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AN INCREASING ROLE FOR THE ECU:
A CHARACTER IN SEARCH OF A SCRIPT

RAINER STEFANO MASERA



INTERNATIONAL FINANCE SECTION

DEPARTMENT OF ECONOMICS
PRINCETON UNIVERSITY
PRINCETON, NEW JERSEY

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The author of this Essay, Rainer Stefano Masera, is the Central Manager for Economic Research of the Bank of Italy and a member of the Deputies of the Group of Ten and of the Committee of Alternates of the European Community Central Banks. He has taught at the Universities of Bergamo and Rome. In addition to articles in professional journals, he has written several books, the most recent being *L'Unificazione Monetaria e lo SME (Monetary Integration and the EMS)* (1980).

PETER B. KENEN, *Director*
International Finance Section

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GLOSSARY

BIS	=	Bank for International Settlements
EC	=	European Community
ECU	=	European Currency Unit
EMCF	=	European Monetary Cooperation Fund
EMS	=	European Monetary System
ERM	=	Exchange Rate Mechanism
EUA	=	European Unit of Account
MESA	=	Mutual ECU Settlement Account
SWIFT	=	Society for Worldwide Interbank Financial Telecommunications
VSTF	=	Very-short-term financing

AN INCREASING ROLE FOR THE ECU:
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1 Introduction

The European Currency Unit has two aspects—official and private. The link between the two is that the value of both is fixed to the same basket of European Community (EC) currencies. They differ, however, with respect to the way they are created, the credit standing of the issuing entities, the returns they offer, and their usability. The official ECU, which is governed by the rules of the European Monetary System (EMS), is used as an international financial instrument, but only in a restricted sense and only by EC central banks, which hold official-ECU positions vis-à-vis the European Monetary Cooperation Fund (EMCF). The private ECU is basically a Eurocurrency that has acquired the character of an international currency, especially for EC market operators, albeit still on a relatively modest scale. Recently, some EC central banks have also built up holdings of ECU deposits with the international banking system. Although these are clearly part of the foreign-exchange reserves of the central banks, they must still be regarded as “private” ECUs and not “official” ones as previously defined.¹

This essay focuses on the growing use and future prospects of the ECU. It points out the advantages of establishing a more direct link between the official and the private sides of the ECU so that the ECU can acquire more of the attributes of both a reserve asset and a common European currency, and it explores the ways and means of doing so.

Section 2 briefly reviews the development of the ECU in the official field and section 3 its development in private markets. The advances made so far by the official ECU have fallen short of the original objective of making the ECU “the center of the EMS.” Nevertheless, its role has been far from insignificant, and a potentially important package of measures designed to improve its usability has recently been adopted. By contrast, the development of the private ECU in both credit and foreign-exchange markets has exceeded the expectations of most observers.

While a number of factors help explain the rapid growth of the private-ECU market, section 4 argues that the main one is the rational portfolio behavior of European operators engaged in international financial transactions. Standard “efficient portfolio” analysis covering the period of operation of the

¹ See facing page for a glossary of acronyms used in this essay.

EMS shows that the ECU has attractive properties, especially for risk-averse investors, in countries with strong currencies as well as in countries with weak ones.

Section 5 assesses the two most important suggestions now under consideration for giving the ECU a central role in the EMS, (1) that the ECU be developed into a full-fledged international reserve asset, and (2) that it gradually acquire the status of a true European currency, functioning in parallel with domestic currencies. My contention is that the two schemes should be viewed as complementary.

International reserve assets must be liquid and fully convertible into other currencies, represent a stable store of value, and provide a competitive return. The portfolio results reported in section 4 suggest that the private ECU has some of these properties while the official ECU has important defects, notably in terms of transferability and convertibility. Following an approach originally suggested by Kenen (1983) for the SDR, section 6 presents a scheme that could be carried out without institutional changes to improve the properties of the ECU by making the official and private ECUs interchangeable.

The counterpart of an expanding use of the official ECU would be its increasing role as a substitute for domestic-currency borrowing and lending, leading to its use as a parallel common currency. Section 7 discusses problems of money and credit control that might arise and points out major differences between the Euromarkets and the ECU.

Section 8 concludes that the proposed two-pronged development of the ECU could become an important instrument with which to foster European monetary integration without threatening monetary stability and credit control. It stresses, however, that this would be so if, and only if, EC governments and citizens did not see such advances as *alternatives* to the necessary adjustment of domestic monetary conditions.

2 A Brief Overview of the Development of the Official ECU

According to the December 5, 1978, Brussels resolution of the European Council that established the EMS, its purpose was the "creation of closer monetary cooperation leading to a zone of monetary stability in Europe." The resolution also stated that the ECU would be at the center of the EMS. It would be used as the numeraire for the exchange-rate mechanism, as the basis for detecting divergencies between Community currencies, as the unit of account for the operations of intervention and credit mechanisms, and as a means of settlement between monetary authorities of the European Community. To serve the last function, a stock of "primary" ECUs would be created through revolving swap arrangements. Participating central banks

would obtain ECUs by depositing 20 percent of their gold and dollar reserves with the EMCF (Committee of Governors, 1985, pp. 13 ff.).

The 1978 Brussels resolution was a compromise between two models of the EMS that had been explored in the technical discussions preceding the establishment of the system. The first model would have used the ECU as the parameter for defining central rates and intervention obligations around prescribed margins. Under this scheme, only one currency at a time would have reached the prescribed margin. The second model, based on the workings of the earlier exchange-rate mechanism known as the "snake," relied on bilateral central and intervention rates. The second approach was adopted, but as a compromise a "divergence indicator" was introduced to single out the deviating currency upon which the burden of adjustment would primarily fall (EC Monetary Committee, 1978, and Ludlow, 1982, Chap. 6.2).

In spite of the considerable technical ingenuity that went into its construction, the divergence indicator gradually lost importance, in part as a result of increased reliance on discretionary unilateral intervention before exchange rates reached the margins for compulsory intervention. The system has therefore evolved *de facto* in the direction of the second model, but there has been a decline in the importance of obligatory interventions at the points defined by the margins around the bilateral central exchange rates. From a formal point of view, devaluations and revaluations are still arranged in terms of the ECU, but this has no economic significance. It is impossible *ex ante* to define all central rates in terms of the ECU.

To make possible the use of Community currencies for compulsory intervention at the margins, the central banks of the countries participating in the Exchange Rate Mechanism (ERM) of the EMS arrange mutual very-short-term credit facilities (VSTF) in unlimited amounts. (These countries are Belgium, Denmark, France, Germany, Ireland, Italy, Luxembourg, and the Netherlands. The United Kingdom and Greece are part of the EMS but not of the ERM.) Spot sales and purchases of Community currencies are credited or debited against the central banks' ECU accounts with the EMCF as of the "value date," or day of intervention. In this way, "secondary ECUs" are created in the form of net creditor and net debtor positions.

A financing operation falls due for repayment forty-five days after the value date, with the possibility of an automatic three-month extension of the settlement date at the request of the debtor central bank. If settlement is not made by means of holdings in the creditor's currency, it is accomplished entirely or in part by transferring "primary ECUs," with the proviso that a creditor central bank is not generally obliged to accept ECUs in settlement of more than 50 percent of its claim.² If settlement is only partially effected through ECU

² Note that the EC central banks can hold working balances in Community currencies within

transfers, the balance is settled by transferring other reserve assets in accordance with the composition of the reserves of the debtor central bank.

While the official ECU has had some importance in the actual operation of the EMS, it has not played the pivotal role some originally envisaged. It has been confined to serving as an official reserve asset and as a unit of account for the VSTF and settlement. Even in this respect, its use has been somewhat limited, largely because dollar interventions have predominated, accounting for two-thirds of total interventions, while mandatory marginal interventions have accounted for only about 10 percent (see Table 1 and Micossi, 1985, for a detailed analysis).

Since the general exchange-rate realignment of March 1983, recourse has not often been made to interventions at the margin and to the VSTF arrangement. To explain why, I must first draw a distinction between two types of intervention in Community currencies:

- *Symmetric monetary-base interventions* occur whenever the intervening central bank uses reserves held at the central bank of the country whose currency is being used, thereby causing simultaneous opposite movements in the monetary bases of the two countries. Interventions at the margin that resort to the VSTF mechanism or spot settlements in official ECUs have this property. Unless sterilized, they imply a contraction of the monetary base in the weak-currency country and an expansion in the strong one.
- *Asymmetric monetary-base interventions* occur when one central bank uses private-market reserves—Eurocurrency or domestic private banking assets—in the other currency. In this case, apart from absorbing or releasing commercial-bank reserves held against domestic deposits subject to reserve requirements, these interventions affect only the monetary base of the country that initiates them, not of the country whose currency is being used.

Since the 1983 realignment, all central banks have sought by preventive intramarginal interventions to avoid the tensions that necessarily arise when exchange rates reach their bilateral margins. This has led some central banks to suggest extending use of the VSTF to finance intramarginal interventions. Any such automatic extension has been firmly resisted by strong-currency central banks, however; presumably they want to maintain control over their domestic monetary policies, which would be impaired by symmetric monetary-base interventions.

These contrasting preferences led to a compromise solution. A “mobilization clause” was introduced as part of a larger package adopted in 1985 to im-

limits laid down by the Committee of Governors. These limits may be exceeded only with the consent of the central banks concerned.

TABLE 1
FOREIGN-EXCHANGE INTERVENTION BY COUNTRIES IN THE ERM
(in billions of U.S. dollars)

	March 1979- March 1983	April 1983- Dec. 1985
U.S. dollars:		
Purchases	34.8	18.8
Sales	107.0	49.1
ERM currencies:		
At the limits ^a	28.0	7.9
Intramarginal:		
Purchases	11.8	27.9
Sales	22.5	15.7
Other currencies: ^b		
Purchases	0.1	3.2
Sales	2.4	0.7
Total:		
Gross	206.6	123.3
Net ^c	-85.2	-15.6
Memorandum items:		
Recourse to VSTF	20.9	3.4
Use of ECU for settlements of interventions	6.9	0.1

^a Interventions at the limits involve balanced purchases and sales; the two are therefore taken together.

^b The figures for 1985 include some interventions in the private ECU market.

^c A minus sign indicates net sales.

NOTE: According to BIS recording practices, intervention figures do not include operations such as customer transactions, swaps with commercial banks, and forward settlements or other transactions that constituted a significant source of positive changes in gross official reserves. This explains why the recorded total change is a high negative figure.

SOURCE: Updated figures from Micossi (1985).

prove the usability of the official ECU. In view of the potential importance of this package for expansion of the ECU in the private markets, I briefly describe its contents (for more detail, see Committee of Governors, 1985, Instrument of 10th June 1985):

a. The mobilization mechanism enables EC central banks in need of intervention currencies to mobilize their net creditor positions in the EMCF, together with some of the ECUs that the EMCF allocated to them against the deposit of gold and dollar holdings. The EC central banks have agreed to facilitate such mobilization operations by providing dollars in proportion to their outstanding ECU swaps with the EMCF (but not in excess of those swaps). The dollars provided in this way may be exchanged for EC currencies with the approval of the central banks issuing those currencies. Mobilization

operations run for three months, are renewable for a further three-month period, and bear interest at market rates. In exceptional circumstances, a central bank may opt out partly or entirely from participation in such operations.³

b. The payments ratio limiting settlements in official ECUs of obligations arising from the use of the VSTF (the acceptance limit) remains at 50 percent as a general rule, but this limit can now be waived to the extent that the recipient central bank is itself a net debtor in ECUs.

c. The return on net positions in ECUs and on ECU-denominated claims under the VSTF has been improved. The interest rate was previously the weighted average of the official discount rates of the member countries; it is now a weighted average of representative money-market rates in those countries.

d. Central banks of nonmember countries and international monetary institutions such as the BIS, which are accorded the status of "other holder" by the EMCF Board, may obtain official ECUs from EC central banks by means of repurchase agreements or reversible swap transactions. "Other holders" are entitled to the same return on their ECU holdings that EC central banks receive on their net ECU positions.

3 The Rapid Development of the Private ECU

In March 1975, before the inception of the EMS, a new European Unit of Account (EUA) was introduced by the Community with a basket-type definition like that subsequently adopted for the ECU (see Allen, 1986, pp. 3-4). It was used in private financial markets as an indexation device for credit contracts (see Aschheim and Park, 1976, and Committee of Governors, 1985, pp. 73-75). But it was not until the inception of the EMS and the establishment of the ECU that its use grew substantially in these markets. The ECU market has shown remarkable growth in terms of both credit and exchange transactions. Because excellent reviews of recent developments are available (see, e.g., BIS, 1985, pp. 127-133, and Allen, 1986), I will deal briefly here only with what I regard to be the key features of this expansion.

The Private ECU Banking Market

The private ECU banking market has grown very significantly compared with other currency sectors of the international banking market, especially from 1982 to 1985. By the end of 1985 it ranked fifth, with a share of more than 3 percent (Table 2). The expansion was mainly the result of borrowing by nonbank residents in Italy and France (see Table 3); expecting broad exchange-rate stability within the EMS, they were attracted by the lower inter-

³ The first activation of the mobilization scheme took place in December 1985 at the request of the Bank of Italy.

TABLE 2

GROWTH OF THE ECU BANKING MARKET COMPARED WITH OTHER SECTORS OF THE INTERNATIONAL BANKING MARKET IN EUROPE:
 AMOUNTS OUTSTANDING, END 1982-END 1985
 (in billions of U.S. dollars)

Currency ^a	1982		1983		1984		1985	
	Assets	Liabil- ities	Assets	Liabil- ities	Assets	Liabil- ities	Assets	Liabil- ities
U.S.\$	832.4	869.5	869.2	908.5	893.4	943.9	924.8	978.6
DM	155.9	141.6	150.0	135.6	142.9	132.6	204.1	191.2
SwF	79.0	71.5	77.0	70.7	67.6	62.1	103.1	92.8
¥	30.6	31.8	28.9	33.4	32.6	32.0	71.6	68.3
ECU	6.5 ^b	5.5 ^b	11.9	10.0	28.2	22.3	54.2	48.2
£	15.5	18.0	14.8	16.4	16.6	17.6	26.1	29.1
Other	63.8	67.4	70.2	69.8	63.9	64.7	88.1	94.9
Total	1,183.7	1,205.3	1,222.0	1,244.4	1,245.2	1,275.2	1,472.0	1,503.1

^a See the Table of Currency Symbols on p. 34.

^b Estimated.

NOTE: Domestic and foreign positions of banks in Europe only.

SOURCE: BIS quarterly statistics on international banking developments.

TABLE 3
STRUCTURE OF THE ECU BANKING MARKET: AMOUNTS OUTSTANDING AT END-1985
(in billions of ECUs)

	Belgium	Luxem- bourg	France	Italy	Nether- lands	United Kingdom	Other Countries ^a	Total	M.I. ^b
Assets of banks from:									
Nonresidents:									
Banks	6.9	3.2	8.5	4.7	3.1	7.5	1.1	35.0	31.1
Nonbanks	1.4	1.8	1.5	—	0.5	1.5	1.1	7.8	6.9
Residents:									
Banks	2.0	1.8	4.3	0.8	0.3	2.7	0.2	12.1	10.8
Nonbanks	<u>0.1</u>	<u>0.2</u>	<u>1.7</u>	<u>2.7</u>	<u>0.2</u>	<u>0.5</u>	<u>0.7</u>	<u>6.1</u>	<u>5.4</u>
Total	10.4	7.0	16.0	8.2	4.1	12.2	3.1	61.0	54.2
Liabilities of banks to:									
Nonresidents:									
Banks	5.6	2.6	7.4	7.6	1.4	8.2	2.3	35.1	31.2
Nonbanks	0.8	1.3	0.5	0.2	0.6	0.2	0.1	3.7	3.2
Residents:									
Banks	1.9	2.0	4.3	0.8	0.3	2.4	0.2	11.9	10.6
Nonbanks	<u>0.3</u>	<u>0.8</u>	<u>0.1</u>	—	<u>1.5</u>	<u>0.6</u>	<u>0.3</u>	<u>3.6</u>	<u>3.2</u>
Total	8.6	6.7	12.3	8.6	3.8	11.4	2.9	54.3	48.2

^a Austria, Denmark, Germany, Ireland, Spain, and Sweden.

^b Memorandum item in billions of U.S. dollars.

NOTE: "Banks" includes other entities not explicitly identified as nonbanks by the banks reporting to the BIS.

SOURCE: BIS quarterly statistics on international banking developments.

est cost of ECU borrowing. It can be estimated that at end-1985 Italian enterprises accounted for ECU 5.4 billion of the ECU 13.9 billion in total loans granted by banks to nonbanks, of which ECU 2.7 billion were from Italian banks and ECU 2.7 billion from banks located in other countries. The corresponding figures for French enterprises were ECU 2.4 billion, of which ECU 1.7 billion were from French banks and ECU 0.7 billion from other banks. Italian and French final borrowers thus accounted for 55 percent of total ECU bank loans to nonbanks.

On the deposit side, funds have traditionally come primarily from Belgium and Luxembourg. It is worth noting, however, that in 1985 Dutch residents were major suppliers of funds—an important development, since it refutes the argument that the ECU cannot be attractive to residents of strong-currency countries. Indeed, there is no reason why the expectation of relative intra-EMS exchange-rate stability that probably led Italian and French residents to borrow in ECUs should not induce Dutch and German residents to lend in ECUs.⁴ At end-1985 banks in Belgium and Luxembourg accounted for ECU 3.2 billion (44 percent) of total nonbank deposits in ECUs, but nearly two-thirds of these deposits came from nonresidents, mainly of Dutch and German nationality. If an estimated ECU 0.5 billion of Dutch deposits with banks domiciled in Belgium-Luxembourg is added to the ECU 1.5 billion of Dutch deposits held in domestic banks, the total amounts to nearly 30 percent of the ECU bank-deposit base.

To put the expansion of the ECU market into perspective, a comparison should also be drawn between the ECU-denominated assets and liabilities of Community nonbank residents and their overall assets and liabilities vis-à-vis banks. As Table 4 shows, in spite of the recent very rapid growth of the private ECU, ECU loans and deposits still represent only a small proportion of total liabilities and assets—0.7 and 0.2 percent respectively.

In all Community countries, with the notable exception of Germany, the ECU is treated—*de jure* or *de facto*—as a foreign currency. ECU transactions are permitted, but they fall under foreign-exchange restrictions against capital outflows, which, although declining, still exist in Denmark, France, Greece, Ireland, and Italy. Thus the controls impede the ability of residents to establish ECU deposits with banks in other countries.

Capital movements are unrestricted in Germany, so its citizens can acquire ECU deposits with banks not domiciled in Germany. Nevertheless, Article 3, paragraph 2, of the Currency Act prohibits residents from entering into indexed debts unless explicitly authorized by the Bundesbank, and the ECU falls under this provision, because it is treated in Germany as a unit of

⁴ Market operators point out also that unless a realignment is anticipated in the short term, certain categories of savers in strong-currency countries show a preference for nominal yields higher than those available on their domestic currencies.

TABLE 4
 COMMUNITY NONBANK ECU-DENOMINATED ASSETS AND LIABILITIES VIS-A-VIS
 BANKS AND THEIR OVERALL SUPPLY AND RECOURSE TO BANK CREDIT MARKETS:
 AMOUNTS OUTSTANDING AT END-MARCH 1985
 (in billions of ECUs)

	Outstanding Borrowing			Outstanding Deposits		
	In ECUs (1)	Overall ^a (2)	(1) as % of (2) (3)	In ECUs (4)	Overall ^b (5)	(4) as % of (5) (6)
Domestic banks	7.7	1,488.3	0.52	1.9	1,465.7	0.13
Foreign banks	<u>3.0</u>	<u>155.3</u>	<u>1.93</u>	<u>1.3</u>	<u>71.6</u>	<u>1.82</u>
Total	10.7	1,643.6	0.65	3.2	1,537.3	0.21

^a Domestic bank lending to the private sector in EC countries and international bank lending to EC residents (excluding Greece).

^b Broad money stock in EC countries and externally held bank deposits of EC residents.

SOURCE: BIS (1985) and quarterly statistics on international banking developments; Committee of Governors of the EEC Central Banks, monthly statistics.

account rather than a foreign currency. Accordingly, German banks cannot issue ECU deposits to residents and German residents cannot incur ECU liabilities.⁵ The main objections commonly raised by the Bundesbank to declaring the ECU to be a currency or placing it on an equal footing with a currency are as follows: (a) the ECU is not backed by any independent monetary authority responsible for its internal and external value; (b) there is no guarantee of the ECU's continuity of value as long as changes in the weights in the basket can be decided upon by the competent authority; (c) there is no institution or arrangement ensuring ready convertibility of the ECU into reserve currencies; (d) there is no clear way to establish a role for the ECU as an intervention currency. A strict line on these points is reported by Whalig (1985), and a somewhat more open one by Poehl (1985). For an opposite view

⁵ The Currency Act was passed in 1948 as part of the currency reform carried out by the occupying powers with a view to establishing and guaranteeing the DM's monopoly as legal tender. Under the Currency Act, residents must be authorized by the Bundesbank if they wish to use currencies other than the DM. With the introduction of the Foreign Trade and Payments Act in 1961, residents were allowed to enter into foreign-currency commitments with nonresidents. In that year, moreover, the Bundesbank issued a general authorization permitting foreign-currency commitments between residents. This general authorization does not apply to the ECU, which is governed by the regulations on indexation clauses. Over the years, in the interest of a stability-oriented monetary policy, the Bundesbank Central Council has always avoided giving authorizations of this sort in connection with money or capital transactions.

and the legal arguments supporting it, see Carbonetti (1987) and Harlandt (1986). See also the discussion of these points in section 7 below.

Largely in view of these institutional factors, the private ECU market continues to be dominated by nonbank *borrowers*. As can be seen from Table 3, only about half of total ECU loans granted by banks to nonbank final borrowers (ECU 13.9 billion) are accounted for by nonbank deposits (ECU 7.3 billion). The banking system covers the rest (a) by borrowing the corresponding basket currencies directly, (b) by borrowing a single currency and simultaneously covering in the forward market, or (c) by borrowing private ECUs from central banks, which hold ECU bank deposits as foreign-exchange reserves.⁶

These factors and the complex web of lending and borrowing that links final savers and users of funds help explain the importance of interbank transactions. Interbank claims and liabilities in other currency sectors of the international banking market correspond to some 70 percent of overall claims and liabilities. Interbank claims and liabilities in ECUs comprise about 75 percent on the assets side and 85 percent on the liabilities side.

The Private ECU Bond Market

In 1985, for the first time, the ECU rose to fifth place among currencies in which foreign bond offerings were denominated (Table 5). Italy, France, and the EC institutions were the largest borrowers. In Italy, especially, ECU issues to residents have become significant. In 1984 and 1985, however, there was increasing participation by non-EC countries and institutions, and notably by operators based in the United States and Japan.⁷ In 1982, over 90 percent of total ECU issues were accounted for by EC borrowers; by 1985, the share had declined to some 60 percent.

The Private ECU Exchange Market

The private ECU exchange market has also expanded significantly. The aggregate daily turnover in Community countries can be roughly estimated at ECU 2.5 to 3 billion. Of this, Belgium and the United Kingdom account for ECU 0.8 to 1 billion and Italy for 0.5 billion. Turnover in Denmark, France, and the Netherlands is between ECU 0.2 and 0.4 billion. In every country except Italy, interbank transactions exceed trade-related transactions.

⁶ The perception of many market operators is that the imbalance is progressively narrowing, not only because of central-bank deposits but also because of the issue of new instruments, such as certificates of deposit, to raise funds from nonbanks directly in ECUs.

⁷ While Japanese borrowers are tapping the market for genuine diversification purposes, it appears that prime U.S. borrowers have been attracted to the ECU market mainly to benefit from the marginally lower cost they enjoy compared with European borrowers. The ECU funds raised are then often swapped against dollars with European borrowers.