1**	1.1	1.1
Consumer prices [1]	0.9	1.3	**1.1**	1.1	1.2	**1.8**	1.5	1.5
Current account [2]	4.1	1.2	**4.0**	4.3	0.7	**4.0**	4.4	0.7
General government balance [2]	-1.0	-2.0	**-0.9**	-1.0	-1.6	**-0.5**	-0.8	-1.2
Primary balance [2]	6.6	2.7	**6.3**	6.1	2.8	**6.1**	6.0	2.9
Public debt [2]	117.4	73.5	**114.4**	114.7	73.1	**110.8**	111.6	71.5

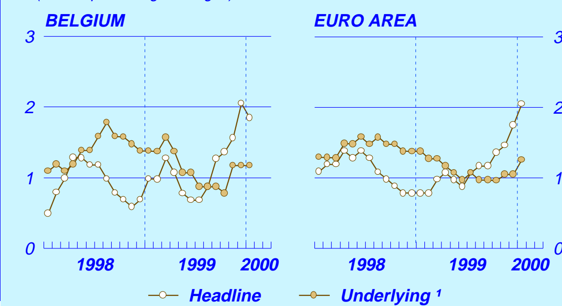
[1] P.c. change. [2] In p.c. of GDP. [3] Forecast from the European Commission (available since November 1999; next publication in spring 2000)

MACROECONOMIC DEVELOPMENTS

BUSINESS CYCLE INDICATOR AND GDP



HEADLINE AND UNDERLYING INFLATION IN BELGIUM AND IN THE EURO AREA
(annual percentage changes)



Source: EC.
[1] Measured by HICP. Underlying inflation corresponds to headline inflation excluding energy and unprocessed food prices.

According to the latest estimates, economic activity has been buoyant during the second half of 1999, growing faster than expected three months ago. As a result, the estimates have been reviewed upwards to 2.3 p.c. for the year as a whole. This comes as a consequence of a rebound in almost all the expenditure categories: private consumption, gross capital formation and, above all, exports. This latter is due to positive developments in the general climate in Europe. In this context, the analysts are expecting an acceleration of activity in 2000 to 3.4 p.c. according to their consensus. The employment component of growth, higher than in the mid-nineties, is such that employment growth in 2000 should reaccelerate.

The adjusted budget for 2000, based on a rather cautious estimate made by the National Accounts Institute (NAI), should entirely comply with the commitments laid down in the stability programme and even exceed them. Moreover, the NAI foresees an inflation rate in line with our consensus forecast. This remains, however, one of the major sources of concern for the current year.

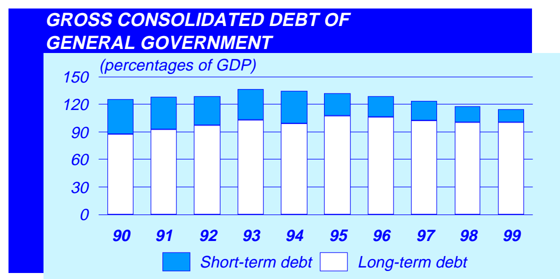
Headline inflation has accelerated since the summer of 1999, mainly due to rising energy prices. Underlying inflation stabilised after its upsurge in November 1999, due to a base effect in services prices. From this month on, the year-on-year calculation of price changes for services was no longer pushed downwards by the sharp fall of telecommunication tariffs in November 1998. The moderate level of underlying inflation is linked to the use of the health index (which notably excludes most petrol products) for the indexation of wages, which limits the pressure of higher oil prices on domestic costs. Both headline and underlying inflation are very close to euro area rates.

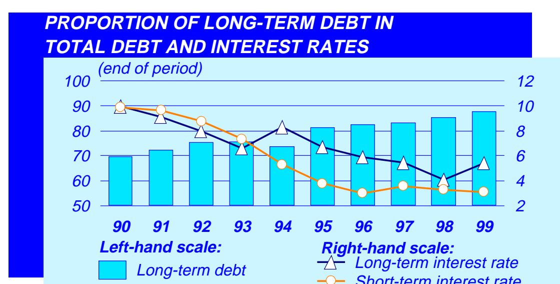
Headline inflation is expected to stabilise before slowing down in the second half of the year. This would reflect the pattern of year-on-year crude oil price rises.

SPECIAL TOPIC

REDUCED VULNERABILITY OF PUBLIC FINANCES TO RISES IN INTEREST RATES

Between 1993 and 1999 the gross consolidated debt of general government (Maastricht definition) decreased by 21.5 percentage points of GDP, from 135.9 to 114.4 p.c. All other things being equal, this reduction means that in the event of a rise of 1 percentage point in the general level of interest rates, the interest charges of general government would have risen in 1993 by 0.2 percentage point of GDP more than in the present situation. The sensitivity of interest charges to changes in interest rates has therefore been reduced during the last few years.





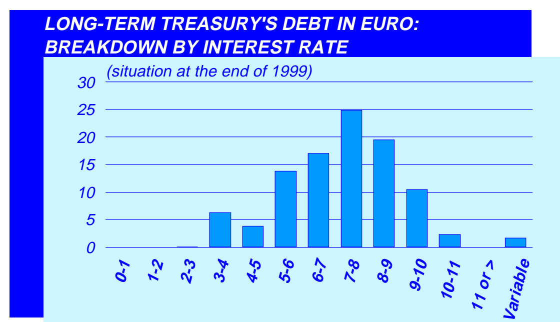
Together with this debt reduction process, the structure of the debt also changed during the nineties. The share of the debt at over one year, which represented about 70 p.c. of the Maastricht debt in 1990, rose to reach some 88 p.c. at the end of 1999. As a proportion of GDP, the reduction in the debt ratio since 1993 only related to the short-term component. Indeed, the debt at over one year remained more or less stable at around 100 p.c. of GDP (see Chart 1).

This strategy of increasing the long-term component of the debt was pursued fairly consistently during the nineties, when the trend of interest rates was usually downward (see Chart 2). There were only two temporary exceptions to that strategy: in 1994, owing to the sharp rise in long-term interest rates which steepened the slope of the yield curve, and to a lesser extent in 1997. At the end of 1998, the long-term interest rates reached a level unprecedented since the fifties. This explains why, despite their rise in 1999, the strategy of increasing the proportion of long-term debt in total debt has not been questioned. In 2000, the long-term component of the debt should be raised further, since it is the intention of the Treasury to pursue its objective of lengthening the duration of the debt.

With regard to the Treasury, whose debt represents some 90 p.c. of the general governement debt, it is possible to calculate the proportion which has to be refinanced during the following year. That proportion, which consists of the whole debt at up to one year and the long-term bonds reaching maturity during the next twelve months, shrank from 39.3 percentage points in 1990 to 22.5 p.c. in 1999. This reduction mainly benefited the debt with a residual maturity of 5 years and more, which rose from 38 p.c. to 49.6 p.c. over the same period.

This change in the composition of the debt appreciably reduced the vulnerability of public finance to exogenous interest-rate shocks in the short run. Indeed, as a proportion of GDP, the share of the Treasury debt for which the period to maturity is less than one year was reduced by some 19 p.c. of GDP between 1990 and 1999, from 43 p.c. of GDP to less than 24 p.c. In the case of the above-mentioned example of a rise of 1 percentage point in the general level of interest rates, this means that such a rise would bring about an increase in interest charges of 0.24 p.c. of GDP in the following year, i.e. 0.19 p.c. of GDP less than it would have been in 1990.

Since 1993, the dynamics of the debt have been favourable, since the level of the primary balance is sufficiently high to lead to an automatic reduction in the debt ratio, which is decreasing on average by 3 to 4 p.c. of GDP per annum. As the implicit interest rate on the general government debt amounts at present to some 6.25 p.c., the annual reduction in the debt ratio leads to a saving in interest charges of 0.2 to 0.25 p.c. of GDP in the following year. As can be deduced from the previous calculation, these structural savings in interest charges could practically offset a rise of 1 percentage point in the general level of interest rates without impairing general government's annual overall balance.



Source: Ministry of Finance.

Moreover, it can be added that in spite of the rise in long-term rates in 1999, market interest rates are still below the level of the implicit interest rate on the general government debt. As far as the long-term component of the debt is concerned, a large proportion of it is always subject to relatively high nominal rates: these reach 6 p.c. or more for about three quarters of the Treasury's long-term debt in euro, and even 8 p.c. or above for one third (see Chart 3). With market rates at their present level, the implicit rate on the long-term debt will continue to decline, because it should be possible for loans reaching maturity to be refinanced at lower rates. This declining trend of the implicit interest rate constitutes another margin which could partly absorb potential interest-rate shocks.

With regard to the latter, it should be emphasized that their probability of occurrence was reduced by the introduction of the EMU. In the absence of the euro, it is indeed highly probable that an asymmetric shock such as the dioxin crisis would have put the exchange rate of the Belgian franc under strong pressure, which would have led to rising interest rates.

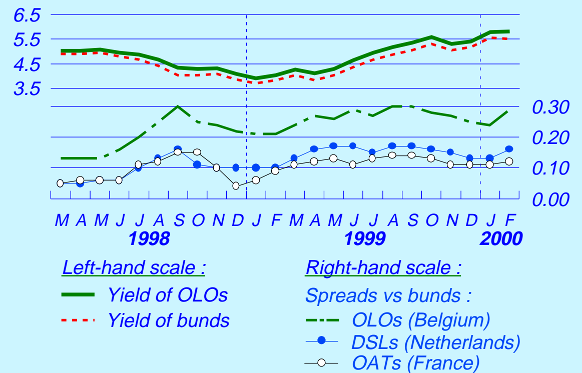
Finally, compared with the situation prevailing in the early nineties, when the debt ratio was increasing, when the share of short-term debt was significantly larger and when the implicit interest rate was not showing a declining trend, the vulnerability of public finances to rises in interest rates has therefore been appreciably reduced.

GOVERNMENT SECURITIES MARKET

PRIMARY MARKET (billions of EUR)

	OLOs Gross issues 1999	OLOs Gross issues 2000	OLOs Net issues 1999	OLOs Net issues 2000	TREASURY BILLS Net issues 1999	TREASURY BILLS Net issues 2000
J	3.811	4.986	3.035	4.506	3.962	1.790
F	8.154	1.028	6.706	0.820	-1.587	0.831
M	1.147		-1.722		-0.196	
A	5.427		1.203		-1.524	
M	0.686		-0.043		0.116	
J	1.879		0.334		0.850	
J	2.876		2.697		1.466	
A	0.441		0.000		0.104	
S	3.905		3.773		-2.533	
O	1.636		0.818		-1.986	
N	0.889		-0.059		-1.992	
D	1.449		0.819		-3.486	

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



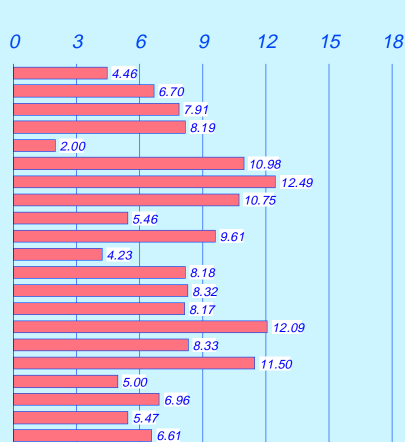
OUTSTANDING AMOUNT AND TURNOVER (billions of EUR)

OUTSTANDING AMOUNT AT 29 FEBRUARY 2000

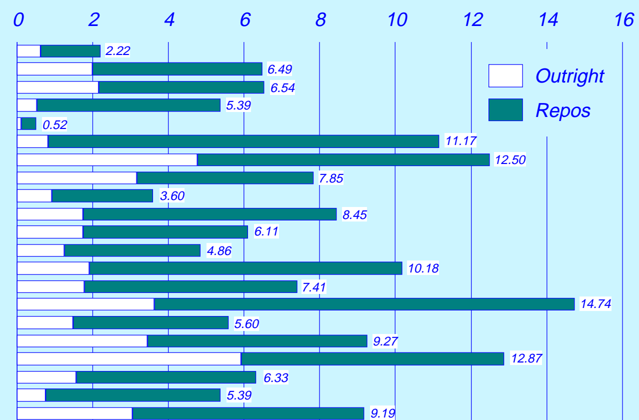
TURNOVER IN FEBRUARY 2000

TREASURY BILLS

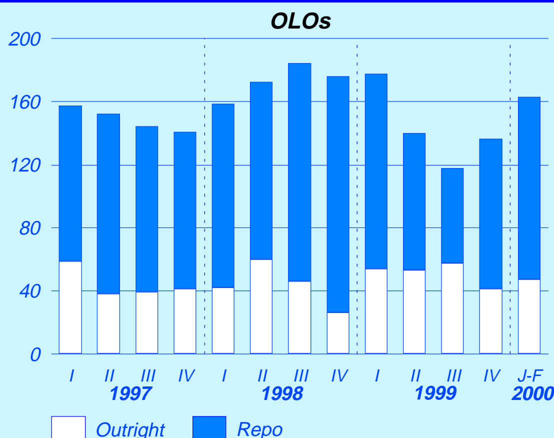
OLOs

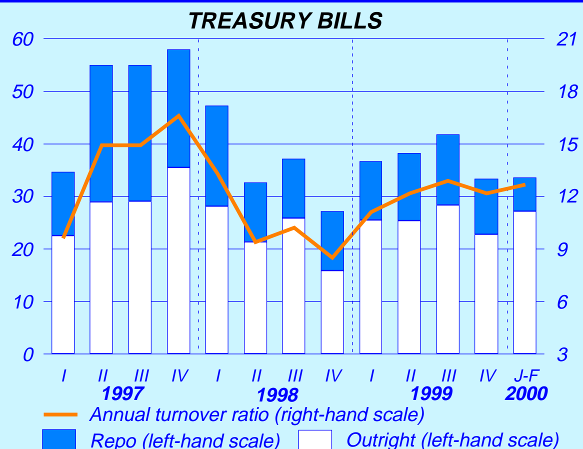


OLO 247 - 10.00% - 08/00
OLO 278 - 7.75% - 12/00
OLO 285 - 5.00% - 03/01
OLO 252 - 9.00% - 06/01
OLO 293 - var. % - 04/02
OLO 259 - 8.75% - 06/02
OLO 251 - 9.00% - 03/03
OLO 265 - 7.25% - 04/04
OLO 275 - 7.75% - 10/04
OLO 273 - 6.50% - 03/05
OLO 294 - 4.75% - 09/05
OLO 283 - 7.00% - 05/06
OLO 286 - 6.25% - 03/07
OLO 257 - 8.50% - 10/07
OLO 288 - 5.75% - 03/08
OLO 268 - 7.50% - 07/08
OLO 292 - 3.75% - 03/09
OLO 295 - 5.75% - 09/10
OLO 262 - 8.00% - 12/12
OLO 282 - 8.00% - 03/15
OLO 291 - 5.50% - 03/28



SECONDARY MARKET ACTIVITY (billions of EUR, standardised monthly averages)





TREASURY HIGHLIGHTS

The Kingdom syndicated EUR 5 billion of its new 10-year benchmark bond (5.75 p.c. OLO 35, due 28.09.2010) with a yield spread of 31 basis points vis-à-vis the Bund maturing 4 January 2010 and of 18 basis points over the OAT interpolated curve. The State chose 28 September as the coupon date instead of 28 March in order to spread payments and reimbursements more equally over those two dates. The allocation of the bonds was the following : Belgium 11.5 %, Euro area non-Belgium 57.6 %, Europe non-euro area 24.5 %, US, Canada, Caribbean 2.7 %, Japan 2.8 %, Asia non-Japan 0.3% and Middle East 0.6 %.
The deal was more than doubly oversubscribed.

The liquidity of the issue is being ensured by its initial size, its listing on Euro MTS and by subsequent auctions.
The syndication included all primary dealers, while recognized dealers joined forces in the selling group.

In 2000, the Kingdom intends to issue about EUR 27 billion of OLO, including the aforementioned amount of EUR 5 billion syndicated bonds. About EUR 11 billion will be issued via auctions, while the remaining EUR 11 billion are expected to be funded with exchange offers of bonds reaching maturity in 2000 and in 2001.

In order to enhance the attractiveness of its auctions and therefore compete more effectively on the euro-market, the Treasury has decided to limit the number of its OLO auctions to five in 2000 (see Prime News December 1999), the first one scheduled on 27 March. The average size of the auctions should be over EUR 2 billion. By doing so, the Treasury offers investors more certainty of getting the amount of paper they are bidding for.

The Treasury manages the debt with reference to the benchmark debt portfolio as established by the Minister of Finance in the General Guidelines for the year 2000. As regards interest rate risk management, the Treasury expects to stabilise the duration of the domestic debt at around 4 years, depending on the absolute level of the interest rate. Focusing on the refinancing risk, the Treasury expects to decrease slightly the overall 2001 refinancing compared to 2000 - the 2000 refinancing showed a substantial reduction in comparison with 1999. The Treasury will also continue to smooth out the overall maturity structure of the debt portfolio by favouring light maturity buckets, especially the 10 year ones. With regard to the currency risk, the Minister of Finance has given a renewed impetus to the reduction of foreign currency exposure in the debt portfolio, by publicly stating his intention to eliminate gradually this risk in accordance with market conditions.

MONETARY POLICY HIGHLIGHTS

At its meeting on 16 March 2000 the Governing Council of the ECB decided to raise the ECB's three key interest rates by 25 basis points each. The interest rate on the main refinancing operations, which continue to be conducted as fixed rate tenders, was raised to 3.50 p.c. starting with the operation to be settled on 22 March 2000. The interest rates on the marginal lending facility and on the deposit facility were increased to 4.50 p.c. and 2.50 p.c. respectively, both with effect from 17 March 2000.

This increase in ECB's interest rates followed the rises decided on 4 November 1999 (+50 basis points) and 3 February 2000 (+25 basis points) and continued the policy of countering emerging upside risks to price stability in a timely and pre-emptive manner, in order to ensure sustainable economic growth in the euro area.

Both of the pillars of the monetary policy strategy were seen to indicate upward risks to price stability. Considering the first pillar, monetary and credit growth continued to signal generous liquidity conditions in the euro area. With regard to the second pillar, most indicators and forecasts pointed to increasing upward pressures on consumer price inflation over the medium term. The strong rise in oil prices and the downward movement of the exchange rate of the euro in the past were putting upward pressure on import costs and producer prices. In the context of a strong cyclical upswing, there was a risk that these developments could, via second round effects, have lasting effects on consumer price inflation. The Governing Council's determination not to tolerate any lasting upward effects on inflation should assure wage negotiators that the prospects for maintaining price stability remain favourable.