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RECENT CURRENCY CRISES SHOW NEED FOR CONSISTENT MONETARY POLICY

-- Floating or Fixed Exchange Rates Far Less Likely to Suffer Crises Than Pegged Rates --

WASHINGTON, D.C. – A new study by the Joint Economic Committee (JEC) provides further support for the emerging consensus that pegged exchange rates tend to be unsustainable, and that countries should choose either floating exchange rates or truly fixed exchange rates.

"Pegged exchange rates have often suffered currency crises because they try to combine inconsistent goals," remarked JEC chairman Jim Saxton. "Unlike truly fixed exchange rates, which have institutional safeguards to ensure that maintaining the exchange rate is the only goal of monetary policy, pegged exchange rates allow latitude for the exchange-rate goal to conflict with other goals. The conflict often generates currency crises."

Argentina and Turkey are only the latest cases where pegged rates have led to currency crises. Turkey's crawling pegged exchange rate, supported by the International Monetary Fund, collapsed in February 2001. Argentina likewise received considerable support from the IMF before ending its currency board-like system with a devaluation on January 6, 2002. Contrary to a widespread impression, the Argentine system was not an orthodox currency board, and close observers of the system long ago identified its unorthodox features as potential sources for a conflict of policy goals and subsequent exchange-rate troubles.

"Given the problems with pegged exchange rates, there are only two policy options that work over the long run for countries that want to be part of the mainstream of international finance," Saxton said. "They can have floating exchange rates, as the dollar does. A floating exchange rate can work well when supported by an appropriate framework, including a commitment to low inflation, protection from short-term political pressures, and accountability for achieving monetary stability.

"The other choice is to establish fixed exchange rates. One way of doing so is to dollarize. Ecuador and El Salvador have adopted the dollar as their official currency within the last two years. Both have seen interest rates fall dramatically as a result of the high credibility that the dollar enjoys. Another way of establishing fixed exchange rates is to establish a common multinational currency, like the twelve European countries that have replaced their separate national currencies with the euro. Exchange rates within the euro zone are fixed, like exchange rates within the United States, though the euro floats against the dollar."

"No exchange rate system can guarantee immunity from currency crises. However, an appropriately chosen exchange rate system can reduce the risk of currency crises. Encouraging other countries to choose exchange rate systems that are sustainable promotes prosperity and financial stability around the world, including right here at home," Saxton concluded.

For a copy of the study, "Why Currency Crises Happen," or other JEC studies of international economics, please visit our website at www.house.gov/jec.

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