

The European Currency Unit

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1. Introduction

Integration of larger areas provides greater resources and variety of demand for accelerated growth via greater efficiency and productivity. As economic blocks emerge in Europe, the Pacific Rim and the Gulf, the countries of the South Asia Association for Regional Cooperation (SAARC) can benefit substantially by working through liberalized trade and factor mobility. Exchange rate stability as a policy tool can provide the necessary flexibility for an efficient and orderly growth of trade and economic development. This has been well confirmed by the success of the European Monetary System (EMS) and other attempts to move back to managed flexibility. Exchange rate stability, however, depends on the convergent character of economic fundamentals and similarity of inflation preferences of the countries concerned. If the countries cannot stabilize their own currencies, the next best thing is to use someone else's. Or national pride can be salvaged by pegging one's own currency irrevocably to a common currency through a central rate without the need for a nominal (outside) anchor. The positive experience of the EMS as an adjustable peg is an explorable example for the SAARC countries to study. This paper just attempts to do that in terms of an investigation of the salient features of the EMS, the background of its success and the scope for the European Currency Unit (ECU) to become the EMS's *bancor*.

The international monetary relationships are still wandering in a non-system even after fifteen years of the collapse of the Bretton Woods system of fixed exchange rate parities. The conflict between the roles of international reserve currency and anchor to the system performed by a single currency, between the need for international liquidity to expand in line with trade and the necessity of preventing excessive growth in the supply of the reserve currency from leading to crises of confidence still remains largely unresolved. It was this conflict that led to the collapse of the Bretton Woods system.