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QUARTERLY NOTE ON THE EURO-DENOMINATED BOND MARKETS

HIGHLIGHTS

- In this issue, we examine developments in July-September 2000 relative to the two previous quarters and, where appropriate, relative to the corresponding period in 1999.

- Third-quarter bond issues in euro totalled €306 billion, down by almost 13 per cent on the average of the previous two quarters of 2000 and by ten per cent on the third quarter of 1999. The trend of lower issuance quarter by quarter seen in 1999 is being repeated so far this year. The decline in issuance can be attributed mainly to lower sovereign borrowing, although volatile market conditions and negative credit spread developments have also played a role.

- Sovereign issuers continued their retreat from the market in the third quarter, as their borrowing requirements were adjusted down. There was also a reduction in issues from the pfandbriefe sector. In contrast, there was a further expansion in corporate issuance, together with a shift away from telecom issuers.

- Conditions for issuance were far from perfect in the third quarter, as exchange rate movements and credit spread widening depressed the primary market.

- A prominent new borrower on the euro bond market - Freddie Mac - is the featured topic in this report, underlining the appeal of the euro bond market also for non-euro area issuers.

This series of notes, and a statistical annex, are available from the European Commission website at:

http://europa.eu.int/comm/economy_finance/document/eurobond/eurobondidx_en.htm

THE EURO-DENOMINATED BOND MARKETS
- JULY-SEPTEMBER 2000 -

INTRODUCTION

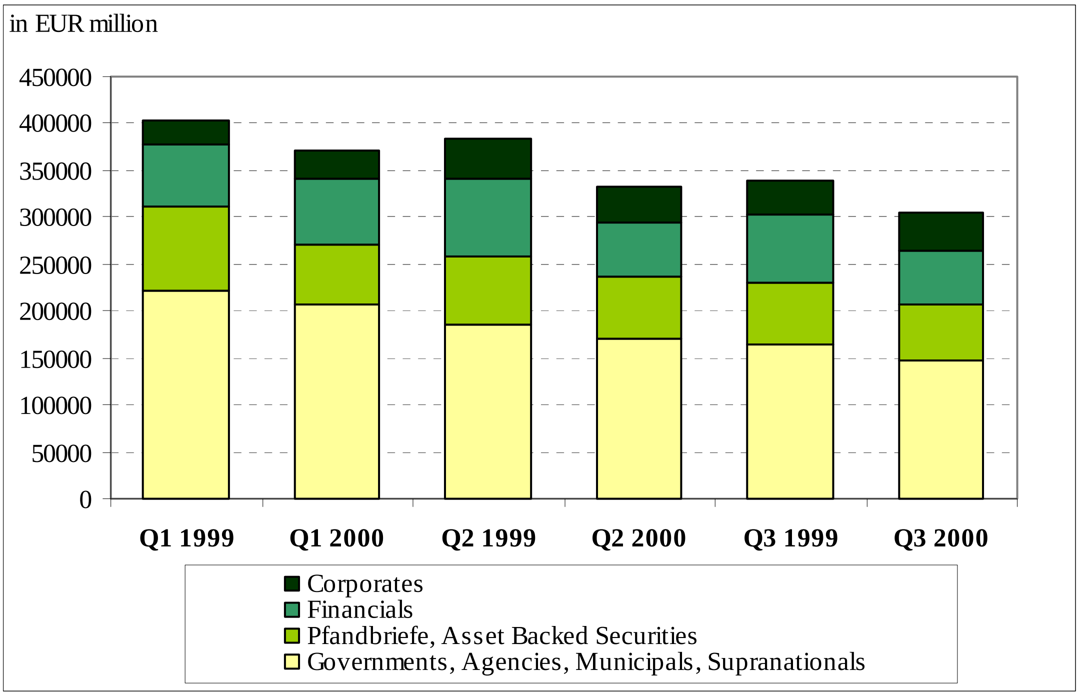
Issuance in euro-denominated bonds in the third quarter of 2000 declined relative to issuance in the previous quarters and in the third quarter last year. The flow of new issuance was again affected by lower supply from sovereign issuers and by a downturn in market sentiment as adverse credit spread developments made borrowing less profitable, particularly for issuers of pfandbriefe securities.

PART ONE: DOMESTIC AND INTERNATIONAL ISSUES

BOND ISSUES

Issuance in euro totalled €306 billion in the second quarter; compared to an average of about €350 billion in the previous quarters of 2000 and €340 billion in third quarter of 1999[1]. According to Thomson financial securities data, the US dollar has extended its advantage over the euro in terms of international bond issuance.

GRAPH 1 - ISSUING ACTIVITY IN 1999 AND 2000



[1] Note: data from previous quarters have been revised from previous editions of this report. All figures are from the DG ECFIN SOF database unless stated otherwise. In this database, all euro denominated issues of an amount of € 50 mn or more are recorded. It should be noted that the database includes all issues of a maturity of 1 year or more (incl. in particular Italian and French discounted paper of significant issue amount). Throughout this note, payment dates - as opposed to announcement dates - of new issues have been taken into account, unless otherwise stated otherwise. Data are subject to revision.

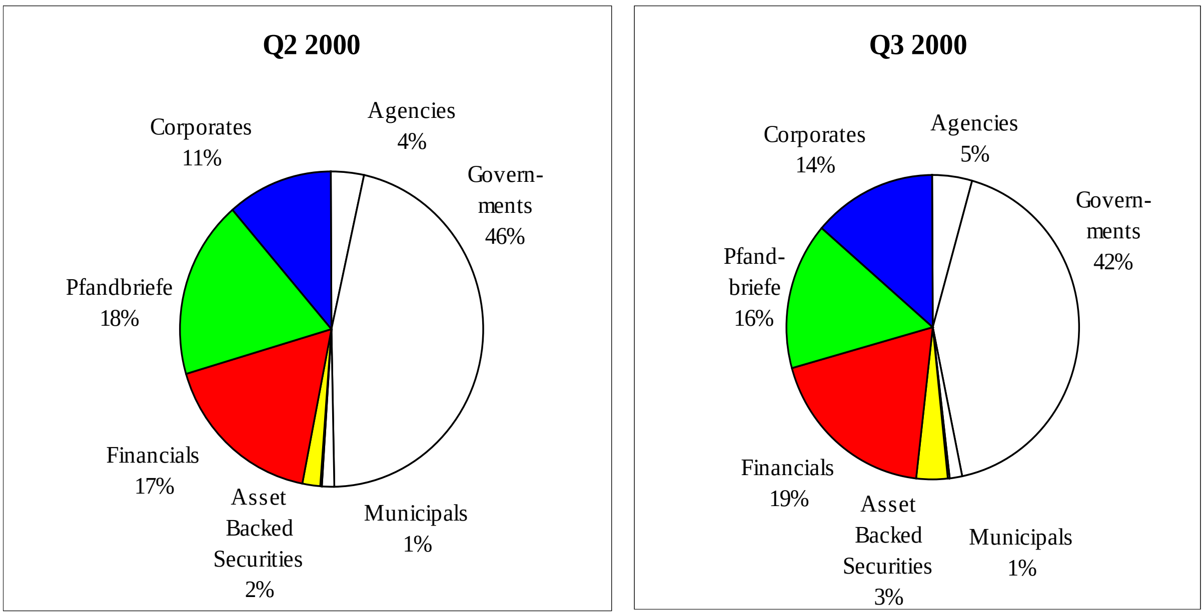
	Q1 2000	Q2 2000	Q3 2000
Governments	194.958	153.469	129.178
Other sovereign	11.909	16.789	19.022
Pfandbriefe+Asset Backed	63.814	66.976	58.354
Financials	70.925	57.224	57.688
Corporates	28.510	38.087	41.665
Total	**370.116**	**332.545**	**305.907**

STRUCTURAL DEVELOPMENTS

Type of issuer

The third-quarter decline in euro-denominated bond issuance reflects a noticeable reduction in sovereign issues and in issues from the pfandbriefe sector. Sovereign issuance fell by close to €25 billion compared to the previous quarter, largely as a result of front-loading in earlier months of this year. The share of government bonds in total issuance was 42% compared to 46% in the second quarter and 52% in the first quarter. Early market projections indicated that total sovereign issuance could be down by more than 10 % this year, but subsequent projections - incorporating exceptional revenues from UMTS licences - put the likely decline closer to 20 %. The most recent estimates scale down the reduction in sovereign issuance to about 15 % as fourth-quarter borrowing calendars for major issuers such as Germany and Italy have been published.

GRAPHS 2 - DIFFERENT TYPES OF ISSUER, % OF TOTAL VOLUME ISSUED



In contrast to the development of sovereign issuance, the corporate sector has contributed actively to the supply of bonds to the market so that its share in total issuance rose to 14% from 11% in the second quarter and from 8% in the first quarter. This was achieved despite the collapse in issuance by the previously highly active telecom companies. As investors re-appraised their substantial exposure to the telecom segment of the market in light of widespread profit warnings from industry analysts, they turned to more traditional corporate issuers. The corporate sector continues to raise substantial amounts of funding through euro-denominated bond issues (even in unfavourable market conditions and widening spreads) thereby developing a capacity in the bond markets to finance a bottom-up re-structuring of the EU economy.

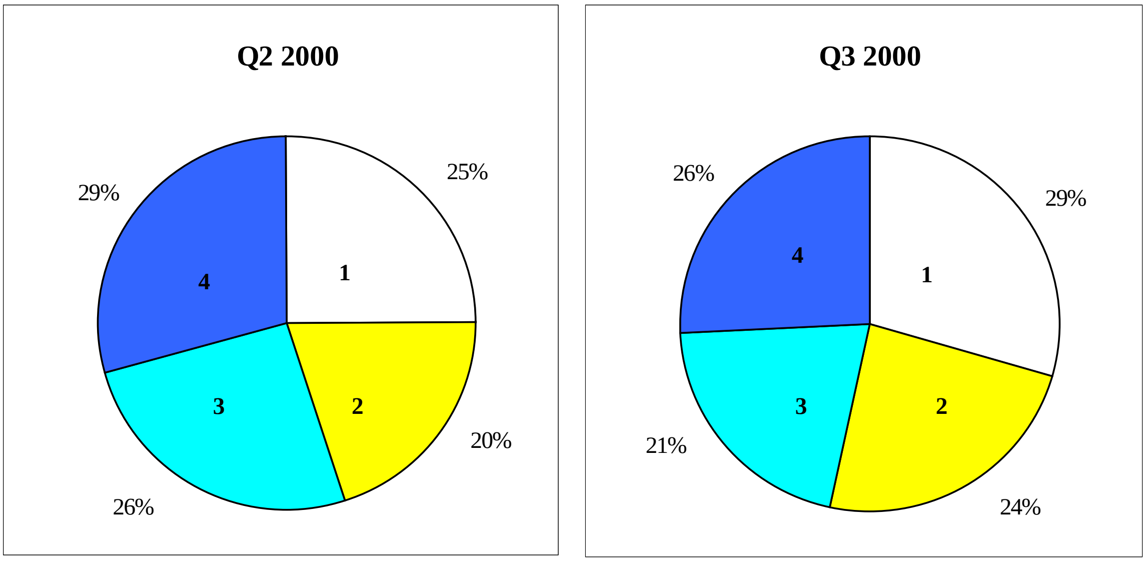
The share of pfandbriefe issuance fell marginally to 16% from 18% in the second quarter. The Pfandbriefe market suffered a setback as credit spread widening made it difficult for many issuers to achieve their normal funding levels in relation to LIBOR. This segment of the market nevertheless maintains a substantial share in total issuance.

A notable event in the third quarter was the establishment of a euro denominated borrowing programme by the US mortgage agency Freddie Mac. Their initial offering under the programme was a €5 billion issue launched in the beginning of September. This was the largest euro issue ever by a non-government issuer (see featured topic for details).

Issue size

Lower sovereign issuance continued the trend decrease in the average issue size in the third quarter. Private sector bonds continue to be issued in all sizes, but with a discernible bias in favour of issues below 1000 million.

GRAPHS 3 - ISSUE SIZE, % OF TOTAL VOLUME ISSUED[2]



Key: (1) between EUR million 50 and 500 (3) between EUR million 1000 and 2000
(2) between EUR million 500 and 1000 (4) more than EUR million 2000

Looking ahead, the average issue size is likely to remain close to the high levels of 1999 as liquidity remains a high priority among investors. The emphasis on large issues is most evident in the government sector but is becoming more important also among

2 It should be noted that if only international issues are considered the share of very big issues is substantially lower. This is due to domestic short-term instruments, which are of a very big size.

agency and pfandbriefe issuers. However, large issue sizes can also be accomplished by reopening issues and by exchange offers.

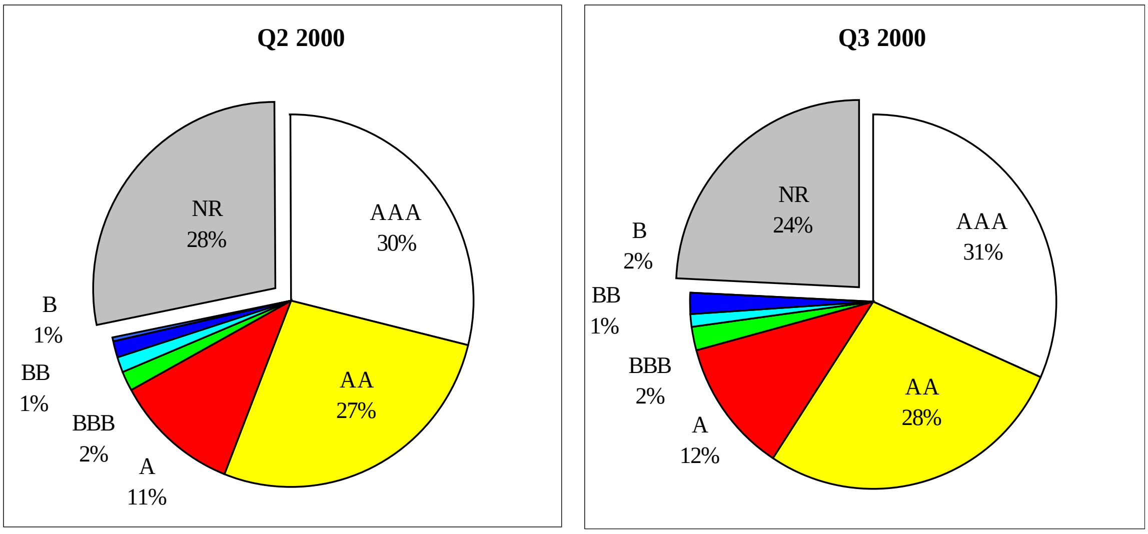
Credit quality

Based on information from the Commission database (which does not provide complete coverage), the distribution of ratings in the third quarter of this year was as follows:

Bond Rating/ Distribution of issues	**AAA**	**AA**	**A**	**BBB**	**BB**	**B**	**CCC**	**NR**
% of total number of issues	23	22	15	2	2	3	0	33
% of total volume of issues	31	28	12	2	1	2	0	24

Compared to the second quarter, the share of highly rated issues increased slightly at the expense of non-rated issues. However, changes in the ratings of issuers have been rather insignificant over several quarters and there is no discernible trend in this respect.

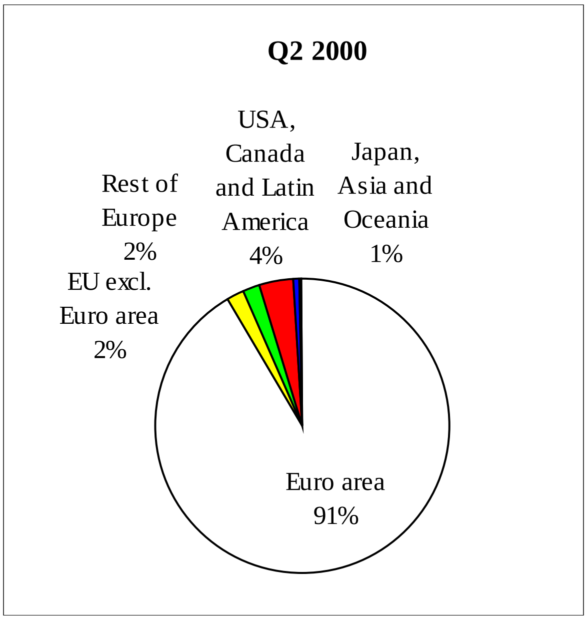
GRAPH 4 - RATINGS, AS % OF TOTAL VOLUME ISSUED WITH A RATING

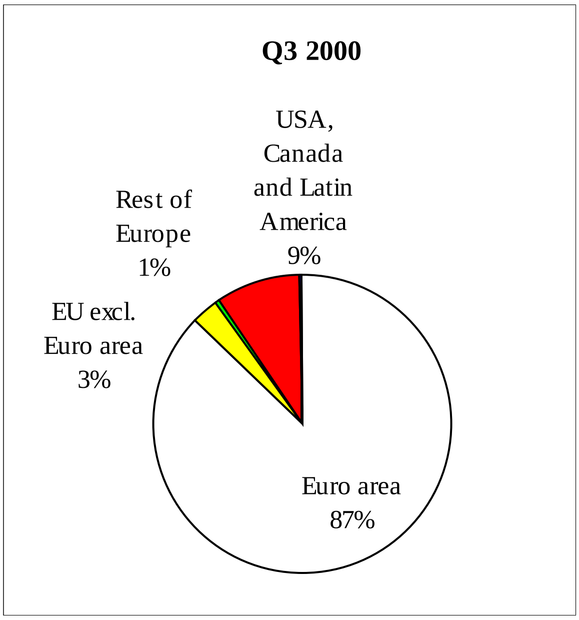


Geographical origin of demand and supply

The geographical origin of issues has remained fairly steady from quarter to quarter with euro-area issuers dominating. However, a rise in the share of issues coming from North America (from 4% to 9%) can be detected between the second and third quarters of this year. The strongest issuing activity came from US multinationals, which are still raising substantial amounts of money in the euro corporate bond market.

GRAPHS 5– ORIGIN OF ISSUERS, AS % OF TOTAL VOLUME ISSUED

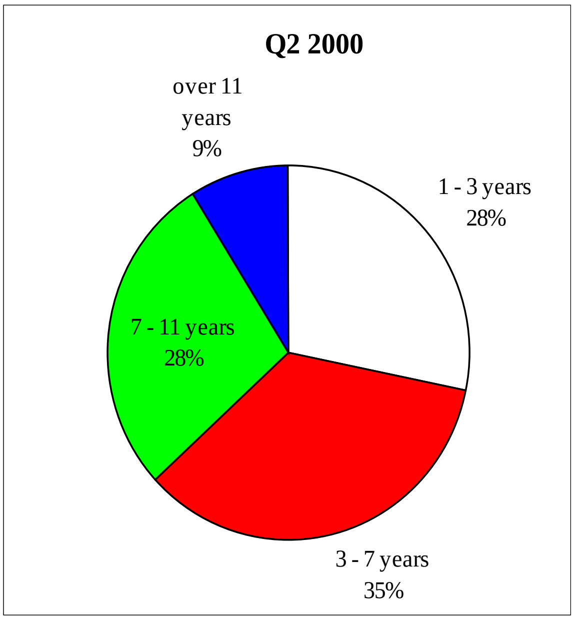


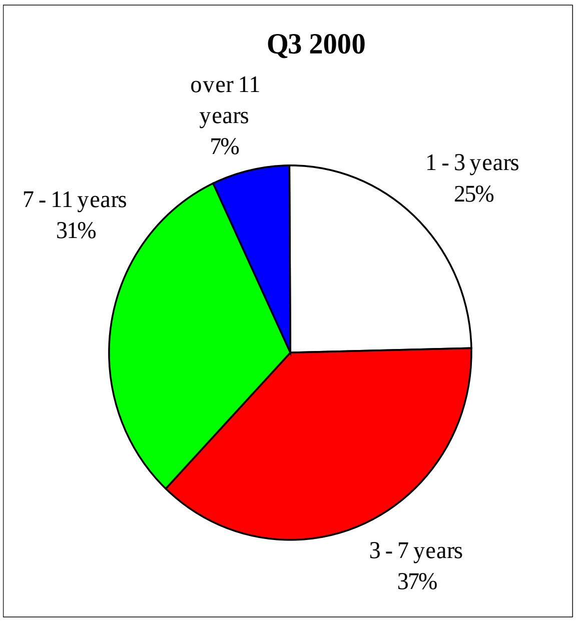


Maturity structure

The trend toward shorter maturities seen in 1999 has resurfaced, with the share of very long issues (over 11 years) falling to 7% in the third quarter from 9% in the previous quarter. This could be one effect of the decline in sovereign issuance, combined with increased volatility and uncertainty in the market.

GRAPHS 6 - MATURITY STRUCTURE: AS % OF TOTAL VOLUME ISSUED

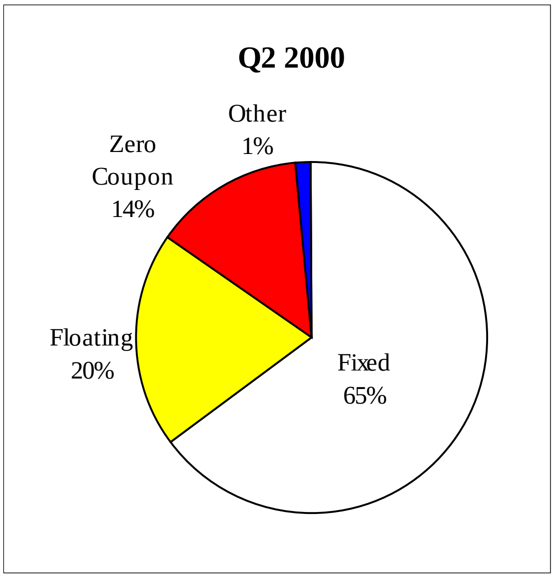


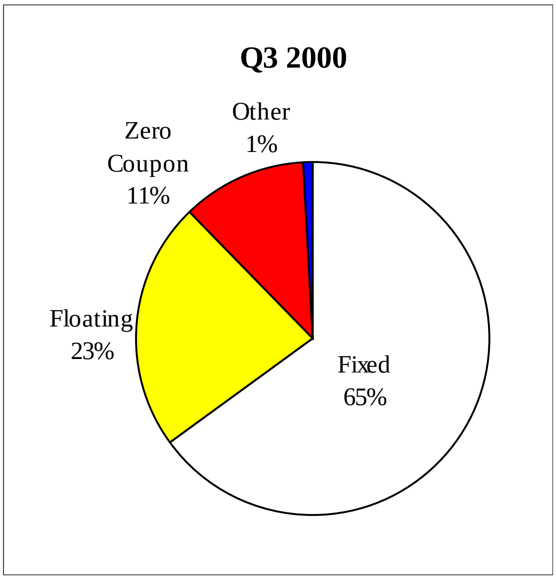


Coupon types

Recently, we have introduced a more detailed description of coupon types, differentiating between four categories of bond issues; fixed rate, floating rate, zero-coupon and other coupon type bond issues. The revival of demand for floating-rate notes seen in the second quarter of this year was reinforced in the third quarter on the back of rising short rates and expectations of further increases in short term interest rates.

GRAPHS 7 – SHARE OF COUPON TYPE IN TOTAL VOLUME ISSUED





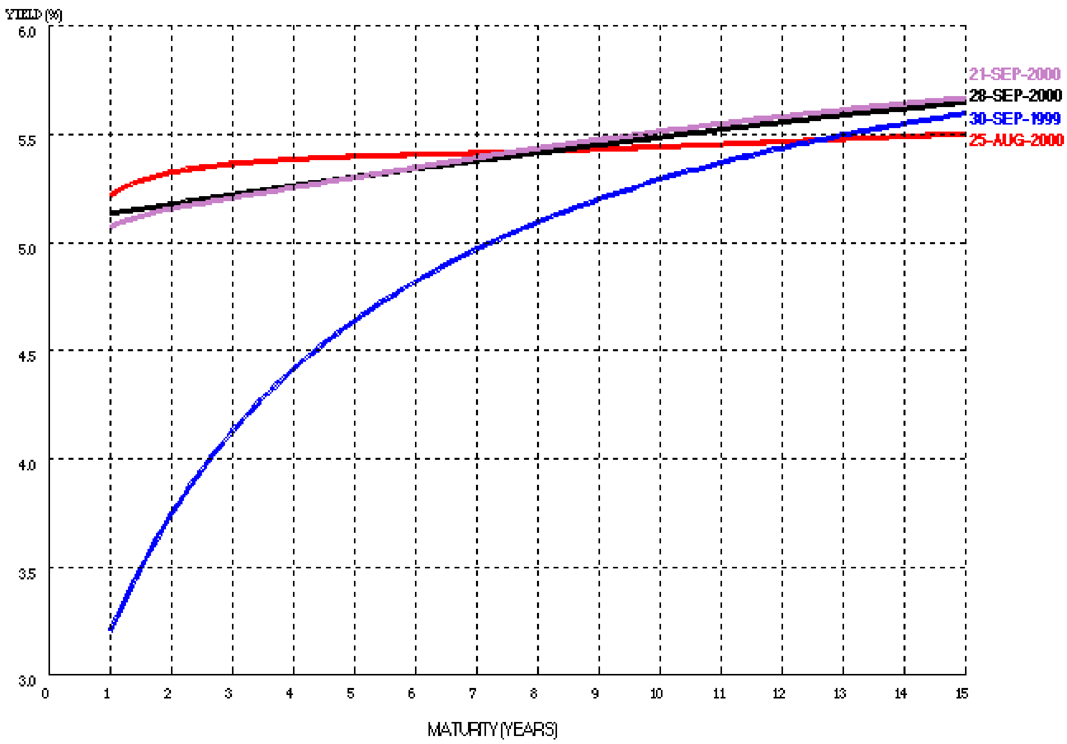
Benchmarks

The question of benchmark status for fixed rate bond issues continues to attract attention. Mr. Juergen Stark, Deputy President of the German Bundesbank commented on the matter on two occasions in September. According to Mr. Stark, differences in liquidity, issuing procedures and the varying efficiency with which the cash, futures and repo markets interact will ensure that yield spreads between sovereign issuers remain in the medium term even if credit ratings are similar. At the 10-year maturity, the German bund is firmly established as a benchmark and the 5-year bund seems also to have acquired benchmark status. However, French issues appear to yield the lowest interest rates at intermediate maturities (3 and 7 years). The absence of a single benchmark complicates the pricing of new bond issues, requiring issuers to spend more time and resources in ascertaining the likely market-clearing price. For the pricing of corporate bonds, the swap market is used more and more as the most relevant pricing reference.

PART TWO: LONG-TERM INTEREST RATE EVOLUTION - YIELDS AND SPREADS

Long-term interest rates ended the quarter at the same level as at the beginning of July, while short-term rates responded to rate increases by the ECB and rose by some 20 basis points over the period. The yield curve flattened somewhat in August but steepened again in September. Analysts attributed movements in the curve over the quarter as a whole to the interaction of monetary policy measures taken by the ECB, rising inflation expectations, developments on the US bond markets and changes in the supply of government bonds.

GRAPH 8 – EURO YIELD CURVE [3]

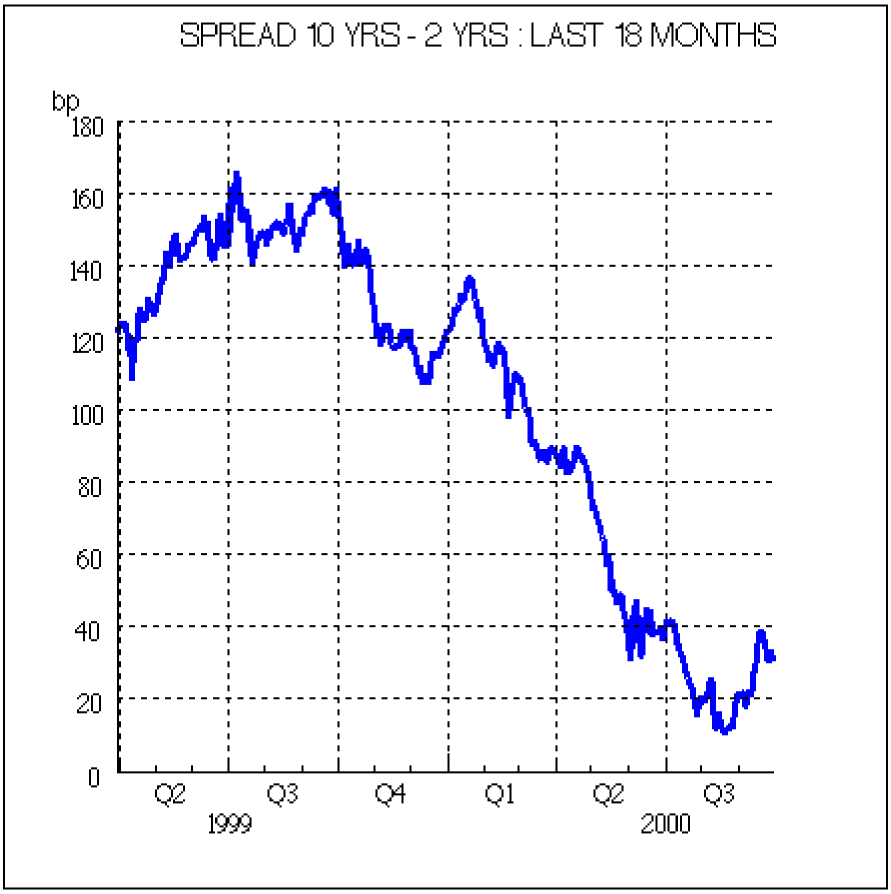


Maturity	1	2	3	4	5	6	7	8	9	10
04/01/99	3.28	3.23	3.22	3.28	3.39	3.51	3.64	3.77	3.88	3.98
31/03/99	2.83	2.98	3.13	3.30	3.48	3.66	3.82	3.97	4.09	4.19
30/06/99	2.83	3.25	3.55	3.80	4.00	4.19	4.35	4.49	4.61	4.71
30/09/99	3.21	3.75	4.13	4.42	4.64	4.82	4.97	5.09	5.20	5.29
30/12/99	3.70	4.27	4.56	4.77	4.94	5.08	5.21	5.31	5.41	5.49
31/03/00	4.18	4.53	4.74	4.89	5.02	5.12	5.21	5.29	5.35	5.41
30/06/00	4.90	5.06	5.12	5.16	5.21	5.27	5.32	5.37	5.41	5.45
30/09/00	5.13	5.17	5.2	5.24	5.27	5.31	5.35	5.39	5.42	5.46

[3] *Source:* Eurostat (A daily update of euro yield curve statistics can be found on the EUROSTAT internet site)

The spread between two and ten-year rates was reduced to a new low of 10 basis points in August and there were expectations in the market of an inversion of the yield curve. This development coincided with market projections of further reductions in the supply of long-term government bonds. Views on government borrowing changed somewhat after publication in September of, among others, the German borrowing plans for the fourth quarter and the spread ended the quarter little changed at close to 40 basis points. The flattening movements in the yield curve mirrors developments in the United States, where the yield curve has been inverted for several quarters but showed a tendency to steepen towards the end of the third quarter.

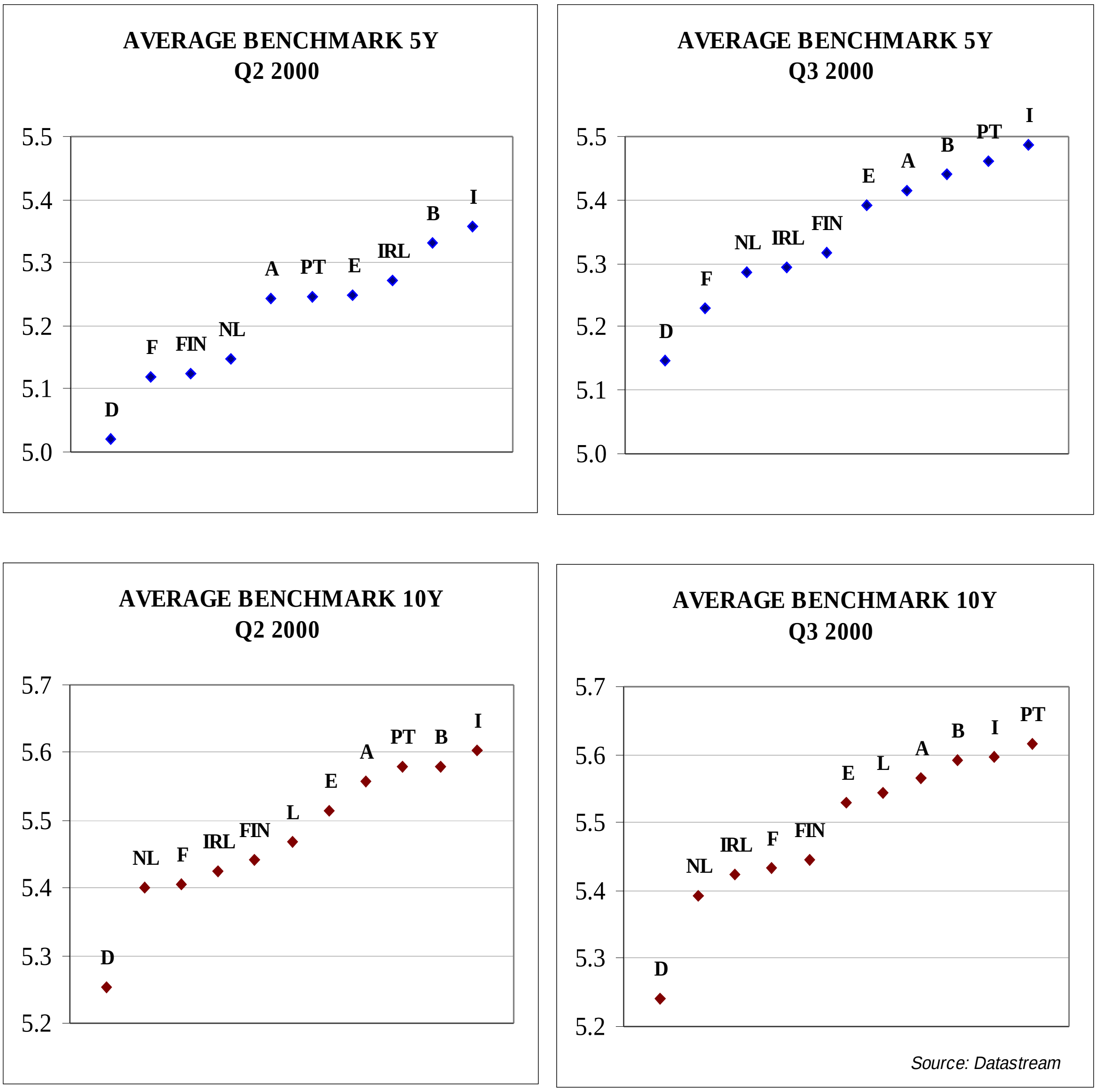
GRAPH 9 – EURO YIELD CURVE 1999 AND 2000



Spreads between sovereign issuers

Yield spreads among euro-area sovereign issuers in the third quarter, remained in the range of 15-40 basis points reached during the second quarter. This new level of spread has established itself in an environment of generally rising interest rates and a much more pronounced spread widening for other types of issuers. This behaviour is not uncommon in the bond markets, with periods of less favourable market conditions characterised by widening spreads between different issuers. Another factor behind the spread widening, quoted by market professionals, was the renewed focus on liquidity by major investors to the detriment of smaller bond issues from Member States with limited financing needs.

GRAPHS 10 – YIELD SPREADS ACROSS SOVEREIGN DEBT ISSUERS



Source: Datastream

It should be noted that this analysis of spreads focuses on the relative position of yields on 5 and 10-year securities. At other maturities, the picture is somewhat different. For example, French government bonds with 3 and 7-year maturities have consistently offered some of the lowest yields within the euro area.

- FEATURED TOPIC -

New major issuer on the euro bond market - Freddie Mac

Freddie Mac, a highly professional US funding machine.

Freddie Mac is a US government sponsored enterprise (GSE) authorised by the Congress to ensure nation-wide access to affordable long-term mortgage credit and to provide secondary mortgage liquidity. Freddie Mac does not originate mortgages but instead purchases them from mortgage lenders (i.e. commercial banks, mortgage banks and thrifts) and either holds them on its balance sheet or repackages the loans into mortgage-backed securities.

The outstanding obligations of Freddie Mac do not benefit from a government guarantee. However, there is a widespread view that Freddie Mac enjoys strong implicit government support. A number of factors can be identified in support of this view, including:

- The agency's important public policy role.
- The likely severe economic consequences resulting from a failure of the agency
- A line of credit from the Treasury of up to $2.25 billion
- An exemption from US state/local taxes and SEC requirements
- Five board members elected by the President
- No limitation on US national banks holdings of Freddie Mac securities

In order to clarify the credit situation of Freddie Mac, there is a proposal to discontinue the line of credit from the Treasury. Credit rating agencies have indicated that such a step would not alter their assessment of the creditworthiness of the institution, which in their view has a very strong financial position on a stand-alone basis.

US dollar borrowing programme

Freddie Mac has previously arranged its financing almost exclusively in US dollars, where it established a borrowing program called "reference notes" in April 1998. Under this programme, securities are issued according to a set calendar with maturities ranging from 2-30 years and a minimum size of $3 billion and a current average size of $5.5 billion. The advent of the "reference note programme" has contributed to an active US agency repo market.

Euro borrowing programme

In September this year Freddie Mac set up a similar "€ reference note programme" with at least €20 billion of issuance in the first calendar year with a quarterly minimum of €5 billion. New issue size will be a minimum of €5 billion in 2-, 3-, 5-, 7-, or 10-year maturities. The securities will be listed in Paris, Frankfurt and Luxembourg with clearing through Euroclear and Clearstream.

The first bond was issued in early September through syndication with a maturity of 10 years and an initial size of €5 billion. The bond will be traded on the EuroMTS government-trading platform with at least 8 market makers and specific bid-ask spreads and quote sizes. Securities issued by Freddie Mac have 20 % risk weighting in terms of banks' capital adequacy requirements. While Freddie Mac USD securities are accepted as collateral with the US Federal Reserve, their euro securities will not be accepted as collateral with the Eurosystem.

Initial market response

The Freddie Mac bond was the first €5 billion issue from a non-government entity and had to offer a yield generous enough to attract European investors, higher than the funding level usually achieved by Freddie Mac in the US market. The issue was priced at 55.5 basis points over the German bund and some 5 basis points over KfW, which is a similar European based credit. Orders for €7 billion was received and the bonds were primarily sold to European investors (over 90 %) with a large number of first-time investors in Freddie Mac securities. According to market sources, the bonds traded well in the first week on the secondary market with some minor spread tightening against the bund and a bit more pronounced improvement against swaps. Trading volume was high with quite tight bid/ask spreads

Comments and analysis

The establishment of a €20 billion borrowing programme on the euro bond market by a US institution has provoked a significant reaction among European issuers. The size of the programme puts Freddie Mac ahead of a majority of EU sovereign borrowers in terms of volume and the AAA credit rating also compares favourably with some EU governments. This will increase the competition for smaller EU sovereigns who have lost their home-market advantage after the introduction of the euro. However, the 20 % BIS risk weighting on Freddie Mac securities compared to the 0 % risk weighting for sovereign borrowers will most likely mean that Freddie Mac will trade at higher yields than EU sovereigns.

Freddie Mac's regular issuance should compare favourably with many supra-national and government guaranteed borrowers on the euro bond market. Most of these borrowers do not match Freddie Mac in size and follow a more "opportunistic" issuing strategy with large variations in borrowing plans. The size of Freddie Mac issues could potentially make it an attractive hedging tool in the euro area. The liquidity in individual issues could allow for more active repo trading.

German Pfandbriefe dominates the AAA non-government sector in the euro area but their spreads to bunds have widened over this year as bunds have benefited from reduced issuance in the wake of high UMTS-licensing proceeds. As a result, Pfandbriefe issuance has been less profitable and issuance levels have been declining. Pfandbriefe enjoy a 10 % BIS risk weighting, which makes them attractive to financial institutions. In this respect, they compare favourably to Freddie Mac securities. However, the Pfandbriefe market is somewhat fragmented with a large number of small issues. Despite the development of Jumbo Pfandbriefe in recent years, Freddie Mac issues could have significantly more liquidity and this could be reflected in the yield differentials between the two market segments.