

S T R A T E G Y

OBRAS DE ALCANTARILLADO Y SANEAMIENTO  
LEY ESPECIAL DE 16 DE MARZO DE 1902  
SUPOSTA DE 22 DE ABRIL DE 1907

OBIGACION  
PORTADORA 0020  
QUINIENTAS PESETAS

AMORTIZACION INTERES ANUAL  
25 PESETAS



Tesoro Público

KINGDOM OF SPAIN

02

# 1 SPANISH TREASURY ISSUANCE IN 2001 AND FORECAST FOR 2002

## 1.1. Balance for 2001

Central government debt issuance in 2001 will total some 64,500 million euros. This figure is down 21% with respect to that for the previous year and down 50% with respect to gross issuance in 1997. Final gross issuance will be in line with that announced at the end of 2000, as a result of the offsetting effects of two factors which did not form part of the forecast but have pulled in opposite directions: a cash deficit in 2000 lower than anticipated and buy-backs of Central government debt for early redemption during 2001. The net result of those two effects is a total gross issuance for the year just 2.4% higher than that forecast in December 2000.

As to terms, final issuance has moved away from that announced to the extent required by market conditions. The increasing slope of the yield curve and the underperformance of its longer term has shifted issuance towards the shorter maturity products above what was initially forecasted. Thus final issuance of Letras will be 10% higher than anticipated, while for maturities beyond 10 years gross issuance will be almost 30% below forecast figures.

## 1.2. Forecast for 2002

In 2002 gross issuance is to be on a par with that for this year at a forecast figure of 64 billion euros. The process, commenced in 1997 of cutting back gross issuance is to be slowed down in the coming year essentially because of the accumulation of maturities on 31 January 2003. Initial issuance forecasts for 2003-2005 are, however, in the region of 50 billion euros per year.

In terms of instruments, issuance of Letras will increase slightly, by 7%, with respect to 2001, in order to take advantage of favourable short-term financing conditions and to promote bill (Letras) market liquidity. Total issuance of Bonos and Obligaciones will be 6.5% lower than this year. That drop will be spread over the different maturities according to market conditions. The decrease will be compatible with the goal that each debt reference should achieve a total circulation value of around 10 billion euros.

The funding programme for the coming year incorporates a specific target in the field of foreign issuance. Nevertheless, the Treasury's strategy will continue to be that followed in the past years of tapping the foreign markets when a saving may be achieved with respect to the financing levels obtained through the traditional issuance in euros.

### TESORO PÚBLICO ISSUANCE IN 2001 AND FORECAST FOR 2002

In billions of euros

	2001	2002
<b>Gross issuance</b>	64.4	64.0
Letras del Tesoro	25.2	27.0
Bonos and Obligaciones	38.0	35.5
- 3 and 5 years	18.0	17.0
- 10 years	13.5	12.0
- 15 and 30 years	6.5	6.5
Non Euro debt	1.2	1.5
<b>Redemptions</b>	61.9	57.2
Letras del Tesoro	34.2	26.0
Bonos and Obligaciones	24.5	29.0
Non Euro debt	0.2	0.6
Other	3.0	1.6
<b>Net Central government funding needs</b>	2.5	6.8

The principal features of the net financing for 2002 are the following:

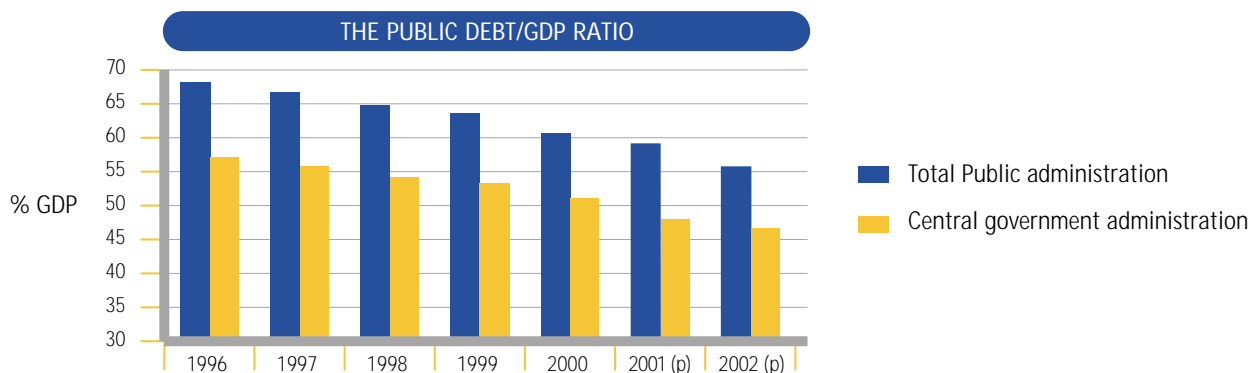
- Net debt issuance will amount to 6.8 billion euros.
- For the first time since the mid nineties, Letras will make a positive net contribution to public funding, given that issuance will exceed redemptions. That net financing will be in the region of 1 billion euros.
- The greater part of the net financing – 6.5 billion euros - will continue to come from Bonos and Obligaciones.
- Foreign currency funding will bring in positive net financing approaching 1 billion euros.
- Other debt (loans, absorbed debt, etc.) will give rise to negative net financing in the amount of 1.6 billion euros.

The Spanish Treasury forecasts for 2002 include a new Central government debt buy-back program of up to 6 billion euros. Next year's funding program will also allow the Treasury to raise the cash needed to face without any difficulting the concentration of redemptions maturing in January 2003.

## 2 THE CENTRAL GOVERNMENT DEBT PORTFOLIO

### 2.1. Outstanding debt

The forecasts outlined in the preceding section will result in a net Central government debt issuance of nearly 7 billion euros that will raise the nominal amount of outstanding debt at the end of 2002 to 314 billion euros, 2.2% more than at the end of 2001. As this increase is lower than the forecast nominal GDP growth, the Central government debt/GDP ratio should continue to fall in the coming year and thus come to stand at under 47%, that compares favourably with the 48% ratio anticipated for the end of the current year, and the 57% ratio registered in 1996.



The part that the Central government debt plays in the economy has become substantially smaller if we consider, in addition to Central government debt, the debt of the autonomous communities and local corporations. On this scale the debt/GDP ratio will have fallen from slightly less than 70% in the mid nineties to around 58% by the end of 2001 and is expected to drop to about 56% by the end of the coming year.

### 2.2. Interest payments

In 2002 Central government debt interest payments will amount to some 17 billion euros. It has been estimated that in 2002 the average cost of the debt in circulation will remain below 6%, as has been the case since 1999. This contrasts with the figures close to 10% registered in the mid nineties.

There will similarly be a significant reduction in the amount of interest payments in terms of GDP. That figure, which reached almost 4.6% in 1996, stands at 2.7% this year and is expected to fall to 2.5% in 2002. This forecast could be slightly affected by the buy-back programme planned for the coming year.

## 2.3. Structure of portfolio

One of the main effects of the debt issuance in 2001 and 2002 is the stabilization, at around 11.5%, of the volume of Letras del Tesoro within the Central government debt portfolio. Thus, in 2002 the balance of bills in circulation will increase for the first time since 1996. These developments, together with some relevant changes in the issuance policy of Letras will favour a notable improvement in the liquidity of the bills market.

The pace at which Bonos and Obligaciones were gaining ground within the Central government debt portfolio has slowed slightly. That growth will, however, continue and consequently, Bonos and Obligaciones are expected to reach around 78% of the debt portfolio by the end of 2002.

At the end of 2001 the foreign currency share of the portfolio will amount to 4.4%. The share of non Euro debt in the total debt portfolio will depend on the possible issuance accomplished through the year 2002. As it has already been said, the possibility of issuing in any non Euro currency will rely on market developments and saving opportunities.

STRUCTURE OF CENTRAL GOVERNMENT OUTSTANDING DEBT								
In billions of euros								
	1995	%	2000	%	2001(p)	%	2002(p)	%
Letras del Tesoro	70.6	31	44.7	15	35.7	11.6	36.5	11.6
Bonos and Obligaciones	116.6	51	225.4	73	238.3	77.5	244.8	77.9
Non Euro debt	19.4	8	12.4	4	13.3	4.3	14.2	4.4
Other debt	22.8	10	24.9	8	20.2	6.6	18.6	5.7
<b>TOTAL</b>	<b>229.4</b>		<b>307.4</b>		<b>307.5</b>		<b>314.2</b>	

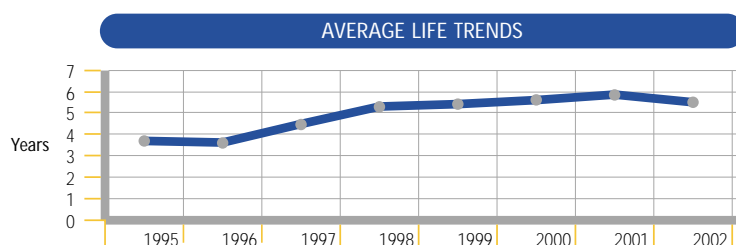
## 2.4. Average life and average cost

The funding policy planned for 2002 will have a significant effect on the average life of the outstanding debt. While the average life reached some six years in mid 2001, under the issuance policy followed in the second half of the year and that planned for 2002, the span will be cut to about 5.5 years. The process will be a progressive one, linked to the evolution of the demand for the Spanish Treasury's products.

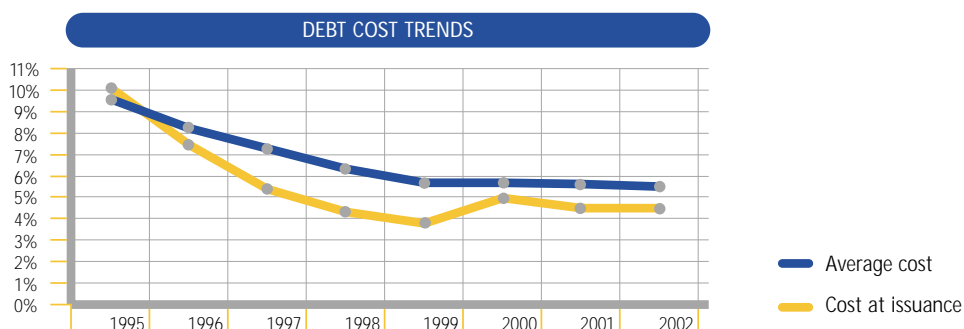
The reduction of the average life comes within the framework of the broader portfolio duration management goal of finding the most suitable cost-risk combination. The precise strategy to be adopted in that regard will be determined through the use of internal simulation models and in the light of the situation of the markets and the outlook for public financing needs.

In order to reach an optimal cost-risk combination, the primary market issuance policy will be supplemented through the use of derivative markets. No specific duration target will be announced. Instead a direction, which at the present time is towards reduction of the duration, will be established and actions will be taken in the marketplace when it is considered that the circumstances are appropriate.

The increase registered in the average life of the debt since the mid nineties has proved compatible with the reduction of the debt average cost. Which currently stands at 5.6%, four percentage points below the figure registered in 1995. The fall in the cost of the outstanding debt as a whole reflects a still more pronounced trend in the contrast issuance, which have fallen from levels greater than 10% in 1995 to close to 4.5% in 2001. Average yield at issuance as the year ends is in the region of 4%.



As the following table shows, in 1999 the average yield at issuance was less than half of that registered in 1995. The effects of that fall have been progressively conveyed to the average cost of the debt, as old debt matured and was replaced with new one at lower rates. The process has, furthermore, been speeded up through debt exchange operations and debt buy-backs. In the year 2000 there was an upturn in issuance costs, in a context of favourable economic prospects for Spain and the rest of Europe, and thus the progressive reduction of the average cost of the debt slowed.



As a consequence of the gradual worsening of the economic situation in Europe and the United States, the downtrend in the average issuance cost recommenced in 2001 and, a further fall in the average cost of the debt portfolio took place. However, this downtrend can no longer be as marked as was that of the second half of the nineties, since a large stake of the debt to be refinanced in the next future was issued in the last four years at rates lower than 5%.

Through the aforementioned debt buy-back, and exchanges, in the course of the last five years old notes to the value of nearly 38.5 billion euros, in nominal terms, have been redeemed prior to maturity. This amount is equivalent to 12.5% of total Public debt and to 18% of all Bonos and Obligaciones currently in circulation. Those exchanges and buy-backs have not only helped to reduce the average cost of the debt but have also been used to smooth the debt redemption profile.

## 2.5. Structure of the Central government debt portfolio by type of investor

It is to be noted that in 2001 there continued to be an increase in the participation of nonresidents in the total holdings of Spanish debt. The countries of the euro zone are primarily behind this trend. Thus, France, Germany, Italy and Benelux account for almost 60% of total nonresident holdings. In contrast, the relative importance of the United Kingdom as a country of origin of our investors has declined, falling from somewhat more than 40% prior to the introduction of the euro to less than 10% at the present time.

As to other groups of investors, investment funds have continued to cut back their holdings of Spanish public debt, in part at the cost of increasing those in the debt of other euro zone States, while Pension Funds and Insurance Companies have kept their balances very much the same as in the previous year.

### CENTRAL GOVERNMENT DEBT PORTFOLIO BY TYPE OF INVESTOR\*

(Nominal balances at maturity in millions of euros)

	1995	%	1998	%	1999	%	2000	%	2001	% up to October
Financial institutions	97,006	51.8	86,202	36.2	91,222	35.2	87,880	32.5	94,610	34.7
Institutional investors**	36,451	19.4	92,275	38.8	84,280	32.5	64,260	23.8	51,980	19.0
Other residents	20,228	10.8	17,621	7.4	18,271	7.0	20,630	7.6	18,060	6.6
Nonresidents	33,543	17.9	41,494	17.4	65,197	25.1	97,090	35.9	107,790	39.5
<b>TOTAL</b>	<b>187,227</b>	<b>100.0</b>	<b>237,592</b>	<b>100.0</b>	<b>258,970</b>	<b>100.0</b>	<b>269,860</b>	<b>100.0</b>	<b>272,440</b>	<b>100.0</b>

(\*) Letras del Tesoro, Bonos and Obligaciones

(\*\*) Investment and Pension Funds, Investment Trusts and Insurance Companies

### 3.1. New developments in 2001

In 2001 there were three main innovations introduced by the Spanish Treasury in relation to its financing policy: amendments to the issuance policy, a new system of liquidity management system and the implementation of an Internet securities sales channel.

3.1.1. **Issuance policy.** The number of auctions has been cut from 115 in 2000 to 83 in 2001 while the average volume allotted at each auction has risen by 16%. The concentration of volume issued in a smaller number of auctions has been particularly noticeable in the first tranches of new bonds, where the amount issued has ranged from 3 to 4 billion euros.

3.1.2. **Cash management system.** This has enabled the Spanish Treasury to obtain a return on almost the whole of its account balance at the Banco de España and to do so with a minimum risk - though one-day repo transactions on Spanish public debt - and without interfering with receipts and payments' management. This system has allowed the Treasury to raise funds in 2001 by around 480 million euros, which compares to somewhat less than 100 million euros obtained in 2000 even though the average account balance was practically the same. The average rate of return obtained in 2001 will be near 4.2%, slightly higher than the short-term State financing cost.

3.1.3. **System for buying and selling securities through Internet.** Established in 2001, this mechanism will be improved in 2002, in order to make it more attractive, thereby facilitating registration procedures and incorporating on-line money movement.

### 3.2. New developments planned for 2002

3.2.1. With respect to the issuance policy, and in addition to the increase in the issuance of bills, to which reference has already been made, the following innovations stand out:

- **Greater flexibility in the issuance calendar.** Although the Treasury will keep announcing the dates for the auctions for the entire year, the term of the securities to be issued each day will be established on a quarterly basis in accordance with the group of Primary Dealers. This is intended to avoid tapping the market for maturities which are not so demanded by investors simply because of the need to comply with what was announced at the beginning of the year.
- **Changes in the Bills' issuance policy.** While the amount of bills issued will be increased, the number of auctions will be reduced in 2002. In addition, bills with the same maturity date may be auctioned over various months to increase the outstanding amount. Lastly, maturities will become more flexible and may reach 24 months. The number of references will be reduced while the outstanding volume of each of them will be increased to reach around 3 billion euros, thereby improving liquidity in the Treasury Bills' secondary market.
- **Syndication of the first tranches of the issuance of Bonos and Obligaciones.** In 2002 the Treasury will have recourse to syndication for at least one of the first tranches of a new bond, probably corresponding to the 5 or 10 year reference, in order to achieve a minimum initial placement of 5 billion euros and a distribution in the primary market that will ensure good performance of the bond in the secondary market
- **Elimination or reduction to the lowest possible level of zero-coupon periods** in the new references.
- **Reopening of strippable bonds.** From 1 March 2002 all issues of strippable bonds in circulation will be reopened so that all of them may be subject to the Directive on savings taxation which should become enforceable early in 2003. Reopenings will be made by small amounts so that the price of the securities may not be affected.

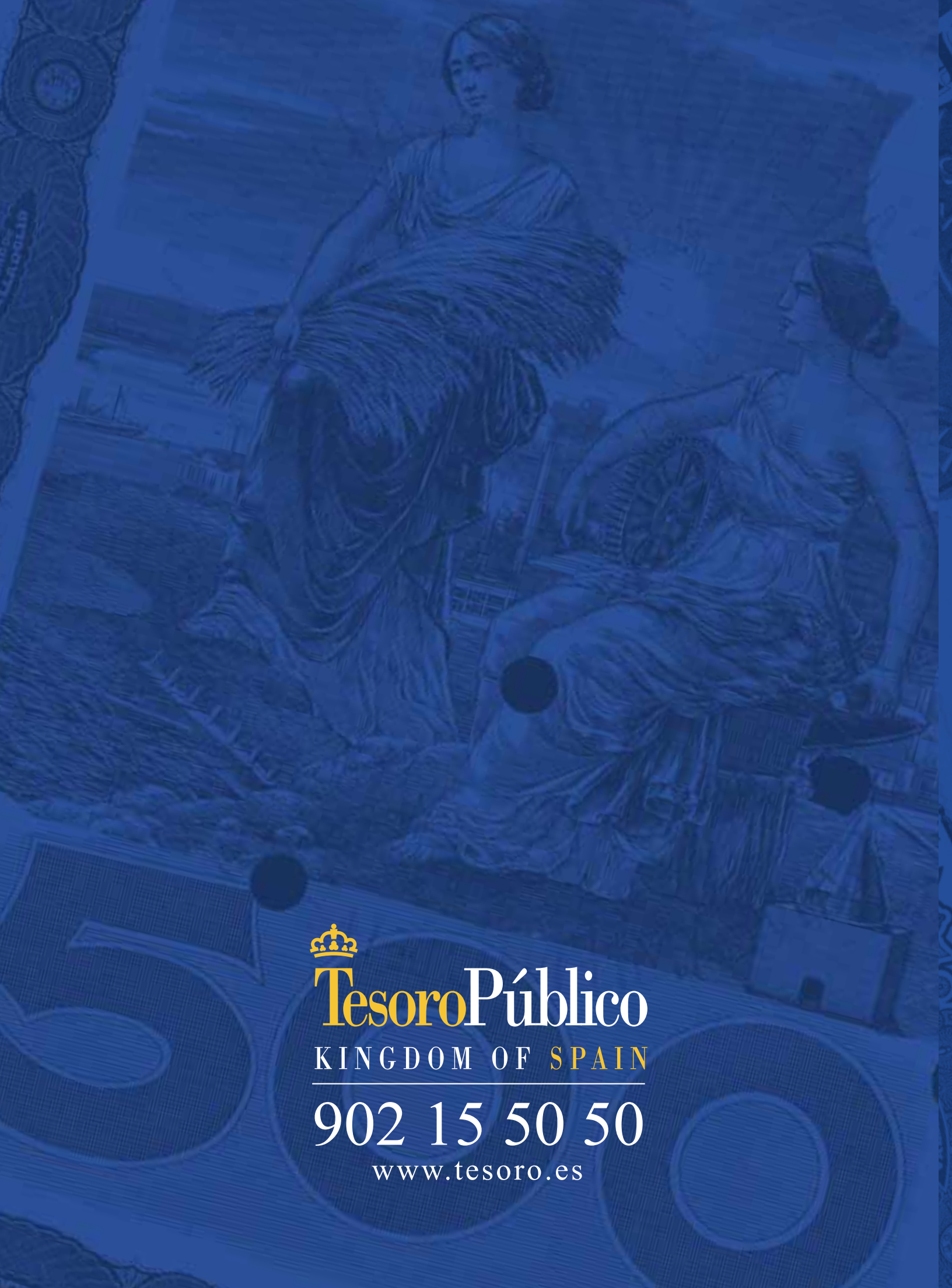
3.2.2. Concerning the portfolio's risk management policy, the objective is to make broader use of derivatives transactions in order to achieve an optimum cost-risk combination according to portfolio analyses performed with simulation models, market expectations and State financing needs forecasts.

For nonresident counterparts, transactions will be covered by ISDA contracts, with a collateralization agreement - Credit Support Annex (English Law) -. In the case of resident counterparts, the contracts designed by the AEB, which are subject to Spanish Law, will be used. A new collateralization annex is being developed nowadays, which may only take effect upon the passing of the new regulations on warranties included in the Finance Act. The Spanish Treasury will implement a one-way collateral system; thus, our counterparts, rather than the Treasury, will have to provide warranties if the value of their corresponding transaction evolves against them.

The transactions will be agreed with Primary Dealers in order to take advantage of the opportunities that the market may offer avoiding an excessive knowledge of our moves, which could entail an additional cost for the State. However, a certain degree of competition between a limited number of entities for each transaction will be maintained.

Lastly, with respect to the management of liabilities, a new buy-back program of Central government debt of around 6,000 million euros will be implemented in 2002. Probably, a lower relevance will be attached to smoothing the profile of future redemptions, which has been already achieved to a large extent through the transactions performed this year. Instead the focus will presumably be on securities with the highest coupons and with a market valuation more favourable for the Spanish Treasury.

3.2.3. Finally, Primary Dealers' commitments will be reinforced in 2002 in order to increase secondary market liquidity. This will allow investors in Spanish public debt to find prices and to trade large volumes for 25 references of Bonos and Obligaciones. The Treasury will increase the value assigned to the compliance of the quoting commitments in the valuation of Primary Dealers as well as in the choice of counterparts for its portfolio management and foreign currency issuance transactions.



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