

Note from the European Commission on the ecu and the first stage of EMU (27 November 1989)

Caption: On 27 November 1989, the European Commission's Directorate General for Economic and Financial Affairs (DG II) addresses a note to the members of the Monetary Committee which analyses the ecu (European Currency Unit) market in the light of the first stage of Economic and Monetary Union (EMU).

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The ECU and the stage one of the EMU (Brussels, 27 November 1989)

(Note for the attention of the members of the Monetary Committee)

The growing use of the ecu by private operators and by certain national authorities raises the question of the role which it could play in the current process of economic and monetary integration.

The background to this paper is twofold:

- the completion of the internal market
 - Stage One in the realization of Economic and Monetary Union in accordance with the Madrid decisions.
- In the report which sets out the specific stages which are to lead to EMU, the Committee for the Study of Economic and Monetary Union does not recommend the strategy of a parallel currency. This strategy is defined as the abandonment of the definition of the ecu as a basket of currencies, and the creation of a new fully-fledged currency, created autonomously and issued in addition to the existing Community currencies, competing with them (§ 47).

By contrast, in connection with an eventual move to a single currency, the Committee was of the opinion that the ecu had the potential to be developed into such a currency (§ 46)

Consequently, the measures envisaged for Stage One include, in the monetary field, the removal of all impediments to the private use of the ecu (§ 52).

In order to provide the elements of an answer to the questions raised above, this paper will outline the development of the ecu market, examine the microeconomic and financial rationale behind the ecu's use and analyse the consequences of its coexistence with national currencies. Lastly, the paper sets out a number of measures which could remove the impediments to the use of the private ecu.

I. A significant expansion in the use of the ecu

The ecu, as defined by Council Regulation, did not experience any expansion in its use by private operators until after its adoption as the central element of the EMS. In less than a decade, it has gained considerable popularity, to the point where, at mid-1989, ecu bond issues and ecu eurocredits respectively represent a net outstanding amount of ECU 42 billion and ECU 35 billion, or 4.3 % and 2.8 % respectively of the outstanding amount of issues and bank eurocredits. It ranks fifth in the world as currency denomination for these operations.

Shortly after these two segments of the market, the largest in volume until now, were consolidated, operators were led to organize the market in a structured way, and to create new instruments, as well as to extend the use of the ecu to the invoicing and settlement of international transactions in goods and services. At the same time, a number of countries, and not only the Member States, started to use the ecu in their policy of external and domestic financing and in interventions on the foreign exchange markets.

With a global volume estimated at nearly ECU 200 billion, the main feature of the ecu market, apart from its size, is the continuous diversification in its users' origin and status, and in the instruments available.

1. The primary bond market

Since 1981, over 605 issues have been launched representing an aggregated total amount of ECU 48.3 billion for international issues alone (ECU 72 billion if we include issues intended for the domestic markets). This market, which declined slightly in 1986, has been growing steadily since then, in terms of both the number of issues and the volume issued. At the end of November 1989, the amount of international issues is already 4.3 % up on the figure for 1988 (ECU 9.7 billion compared with ECU 9.2 billion).

If study is limited to international securities in the narrow sense, some significant trends show that this segment of the market has reached maturity:

- the average amount of issues rose from ECU 45 million in 1981 to ECU 114 million in 1989;
- after peaking at almost 30 % in 1985, the share of issuers of French or Italian nationality, fell back to 23.5 % in 1989, while the share of Community institutions fell from 27.6 % in 1984 to 11 % in 1989;
- the share of non-Community issuers, although it had always represented some 40 %, rose to 44.5 % in 1988 and 47 % in 1989, with Japanese and United States issuers accounting for almost half this share;
- all the financial innovations on the securities market are used for ecu securities convertible securities, securities with warrants attached, with floating rates, with choice of repayment currency, with swaps, with zero coupons, etc.
- companies are the main issuers of ecu securities (70.6 % in 1988, 81.3 % in 1989) with non-Community companies making over half of issues (51.2 % in 1988, 55.5 % in 1989);
- with regard to national or international securities issued by governments, Italy has, since 1982, been operating a programme of issuing long-dated ecu Treasury bills (CTE), available to foreign investors (the present total amount outstanding is some ECU 20.0 billion): it has been followed by many other States (Belgium, Denmark, Ireland, Austria, Hungary, Sweden, New Zealand) which have issued ecu securities and are tending to do so more regularly. In particular, France, in April 1989, launched a programme of eight year ecu Treasury bonds (Obligations Assimilables du Trésor – OATs) and regularly issues additional fungible instalments (the volume issued to date stands at ECU 1,652 million). Greece has been issuing securities indexed on the ecu since May 1989 and on 1 October the Portuguese Government launched a programme for borrowing in ecus with a denomination option in escudos or ecus.
- Lastly, the revision of the ecu's composition, which took place from June to September this year, does not seem to have disrupted the primary market, either in the months preceding it, or in those following it.

2. The secondary bond market

Until recently this market suffered from certain handicaps: no official quotation, except on the Luxembourg stock exchange, and the non-liquidity of certain securities, mainly due to their insufficient volume on issue. However, the market's liquidity has been increased very substantially by the interest of institutional investors of open-ended investment companies for ecu securities — which mainly have high-status signatures — and by the increase in the amount of unit issues (in 1989, 20 issues exceeded an amount of ECU 125 million), and the establishment of programmes of fungible issues.

The monthly volume of operations — although it fluctuates as it does for all the other currencies of issue — was some ECU 27 million in 1989, or some 7 % of the secondary Eurobond market compared with some ECU 9 million in 1985 (2.9 % of the market).

The revision of the ecu did not disrupt this market as might have been feared. The most that can be said is that activity slowed down in May and June (6.6 % and 5.7 % of the market respectively) to recover very briskly in July (8.2 %) and to move back above its average volume since then. The mechanical variation in the interest rate caused by the revision of the basket has been smaller in relative terms than those experienced for other reasons by other international currencies.

3. The bank market

The ecu banking market has expanded considerably, doubling in volume since 1984. In June 1989, the banking sector's assets stood at ECU 114.1 billion compared with ECU 102.7 billion for liabilities. Net ecu positions represent some 2.8 % of the banking sector's total net external position in foreign currencies, compared with 1.8 % in June 1985. Ecu assets totalled 2.2 % (2 % for liabilities) of the international banking market, compared with 1.4 % (and 1.3 %) four years earlier.

Liabilities vis-à-vis the non-bank sector alone represent ECU 9.5 billion compared with assets of ECU 25.4 billion. The increase in ecu credits, which had slowed down slightly in line with operators' general lack of enthusiasm for bank financing, has recovered since the end of 1988, as has the increase in deposits, though to a lesser extent.

The difference between ecu assets and ecu liabilities reflects an imbalance between the supply of and the demand for ecu. The imbalance is chiefly due to the small use of the ecu in transactions and to the relatively smaller yield on ecu bank deposits compared with other types of investment (but this phenomenon is the same whatever the currency). The sharply negative balance for the non-bank sector is also partly due to difficulties in obtaining statistical data; as a result it is appreciably overvalued. It is difficult to record the total amount of assets and liabilities resulting from operations between resident institutions, particularly between central banks, some of which are holding increasing amounts of ecu assets, and banks of the same nationality. According to the most recent estimates, the net assets of central banks have risen from under ECU 1 billion at the end of 1984 to almost ECU 16 billion at the end of 1989.

The amount of interbank ecu transactions, which is relatively larger than in other currencies, can be explained by this imbalance. However, the use of the ecu in commercial transactions, which is starting to become significant should help to reduce the imbalance and as a result, the excessive importance of the interbank market.

Ecu transactions in international merchandise trade, which were virtually non-existent in 1984, are beginning to expand and they are reported in most member countries. Depending on the case, they represented between 0.3 % and 1.1 % of goods exports and between 0.1 % and 0.5 % of goods imports in 1988. The development of this use of the ecu is closely linked, inter alia, with that of short-term instruments permitting efficient financial management.

Lastly, the banking market possesses a very efficient clearing system which covers 45 banks and handles some 3500 orders a day representing an amount of approximately ECU 23 billion; since October it has been recording these orders on a "same day" basis.

4. The short-term segments of the ecu market

Although virtually all short-term financial instruments exist in ecu, this segment of the market is relatively unknown, statistically, and is in a take-off phase, apart, of course, from the foreign exchange market, which several years ago reached a stage of maturity (it represents 2 % of the foreign exchange markets) and the forward market which, although narrow, is active.

It is also worth mentioning the existence of ecu credit cards, and ecu travellers cheques, and that several countries (including France, since March 1989, and Spain, since September) permit the opening of ecu bank accounts. From 1990, the Eurocheque group will allow users to issue ecu cheques guaranteed for a maximum of ECU 270.

However, the best known instruments and those dealt in the most are the Italian one-year ecu denominated Treasury bills (BTE) and the British Treasury's one-, three- and six-month T-bills. The Italian Treasury has been issuing ecu-denominated Treasury bills since October 1987: at the end of November 1989 the outstanding amount totalled ECU 5.6 billion, of which 45.8 % was sold to non-residents; demand is almost twice as high as supply. Since October 1988, the British Government has had a programme of monthly issues by tender of ecu Treasury bills, maturing at between one and six months. The first tender was for ECU 200 million at one month, ECU 500 million at three months and ECU 200 million at six months. The demand for these securities is twice to three times as high as supply and has led to the supply being increased by ECU 100 million over the six months since September. The secondary market is extremely liquid and very active, representing a monthly volume of some ecu 4.5 billion.

The revision of the ecu has not reduced demand for this paper on either the primary or the secondary market.

Another well known programme is that of the EIB's short term paper, launched in October 1984. This paper has maturities of between one and six months, and is constantly renewed on maturity; the amount of paper issued has been raised from ECU 100 million to ECU 400 million since 1988. The attractiveness of these securities is such that they circulate relatively little. The EIB has also started a programme of Treasury bills for ECU 200 million.

Many banks and companies are issuing short-term paper in the form of notes, certificates of deposit or trade bills but their volume is not known. The most original programme is probably that of the Australian Wheat Board which, since November 1988, has been issuing commercial paper with maturities ranging from 7 days to one year for an amount of ECU 200 million.

The organized futures markets (Chicago Mercantile Exchange – CME, Philadelphia Financial Instrument Exchange – FINEX London International Financial Futures Exchange – LIFFE) have also created new ecu instruments. Since the end of 1985, the United States markets have been offering currency options and ecu-dollar futures contracts. The volume of activity is linked to the climate on the foreign exchange markets, but remains limited because of the small amount of ecu transactions with the United States. By contrast the futures contract on three-month ecu interest rates, launched by LIFFE on 26 October 1989, seems to be meeting a need and its initial activity has been greater than that expected by the market makers (between 500 and 1500 contracts a day coming from several dozen traders).

The large appetite of traders, demonstrated by applications recorded for existing short-term paper which is being met by the initiatives taken by the organized markets, are a sign of the ecu market's vitality. They could permit the removal of one of the main technical impediments to the ecu's use in transactions, namely the insufficient number of instruments permitting treasury management and the active cover of foreign exchange and interest rate risks.

Furthermore, the experience of both the 1984 and the 1989 revisions, the second being more in line with the requirements of the market in its procedure, show that the ecu's characteristic of an open basket are not a handicap for the ecu, provided that the rules are known and that they respect the logic of the market.

II. The microeconomic and financial rationale behind the use of the ecu

Because the ecu is a recently created instrument, still unfamiliar to traders, and is handicapped by the existence of various kinds of impediments and by the narrowness of certain segments of the market, its commercial use remains limited.

The dynamic development described above shows that the ecu meets a need and is based on a microeconomic rationale. This is demonstrated all the more clearly by the fact that the dynamism has strengthened despite the disappearance of certain instances of positive discriminations, connected with exchange control systems, which were of benefit to the ecu in some Member States at the outset.

In the present situation in which productive and financial forces are being liberalized and Europe is moving towards economic integration, the ecu has considerable competitive advantages for satisfying the needs of firms.

1. Companies and the ecu

Different levels of analysis can be envisaged depending on several factors: these are chiefly the size of firms (small and medium-sized firms) or large companies with centres of productions in several countries, followed by the possible uses of the ecu (transactions, treasury, finance; strategies for internal systems management).

a) The large multinational companies

Since 1987, almost 200 of the largest European firms have joined an Association (the Association for the Monetary Union of Europe) in order to promote the use of the ecu by training and informing executives.

Whatever the level of microeconomic analysis, it is clear that for a company open to the outside world, the standardization of the unit of monetary and financial measurement represents considerable rationalization, generating large gains in the management of complex systems.

For a large company with establishments in several countries the use of a transnational standard, such as the ecu, has many advantages in the functions of production, purchasing, logistics, sales and distribution:

- by simplifying management and permitting discussion to take place around a fixed cost price;
- by permitting greater specialization by production units;
- by making it easier to evaluate each unit's performance and the relative performance by country, and to fix a stable selling price;
- by helping to standardize the management of selling conditions and prices (trade terms) in relation to distributors.

Use of the ecu is therefore consistent with rationalization and with a maximization of the company's long term objectives and strategies.

From the point of view of purely functional logic, the choice of the reference currency is unimportant. Thus, despite its erratic movements, the dollar is chosen as a reference currency in many industries or firms. The total dollar integration of the oil market, from the oil well to the petrol pump, is the best example of this: there is total rationality and the exchange risk is borne only by the relatively captive final user. The choice of the ecu as a currency for the standardization of the domestic markets of multinational groups depends on managerial policy more than on the intrinsic qualities of this monetary unit. The pioneering efforts of Saint-Gobain's glass division, which has been using the ecu since 1982, together with the more recent IATA and Eurocontrol decisions to use the ecu are extremely significant.

In monetary and financial terms, a currency's competitiveness is greatly enhanced by traders' habits, and by the degree of sophistication and above all by the size of its market. However, situations are not immutable: no international currency is superior to all the others, either in time or in space. Financial calculations based on exchange rate and interest rate movements and the variability of rates make it possible to evaluate the relative positions of currencies in time on the basis of the trader's nationality. Also, the trader's preference for one currency or another may vary depending on whether he is a lender or a borrower.

Comparative analyses of risks and yields show that the competitiveness of the ecu is good in both time and in space. Its behaviour, whatever the trader's nationality and whether or not they are European, tends to be more stable over time than that of other currencies, while providing a satisfactory overall yield.

In a situation in which its component currencies are divergent — even slightly — its character of an average tends to smooth the movements in its exchange rate and its interest rate, while cushioning fluctuations. Furthermore, for the non-European traders the ecu represents the Europe risk better than any of its components.

In a situation of greater convergence, the ecu basket would be neither better nor worse than another European currency. However, so long as exchange rates are not irrevocably locked, it would retain the advantage of providing protection against the risk of a possible resurgence of instability in one or other of the basket currencies. Its geographical basis, extending to all the economies of the Member States, will maintain its unique quality of a currency covering the Europe risk.

However, the financial management departments which, having access to the financial markets, justify their existence by speculating on risks and associated potential profits, may be reluctant to use the ecu because it

offers less opportunity for maximizing the short-term profits provided by more volatile instruments.

The transition to a European integrated area and the development of short-term ecu instruments should, in the long run, reconcile the two conflicting points of view of the short and the long term, since the behaviour of non-European currencies vis-à-vis the ecu will create the profit opportunities expected by finance departments.

b) Small and medium sized-enterprises

As in the case of large firms, the logic of the choice of a currency by an SME open to the outside world mainly depends on its cost structure. However, the great difficulty for this type of firm in gaining access, on competitive conditions, to international financial markets — because of both domestic and external costs — eliminates the conflict between the logic of short and long-term which exists in large firms.

An SME, importing and exporting products from or to one or more foreign countries will therefore benefit from using a currency such as the ecu for obvious reasons connected with the simplification and rationalization of the overall management.

2. The Commission and the ecu

The ecu, in its primitive form of EUA was created for the needs of the Commission, which has always shown a particular interest in the expansion of its use. The rationale behind its use by the Commission is similar to that behind its use by a multinational company, but even more well-founded. For, with receipts in twelve different currencies and expenditure spread over time and in different proportions chiefly in these twelve currencies, the use of a common denominator which has the appropriate financial and monetary qualities represents an optimum rationalization objective. It permits better, simpler and less costly management, transparency of accounts and integrated financial management.

This is why the Commission has developed its ecu activities in several directions:

— in the budgetary expenditure which depends on its authority (studies, contracts, subsidies, foreign aid, etc...);

— in its own and the European Investment Bank's financial activities of lending and borrowing on the financial markets;

— in the use of the Structural Funds, in accordance with the Council Decision of December 1988.

In this same spirit of rationalization, the Commission has taken the initiative in proposing amendments to the budgetary regulations to encourage the use of the ecu:

— in the proposal for a revision of the Community's Financial Regulation;

— in the activities of the European Coal and Steel Community, as a currency for denomination and settlement of aids. Although the ECSC uses the ecu very widely (for receipts, for its reserves and for its treasury), this proposal has not yet resulted in a decision by the Council.

The Commission is also involved in consultations with its staff which are to lead to a proposal for salaries to be paid in ecu, and in studies relating to its actual use in the agrimonetary system for agricultural expenditure.

The Commission welcomes the initiatives taken by the Member States or by traders to develop ecu activities which permit either the consolidation of existing markets, or the creation of new instruments. These help to increase the market's liquidity, and its volume, and therefore to increase its competitiveness and to reduce transaction costs. It is in the same spirit that the Commission has helped to set up the clearing system for banks and is developing an information scheme for private operators on subjects concerning the ecu.

III. The coexistence of the ecu with national currencies

On the assumption that the present dynamic development of the ecu market continues, a number of fears have been expressed concerning its impact on national-stability oriented monetary policies. These fears relate mainly to the risks that certain currencies will be crowded out by the ecu, that there will be an additional constraint on national policies and that money creation will be excessive and uncontrolled.

The analysis of the relevance of these risks must first be set in the context of the freedom of capital movements and financial services. It then becomes apparent that greater use of the ecu could reduce the risks which have just been mentioned.

1. The constraints connected with the liberalization of capital movements

The numerous studies which have preceded and followed the decisions relating to capital liberalization have shown that it would result in additional constraints on monetary policies and in a number of difficulties.

First, the complete freedom of capital movements introduces, at international level, keener competition between the currencies of the Member States. The currencies which already have international currency status and a developed market, and which are based on powerful economies have a competitive advantage which the others will find it difficult to eliminate. The substantial development of one or more of the Member States' currencies, apart from increasing competition between currencies, is liable to entail, for the issuing country or countries, substantial constraints on monetary policy, or even constraints which are difficult to reconcile with the domestic objectives of growth and stability.

Secondly, the increase in capital flows and their volatility are liable to generate tensions for the system, and consequently, for monetary policies. Lastly, it will be more difficult to define and to measure the monetary aggregates which, alone, permit the construction of a monetary policy and the attainment of the targets set. All these factors, which are well known, have led to the adoption of measures to strengthen the functioning of the EMS and to Stage One of EMU being centred on the strengthened coordination of economic and monetary policies.

During Stage One, greater use of the ecu basket is not likely to exacerbate the problems mentioned above, but instead could attenuate some of them.

2. The potential effects of greater use of the ecu

In view of its basket structure, and the absence of a central issuing bank, the ecu is a substitution currency rather than an additional currency. It is an alternative to a variety of possibilities. Ecu capital flows will correspond to the flows resulting from the optimum allocation of resources, a sought-after objective. The ecu used in real and financial international exchanges offers an extremely limited potential for net money creation.

This basket structure also avoids the need for interventions to support its exchange rate. For, should the market rate deviate from the rate which automatically results from the sum of the components, arbitrage is always possible. The profit opportunities for traders are such that arbitrage is systematic. The risk created by this state of affairs is essentially that it could cause undesired and disruptive capital flows in certain currencies.

This risk can be minimized for several reasons. Pursuant to a mandate from the Committee of Governors, the evolution of the ecu market is followed regularly by the group of experts under the Chairmanship of Mr Dalgaard. In its latest report in December 1988 the group of experts concluded that the developments in the use of the private ecu had not given rise to any particular concern and that the implications for balance-of-payments flows, exchange rates and monetary policies had remained limited. Furthermore the experience of the review of the ecu basket in September 1989 had no disturbing effect on either exchange rates or the

interest rates of the component currencies. Yet it did involve substantial modifications in the structure of operators' portfolios and led to a significant demand for currencies which had not previously been components of the ecu. Lastly, as already mentioned, the increase in the commercial use of the ecu should help to reduce the imbalance which exists between assets and liabilities and thus to limit arbitrage operations and their possible perverse effects.

In the situation of the international competition between currencies which will obtain during stage one of Economic and Monetary Union, the increased use of the ecu should mean that either a single country or only a few countries do not have to bear the cost, in terms of domestic monetary policy, of an excessive development of their currency on the international markets. This aspect is stressed in the UK Treasury's paper which was presented to the ECOFIN Council on 13 November 1989.

Lastly in an environment of greater convergence of economic policies, and particularly monetary policies, the problems connected with interventions on the foreign exchange markets against third currencies will become more acute. More than it does at present, intervention in a single currency could give rise to unwanted and undesirable tensions between the currencies of the Member States. The experience which certain central banks have gained over a period in relation to ecu interventions against third currencies suggests that the ecu could play a positive stabilizing role at this level. This would however imply that its market was developed enough not to be destabilized by interventions and that the central banks were able to manage their ecu assets rationally.

IV. Measures permitting the removal of impediments to the use of the private ecu

The foregoing considerations, taken together, represent an argument in favour of removing the impediments to the use of the ecu, as envisaged, moreover by the report of the Committee for the Study of Economic and Monetary Union, as early as Stage One of Economic and Monetary Union: the European Council has set the starting date for Stage One at 1 July 1990.

Not only could the ecu play a positive role in the current process of competition between currencies, but it possesses serious advantages in favour of it becoming a common currency. But in order to achieve this, it must be free from handicaps imposed by law or regulation, and the confidence of private operators — crucial to its development — must not be unduly shaken by the authorities which have created and which define it.

Admittedly, some of the advances can come from the private sector and from individual actions by the Member States, following on from those which have already been taken. These are desirable because they have an effect not only on the domestic markets of the countries involved, but also at international level and on the whole of the ecu market which they help to consolidate. However, they are insufficient and must be supplemented by Community action aimed at removing the impediments to the ecu's use.

A number of general measures would be necessary for the ecu to be treated everywhere as an international currency with the potential necessary to become a common European currency. Subject to a more extensive review of national rules, the following measures could be proposed, in the framework of the large European capital market in which all exchange controls would be abolished:

- the ecu should be recognized as a foreign currency in those Member States where it is not yet so recognized;
- where there is an official fixing on the foreign exchange markets, the ecu should be quoted and, if possible, should rank second, as it does in several countries;
- the residents of all the Member States should be permitted to issue in ecu the whole range of securities authorized on their own markets;
- when tendering for public works contracts, firms could be authorized to present their bids in ecu;

— companies established in several European countries could be authorized:

- to draw up their balance sheet in ecu;
- to issue ecu shares, quoted on domestic stock markets
- to remunerate their shareholders in ecu

— residents could be allowed to open ecu accounts and to use these accounts for their international payments, either when purchasing products from abroad (mail order purchases, transfers, etc...) or when travelling in other countries. The rules concerning such accounts and their use should not be discriminatory or prohibitive;

— the use of the ecu extended in the budget of the Communities should be extended;

— similarly, the ecu's potential could be exploited in international negotiations and agreements concluded between the Community and non-Member States or non-Community areas.

Conclusion

Although the ecu is an instrument in the forefront of international banking and financial activity, its use by firms in international transactions and in the internal management of large international groups is still only marginal, even though there are a few relevant examples of such a use.

Several factors may help to explain the ecu's restricted use as an international currency. First of all, the ecu is a recent phenomenon. The size of the ecu financial market started to become significant only in 1984. Then, as numerous surveys show, the European monetary unit, its qualities and its potential still remain largely unrecognized by operators. Lastly, in addition to various kinds of handicaps, the competitive use of the ecu in transactions suffers from the narrowness of certain segments of the short-term market. If it is to be used in transactions by large groups, it is necessary for an efficient management of funds to be operated and, conversely, the instruments which can enable such efficient management to be operated depend on the fact that transactions do take place. This logical circle may be broken, and is starting to be broken, partly because of the launching of short-term ecu paper such as UK government Treasury bills and the LIFFE figures contract on ecu interest rates, and because of the increased liquidity of the secondary bond market resulting from the floating of large issues and fungible complementary issues (OATs in France).

[...]