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Book Review

Trauma to Triumph: Rising from The Ashes of The Asian Financial Crisis*

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This book is edited by Hoe Ee Khor, Diwa C. Guinigundo, and Masahiro Kawai. A number of authors participated to write thirty chapters that constitute five parts.

Part I is an introduction and overview written by the editors. This part explains the purpose and methodology of this volume. They argue that while "the Asian financial crisis (AFC) is considered one of the most significant and devastating economic and financial crises in recent history," the region recovered strongly and the success in surmounting the crisis and implementing reforms made the region more resilient.

The title of Part II is "What Happened During the Asian Financial Crisis and the Global Financial Crisis." It consists of 12 chapters. Chapter 1 is an introduction. The other chapters are based on 32 interviews involving interviewees from nine countries in Asia and from the International Monetary Fund (IMF). The interviewees were from pivotal organizations engaged in responding to the AFC that included the relevant ministries, central banks, international organizations, and investment firms. Nine chapters from Chapter 2 to Chapter 10 cover Thailand, Indonesia, Korea, Malaysia, Philippines, Hong Kong, Singapore, Japan and China. Chapter 11 is on the IMF and Chapter 12 is personal takeaways from the Asian Financial Crisis.

Among the nine economies, this book grouped Thailand, Indonesia and Korea because they have in common that they were most severely affected by the crisis. This

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book grouped Malaysia separately because, while it was also affected by the crisis, it differs from the three countries mentioned above in that it has responded to the crisis using unorthodox methods such as capital controls. The Philippines was also grouped separately because it differs from the other four countries in the sense that it already had an ongoing IMF program before the crisis. This book also grouped Hong Kong and Singapore separately because they have one thing in common as international financial centers, and they were relatively less affected by the crisis. Finally, Japan and China were hardly affected by the crisis and constitute a final group.

Although the interview does not analytically show the cause of the crisis or the process of overcoming the crisis afterwards, regardless of the country in which it took place, since the Asian financial crisis was so shocking, the interviewees convey the events of that time very vividly. One regret is that the focus of the interview is on the AFC, so there is a sense of neglect about what happened during the global financial crisis (GFC).

The title of Part III is “The Asian Financial Crisis and the Global Financial Crisis: Experiences from the ASEAN+3 Economies.” In this part, more analytical analyses on the causes of the crises are made. Here, rather than analyzing the common causes of the East Asian crisis, the causes and developments of individual countries’ crises are explained. Part III consists of 10 chapters, each allocated to Thailand, Indonesia, Malaysia, Korea, Philippines, Hong Kong, Singapore, ASEAN’s new members, China and Japan. The analysis of each country’s experience is quite successful, but the main theme is somewhat lacking.

On the causes of the crises, this book emphasizes macroeconomic imbalances and volatile capital flows. While the affected countries suffered from weak fundamentals such as double mismatches, i.e. the maturity and currency mismatches of the financial and nonfinancial industries, trade deficits and large corporate debts, as this book argues, the sudden reversal of capital flows also contributed to the crisis of the entire financial system and ensuing collapse of the real sector. This book also emphasizes capital account liberalization without much preparation as a cause of crises, but it neglects the role financial institutions played to aggravate the situation. For example, in Korea, merchant banks affiliated to chaebols showed how the moral hazard of financial institutions worsens the situation if there is no separation between financial and industrial sectors. When the parent company was at risk, the merchant banks continued to supply funds despite the possibility of bankruptcy. As a result, the scale of insolvency snowballed.

Another aspect of the crisis that is not fully explained in the book is the role of the exchange rate. The book explains well the difficulty faced by Hong Kong, which maintained the stability of its exchange rate by adopting a currency board system. As well explained in Chapter 19, Hong Kong was attacked by speculators who took a double-play strategy of shorting both Hong Kong dollars and domestic stocks. In crisis-affected countries like Thailand, Indonesia and Korea, the exchange rate was not fixed *de jure* but fixed *de facto*. In such a situation where the exchange rate is practically fixed, foreign borrowings tend to increase excessively in order to take advantage of the low interest rates abroad. In addition, the fixed exchange rate does not alleviate foreign shocks. Recently, Rey (2013) argues for a policy dilemma rather than trilemma, reflecting global financial cycles that manifest irrespective of the exchange rate regime. Obstfeld et al. (2017) challenged this view by providing empirical evidence of the stabilizing properties of flexible exchange rates based on some 40 emerging markets over 1986-2013. They further argue that intermediate exchange rate regimes with a limited degree of exchange rate flexibility are almost equally insulated from global financial volatility. More recently, however, Eichengreen et al. (2020) also provide findings more consistent with the traditional trilemma framework, but with a nuanced view that limited flexibility is not enough to avoid accentuating the impact of external volatility on domestic conditions.

One lesson learned from the Asian financial crisis is, as emphasized in Chapter 14, the necessity of the development of the local currency bond market that is believed to help avoid the double mismatch problem. Eichengreen et al. (2005) use the term "original sin," which indicates that for most emerging economies, domestic currency cannot be used to borrow abroad or to borrow long term. If an emerging country's financial liabilities are largely denominated in a foreign currency while its financial assets are largely denominated in domestic currency, a sudden reversal of capital flows causing sharp depreciation of the exchange rate aggravates its balance sheet and destabilizes the financial system. To overcome the original sin problem and enhance financial stability, ASEAN+3 countries (Association of Southeast Asian Nations plus China, Japan, and Korea) have prioritized the development of the local currency market as a policy goal. Park et al. (2021) show that the size of local currency bond markets has increased particularly in Korea, Thailand, and China since the Asian financial crisis. They also provide empirical evidence that the development of the local currency bond market promotes financial stability in emerging economies.

However, the development of local currency bond markets is not a panacea. If global investors participate in the local currency bond market, a tightening of global financial conditions causing sharp depreciation of the domestic currency aggravates the balance sheet of global investors. A weaker domestic currency tightens the value-at-risk constraints of global investors by lowering the value of local currency assets of global investors in their home currency terms. This situation makes them withdraw their investments from emerging market countries. Hence issuing bonds in local currency is not sufficient to insulate emerging market economies from shocks generated from changes in global financial conditions. Recently, Carstens and Shin (2019) have coined the term "Original Sin Redux" for this situation of shifting the currency risk from domestic borrowers to foreign investors.

Another lesson learned collectively as a region is, as emphasized in Chapter 18 and elsewhere, the need for regional cooperation. As explained in Chapter 22 and elsewhere, Japan initially proposed to construct an Asian Monetary Fund. However, this attempt failed and ASEAN+3 instead established the Chiang Mai Initiative. This progress is well explained in Part IV. One shortcoming of the Chiang Mai Initiative is that it is mainly for bilateral swap arrangements among ASEAN+3 countries. It is also subject to the moral hazard problem since there is no institution responsible for surveillance of the member countries. The Chiang Mai Initiative evolved to the Chiang Mai Initiative Multilateralisation, which is a multilateral currency swap arrangement with a total size amounting to 240 billion US dollars. ASEAN+3 countries also agreed to establish an independent surveillance unit called the ASEAN+3 Macroeconomic Research Office, located in Singapore.

The inefficacy of the IMF policy, as stressed in Part III and Part IV, and the stigma effect related to the IMF's liquidity-support packages can fully explain the efforts of the Asian region to come up with a way to help each other. However, it is questioned whether greater regional cooperation will contribute to financial stability in the region. If the Chiang Mai Initiative Multiateralisation works as another safety net, it may further aggravate the moral hazard problem and reckless foreign borrowing can be increased. In this regard, Park and Shin (2020) provide a rationale for further regional financial integration. Using BIS statistics, they find that lenders tend to behave more favorably toward emerging market economies in the same region. That is, the lenders withdrew funds less from same-region borrowers during the global financial crisis than from outside their region. This evidence indicates that further regional financial integration that can be enhanced by arrangements such as Chiang Mai Initiative Mulitilateralisation can contribute to financial stability in the region.

While the book focuses on the experiences of the Asian financial crisis of 1997-1998 and lessons learned from it, the analyses on the global financial crisis and lessons from it are relatively insufficiently provided. In addition, no analysis has been done on the Covid-19 crisis. Recently Shin and Shin (2022) provide a new angle for Korea's experiences during the global financial crisis and the Covid-19 crisis and draw lessons from them. According to them, Korea's macroprudential policies such as Loan-to-Value, Debt-to-Income regulations and bank levy were mainly imposed on the banking sector. This is because sudden reversals in bank short-term borrowings were a major culprit that aggravated the financial system during both crises. These measures were quite effective, as Bruno and Shin (2014) provide supporting evidence. However, the financial stresses experienced by the Korean economy during the Covid-19 crisis of March 2020 highlights that these measures were not sufficient. As explained by Shin and Shin (2022), the major players at that time that aggravate the financial markets were non-bank financial intermediaries such as insurance companies and securities firms. They argue that, when the Covid-19 pandemic hit the global financial markets, Korean securities firms experienced a severe dollar shortage as global stock markets crashed, because they suffered from margin calls related to structured products such as equity linked securities (ELS). Insurance companies also contributed to the severeness of the financial stress through their FX-hedging activities in the FX swap markets. They argue that this experience during the Covid-19 crisis poses a new challenge for the Korean economy and other countries as well to incorporate non-bank financial intermediaries in the marcroprudential framework.

Overall, this volume vividly delivers the experiences of East Asian countries during the Asian and global financial crises. Then this book draws key lessons learned from them. Therefore, this volume will become a must-read for studying the crises of East Asian countries. It will also provide policy makers with a new perspective to work towards financial stability.

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