NOTE: Think you know what triggered the Asian economic crisis? St. Louis Fed economist Michelle Clark Neely analyzed the economic tigers of Southeast Asia and found that their "tails" are not simple ones to tell.

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The Asian Crisis: What Happened?

ST. LOUIS — The recent economic crisis in Asia likely occurred because either the region's financial systems were severely flawed, or a swift change in investors' expectations caused massive outflows of capital that triggered and fed the crisis or both ¾ said Michelle Clark Neely, an economist with the Federal Reserve Bank of St. Louis.

Neely analyzed both theories for "Paper Tigers? How the Asian Economies Lost Their Bite," an article in the January issue of *The Regional Economist*, t he St. Louis Fed's quarterly review of business and economic issues.

Since the crisis began, economists and policymakers have been searching for what triggered the Asian crisis and its spread to emerging markets around the world. Although a number of e xplanations have been offered, Neely observed that the vast majority of views fall into one of two camps: the "fundamentalist" view and the "panic" view.

The fundamentalist view holds that although there were no obvious macroeconomic warning signs, changes occurred in the Asian economies over the last several years that made

them vulnerable to a financial crisis. "Because most currencies in th e region were linked in one way or another to the stronger U.S. dollar, the Asian countries were at a competitive disadvantage in export markets," said Neely. "As a result, export growth, which is the engine driving these economies, began to sl ow."

At the same time, she noted, an increasing portion of foreign capital inflows to the region consisted of liquid portfolio investment, rather than long-term foreign direct investment.

The bulk of these liquid capital flows were channeled int o domestic investments by local bank and nonbank financial institutions.

"Frequently," said Neely, "the same assets ¾ land, real estate and financial assets ¾ were used for collateral and investment, driving the value of existing collateral up, which in turn, spurred more lending and increased asse t prices. Risk was further heightened when local banks, in response to low interest rates and 'stable' exchange rates at home, began borrowing foreign exchange abroad. These banks then converted the foreign exchange to domestic currency and lent the pr oceeds domestically, assuming all the exchange rate risk."

The result? "A bubble that was bound to burst," said Neely. "Once the crisis started, asset prices fell, causing nonperforming loans to rise and the value of collateral to fall. Domestic lending then declined and asset prices fell even further."

Those who subscribe to the panic or "disorderly workout" theory, on the other hand, maintain that the economic fundamentals in Asia were essentially sound. They contend that a swift change in expectations was the impetus for the massive ca pital outflows that triggered and fed the crisis.

Neely said that backers of the panic theory point to four factors to support their premise:

- **The crisis was largely unanticipated. "There were no warning signals, such as an increase in interest rates on the region's debt or downgradings b y debt-rating agencies," said Neely.**
- **Prior to the crisis, there was substantial lending to private firms and banks that had no government guarantee or insurance. Said Neely, "This fact contradicts the idea that investors were knowingly making bad deals and assuming that they would be bailed out."**
- **Once the crisis was under way, even viable domestic exporters that had confirmed sales couldn't get credit, suggesting lenders were irrationally spooked by the crisis.**
- **The trigger for the crisis was not the deflation of asset values, as the "fundamentalists" argue, but, rather, the sudden withdrawal of funds from the region.**

"Regardless of which theory is correct," concluded Neely, "some prescriptions for mitigating future crises, wherever they may occur, should include greater transparency in financial transactions, more stringent regulatory oversigh t and consistent application of accounting standards. It would be unrealistic to expect that such crises can always be prevented, but striving for less fallout and contagion when they occur is a goal worth pursuing."

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