ELSEVIER

Pacific-Basin Finance Journal 8 (2000) 153–175

PACIFIC-BASIN
FINANCE
JOURNAL

www.elsevier.com/locate/econbase

Capital movements, banking insolvency, and silent runs in the Asian financial crisis ☆

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Abstract

This paper supplies an agency-cost and contestable-markets perspective on the financial policies that triggered the Asian financial crisis. The agency-cost analysis hypothesizes that individual-country regulators knew that politically directed loans had made their banks insolvent, but purposefully gambled that deregulation could allow the insolvent banks to grow their way out of trouble.

The contestable-markets paradigm sets this gamble in the context of offshore innovations in financial technology and regulatory systems that made it progressively easier for worried Asian citizens to move funds to foreign institutions. These perspectives portray the simultaneous breakdown of repressive financial systems as a technology-led victory of market forces over longstanding government efforts to wall out foreign financial competition. © 2000 Elsevier Science B.V. All rights reserved.

JEL classification: G2; F3; K2

Keywords: Banking deregulation; Bank runs; Financial crisis; Economic insolvency; Banking subsidies

1. Introduction

Furman and Stiglitz (1998, p. 12) stress that any credible explanation of the East Asian crisis must account simultaneously for the crisis and for the region's precrisis record of growth and stability. Their own explanation (pp. 13–20) roots the crisis in government financial policies and not in the management of foreign

☆ This paper extends and refocuses analysis originally presented in Kane (1998).

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0927-538X/00/$ - see front matter
PII: S0927-538X(00)00009-3

trade regimes, international liquidity, or monetary and fiscal aggregates. Furman and Stiglitz blame East Asian governments for

1. undertaking rapid financial and capital-account deregulation without addressing the concomitant need to beef up their supervisory capacity, and
2. failing to be ''aware'' of the systemic risk posed by the growing possibility that the massive precrisis inflows of private capital into their countries might fail to earn returns large enough to service the foreign debt being generated.

The explanation tendered in this paper supplies an agency-cost and contestable-markets perspectives on these so-called policy mistakes. The agency-cost part of the argument portrays the crisis as the fruit, not of blindness, but of time-inconsistent policy gambling. It rejects the hypothesis that East Asian authorities could have truly blinded themselves to the growing vulnerability imposed on their banking systems by booking loans dictated by political pressure at par. Instead, the analysis substitutes the more reasonable hypothesis that authorities had this guilty knowledge and responded to this information myopically by gambling that deregulation would enable their insolvent banks to grow their way out of trouble. The operative strategy had two components: helping to cover up the losses imbedded in bank loan portfolios and enabling their banks to compete more aggressively for domestic savings and foreign funds.

The regulatory-gambling model treats the decision to poorly supervise financial and capital account liberalization as a purposeful rather than inadvertent move. Regulators and politicians hoped to preserve the rents earned in the past by directing cheap loans to politically powerful parties and sectors. These hopes were encouraged by high precrisis rates of economic growth and by the obvious difficulty of establishing the purposefulness of their scheme if the strategy failed.

The contestable-markets part of the story sets this gamble in the context of the increasing globalization of financial services competition. Year by year, offshore innovations in financial technology and regulatory systems have been expanding opportunities and lowering costs for worried Asian citizens to move their wealth into foreign institutions. Viewed from this Schumpeterian perspective, the successive breakdown in the financial systems of the five Asian crisis countries was less a matter of Kindleberger–Minsky ''psychological contagion'' than the simultaneous destruction of longstanding government efforts to wall out foreign competition. Advances in information and contracting technology made it easier for foreign firms to surmount barriers to entry in distant markets at the same time that improvements in Western regulatory systems made offshore institutions seem safer to Asian citizens than ever before.

2. Precrisis and postcrisis movements of capital

Beginning in mid-1997, five East Asian countries lapsed into severe financial crisis: Indonesia, Malaysia, Philippines, South Korea, and Thailand. The crises