

ECU financial activity

The European Community's 1992 internal market programme and the UK government's recent issues of ECU Treasury bills have heightened interest in the ECU. This article⁽¹⁾ examines the development of ECU banking business in Europe and, more particularly, in London and looks also at ECU bond and money markets. The article contains views and opinions expressed by a range of bankers involved in ECU markets in London. Among the principal findings are:

- *The stability of the ECU in foreign exchange markets is a major attraction to borrowers and investors. The use of the ECU in banking and eurobond markets is now well established. The ECU accounts for two and a half per cent of banks' outstanding international lending and four per cent of the stock of international bonds.*
- *ECU banking business is primarily interbank. The ECU is not widely used for commercial and trading purposes, although in some countries, notably Italy and France, it has an established and growing role. Future growth will depend on how well the ECU meets demands from the non-bank sector.*
- *London is the main centre for issues of ECU eurobonds and the second largest centre for ECU banking business.*
- *The issue of ECU Treasury bills will make a contribution to the development of the use of the ECU in international financial markets and should enhance London's role as a major centre for ECU transactions.*

Introduction

The European Currency Unit (ECU) has both an official and a private form. It is private ECUs which are the principal subject of this article. The currency composition of the two forms of the ECU is identical; thus there is no difference in their value relative to other currencies and no distinction between the two when used as units of account (see the note on page 510). However, the two are quite distinct in the ways in which they can be created and used. Private ECUs are composite currency units which can be created, for example, by bundling up the appropriate amounts of the component currencies. The private ECU⁽²⁾ is now well established in international banking, capital and foreign exchange markets (see page 514 for a note on theoretical ECU yields).

The creation and use of official ECUs is tightly circumscribed. Official ECUs are not fungible with private ECUs. They are held only by the central banks of those countries which have joined the European Monetary System (ie all member states of the European Community) and by other central banks and international monetary institutions which have been accorded the status of 'other holders' of official ECUs by the European

Monetary Co-operation Fund (EMCF). The EMCF administers the European Monetary System (EMS). Official ECUs are created as a result of swap arrangements between EMS members and the EMCF. Under these arrangements, EMS members swap 20% of their dollar and gold reserves for official ECUs (the latter being liabilities of the EMCF). Official ECUs can be used only in transactions with other holders of official ECUs and are most commonly used to settle interest and repay principal on borrowings made under the Very Short Term Financing facility (a credit facility whereby central banks provide each other with currency which is then used for intervention in the Exchange Rate Mechanism⁽³⁾ of the EMS). Official ECUs themselves cannot be used for intervention, since this would involve transferring official ECUs outside the central bank network; however, a 'mobilisation' facility allows central banks to swap part of their holdings of official ECUs for foreign currency if needed for intervention.

Banking markets in Europe

At the end of 1982, the earliest date for which ECU banking figures⁽⁴⁾ are available, international banks' ECU

(1) Written by R J Walton in the Bank's Financial Statistics Division.

(2) At end-September 1988, 1 ECU = £0.6550 and \$1.1043.

(3) The EMS was set up in 1979 to help to stabilise European Community exchange rates—'a zone of monetary stability'. The key element of the EMS is the Exchange Rate Mechanism (ERM), whereby the exchange rates of participating currencies have to be kept within a margin of agreed central rates. All member states of the European Community are members of the EMS, but the United Kingdom, Greece, Portugal and Spain do not participate in the ERM.

(4) Statistics collected from the banks in the Bank for International Settlements (BIS) reporting area.

The European Currency Unit

The ECU was officially introduced in 1979 in connection with the start of the European Monetary System (EMS); it replaced the European Unit of Account, which had been established in 1975. In the EMS, the ECU serves as the basis for determining exchange rate parities and as a reserve asset and means of settlement. The ECU is a composite currency which at the moment contains specified amounts of the currencies of ten of the member states of the European Community (EC) as follows:

Currency amount	
0.71900	German mark
0.08780	Pound sterling
1.31000	French francs
140.00000	Italian lire
0.25600	Dutch guilder
3.71000	Belgian francs
0.14000	Luxembourg franc
0.21900	Danish krone
0.00871	Irish pound
1.15000	Greek drachmas

The composition of the ECU is reviewed by the EC every five years. Between these normal revision dates, the weights of currencies can change by large amounts because of movements in exchange rates. The weight of stronger currencies will tend to rise and weaker currencies will lose weight. If the value of any currency has changed by 25%, a re-examination of the weights can, on request, take place. The next five-year review is due in September 1989. Any change in the composition of the ECU can be made in line with underlying economic criteria, must not affect the value of the ECU at the moment of transition and must be adopted unanimously by the EC Council of Ministers. Subject to these conditions, and taking into account the necessity of ensuring a stable development of the functions and uses of the ECU, there is also a presumption that all member states of the EC have a right to have their currency included in the ECU. At the next review, the currencies of the EC's two most recent member states, Spain and Portugal, could, therefore, be included.

assets amounted to ECU 7 billion. At the end of March 1988, the figure had risen to ECU 90 billion (Table A), of which 76% was cross-border. From the outset, the ECU banking market was predominantly interbank and this remains the case, with interbank lending accounting for 77% of international ECU assets at end-March 1988. The market is also characterised by a disparity between ECU assets and liabilities, with the net asset position expanding from ECU 6 billion at end-1985 to ECU 14 billion at end-March 1988. Much of this was due to the increased demand by non-banks for ECU loans. ECU business is heavily concentrated in a handful of European financial centres, with banks in France, the United Kingdom, Belgium, Italy and Luxembourg accounting for 90% of all business.

Table A
ECU lending by BIS-area banks

ECU billions, amounts outstanding at end-periods: percentages in italics

	1983	1984	1985	1986	1987	March 1988
Total international assets	14.4	39.8	63.1	70.7	82.4	90.3
<i>of which:</i>						
Banks	9.7	28.6	49.1	54.9	62.1	69.4
Non-banks	4.7	11.1	14.0	15.8	20.3	20.9
<i>of which:</i>						
France	27	32	28	29	26	26
United Kingdom	14	17	19	19	20	22
Belgium	21	17	16	18	20	19
Italy	24	20	13	13	11	11
Luxembourg	10	8	11	10	11	9

Source: BIS.

The development of ECU business has been affected by official regulations. Exchange control restrictions in France and Italy have, in the past, accorded the ECU a favourable position in comparison with other non-domestic currencies. However, in the Federal

Republic of Germany, currency regulations defined the ECU as an index-linked unit of account which was forbidden by the Bundesbank. This restricted the ECU's use, although German companies invested in the ECU via German banks in Luxembourg. The German restrictions were revoked in June 1987. Most EC countries now treat the ECU on the same footing as foreign currencies.

The growth of banks' ECU assets was stronger in 1987 than in 1986, probably benefiting from a more favourable outlook for stable exchange rate relationships among the constituent currencies. In the first quarter of 1988, the ECU took a 15% share of banks' new cross-border lending. In cross-border lending, the ECU now ranks sixth among international currencies, accounting for 2.6% of outstanding lending at end-March 1988 (Table B).

Table B
Currency shares of cross-border lending by BIS-area banks^(a)

Percentages: flows exclude estimated exchange rate effects

	1985	1986	1987	1988 to end-March	Outstanding at end-March 1988
US dollars	30.5	58.8	47.3	- 1.2	51.7
Yen	24.1	16.4	29.5	29.1	13.5
Deutschemarks	16.2	6.9	9.0	-10.0	12.8
Swiss francs	10.1	2.8	0.5	7.8	6.0
Sterling	4.0	4.5	3.3	24.3	4.1
ECU	7.7	1.9	2.4	15.1	2.6

Source: BIS.

(a) Excludes the lending of the 'offshore' banking centres, for which currency detail is not available.

International interbank market

Outstanding ECU assets in the international interbank market increased from ECU 49 billion at end-1985 to ECU 69 billion at end-March 1988. The market is well balanced. Banks had a net asset position of

Table C
International interbank business in ECU
by BIS-area banks

ECU billions: flows exclude estimated exchange rate effects

	1985	1986	1987	1988 to end- March	Outstanding at end-March 1988
Assets	19.0	5.6	6.5	7.5	69.4
Liabilities	19.1	4.4	7.1	6.5	69.1

Source: BIS.

ECU 0.3 billion at end-March 1988 (Table C). Since end-1985, the interbank market has grown in importance as a source of ECU funds. At end-March 1988, the interbank liabilities of banks in the United Kingdom and Italy exceeded their interbank assets by ECU 0.9 billion and ECU 2.6 billion respectively (Table D), although this year banks in the United Kingdom have expanded their assets at a faster rate than their liabilities. Banks in France and Belgium were net suppliers of ECUs.

Table D
Net flow of international interbank funds in
ECU of banks in Europe

ECU billions: net outstanding at end-March 1988

Liabilities	Assets
Banks in the United Kingdom 0.9	Banks in France 3.4
Banks in Italy 2.6	Banks in Belgium 1.1

Source: BIS.

In September 1985, the ECU Banking Association (EBA) was established with the prime purpose⁽¹⁾ of developing the ECU clearing system. The EBA has eighty-two members. Selected member banks of the EBA provide a clearing system for ECU payments which is co-ordinated by the BIS. Thirty banks from ten different countries are involved; later this month, the number will increase to thirty-three. The ECU clearing mechanism rests on a function which nets ECU payments among the clearing members and a settlement function assumed by the BIS. From March 1988, new enhanced clearing provisions were introduced with respect to the 'value date' for settlement of ECU-denominated transactions between clearing system member banks. Settlement is now generally on a 'same day' rather than 'next day' basis.

International business with non-banks

There was little change in non-banks' ECU deposits with international banks in the first quarter of 1988 (Table E). ECU lending to non-banks has increased over the last two years, in part a consequence of the larger number of banks offering foreign exchange facilities in ECU. On a net basis, banks' outstanding assets stood at ECU 14 billion at end-March 1988, compared with ECU 7 billion at end-1985. Over the first nine months of 1988, ECU syndicated credits accounted for 4% of announced syndicated credits, above the proportion recorded in 1986 and 1987, but below the share of 7% in both 1984 and

Table E
International ECU business with
non-banks by BIS-area banks

ECU billions: flows exclude estimated exchange rate effects

	1985	1986	1987	1988 to end- March	Outstanding at end-March 1988
Assets	2.8	1.9	4.5	0.6	20.9
Liabilities	4.3	-0.8	0.6	—	6.9

Source: BIS.

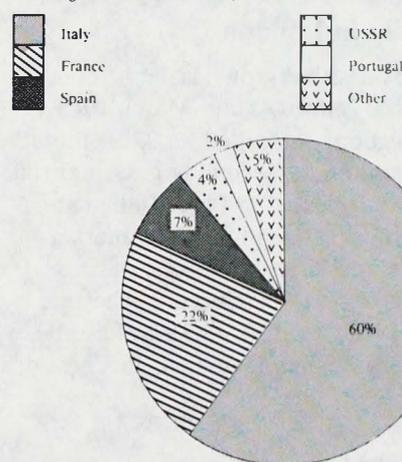
1985. Since 1982, over 80% of syndicated ECU loans have been to Italian and French borrowers (Chart 1). Corporations in Spain and banks in the USSR have also borrowed in this market during the last two years.

ECU commercial activity

The majority of currencies making up the ECU participate in the Exchange Rate Mechanism (ERM) of the EMS (the exceptions are sterling and the Greek drachma). Because of the constraints imposed on exchange rates by the ERM, the ECU has a degree of stability which has been attractive particularly to borrowers in countries such as France, Italy and Greece where the ECU has a lower nominal interest rate than the domestic currency. Borrowers in Italy and France, and in certain other European countries, have used the ECU successfully for

Chart 1
ECU syndicated credits by country of borrower

Percentage shares: 1982 to end-September 1988



short-term trade financing. The use of the ECU as an alternative to domestic currency borrowing has also been promoted actively in Italy and France.

The ECU's role in commercial transactions is developing in Europe, albeit slowly. Some large Italian and French manufacturing companies invoice in ECU, and certain European companies, notably Saint-Gobain (France), use the ECU, rather than the national currency, as the primary unit of account when publishing their accounts. ECU invoicing accounts for 1% of all foreign trade in Italy and France. It has also been used in the denomination of share

(1) The EBA has two further aims—to promote transactions in ECU and to represent its members in all matters concerning the use of the ECU in their relations with national and European authorities.

capital. Subsidiaries of some Italian banks located outside Italy now measure their capital in ECU. In addition, there has been an increasing interest from Middle Eastern and North African traders in switching from invoicing their imports and exports in US dollars to the ECU. This was mentioned as particularly attractive to both the exporter and the importer in the shipment of oil to countries such as Italy and France. Many Italian companies borrow and invoice in ECU to finance imports and exports to countries such as Germany and France which are the main trading partners of Italy. As mentioned earlier, they prefer to use the ECU against the Italian lira to save on the cost of borrowing, and against the deutschemark and the French franc because of the perceived stability of the ECU in the foreign exchange market.

ECU invoicing in the travel industries is evolving. Later this year, the International Air Transport Association will offer the ECU alongside the US dollar and sterling as a means of clearing payments between airlines. Consortia of European companies covering both air traffic control services and maintenance contracts on aircraft are also switching the currency denomination of their invoices to the ECU. However, corporate treasurers and the public at large in many countries are still undergoing an educational process in their use of the ECU. Lack of demand stifled the initial development of ECU travellers cheques, although in certain countries, notably Belgium and France, demand is picking up slowly.

ECU banking activity in London

In recent years, ECU business has grown faster in London than in any other financial centre. At end-March 1988, banks in the United Kingdom accounted for 22% of total ECU activity, making London the second largest financial centre involved in ECU business after Paris. Italian and Japanese banks are the most active in the ECU market here, accounting for 29% and 25% respectively of outstanding assets at end-June 1988 (Chart 2). They are followed by British banks (accounting for 19% of assets), US banks (10%) and French banks (7%). ECU business of

Chart 2
ECU assets of banks in the United Kingdom

Percentage shares by nationality: at end-June 1988

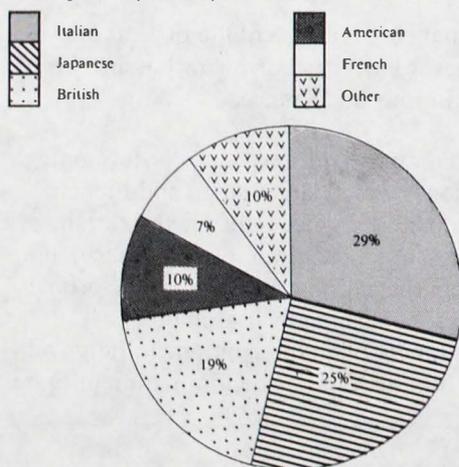


Table F
ECU business by banks in the United Kingdom

ECU billions, amounts outstanding at end-periods

	1983	1984	1985	1986	1987	June 1988
Total liabilities	1.6	5.6	12.2	13.8	16.4	19.0
of which:						
UK banks	0.4	1.6	2.5	2.6	2.9	4.8
Other UK residents	—	0.1	0.6	0.7	0.8	0.7
Overseas residents	1.1	3.8	8.4	9.1	11.7	11.9
Forward sales	0.3	1.7	4.1	9.3	14.8	20.7
Total assets	2.1	7.0	12.9	15.3	19.1	25.1
of which:						
UK banks	0.3	1.7	2.7	2.8	2.9	4.4
Other UK residents	—	0.2	0.4	0.8	1.1	1.1
Overseas residents	1.7	5.0	9.0	9.8	12.6	15.7
Forward purchases	0.4	2.2	4.1	9.1	14.7	22.2

Source: Bank of England.

banks in the United Kingdom expanded more rapidly than business in any other currency in the period since end-1984. Total assets more than tripled in this period to ECU 25 billion (Table F).

Cross-border lending

The ECU's share of the cross-border business stood at 3.4% at end-June 1988 (Table G). This has increased steadily since end-1983 when it stood at 0.3%. The most significant period of growth in percentage terms was between 1984 and 1985 when cross-border lending doubled to 1.5%. Close to two thirds of ECU business in the United Kingdom is with overseas residents, particularly those in Italy and France. There is, however, a wide geographical distribution of activity which now includes countries such as Iceland and Botswana.

Table G
Currency shares of cross-border lending by banks in the United Kingdom

Percentages: outstanding at end-periods

	1983	1984	1985	1986	1987	June 1988
US dollars	76.3	75.6	66.4	62.3	57.1	57.9
Yen	2.1	2.9	5.8	8.2	11.3	11.3
Deutschemarks	8.0	8.0	9.7	10.1	10.9	9.7
Sterling	5.6	5.4	7.0	7.2	8.4	9.4
Swiss francs	4.5	4.0	5.7	6.2	5.6	4.5
ECU	0.3	0.8	1.5	1.6	2.1	3.4
French francs	0.7	0.6	0.8	0.9	1.0	1.0
Dutch guilders	0.7	0.5	0.6	0.6	0.6	0.5
Italian lire	0.2	0.2	0.2	0.3	0.4	0.5

Source: Bank of England.

Italian banks in London lend primarily to companies in Italy; loans average ECU 35 million. These loans are normally guaranteed by the branch in Italy placing the business with the bank in London. Such loans are attractive to the borrower because they are Libor-linked and carry withholding tax concessions applicable to loans routed through offices located abroad. This practice has the blessing of the Italian Ministry of Finance.

Interbank market

The UK market is essentially in interbank deposits. The market is growing and, with an increasing and diverse population of counterparties, liquidity is said to be stable and deep. For some banks, ECU deposits are being arbitrated into dollars, through the forward market.

Certain banks, including Italian banks who are among the leading market makers, see the ECU interbank market as an important source of funds from which to finance their lending to non-banks. The ECU certificate of deposit market has not developed to any great extent. Although certificate of deposit facilities exist in London, there is virtually no secondary market activity and only a modest volume outstanding.

UK non-banks

Over the last two years, ECU loans to UK non-banks have risen by 40% to ECU 1.1 billion, representing 4% of UK banks' total ECU assets at end-June 1988. This growth stems from the greater use of the ECU as an investment currency and in trade finance. A number of banks in London have been promoting the ECU among their corporate customers. Although some report an upsurge in interest, they also note that this has not been translated into new business on a significant scale. ECU invoicing remains fairly limited and companies tend to use the foreign exchange market largely to cover themselves against their exposure to specific currencies. The build-up to 1992 is seen as potentially an important period in the development of ECU business.

Off-balance-sheet activity

A number of banks in London have become involved in ECU off-balance-sheet activity, although a lack of treasury paper to act as a hedge for other instruments denominated in ECU has checked innovatory developments. Turnover in the forward market has expanded from ECU 8.5 billion at end-June 1986 to ECU 22.2 billion two years later. British and French banks together account for over 70% of activity in the forward market. Although it is still a fairly thin market in terms of the number of counterparties, as the cash markets in ECU instruments develop, forward ECU markets may unfold according to market needs. Future demand for forward ECU positions will depend crucially, however, on a wider commercial use of the ECU.

There is no interest rate futures contract in ECU. Following the announcement of the UK Treasury bill programme, LIFFE said that it would re-examine the possibility of introducing a futures contract on ECU deposit rates. Exchange-traded ECU currency futures contracts were launched during 1986 in the New York Cotton Exchange, the Chicago Mercantile Exchange and in the Philadelphia Board of Trade. An options contract exists only in the Philadelphia Stock Exchange. All these contracts are for the US dollar/ECU spot exchange rate. Liquidity is low and, at present, there is no underlying commercial demand for the contracts as a hedging instrument (ECU invoicing in EC/US trade is limited).

ECU foreign exchange market

A survey in 1986 of the foreign exchange market in London⁽¹⁾ indicated that ECU-denominated transactions

were about 1% of the total daily turnover of \$90 billion. British and other EC banks accounted for 80% of ECU business.

According to bankers, ECU/deutschemark and ECU/US dollar transactions are expanding markets in London—both spot and forward. Deals in ECU are on a par with French francs, Dutch guilders and Belgian francs. Trading has been enhanced by the ECU clearing system, creating a more efficient and fluid market, and by an increase in the number of market makers. The major counterparties are British banks, other EC banks and Japanese banks in London. The ECU is traded also against the other EMS currencies. Corporate investors have looked to the ECU as a source of currency diversification, with a lower volatility than non-EMS currencies. However, opportunities for arbitrage are fairly limited because of the degree of stability of the ECU.

The market in New York for ECU/US dollar has also grown in the last two years, in part underpinned by the existence of exchange-traded ECU futures and options in New York, Chicago and Philadelphia.

One particular corner of the ECU market is that of splitting ECUs into component currencies in order to arbitrage through forward positions. Such activity can also help to close foreign exchange positions in component currencies. A few banks, including some of the British clearers, are involved in doing this in London. The underlying conditions in the foreign exchange market which make this activity possible are a general excess supply of ECUs. Since the ECU cannot fall significantly in value against its components, ECUs which are offered in the spot market are disaggregated and sold as component currencies. It is understood that banks in Brussels and Paris are more active in this segment of the market. But some banks consider this activity labour-intensive and potentially unprofitable in terms of dealing resources, in particular the costs involved in writing a number of separate dealing tickets for each transaction. Splitting the ECU will become more expensive if Spanish pesetas and Portuguese escudos join the basket of currencies. For those banks which do not do this on a regular basis, the incentive to split is caused usually by a large ECU order late in the day, driving the price away from those of the component currencies. The creation of ECUs from the constituent currencies occurs also through arbitrage opportunities; creation is probably less frequent than division.

ECU capital markets

Since the launch of the first ECU eurobond in 1981, the stature of the ECU has increased in international capital markets. By 1985, the ECU was the fifth most utilised currency for international bond issues, accounting for 4.5% of total international fixed-rate and floating-rate bond issues. Since then, its development has slowed. In 1986, issues of ECU international bonds fell as a

(1) See 'The market in foreign exchange in London', in the September 1986 *Bulletin*, pages 379-82.

Theoretical ECU yields

It is possible, in principle, to create a synthetic ECU asset corresponding to any existing ECU asset. The simplest case involves replicating an ECU term deposit by placing a bank deposit in each of the individual currencies in the ECU basket. The return on the synthetic deposit can be calculated easily, by converting the proceeds from each maturing currency deposit into ECU using the forward exchange rate. (When forward rates are not observable, they can be constructed using spot exchange rates and interest rate differentials.) In general, synthetic deposit rates calculated in this way have often exceeded bid rates for ECU deposits, suggesting that ECU deposits are typically good value. Since bid-ask spreads in some component currency markets are rather wide, there may, however, be little arbitrage—in the sense of borrowing component currencies to place on ECU deposit at the same maturity.

The calculation is similar in the case of securities, but is complicated considerably by the difficulties of finding comparable instruments in the various ECU currencies. However, calculations generally suggest that ECU bonds yield less than a synthetic basket of bonds of comparable maturity and credit quality. This may represent the margin that the investor is willing to pay for the convenience of a ready-made asset diversified across the component currencies.

proportion of the total to 3.1%, and they accounted for a little over 4% of total international bond issues in 1987 and in the first nine months of 1988 (Table H). In this latter period, ECU bond issues rose to ECU 6.0 billion, compared with ECU 6.5 billion in the whole of 1987 (Chart 3). This increase reflected the improved swap opportunities for borrowers to raise primarily floating-rate dollars at below Libor rates.

According to BIS figures, the ECU accounted for 3.9% of the total stock outstanding of international bonds, compared with 9.5% for the deutschemark and 6.2% for sterling at end-June 1988.

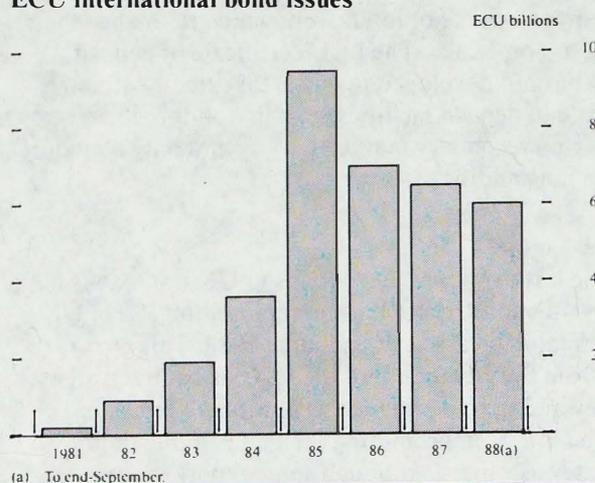
The attraction of ECU issues for borrowers is that, like any euro-issue, they are free from national restrictions;

Table H
International bond issues by currency of denomination

Percentages	1981	1982	1983	1984	1985	1986	1987	1988 to end-Sept.
US dollars	60.4	62.9	55.5	63.5	60.4	55.0	35.8	36.8
Swiss francs	17.7	15.5	19.0	12.1	9.1	10.5	13.6	12.5
Sterling	2.9	2.7	3.9	5.1	4.0	4.9	8.5	11.2
Deutschemarks	5.3	7.5	8.7	6.4	6.9	7.3	8.5	10.0
Yen	6.4	5.2	5.5	5.4	7.5	10.2	14.1	9.3
Canadian dollars	1.4	1.6	1.6	2.1	1.9	2.7	3.4	5.8
ECU	0.5	1.3	2.2	2.6	4.5	3.1	4.2	4.1

Source: Bank of England ICMS database.

Chart 3
ECU international bond issues



they also provide a degree of diversification of liabilities. The majority of borrowing has been by bodies within the European Community (EC), among which governments and supranational institutions have been dominant (Table J). However, more recently an increasing number of borrowers have been European private sector corporates and banks, as well as borrowers from Australia, Japan and the United States. For investors, the ECU offers exchange and interest rate stability, and has been attractive particularly to investors whose national currencies have not developed a eurobond market of their own. Moreover, ECU eurobonds have offered a generally higher yield than that of strong European currencies such as the deutschemark and the Swiss franc (but see the note on theoretical ECU yields on this page). The ECU, as a basket of European currencies, has enabled investors to participate in German, French and UK bond markets, while reducing the risk of foreign exchange losses. This strength has appealed to investors such as the Japanese in building up a broader currency portfolio of bonds.

Table J
Top ten issuers of ECU international bonds^(a)

	ECU millions	As a proportion of total international ECU bonds (per cent)
European Investment Bank	3,010	8.4
European Commission/European Coal and Steel Commission	2,790	7.8
World Bank	1,240	3.5
Kingdom of Denmark	1,200	3.4
Republic of Italy	928	2.6
Crédit Foncier de France	910	2.6
Crédit National	725	2.0
Eurofima	718	2.0
Republic of Ireland	590	1.7
Banque Française du Commerce Extérieur	550	1.5
Total	12,661	35.5

Source: Bank of England ICMS database.

(a) Total at end-September 1988: ECU 35.7 billion.

ECU bonds account for a small portion of total new eurobond issues, partly because of limited liquidity in the secondary market. The size of issues has until recently been relatively small, and, since a large proportion of ECU eurobonds is purchased by retail investors who tend to hold them to maturity, the amount of paper which is

available for trading is often limited. Moreover, the market has lacked large 'benchmark' issues whose secondary market prices are used as guides in the pricing of new issues. The growth of the market has been hampered also by the limited size of the investor base. ECU eurobond investors have traditionally been located in a few countries (Benelux, France, Italy and Switzerland). However, these problems are being ameliorated. Issues are larger now and non-EC investors are reportedly more active. The benchmark problem could be resolved eventually by the launch of a number of large issues such as the ECU 500 million deal for the European Commission and the European Coal and Steel Commission in June of this year, the largest-ever issue in the sector.

The market has suffered also from the lack of an ECU money market, limiting ECU eurobond investors' ability to move down the yield curve when they think ECU bond yields are set to rise. Short-term markets in ECU securities are still in the early stages of development; instruments of original or residual short maturity are not very liquid and term deposits do not afford complete flexibility. The commercial paper market, which began about two years ago, is very small, with hardly any secondary market. The only short-term ECU assets available to euromarket investors have been bank deposits, certificates of deposit and some ECU-denominated eurocommercial paper issued under multi-currency facilities. The issue of UK government Treasury bills (see below) should help alleviate this problem.

In domestic capital markets, ECU bonds issued by the Italian government with maturities of between four and eight years, known as Treasury Certificates, have been in existence since 1982. There have been eighteen issues, amounting to ECU 12.95 billion, of which ECU 4.25 billion was issued during the first nine months of 1988. Since September 1987, there has been a withholding tax of 12.5% on the coupon. Because the post-tax yield is close to the yield on other ECU bonds with similar maturities and credit standing, but whose interest payments are not subject to withholding tax, Italian Treasury Certificates have been particularly attractive to those non-resident investors who can reclaim the tax by way of equivalent tax credits in the home country. A significant share of these instruments is held directly by foreigners for this reason. The Republic of Ireland has also issued ECU-denominated debt in its domestic market.

In October 1987, the Italian government became the first to issue ECU-denominated short-term domestic instruments. By end-September 1988, there had been eight auctions⁽¹⁾ totalling ECU 5.78 billion. With the exception of the first issue, which took place shortly after 'Black Monday' last year, all have been oversubscribed.

The maturities slightly exceed one year and the instruments are allotted at a par issue price. The instruments are in bearer form, with a denomination of ECU 1,000; being domestic government bonds, they are also subject to the withholding tax of 12.5%. In the issues that have taken place this year, the yield, on a net basis (after the 12.5% withholding tax had been deducted), was below the 12-month ECU Libor, by 0.4% for the last two issues. The first five auctions were essentially domestic, sold in Italy with payment in Italian lire, and not marketed internationally. Only certain Italian institutions were allowed to bid directly. The three most recent issues in April, June and August were tailored to suit foreign investors. The new instruments could be paid for directly in ECU by non-resident investors. These three issues were oversubscribed by between 120% and 200%, and together accounted for ECU 2.75 billion.

In August of this year, a programme of monthly issues by tender of UK government ECU Treasury bills was announced. The programme will provide the UK government with added flexibility in the management of the United Kingdom's foreign exchange reserves. It will also make a contribution to the development of the use of the ECU in international financial markets by improving the liquidity of the ECU securities markets and by helping to encourage a wider range of sovereign and corporate borrowers to raise finance in ECU. The programme should enhance London's role as a major centre for ECU transactions. An Information Memorandum setting out the arrangements for an initial series of six tenders was issued on 14 September.

UK government Treasury bills are similar in form to conventional sterling Treasury bills, but denominated and payable in ECU both on subscription and at maturity. The bills differ in a number of respects from the Italian instruments: the bills are of shorter maturity, being issued for one, three and six months; they are issued at a discount to their face value; and they are not subject to withholding tax. The principal method of payment for and delivery of the bills is through Euro-Clear and CEDEL clearance systems. However, the EBA is currently studying the practicalities of a London-based settlement system for the same-day settlement and delivery of the bills.

The UK authorities have emphasised the importance of the development of an active secondary market in the bills. Twenty-nine institutions act as market makers in the bills in the secondary market as well as providing support at the tenders themselves. In order further to support market liquidity, the Bank has undertaken to make a price to those institutions for any bills they may offer, at least in relation to any bills issued in the initial series of tenders.

The first tender for bills under the programme was held on 11 October. ECU 900 million of bills were offered,

(1) There were no auctions in March, May, July or September 1988; there were, instead, issues of Treasury Certificates in ECU in each of those months.

comprising ECU 200 million at one-month maturity, ECU 500 million at three-months maturity and ECU 200 million at six-months maturity. The tender was over-subscribed at all three maturities, by multiples ranging from 3.5 to 4.6 times the amount of bills on offer, and all of the bills on offer were allotted. The average yield on the bills allotted at each maturity was between $\frac{7}{8}$ % and $\frac{1}{4}$ % below ECU Libid. The second tender for bills was held on 8 November. ECU 750 million of bills were offered, comprising ECU 300 million at one-month maturity, ECU 250 million at three-months maturity and ECU 200 million at six-months maturity.

Assessment

The main incentive for employing the ECU in financial and commercial transactions is risk avoidance, rather than speculation. The ECU allows users to achieve currency and interest rate diversification within a single instrument. The volatility of both interest and exchange rates has been a contributory factor in the ECU's appeal, particularly as the risk avoidance motive is reinforced by increasing confidence in the stability of EMS currency relationships.

The UK government ECU Treasury bill programme has been welcomed as providing encouragement to the wider

use of ECU securities in investment management. The increase in institutional investor participation should in turn make more funds available for borrowers. In particular, it may help to develop the ECU bond market further. The market for ECU bonds has failed to mature as rapidly as other major eurobond markets, as evidenced in poor secondary market liquidity and because of the lack of a reference point similar to that provided to other currency sectors by their respective government bond markets. The issue of Treasury bills in ECU and large liquid bond issues, such as the European Commission issue, should help to establish reference points in different maturities, and go further in providing borrowers and investors with greater flexibility in their use of both money markets and bond markets. At the moment, there is a very thin market in ECU at maturities under five years. The issue of ECU Treasury bills should stimulate the development of liquidity in short-term ECU instruments.

The liquidity of ECU interbank and foreign exchange markets is growing. The issue of ECU paper with maturities extending over a wide band of maturities should provide a further spur to development. But the long-term development of the ECU is dependent also on a wider corporate interest and an extension of the ECU's role in commercial transactions.