Exchange rates:

All exchange rate systems have to have some sort of an adjustment mechanism. If there was no such mechanism, two countries would have to have the same:

1. Inflation and productivity rates
2. Interest rates
3. Profits and change in share values
4. Confidence in speculative attacks

In reality, these will never happen in any two countries so eventually, you have to adjust rates.

Every system has problems and advantages though:

**Currency board:**
- Lose control over monetary policy – can’t fight inflation or deflation.
- Balance of payments controls the change in money supply.
- Risk goes down (but it doesn’t go to zero).

**Fixed exchange rates:**
- Infrequent but large adjustments – eventually, you’ll run out of reserves from continually defending your currency. When this happens, you get a big adjustment.
- Very ripe for speculative attacks – this is a dream investment because the worst-case scenario is break-even.
- Undervalued rate leads to export-led economy.

**Flexible exchange rate:**
- Higher monetary and fiscal flexibility – but also less discipline and responsibility for things like inflation.
- Rates are not stable and are subject to big swings.
- High private risk which leads to high risk premiums on investments.
- Free (clean) float – no government intervention.
- Managed (dirty) float – government intervention.

**Asian crisis**

In 1997-1998, nobody saw it coming. The IMF and the World Bank were telling everyone to copy East Asian model. The only person to predict the meltdown was George Soros in early 1998. However, no one believed him (which just shows that you can be a world-famous economist and still not get any respect for your predictions).

What caused it?

1. Weak economies in Europe caused money to flow into East Asia. When Europe recovered, though, the money left Japan. So the Japanese banks called in their loans and even more money went out of East Asia. The Japanese crisis affected the whole
region because Japanese banks had made many loans in the region. Other than banks, there was almost no impact of the Japanese slowdown on East Asia because the Japanese has almost no imports from there.

2. U.S. S&L crisis led to low U.S. interest rates causing money to flow into Japan. When the crisis was solved, interest rates went up again and money left Japan (same effect as we saw in Mexico in 1995).

3. Major thing was China – The joined the world economy in late 1980s and immediately started a $100b trade surplus, which was taken from other East Asian countries. They were a better country for business in many ways, including low wages (where the game was basically over). South Korea also got squeezed out – by China at the bottom (low wages) and Japan at the top (increasing their exports).

4. Diversification – people were buying many things in countries they didn’t know anything about because the countries were not transparent. This fostered a (nervous) herd mentality as everyone was watching the insiders for what to do.

5. All countries had adopted the Japanese economic model:
   a. Heavy government involvement
   b. Banks being used as instruments for economic development with forced lending to specific industries which were guaranteed by the government.
      i. Leads to lots of bad loans to friends and family (moral hazard).
      ii. Financing system becomes debt system instead of equity – debt systems are incredibly weak during a recession.

6. System was a profitless capitalism because the focus was on growth and market share. During a downturn, this goes immediately into losses.

7. No provisions for bankruptcy so there was no way to restructure debt.

8. Take Indonesia as an example of a really messy situation:
   a. Tried to make a national car (pretty stupid idea).
   b. They weren’t really a country (just thousands of small islands).
   c. Didn’t have any real government.

The Asian crisis had mostly to do with external things – internal things were only a second-order effect.