From Financial Liberalization to Financial Integration: A Law *in* Finance Reinterpretation of the Asian Financial Crisis and its Implications for the Future of Thailand and South East Asia[1]

1. Thailand and the Asian Financial Crisis: An Oft-Rehearsed Story Full of Unanswered Puzzles

Amidst a downpour of the gloomy monsoon season of 1997, the Bank of Thailand decided to float the local currency, Thai baht, after a series of countermeasures against speculative attacks went in vein. The dramatic unpegging, while largely anticipated, sets off a disastrous chain reaction resulting in financial and economic collapses throughout the region and beyond. GDP growth rates plummeted precipitously with both financial and non-financial corporations which were excessively exposed to foreign denominated liabilities going under triggering mass unemployment and various other socio-economic consequences. The unprecedented scale and magnitude of the crisis prompted the governments of the crisis-hit countries to seek IMF-led bailouts which were not only deeply humiliated at the time but also in hindsight proved to be limited in their intended effects and in some cases somewhat backfired. In many ways, the Asian Financial Crisis (AFC) can be regarded as the most significant milestone in the recent history of international financial development. Its impacts and the subsequent responses have almost single-handedly defined the financial reform and policy direction of the ensuing period and possibly going into the future.

For over 19 years since the crisis, the mainstream explanations of the AFC have been widely deemed sufficient and satisfactory such that any attempts to reignite the debate has not since gained any traction. The standard version of the AFC evolves around two story arcs: bad government, and bad globalization. Firstly, the AFC was a result of collective economic and financial mismanagement by the crisis-hit governments in the region. The accusations range from corruption

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and cronyism[2], gross incompetence[3], to the failure of the so-called Asian Economic Model.[4] On the other hand, the perspective more sympathetic towards the beleaguered parties would argue that the East and South East Asian nations were the unfortunate victims of unfettered and extreme capital volatility as a result of premature liberalization.[5] These two standard diagnoses of the situation inevitably leads to one important but fundamentally flawed implication of the role of Thailand in the AFC. While the collapse of the Thai baht in July 1997 can be considered as a triggering event of the unprecedented financial calamity, that is the extent of the importance of Thailand in the grand scheme of things – an alarm bell warming foreign investors to flee the region. In other words, with the problems of bad government and bad globalization so prevalent in the region, the crisis could have been set alight with any one of the figurative matches.

Nonetheless, when trying to parse each of these contentions, none stacks up well against the facts of the situation. Crony capitalism as well as inferior economic and financial regulatory standards had been rampant in Thailand and arguably throughout the region for a long time and at least since the beginning of the industrialization era from the 1970s to the early 1980s.[6] Considering the fact that foreign liabilities on the balance sheet of the Thai financial sector grew exponentially in the early 1990s immediately prior to the advent of the crisis, the two decades earlier witnessed only a negligible presence of external debt on the private sector's balance sheet. It should also be noted that an independent international anti-corruption watchdog revealed Thailand in the 1990s was perceived to be least corrupt in contrast with the situations in any previous decades earlier.[7] Furthermore, the Bank of Thailand first adopted and practiced the capital adequacy requirement

[2] Eddy Lee, 'The Debate on the Causes of the Asian Crisis: Crony Capitalism Versus International System Failure' (1999) 2/99 Internationale Politik und Gesellschaft 162; Helen Hughes, 'Crony Capitalism and the Eastern Asian Currency and Financial "Crises"' (1999) Spring 1999 Policy Magazine 3.

[3] Andrew Sheng, *From Asian to Global Financial Crisis: An Asian Regulator's View of Unfettered Finance in the 1990s and 2000s* (Cambridge University Press 2009); Ammar Siamwalla, 'Out of the Frying Pan: The Thai Economy between Two Crises' <http://www.ilo.org/wcmsp5/groups/public/---asia/---ro-bangkok/documents/meetingdocument/wcms_101736.pdf> accessed 13 December 2013.

[4] Paul Krugman, 'The Myth of Asia's Miracle' (1994) 73(6) Foreign Affairs 62; Jong H Park, 'The East Asian Model of Economic Development and Developing Countries' (2002) 18 Journal of Developing Societies 330.

[5] Steven Radelet and Jeffrey D Sachs, 'The East Asian Financial Crisis: Diagnosis, Remedies, Prospects' (1998) 29 Brookings Papers on Economic Activity 1; Joseph E Stiglitz, 'Capital Market Liberalization, Economic Growth, and Instability' (2000) 28 World development 1075.

[6] Phongpaichit Pasuk and Chris Baker, *Thailand: Economy and Politics* (2 edition, Oxford University Press 2002). at 72.

[7] Ha-Joon Chang, 'The Hazard of Moral Hazard: Untangling the Asian Crisis' (2000) 28 World Development 775. at 780.

based on Basel Accord (Basel I) during the early 1990s, compared to the preceding period in which the financial regulatory framework was based on a set of indigenous wisdoms and conventions, supposedly more backward and thus problematic than the internationally accepted concept drawn up by the Basel Committee on Banking Regulation. In other words, the bad government story does not seem to bode well with the developmental path of the Thai economy and in particular of the financial sector.

Likewise, the bad globalization narrative also falls short of attaining any convincing force. This school of thought argues that it was the foreign investors who staged a run against the region due to intensified speculations and growing concerns with the underlying economic fundamentals of their investments.[8] Yet, this theory is rife with potential plot holes. It assumes that the role of the government (and by extension, its law and legal institutions) was confined to liberalization and thus played no significant part in the direction of financial development whatsoever. In other words, the story simply grosses over the institutional aspect of the governance structure of the Thai financial system and indeed the international capital market. Crucially, the bad globalization proponents fail to comprehensively explain the mechanics and the chain of causation from the sources of the capital, the influx of foreign capital into the Thai financial sector, to the linkage between the banking crisis and the subsequent problem with the plummeting value of Thai baht. Instead, the mainstream commentators have chosen to dissect the entire saga into small seemingly disconnected episodes; namely, the one that highlights the nature of capital volatility[9], the one with a critical examination of domestic and international regulatory proficiency[10], and the one conceptualizing the theory of financial crises in the context of emerging market economies.[11] Consequently, it is argued that the AFC has never been treated with a coherent, holistic explanation

[8] Steven Radelet and Jeffrey Sachs, 'The Onset of the East Asian Financial Crisis' (National Bureau of Economic Research 1998) Working Paper 6680 <http://www.nber.org/papers/w6680> accessed 14 December 2013.
[9] Kristin J Forbes, *Capital Flow Volatility and Contagion: A Focus on Asia* (4 December 2012), MIT Sloan Research Paper <http://papers.ssrn.com/abstract=2185011> accessed 7 March 2016.
[10] Randall S Kroszner and Philip E Strahan, 'What Drives Deregulation? Economics and Politics of the Relaxation of Bank Branching Restrictions' (National Bureau of Economic Research 1998) <http://www.nber.org/papers/w6637> accessed 26 February 2016; Rafael Repullo and Javier Suarez, 'The Procyclical Effects of Bank Capital Regulation' (2013) 26 Review of Financial Studies 452; Maximilian JB Hall, 'Banking Regulation and Supervision in Japan: Some Issues and Concerns' (2003) 11 Journal of Financial Regulation and Compliance 45.
[11] Hyun Song Shin, 'Liquidity and Twin Crises' (2005) 34 Economic Notes 257; Itay Goldstein and Assaf Razin, 'Three Branches of Theories of Financial Crises' (National Bureau of Economic Research 2013) Working Paper 18670 <http://www.nber.org/papers/w18670> accessed 17 September 2014.

that reflects the nuances and peculiarities inherent in the Thai financial system and the regional capital market at the time.

Not only do we have to contend with the inadequately explained puzzles of the AFC as articulated above, but the time is also ripe for a revisit to this almost two-decade-old debate in the light of several significant issues emerging in the intervening era. The first key development is cross-border capital flow which was grounded to a halt by the AFC but not only now returns, but also intensifies especially in the second half of the 2000s prompting leading economists in the field to label this decade a period of extreme capital flow volatility.[12] Yet with the cataclysmic disruptions to the international capital market brought about by the Global Financial Crisis of 2008-9 (GFC), certain countries in the region, notably Thailand – the epicenter of the AFC, fared far better than other more developed nations such as South Korea and Singapore[13], even though all three countries encountered sudden reversal of foreign capital inflows.[14] Overall, despite slumps in GDP growths particularly as a result of collapses in international trade, the emerging Asian economies have recovered more quickly than their advanced economic counterparts. Some empirical works pointed out to the components of capital flow in the 1990s and the 2000s as the main differentiating factors[15] while the literature on international financial contagion suggested that developing East Asian countries were more connected through trade linkages as opposed to the US and the European Union whose financial linkages became the primary transmission channel of the GFC.[16] The current discussion on the impact of the GFC in Asia helps build a contrasting picture facing Thailand during the two international financial crises which allows for an in-depth investigation into the ways in which initial systemic vulnerabilities as well as the specific structure of the domestic financial sector, and the specific nature of the capital flows caused the crises.

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[12] Kristin J Forbes *Capital Flow Volatility and Contagion* (n 8); Kristin J Forbes and Francis E Warnock, 'Capital Flow Waves: Surges, Stops, Flight, and Retrenchment' (2012) 88 Journal of International Economics 235.

[13] South Korea and Singapore received and activated emergency central bank swap facilities from the US Federal Reserves, while Thailand was never forced to draw upon its swap lines provided by its Chinese and Japanese counterparts. Brad Setser, 'Brad Setser: Follow the Money » Where Is My Swap Line? And Will the Diffusion of Financial Power Balkanize the Global Response to a Broadening Crisis?' <http://blogs.cfr.org/setser/2008/10/18/where-is-my-swap-line-and-will-the-diffusion-of-financial-power-balkanize-the-global-response-to-the-broadening-crises/> accessed 4 September 2014.

[14] Fernando Broner and others, 'Gross Capital Flows: Dynamics and Crises' (2013) 60 Journal of Monetary Economics 113.

[15] Forbes and Warnock (n 11).

[16] Olivier J Blanchard and others, 'The Initial Impact of the Crisis on Emerging Market Countries [with Comments and Discussion]' [2010] Brookings papers on economic activity 263.

Another important aspect of the GFC which helps shed the new light on the AFC is the international crisis resolution process for financially liberalized developing countries. While the economically advanced nations might have a large enough balance sheet to absorb any contingencies and losses sustained during the crisis, smaller countries hampered by reserve constraints were suddenly facing with acute balance of payment crisis. The Eastern European bloc encountered this precise problem when Western European financial conglomerates decided to repatriate the funds back in order to recapitalize their headquarters. Likewise, a number of East and South East Asian governments had to grapple with significant depreciation of their currencies as foreign investors fled back to the safety of the US dollar and the US government-backed securities. Inevitably, they became beholden to the willingness of the great financial powers including to the international financial institutions to provide emergency support and abide by both ex ante rules and any additional ex post conditions justified by the apparent need to prevent moral hazard. This reality bears a striking similarity to the conundrum facing Thailand during the AFC. Notwithstanding any reforms of the international financial governance framework, the situation of emerging economic nations with reserve constraints vis-à-vis the financially more powerful countries has not changed significantly in the past 20 years.

Undoubtedly, the AFC have influenced various economic and financial initiatives of the Association of South East Asian Nations (ASEAN) whose member states were beset by its disastrous consequences. The ASEAN Economic Community (AEC), agreed in 2003 and entered into force in December 2015, was primarily inspired by the idea that economic and financial integration may be able to curtail the likelihood of financial crises erupting again in the future through enhancing market efficiency and regulatory standards. An economic union would allow capital to flow to capital-poor economies, where returns should be higher boosting investment and growth. Furthermore, a single market in banking and financial services provides opportunities for investors to conveniently and cost-effectively diversify their portfolios and thus become less exposed to localized financial disruptions. In addition, the less developed member states would benefit from regional coordination, support, and resources in order to strengthen their institutions and expand the capacity to absorb the inflows of capital without jeopardizing the systemic viability of the entire region. While certainly not without its advocates, the premise that an informationally efficient financial system might have prevented an incident such as the AFC could not be any more contentious at the present time in the light of the subprime crisis in the US and the Eurozone crisis,

the two most developed financial markets in the world.[17] A reexamination of the onset of the AFC hence serves as a timely reminder that even though the AEC can and indeed will yield a range of socio-economic benefits, a caution should be exercised with regard to its contribution toward the overall regional systemic stability.

Ultimately, the AFC is still a topic of considerable interest simply because there are still a lot of questions left unanswered. It is believed that a good place to start the exploration is to embrace, as opposed to abstract from, the governing framework and the real mechanics underpinning the Thai and regional financial systems. The AFC, like all modern financial crises before and after it, is a complex social construct involving interplays among various stakeholders. In the present setting of a financially globalized world, financial activities invariably entail interactions between states through a number of channels such as the currency exchange market, regulatory and supervisory coordination, and when necessary their enforcement and adjudicating powers. Private institutions such as banks and insurance companies can operate with presence scattered across the national jurisdictions and therefore must find the most efficient strategy to minimize their compliance costs while maximizing the profits. The system of global finance is then buttressed by a loose governance structure of international institutions, intergovernmental agenda-directing forums, and various non-governmental standard setters. Unless it takes into account this elaborate public-private hybrid organization of contemporary finance, no theory of the AFC can accurately describe the incident, let alone provide helpful ballparks for future financial development policy formulation.

2. The Approach of this Dissertation

After correcting the flaws and misinterpretations embedded in the standard accounts of the AFC, the primary goal of this dissertation is to propose a new comprehensive account of the AFC that better reflects the construction and operation of finance in the region at the time. In addition, the dissertation also appeases the impacts of the AFC on subsequent national and international

[17] Beth Gardiner, 'Back to School' *Wall Street Journal* (17 June 2010) <http://www.wsj.com/articles/SB10001424052748704324304575306442966044342> accessed 23 March 2016. Of course, there are academics who still insists on the existing analytical model. See for instance, Ronald J Gilson and Reinier Kraakman, 'Market Efficiency after the Financial Crisis: It's Still a Matter of Information Costs' (Social Science Research Network 2014) SSRN Scholarly Paper ID 2396608 <http://papers.ssrn.com/abstract=2396608> accessed 18 March 2015.

financial reforms. To reiterate, the choice of case study shows just how significant of the role of Thailand is in understanding the AFC. The decision of the Bank of Thailand to float its currency Thai baht against the global moneys such as the US dollar and the Japanese yen on July 1, 1997 was merely the eventual manifestation of the structural interdependence between law and finance as well as between the undeniable presence of the state in the financial market which according to the mainstream dogma is decidedly privately constituted. In other words, Thailand is a crucial piece of the jigsaw in order to understand the AFC precisely because the institutional details encompassing the governance design, regulatory scaffolding, and underlying mechanical operation of contemporary finance do matter.

Nevertheless, the collapse of the Thai baht is symbolic in the sense that the event effectively bookended an impressive record of economic growth which started from the rapid industrialization in the 1970s and had last over two decades. This caught both the market and many in the academic community off guard, especially considering the fact that the World Bank had only published its seminal work explaining the phenomenon so called the "East Asian Miracle.[18] In part, the publication's empirical findings went against the standard narratives of the crisis. In other words, while there may be long-running problems with these Asian nations, they could not in and of themselves be regarded as defining factors of the AFC.[19] Some signs of growing financial risks notwithstanding[20], traditional indicators such as the government budget balance, domestic saving and investment rates, as well as global commodity price levels may no longer be reliable for detecting an impending financial catastrophe.[21] Due to the central role that Thailand played in both the narratives of the Asian economic success stories as well as the region's spectacular downfall, the AFC has since been colloquially dubbed the "Tom Yum Kung Crisis" after a Thai soup dish

[18] World Bank, *The East Asian Miracle: Economic Growth and Public Policy.* (Oxford University Press 1993).

[19] To summarize, the report found that between 1965 and 1990 the 8 high performing countries, including Thailand, managed to stabilize their economies with "sound development policies that led to fast growth." Furthermore, "their public policies promoted rapid capital accumulation by making banks more reliable and encouraging high levels of domestic savings. See more of the summary at < http://documents.worldbank.org/curated/en/1993/09/698870/east-asian-miracle-economic-growth-public-policy-vol-1-2-main-report> accessed on May 5, 2016.

[20] There are signs of growing imbalances such as overvalued currencies, growing account deficits, and slowing export growth rates – yet these signaled a slowdown of an otherwise exceedingly good economic boom period in Asia.

[21] Radelet and Sachs (n 7).

well known for its heat and spiciness. Consequently, Thailand is a logical place to start investigating the origin of the AFC.

In the light of the deficiencies in the existing explanations of the AFC as well as the financial development during the intervening period expounded above, it is imperative that the dissertation begins its examination by asking the following three interrelated questions. First, how do we account for the systemic vulnerabilities which seemingly went unnoticed during the preceding high-spirited era? Secondly, how could these vulnerabilities morph into a full blown financial crisis? And lastly, how should the crisis resolution arrangements put together at the time of the crisis be assessed with the benefit of hindsight and how does the experience inform us regarding the nature of the international financial governance structure?

3. The Theoretical Framework: Legal Theory of Finance (LTF)

In answering these research questions, the dissertation argues that Legal Theory of Finance (LTF) presents the best available roadmap for understanding the nature of contemporary finance and thus uses it as the operating framework of analysis. LTF proposes a new conceptual map of the intricate relationships among various stakeholders and reinterprets the role of law and legal institutions in finance[22] beyond the traditional law and finance dichotomy which divides legal traditions based on their respective levels of investor protection.[23]

The starting point of LTF which also distinguishes itself from the many variants of the neoclassically inspired theory of finance is the observation that contemporary finance is inherently unstable due to fundamental uncertainty and constant struggle of market participants to leverage their non-cash assets to fund their liabilities.[24] Fundamental uncertainty may be defined as a

[22] For a more detailed description of the LTF, see Katharina Pistor, 'A Legal Theory of Finance' (2013) 41 Journal of Comparative Economics 315; Dan Awrey and Katharina Pistor, 'An Overview of the Legal Theory of Finance', *Law and Finance Workshop* (Federal Reserve Bank of Chicago 2014). (on file with the author).

[23] Rafael La Porta and others, 'Law and Finance', *Corporate governance* (Springer 2001) <http://link.springer.com/content/pdf/10.1007/978-3-642-59499-1_3.pdf> accessed 10 March 2016; Florencio López de Silanes and others, 'Law and Finance' (1998) 106 Journal of political economy 1113; Rafael La Porta and others, 'Law and Finance' (National Bureau of Economic Research 1996) <http://www.nber.org/papers/w5661> accessed 10 March 2016.

[24] In the mainstream financial literature, this potential instability is defined as liquidity constraints in which funding liquidity (the liability side of the balance sheet) is a function of market liquidity (the asset side of the balance sheet). See Markus K Brunnermeier and Lasse Heje Pedersen, 'Market Liquidity and Funding Liquidity' (National Bureau of Economic Research 2007) Working Paper 12939 <http://www.nber.org/papers/w12939> accessed 26 February 2014.

perpetual state of high information costs in the sense that no economic actor is able to obtain all relevant material information or possesses the decision-making capacity to achieve accurate estimations of a future income stream and the availability of affordable refinancing options in either short run or long run. In other words, contemporary finance revolves around a system that continuously makes bets on an uncertain future and has to constantly readjust both asset and liability sides of its balance sheet in order to accommodate the outcomes of future events. In an idealized world where there were no future uncertainty, and thus informationally costless, the parties can write a contract that is able to account for all future contingencies and risks, and therefore ex ante manage potential funding problems that may or may not arise. In the imperfect and highly uncertain world that we live in on the other hand, the readjustment by the private parties cannot be anticipated ex ante, i.e. at the time that the contracts were written. Hence, in such a world, the prophylactically complete contract is factually impossible.

The law is therefore critical not only in provoking each individual market participant's demand of funding in order to "balance the balance sheet", but also in coordinating the funding needs across the entire financial system. To put it differently, during the good times, the force of the law is often ignored or since the market participant can simply liquidate her non-cash assets and find takers in the market. In the period of heightened uncertainty in which transaction costs are prohibitive, the role of law becomes decisive. The law as agreed ex ante can force a sufficiently large number of market participants to seek cash or cash-like assets to satisfy their outstanding liabilities while there is no private suitor in the market available and ready to stand on the other side of the transaction and take non-cash assets without demanding a large haircut to reflect the dire situation of high transaction cost and uncertainty. This could potentially transform financial instability into a financial crisis. The LTF's emphasis on the role of law in dictating actions in a contemporary financial market should be contrasted with the standard economic and financial paradigm which focuses on the role of incentive in shaping the decision making process which becomes irrelevant or at least secondary in the implementation of the law.

Against this backdrop of contemporary finance's inherent instability fueled by fundamental uncertainty and balance sheet constraints, LTF proposes four interconnected propositions which further enhance our understanding of the relationship between law and finance.

Firstly, law is endogenous to finance. In other words, finance does not exist outside the legal realm. At the most basic level, an arm-length financial transaction relies on a legally recognized form of IOU in order to render it enforceable by regulatory authorities and ultimately by the court of law. Virtually all financial claims, once stripped off their complex languages, can be reduced to private contracts, often referred to as equity, debt, or derivatives. Some credible private organizations may play an important legislative role in some sectors of the financial system. The most notable instance of this is the International Swaps and Derivatives Association (ISDA) which represents major issuers and brokers of these instruments and publishes a standard form contract known as the "Master Agreement". Another significant party responsible for scalability of finance through law is transnational law firms who have utilized their local presence and connection in order to influence and lobby the legislature and regulatory authority for an adoption of legal principles which are crucial in protecting and furthering their clients' interest. A case in point is the failure to repeal or modify the bankruptcy safe harbor for qualified financial contracts (QFC) even if it has become clear that the special treatment afforded to the bankrupt's QFC counterparties hastened and exacerbated the GFC.[25] As a result, a contemporary finance would not be able to function as it does today without private laws of contract and trust, the state authorities that enforce these legally recognized instruments and adjudicate any potential disputes, and credible private rules which internationalize and harmonize financial practices around the world.

The construction of finance is always a dynamic process. Public law can be enacted to influence or change certain aspects of market structure, which in turn encourages private law innovations. This can be seen in the global foreign exchange market which has its genesis from an amendment to the 1974 Commodity Futures Trading Commission Act.[26] Moreover, regulatory arbitrage is responsible most for proliferation of contractual innovations. Every new iteration of the Basel Accord has led to new forms of financial products, such as collateral swaps and synthetic exchange-traded funds, designed specifically to minimize the impact of the regulatory capital

[25] Charles W Mooney, 'The Bankruptcy Code's Safe Harbors for Settlement Payments and Securities Contracts: When Is Safe *Too* Safe?' (Social Science Research Network 2014) SSRN Scholarly Paper ID 2457967 <http://papers.ssrn.com/abstract=2457967> accessed 2 May 2016; Mark J Roe, 'The Derivatives Market's Payment Priorities as Financial Crisis Accelerator' (2011) 63 Stanford Law Review 539.

[26] Pistor (n 21). at 321-322. For more details of the construction of the global FX market, see Rachel Harvey, 'The Legal Construction of the Global Foreign Exchange Market' (2013) 41 Journal of Comparative Economics 343.

requirements.[27] Precisely due to the fast-paced evolution of finance, public law needs to remain forever changing in order to remain enforceable and contain any potential detrimental effects.

In short, LTF claims that a contemporary financial system cannot possibly naturally occur. To the contrary, finance was made and bound within a dynamic system of rules.

Secondly, financial markets are both privately and publically constituted. Its hybrid property may be observed from just about every important facet fundamental to the structure of a financial system. State institutions play a number of decisive roles in all legally enforceable financial contracts from giving them legally binding force, providing a regulatory and governance scaffolding, and instituting a platform and procedure under which the disputing parties may resolve their differences. In lieu of a barter system in which people agree to exchange a good or service with another good or service in return, both the financial market and other economic sectors rely on the state-issued fiat money as a medium of exchange or the mean of final settlement. This observation holds for both a simple sale of a widget which money is used as a medium of exchange and a complex financial repurchase agreement in which money is treated as financial collateral. Lastly, it is the state through an entrusted agency such as the central bank who must stand behind and effectively guarantee all individual liabilities that ultimately make up the financial system. Tellingly, the role of lender of last resort cannot be practically performed by any private agents since they are bound by hard budget constraints and attain no authority to print the state money. In sum, finance is never purely private or purely public but necessarily hybrid.

Thirdly, finance is inherently hierarchical which makes the elasticity of law highly relevant. During the times when funding options are ample or when there are no shortage of market-based takers for non-cash assets, law and its rigid consequences may not appear a cogent consideration. In other words, a private financial institution does not have to contend with the problem of hard budget constraints even though it is a decisive factor that distinguishes a private agent from a sovereign state. Furthermore, private-issued "money" could be virtually freely traded as if it were as credible and safe as a state-made counterpart.[28] Such a blissful state of affairs effectively impairs or conceals the hierarchical structure of the financial system.

[27] Dan Awrey, 'Toward a Supply-Side Theory of Financial Innovation' (2013) 41 Journal of Comparative Economics 401.

[28] The story of credit rating during the crisis

Absence of viable funding availabilities and an exuberant market for non-cash assets, the inherent hierarchy of finance can be readily observed. Firstly, the crisis reveals that a private money that must eventually be paid or settled in another medium or mean of settlement does not attain the same status as the state-created fiat money itself. Secondly, in such times, budget constraints matter considerably. A private actor may decide to intervene and provide funding to or absorb outstanding liabilities of another private actor but only to the extent that its own survival is not at risk; hence, the private bailouts formulated for Long Term Capital Management in the late 1990s and Bear Stearns in the precursor to GFC. Only the ultimate lender of last resort in a given financial system can provide a backstopping mechanism sufficient enough to avoid a total financial calamity. Nonetheless, this does not mean any states can become the ultimate lenders of last resort for their own respective financial systems in all instances. At the international level or with regard to a globalized domestic financial system, the criteria of the global financial hierarchy remains 1) who controls the world's *de facto* reserve currency – the US Dollar; 2) whose existence is systematically important or deeply interconnected with that of the controller of the world's reserve currency; and then 3) who accumulates a large enough reserve currency pool to guarantee or back their own financial system.

Through analyzing the role of the lender of last resort at the apex of the hierarchy of finance vis-à-vis the other parties in the system, LTF asserts further that law in finance, be it private laws, privately formulated rules, or even public laws, is elastic. Elasticity of law is defined as "the probability that ex ante rights and obligations will be *relaxed or suspended* in the future; the higher that probability the more elastic the law."[29] Elasticity can be achieved by design through statutory incompleteness and regulatory and judicial interpretive discretion[30] which acts as a "safety valve" to ensure flexibility necessary to adapt the legal rules in response to unforeseen occurrences that cannot be accounted for ex ante. Facing with the urgency of managing the financial crisis however, public authorities, especially the central bank, have to take extraordinary steps that they would not have otherwise contemplated. The elasticity of law can thus be improvised ex post at the apex of the hierarchy but not at the periphery, which is not considered important to financial stability of

[29] Pistor (n 21). at 320.

[30] Annelise Riles, 'Managing Regulatory Arbitrage: A Conflict of Laws Approach' (2014) 47 Cornell International Law Journal 63. for an argument for affording the court and regulatory authorities necessary discretion to apply the Conflict of Law methodology to preempt or counteract harmful regulatory arbitraging practices.

the entire system. Ironically its unfortunate demise is critical in order to preserve the credibility of law.

Fourthly, law is a source of financial instability. Let's begin by examining the destabilizing role of law in a microeconomic relationship. Due to the two preconditions of contemporary finance expounded above, the rigid enforcement of contractual rights and obligations, in the time of crisis, heighten counterparty risks especially the risk of default and subsequent insolvency. A bank run is created by the depositors deciding to simultaneously invoke their right to withdrawal on demand. More crucially, law can become a source of systemic vulnerability especially when a contractual innovation have been successfully employed in order to arbitrage the regulatory framework and then duplicated en masse by the rest of the market, effectively amplifying the destabilizing effect of structural rigidity inherent in the contractual arrangement throughout the financial system. In addition, this effect of law has far-reaching global implications notably as the regulatory techniques are being harmonized, transplanted, and copied by the major financial systems while transnational law firms leverage their networks and connections to provide cost-effective compliance solutions to market actors around the world.

4. Towards the LTF Theory of Asian Financial Crisis

LTF provides a helpful lens which enhances our understanding of contemporary finance, and particularly sheds some necessary light onto the legal foundation of a financial system. This dissertation proceeds a step further by utilizing the conceptual building blocks of LTF to analyze the sudden rise and fall of "hot money" and its impacts on systemic stability in the context of a recipient developing economy. The hotness in this sense attains two important properties.[31] Firstly, it refers to the relative ease and fleetness it moves from one country to another. Secondly, it tends to increase the recipient's financial fragility. Indeed, it is associated with a higher likelihood of financial crises with noteworthy episodes of wide spread debt defaults, banking crises, and plummeting local currency values.[32] Crucially, hot money is widely considered the catalyst if not

[31] Anton Korinek, 'Hot Money and Serial Financial Crises' (2011) 59 IMF Economic Review 306. at 307.
[32] Carmen M Reinhart and Vincent R Reinhart, 'Capital Flow Bonanzas: An Encompassing View of the Past and Present' (National Bureau of Economic Research 2008) Working Paper 14321 <http://www.nber.org/papers/w14321> accessed 29 March 2016. at 25-38.

one of the major causes of the AFC.[33] As laid out in detail earlier in this chapter, Thailand experienced several episodes of hot money in the past two decades; first during 1990 and 1991, second between 1995 and 1996, and third from 2004 to 2006.[34] Yet, only one of these "bonanzas" transformed the country's systemic vulnerability to a full blown financial crisis.

Before elaborating the analytical framework of hot money, some premises and preconditions on which it rests must be stated from the outset. Since this conceptual sketch of hot money advances from the building blocks of LTF, it acknowledges the inherent stability of finance and its implications, namely fundamental uncertainty and balance sheet constraints.[35] In addition, the framework focuses specifically on the impacts of hot money on a specific class of recipients; the globalized developing economic nations. There are at least two commonly observable characteristics shared by the members of this class. Firstly, they all practice, despite some variations, financial market liberalization which entails at a minimum lifting restrictions on cross-border financial transactions. While some of these countries have in past decided to reverse part of the measures, such moves away from full liberalization by the developing countries are usually transient representing a step in an ex post crisis resolution plan.[36] Alternatively they encounter extremely negative market reactions and eventually have to be abandoned.[37] For the purpose of conceptualizing the operating framework of hot money, this first precondition indicates that the analysis cannot appease a financial system as a purely domestic, self-contained unit. In other words, the LTF building blocks must now incorporate into its rubric the governing architecture of cross-border financial activities, in addition to the legal foundation of private contracts and rules, and their respective regulatory framework.

Secondly, the conceptual model does not encompass all globalized or liberalized financial markets but specifically focuses on those systems within developing economies. By this, it refers to the

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[33] Korinek (n 30); Forbes and Warnock (n 11); Graciela L Kaminsky and Carmen M Reinhart, 'The Twin Crises: The Causes of Banking and Balance-of-Payments Problems' [1999] American economic review 473; Graciela L Kaminsky and Carmen M Reinhart, 'On Crises, Contagion, and Confusion' (2000) 51 Journal of international Economics 145.
[34] Reinhart and Reinhart (n 31). at 16. Kristin J Forbes *Capital Flow Volatility and Contagion* (n 8). at 14.
[35] Pistor calls this "liquidity constraints". See Pistor (n 21). at 316.
[36] For instance, Malaysia's capital control during the AFC. See Ethan Kaplan and Dani Rodrik, 'Did the Malaysian Capital Controls Work?' (National Bureau of Economic Research 2001) Working Paper 8142 <http://www.nber.org/papers/w8142> accessed 4 May 2016.
[37] Thomas Fuller and Wayne Arnold, 'Thailand Scraps Capital Controls after Stocks Plummet - Business - International Herald Tribune - The New York Times' <http://www.nytimes.com/2006/12/19/business/worldbusiness/19iht-baht.3954800.html> accessed 4 May 2016.

countries that do not have the authority to issue either world's reserve currency (US Dollar) or any other major currencies frequently adopted as a final means of settlement in the global financial system (such as the GB Sterling, EURO, and Japanese Yen). Furthermore, they are naturally stifled by hard budget problems, and as a result perennially subject to the risk of default on the outstanding foreign liabilities. To put it differently, the framework here concerns the countries that populate the peripheral space in the hierarchy of global finance and thus are beholden by the structural rigidity of the financial system, as opposed to the parties at or near the apogee whose authorities allow them to manipulate the elasticity of law.

Mindful of the preconditions laid out above, the LTF Theory of Hot Money (LTHM) posits that (1) law is a driver of the surges and reversals of hot money vis-à-vis the globalized developing economic countries. Not only can law drive the flows of hot money, (2) it also becomes a source of financial instability and can in certain cases instigate a financial crisis. Once the crisis unravels, (3) the recipient countries are hand-tied by the preconditions of the hierarchy of global finance and must accept the consequences of the full force of the law or rely on the parties residing in the higher position of the hierarchy to provide an adequate backstop or guarantee necessary to resolve the crisis. The rest of this section is devoted to unpacking the three aforementioned components.

(1) Law is a driver of hot money. In essence, the construction of hot money is strictly constituted in law, comprising of the governing structures which connect the source and the recipient of the capital inflows and the law and regulation that spurs private contractual innovations. The governing structures of cross-border financial transactions can do more than just liberalization. In addition, they attract certain activities to or discourage the others from financial markets or institutions, depending on the impacts on the private costs of compliance.[38] With regard to the latter, hot money at its core is a collection of specialized private contract which assign rights and obligations among counterparties. Furthermore, the contract also specifies scenarios or events which triggers certain consequential actions. It can bestow the creditor the rights to demand more collateral, or call on the full repayment of the principal. Instead of conferring rights, the triggers also insist on certain undertakings from the debtor after the predetermined contractual conditions have been met.

[38] Awrey and Pistor (n 21). at 5.

Obviously, not all cross-border activities should be classified as hot money since some of them do not invoke the destabilizing effects emanated from the structural rigidity in the financial system. Cross-border financial activities can be divided into four categories according to their potential to become channels for international financial contagions.[39] Firstly, the recipient and source countries may engage with each other in a bilateral trade relationship i.e. the former exports goods or services in return for monetary consideration. While a crisis in the source/importing nation weakens the exports and possibly the overall economic performance especially of the export-oriented counterpart, bilateral trade in and of itself does not destabilize the latter's financial soundness.[40] Likewise, a channel for contagion through portfolio investment generally does not implicate financial instability particularly since shares, stocks, and depository receipts for instance are equity-based which entails an ex ante legal partitioning of risk. Between 1991 and 1994, Thailand encountered a few large scale foreign withdrawals as a result of both internal and external factors, yet foreign investment in the Stock Exchange of Thailand bounced back and went on to reach a new high from the late 1996 to the beginning of 1997.[41]

Banks and lending institutions on the other hand are capable of aggravating systemic vulnerability for at least two reasons. They engage in fundamentally unstable undertakings of borrowing shorter-term funds to invest in financial assets with longer-term maturities. Crucially in the international capital market, the financing contract may stipulate to such extent that the maturity may not be a fixed date in the future but rather determined by an occurrence of a specified event in the future. Moreover, the governing structure of the financial system or the regulatory framework under which the lending and borrowing banks are subject can potentially influence the types of assets and liabilities they may legally hold on their balance sheets. Lastly, the financial contagion literature identifies the channel based on foreign investors' reappraisal of the recipient country's fundamentals. Nonetheless, strategic adjustment or reassessment in and of itself does not have a direct implication on financial stability. Rather, it is the implementation or repercussions of the legal codes embedded financial practices and assets that matter. In other words, a readjustment

[39] Forbes and Warnock (n 11). at 14.
[40] One of the reasons why most of Asian economies managed to quickly recover from the GFC is that they were affected by the drag of falling export demand and financing, as opposed to the structural problems in the region's financial system. See Takatoshi Kato, 'Implications for Asia from the Global Financial Crisis and Policy Perspectives, Remarks by Takatoshi Kato, IMF Deputy Managing Director' (Harvard Asia Business Conference, Boston, MA, 14 February 2009) <https://www.imf.org/external/np/speeches/2009/021409.htm> accessed 5 May 2016.
[41] Sources: World Bank, IMF, and the Bank of Thailand websites.

which leads to a sell-off of stock holdings should not be a cause of concern, while a decision to not roll over the short-time financing contract once the maturity has reached could potentially have a market-wide impact. The former concerns divestment of stock ownership, a legal right that does not invoke contingent or future liability per se. The latter, on the other hand, is a legal right as a creditor to demand repayment, executable regardless of the expectation or financial situation of the counterparty.

(2) Hot money is a source of instability and crisis. Not only can law drive and dictate the direction of hot money, but also does it in such a large quantity that a total and sudden reversal would leave the recipient country in a financial turmoil. To be clear, law as a socially invented device by itself cannot scale. The scaling is done by both public and private agents who enact, enforce, and take advantage of law and legal institutions. Take the following three examples. International law firms often adopt a common strategy or employ a similar contractual innovation throughout their global network to further their client's interests.[42] Regulatory convergence and transplant can inadvertently become a transmission channel of systemic vulnerability as the same repertoire of regulatory arbitraging techniques may now become prevalent across jurisdictions.[43] Furthermore, the financial governance structure may allow and even encourage certain kinds of financial transactions without due regard to the accumulative effect on systemic sustainability.[44]

[42] For the role of transactional lawyers in addressing (or exacerbating) the potential systemic consequences of their client's actions see Steven L Schwarcz, 'Lawyers in the Shadows: The Transactional Lawyer in a World of Shadow Banking' (2013) 63 Am. UL Rev. 157.

[43] A lack of regulatory competition in international securities regulation could lead to a race to the bottom. See Roberta Romano, 'The Need for Competition in International Securities Regulation' (2001) 2 Theoretical Inquiries in Law <http://www.degruyter.com/view/j/til.2001.2.issue-2/til.2001.2.2.1029/til.2001.2.2.1029.xml> accessed 5 May 2016; Roberta Romano, 'Against Financial Regulation Harmonization: A Comment' [2010] Yale Law & Economics Research Paper <http://papers.ssrn.com/sol3/papers.cfm?abstract-id=1697348> accessed 5 May 2016.

[44] For evidence that financial liberalization creates structural influence and give rise to new highly speculative units of investment in the context of the Mexican Peso Crisis in the early 1990s, see Moritz Cruz, Edmund Amann and Bernard Walters, 'Expectations, the Business Cycle and the Mexican Peso Crisis' (2006) 30 Cambridge Journal of Economics 701.

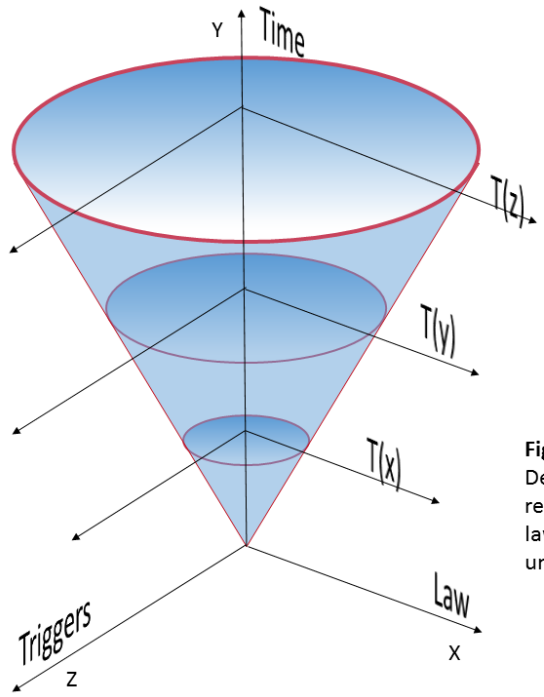

Figure 1: Stylized Depiction of the relationship between law and timing uncertainty

This unique scaling mechanism coupled with fundamental uncertainty provides law with a systemically destabilizing property. This characteristic is expressed by a function of the completeness of law in the horizontal dimension and its incompleteness in the vertical dimension. Consider the stylized depiction above. X and Z axes map the relationship between the law and the trigger which determines which law will be invoked in a given situation. The counterparties (in the case of private contractual arrangements) and regulated entities (in the case of public regulation of private activities) are able to deduce their rights and obligations from the respective governing legal documents that correspond with all relevant situations stipulated therein. Even when the black-lettered texts themselves are ambiguous, the law generally either provides a procedure to appoint or explicitly authorizes an arbiter who will then clarify such vagueness. In this sense, the law is internally complete. Law however is not complete when considering the time dimension (Y axis). Timing is a crucial part of law enforcement yet it is one of the uncontrollable factors and render the structural rigidity of law potentially systemically destabilizing. Timing is decisive even in a simple loan contract with a fixed maturity date for it is impossible to predict or know for certain the financial situation of the counterparties at the due date. Depositors with a contractual right to withdraw their cash on demand from the bank present another paradigmatic example of the time incompleteness of law. In other words, law tells the parties what to do under a given circumstance but *not when* to do it.

More pressingly for the present purpose, the time incompleteness of law leads to a serious coordination problem with regard to hot money. The law and legal institutions that make up the construction of hot money intensify the influx into the recipient country as long as it offer the most viable solution for their balance sheet challenges. Go back again to Figure 1, a recipient financial system may be perfectly content with being increasingly exposed to the contingent liabilities from becoming overly reliant on the hot money funding over time, i.e. from T(x) to T(z) where the surface of the circle represents the exposure to hot money. This is generally due to the fact that hot money is often represented by contractual arrangements that conceal the default risk or at least make it appear either insignificant or at least manageable. To illustrate, when adopting a standard form of certificate of deposit (CD) with a short maturity date of 1 to 6 months, the counterparties expect the contingent liabilities to be rolled over allowing the issuer to effectively skip the full repayment of the principal sum. Furthermore, if a longer term contract is adopted, it usually contains the so-called default clause that, once invoked, would shorten the maturity date. With the interplay between the timing uncertainty and the internal completeness of law, the recipient financial system could very well arrive at T(z) without enough cash or cash-like assets to satisfy the contractual obligations that have become outstanding due to changes of circumstances.

(3) Hot money exposes the hierarchy of global finance and precludes self-sustainability. Facing with a possibility of widespread default throughout the financial system and its detrimental socio-economic consequences, the recipient government would have to step in and provide backstopping support even if the crisis resolution management entails suspending the force of the law or stretching the reach of the legal framework so that the relevant authorities can adequately deal with the emergency situation at hand.[45] This autonomy over the domestic financial system and the capacity to provide adequate assistance is a hallmark of an agent at the apogee of the hierarchy of finance.

[45] Two recent examples can be drawn from the interpretation of the authority under section 13(3) of the US Federal Reserve Act of 1913 to intervene in the business of a nonbank (for instance, an investment firm) in the "unusual and exigent circumstances" and the legal ramifications including from the President of the ECB Mario Draghi's "Do Whatever It Takes" remark and the Outright Monetary Transaction program (OMT). See for instance, 'The History of a Powerful Paragraph | Federal Reserve Bank of Minneapolis' <https://www.minneapolisfed.org/publications/the-region/the-history-of-a-powerful-paragraph> accessed 6 May 2016; 'ECB's "Whatever It Takes" May Be Too Much for German Top Court - Bloomberg' <http://www.bloomberg.com/news/articles/2016-02-15/ecb-s-whatever-it-takes-may-be-too-much-for-german-top-court> accessed 6 May 2016.

Nevertheless, a recipient country of hot money in the proposed conceptual model do not enjoy such luxury. Confined by the conditions of the hierarchical organization of international finance, its central bank can no longer bail out the financial system and must rely on three available second-best options. Firstly, its financial wherewithal to do so is constrained by the amount of foreign reserves which can be readily traded into the cash assets required as a mean of final settlement. Even though the reliance on foreign reserves accumulation is the most self-sustainable option, it is also the most restricted and has in many past crises been proved grossly lacking. Secondly, the recipient country may pre-empt the devastating consequences of hot money exposure by carefully managing of its own currency valuation. By having an inflexible currency regime, the government essentially subsidize the external costs of hot money and as a result inadvertently encourages the gravity of the potential problem. In many export-oriented countries, the currency management policy is an important tool of the government's economic policy in order to support its fledging industrial and manufacturing sector such that an idea of abandoning the currency exchange regime could potentially encounter political backlash and possibly legal challenges in either the court of justice or administrative court. Thirdly, the recipient state, which has exhausted every self-sustainable avenue, could be reasonably assured of support from the foreign counterparts or international communities which are financially interconnected meaning that the demise of the former's financial system would have catastrophic contagious ramifications in the latter. The financial assistance may be forthcoming in several ways. In a legally formed regional bloc, the central banking authority may have a legal duty to provide a bailout for a crisis-hit member state. In a less formalized regional system, the obligation to intervene could be detailed in a soft-law instrument signed by the technocratic representatives and endorsed by the political leaders. Absent a supranational or intergovernmental structure, economic, political, and even social ties could prompt a powerful ally to intervene. A case in point is the US involvement in the Mexican Peso Crisis in 1994. Despite no legal obligation to act, it is argued that the US administration had no choice but to support the Mexican currency due to the economic and political situations at the time.[46] The US has been an important trading partner accounting for more than 60 percent of the Mexican total trade value in the 1980s, which increased even further to 74.9 percent in 1994 after the NAFTA was signed in December 1992. More importantly, the Clinton administration, which

[46] Saori Katada, *Banking on Stability* (The University of Michigan Press 2001) <http://www.press.umich.edu/17336/banking_on_stability> accessed 18 May 2015. at 152.

had strongly supported this trade agreement with Mexico, faced the presidential election in 1996 and thus had vested interests to ensure that the Mexican economy was seen as a success. Crucially, the Mexican government was well aware of the intertwining fate between the two countries and was confident of the spectacular rescue package that soon followed.[47]

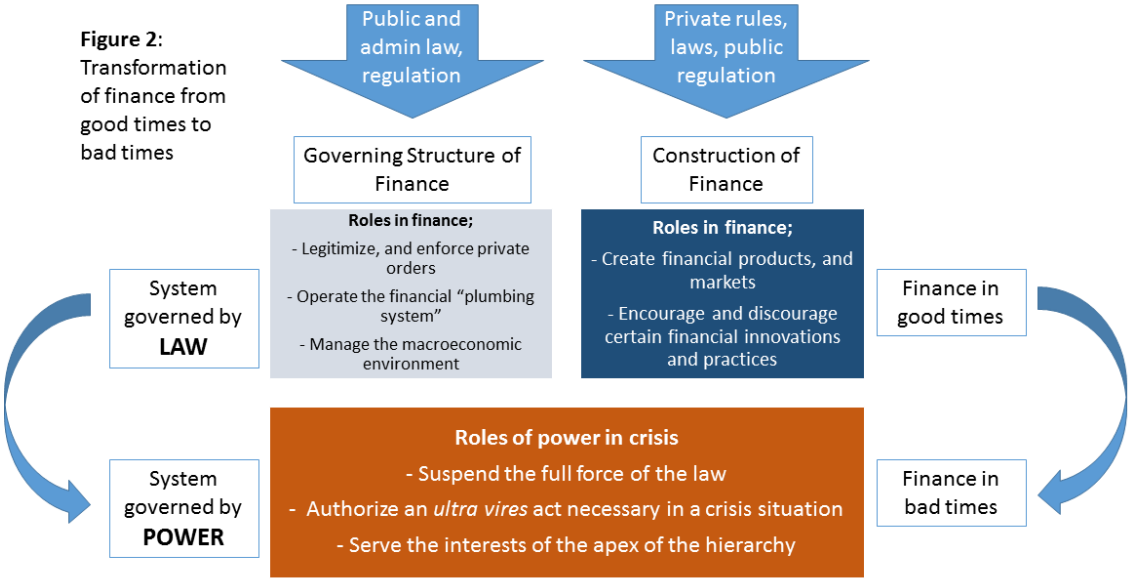

Figure 2: Transformation of finance from good times to bad times

Failing all three aforementioned second-best solutions, the recipient country of hot money is left fully exposed to the repercussions of the hierarchical structure of global finance in which the interplay between law and power is most salient. Without means to support its own financial system, the crisis-hit nation must rely entirely on the third parties' discretion to avoid a full blown crisis. Power in finance operates in a sharply different manner from law. Unlike law which is exercised according to the rules enacted ex ante, power operates in an ex post fashion often without being legally obliged to do so.[48] The role of power is to supplement the deficiencies of a system governed by law in the time of crisis. It does so by both relaxing legal rigidity and reinterpreting legal authorities such that an unprecedented action can then be taken in order to resolve the ongoing precarious situation. Most crucially however, the power dynamics will be exercised solely to further and protect the self-interests of the parties at the apex of the system. In most of the times it

[47] ibid.
[48] Pistor (n 21). at 323.

has been done so without any due regard to the long term prospect of the requesting nation or the welfare of the entire international community unless the survival of the latter is somehow implicated in the safety and soundness of the former's financial system. Even after the major legislative and organizational reform in the mid-2000s, the IMF Articles of Agreement still states as an important condition for authorizing fund financing that the requesting member state must be able to satisfactorily demonstrate that it can repay within *the relatively short timeframe* mandated under the Articles.[49] Another example of self-serving exercise of power can be observed from the temporary authorization of dollar liquidity swap lines by the US Federal Reserve in response to mounting pressures in bank funding markets. While this was well within its statutory power stipulated in section 14 of the Federal Reserve Act, the Fed's decision to extend the facilities to some but refuse the other requesting nation was based solely on its objective to buttress the functioning of the international dollar funding market, and thus its role as the world's reserve currency.

A moment should be spared to clarify an assumption made by LTHM regarding the role of the state vis-à-vis its domestic financial system. The state, as a holder of national sovereignty, is entitled to exercise its discretion, including declining to nationalize private foreign liabilities incurred by the domestic financial institutions. Obviously, the foreign creditors do not realistically have a recourse against the state in the local court and thus must rely on the foreign court to enforce the contractual obligation, but only if the latter is mandated by the parties' choice of forum.[50] The decision to default or abandon the problem of debt overhanging is undoubtedly not without its myriad of repercussions. For a start, the country, both public and private sectors, may find it difficult to find external funding sources after the debt default and potentially disputes with the foreign creditors. A recent case in point is again Argentina and its sovereign debt crisis which last over 15 years before the country could re-enter the international financial market in 2016 after the government reached an agreement with the holding out creditors.[51] In addition, a collapse of the

[49] Articles IV and V, the IMF Articles of Agreement together require the Fund to ensure "adequate safeguards" are in place to guarantee the timely repayment.

[50] See for instance, *Republic of Argentina v. NML Capital, Ltd. 134 St.Ct. 2550 (2014)* in which the US Supreme Court ruled that the US Foreign Sovereign Immunities Act of 1976 does not provide a foreign-sovereign judgement debtor with immunity from post-judgement discovery of information concerning its extraterritorial assets.

[51] Elaine Moore, 'Argentina Returns to International Markets with $16.5bn Debt Sale' *Financial Times* (20 April 2016) <http://www.ft.com/intl/cms/s/0/67603844-0637-11e6-9b51-0fb5e65703ce.html?siteedition=uk> accessed 7 May 2016.

domestic financial market could cause a disastrous disruption in the real economic sectors which depend on the former for funding as well as lead to an array of wide-ranging socio-economic problems. As a result, the model assumes that despite its sovereign power, the state would want to avoid the consequences of foreign debt default.

5. LTAFC and the Standard Stories of the Crisis

In some ways, it is not difficult to see why the standard accounts of the AFC have completely dominated both academic and policy discussions since the crisis erupted over 19 years ago. The stories have provided much needed justification to certain rhetoric favored by interest groups in both professional circles. The bad government story or in a more technical term the state capture narrative[52] has become political ammunition for local politicians to run an electoral campaign based on the populist anti-establishment platform.[53] Likewise, it has served well the interests of large multinational corporations which have constantly been arguing for better protection of their investment and property rights in the developing countries.[54] Furthermore, the academic community is awash with both sides of the literature arguing for and exercising cautions against the effects of economic and financial globalization, especially its impacts on developing countries.[55] The debate has since influenced the development agenda of many international organizations such as the UN, World Bank, and OECD as well as shaped the reform initiatives of the international economic governance landscape.

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[52] Joel S Hellman, Geraint Jones and daniel Kaufmann, '"Seize the State, Seize the Day": State Capture, Corruption, and Influence in Transition' (The World Bank 2000) Policy Research Working Paper Series 2444 <https://ideas.repec.org/p/wbk/wbrwps/2444.html> accessed 7 May 2016; Joel S Hellman and Daniel Kaufmann, 'Confronting the Challenge of State Capture in Transition Economies' (2001) 38 *Finance and Development | F&D* <http://www.imf.org/external/pubs/ft/fandd/2001/09/hellman.htm> accessed 7 May 2016.

[53] Jephraim Gundzik, 'Thaksin's Populist Economics Buoy Thailand' *Asia Times* (3 August 2004) <http://www.atimes.com/atimes/Southeast_Asia/FH03Ae01.html> accessed 7 May 2016; 'Thaksin's Way' [2005] *The Economist* <http://www.economist.com/node/3623091> accessed 7 May 2016.

[54] Many economists adopted the corporate governance measurement as an indicator of economic prospects. See for instance, Simon Johnson and others, 'Corporate Governance in the Asian Financial Crisis' (2000) 58 Journal of Financial Economics 141; Rafael La Porta and others, 'Investor Protection and Corporate Governance' (2000) 58 Journal of Financial Economics 3; Stijn Claessens, Simeon Djankov and Larry HP Lang, 'The Separation of Ownership and Control in East Asian Corporations' (2000) 58 Journal of Financial Economics 81.

[55] For the proposition of globalization, see, for instance, Jagdish Bhagwati, *In Defense of Globalization: With a New Afterword* (Oxford University Press 2007).; for the rebuttal, see Joseph E Stiglitz, *Globalization and Its Discontents*, vol 500 (New York Norton 2002).; and for a more nuanced approach: Dani Rodrik, *One Economics, Many Recipes: Globalization, Institutions, and Economic Growth* (Princeton University Press 2008); Joseph E Stiglitz, *Making Globalization Work* (WW Norton & Company 2007).

Nevertheless, not only have the standard accounts not managed to successfully answer all the puzzles posed at the beginning of this chapter, but also their intellectual foundation is susceptible to reexamination despite the enduring popularity. To this end, the dissertation argues that the standard theories of the AFC are based on a fundamental misinterpretation of the nature of contemporary finance. Behind the colorful anecdotes, both theories are effectively logical derivatives of the neoclassical economic thinking which champions a quest to achieve the market efficient utopia. By this, the proponents of this school of thought claim that the principal function of the market is allocation of economic resources. In order to perform this role well, we as a society must strive to create a market in which prices fully reflect all available information which allows for firms and investors to make efficient investment decisions.[56] The state capture story is therefore a case of moral-hazard induced market failure. It has been argued that the state explicitly or otherwise gave guarantees to financial institutions resulting in the latter's reckless behaviors.[57] There have been many plausible bases for the said guarantees ranging from an honest desire to protect the saving public to nepotistic and outright corrupt dealings in favor of politically connected associates.[58] On the other hand, the globalization-writ-large version of the crisis took inspirations from the famous market-for-lemons problem and a classic Diamond-Dybvig model of a bank run.[59] The former would consider the Asian debt market akin to Akerlof's market for used cars. The collapse came through adverse selection which effectively drove away fundamentally sound and carefully managed prospective debtors out of the market. In addition, the AFC has also been compared with a situation of a panic run in which the lack of reassuring information regarding future viability of Asian, as an investable asset class, was so stark that the only rational choice each creditor can make is to flee the region.

Regardless of the varying details, both theories make two interrelated assumptions; firstly, that the incentive structure together with the financial decision making process drives financial outcome; and secondly, that an informationally efficient market is crisis-free. Unfortunately, both do not

[56] Burton G Malkiel and Eugene F Fama, 'Efficient Capital Markets: A Review of Theory and Empirical Work*' (1970) 25 The Journal of Finance 383. at 383.
[57] Paul Krugman, 'What Happened to Asia?' <http://web.mit.edu/krugman/www/DISINTER.html> accessed 13 December 2013.
[58] Krugman (n 3).
[59] George Akerlof, 'The Market for Lemons: Qualitative Uncertainty and the Market Mechanism' (1970) 84 Quarterly Journal of Economics; Douglas W Diamond and Philip H Dybvig, 'Bank Runs, Deposit Insurance, and Liquidity' (1983) 91 Journal of Political Economy 401.

reflect the reality of how finance operates today. First of all, contrary to what most law and economic proponents might have said[60], incentive only has a limited influence (if at all) on the outcome in a legally constituted system of finance. Once a financial arrangement is formalized in an enforceable, legally recognized form, the legal codes embedded in such an instrument and the governance framework which provides a structural foundation for the entire financial system dictate the outcome, many times, in contrary to the intention of the contractual parties themselves.[61] Crucially, this particular manifestation of finance is by design, and not a result of a spontaneous, naturally derived phenomenon. Both market participants and the states need the legal system to grow finance beyond its embryonic relationally based gathering of seasoned financiers and their close affiliates.[62] As a consequence, incentive can only come into play if and when the conditions of the legally binding arrangement so allow.

This brings us to the next interrelated misconception regarding finance. It is submitted that efficiency does not necessarily reduce or offset the likelihood of a crisis. Precisely due to the role of law *in* finance and the fact that incentive plays an insignificant part in financial outcome, the tendency of a crisis is neutral to informational efficiency. A market participant can possess both perfect information and impeccable computational skills to process the cornucopia of materials he has, and yet he is compelled by law to make a systemically destabilizing decision. For instance, a foreign institutional creditor could be forced by a triggered contractual clause to make an untimely decision whether or not to exercise his contractual right to terminate the financing contract, knowing that the regulatory dynamics of its own balance sheet would result in its reaching a conclusion that would heighten the default risk of the counterparty. To put it differently, the AFC could have still happened even if the Thai financial system were considered as an efficiently run unit. As argued in the first section of the chapter, the Thai economy, financial market, even the Thai politics in the 1990s had been vastly improved compared to the preceding decades.

[60] Most notably, Ronald J Gilson and Reinier H Kraakman, 'The Mechanisms of Market Efficiency' (1984) 70 Virginia Law Review 549; Porta and others (n 22).

[61] The only exception to this is during the time of crisis when, if the crisis is to be avoided, power must take the center stage and as a result, law shall be suspended.

[62] To be clear, this is a totally different and should be distinguished from the standard law and economic claim that law is considered a tool or an institution that provide credible commitment. See for instance in the context of the financial crisis in the developing countries: Barry Eichengreen and Ricardo Hausmann, 'Exchange Rates and Financial Fragility' (National bureau of economic research 1999) <http://www.nber.org/papers/w7418> accessed 9 May 2016.

Getting the basic conceptual foundation right matters not just for the sake of argument but is also hugely consequential to the crisis resolution management and subsequent reform initiatives intended to address the systemic shortcomings. The much excoriated, heavy-handed approach of the IMF intervention was partly rooted in the standard thesis since it was designed – albeit falsely – that drastic structural measures including weeding out bad banks and finance companies would reignite efficiency and reinstate market confidence. Furthermore, all domestic and regional financial reform agendas since have been devised and implemented based principally on the neoclassical misinterpretation of the financial system we have at the present. In other words, while the subsequent reforms such as the new corporate governance and prudential regulatory frameworks are certainly worthwhile, they do not have a direct effect on the propensity of future crises since they were founded upon a mistaken conception of the root cause of the AFC.

6. The Structure of the Dissertation

The methodological approach adopted by this dissertation requires some justification. As previously stated, the thesis proceeds via an in-depth case study of the Thai financial system as it went through the period of financialization in the running up to the AFC, then addressing the unfolding of the crisis itself, before critiquing the crisis resolution process. The project consciously avoids adding any comparative component or adopting a survey of various crisis-hit countries for several reasons. This research approach, consistent with LTF and its intellectual heritage, depicts all financial crises such as the AFC as a highly complex socio-economic phenomenon that is unique to each locale. The Korean experience of the AFC could possibly rest upon the peculiar nature of its industrial conglomerates, the chaebols", while the Indonesian counterpart allegedly revealed a total failure of its corporate governance structure. While it is true that if they are analyzed using the LTF-inspired framework depicted above, we can identify common themes, and patterns but only in expense of nuances and details of a single case study. For instance, a comparative or a survey study may not be able to critically analyze the role of law in instigating two mutually reinforcing, simultaneous crises in both the currency exchange market and in the banking sector, since it is difficult if not impossible to design an appropriate research framework that account for all independent variables and still adopts the LTF framework. What generally happens is that scholars who study financial crises across time and place had to sacrifice some

amount of reality through adopting assumptions which abstract from reality or rely on statistical analysis.[63]

Rather, this dissertation aims to explain how law shapes the financial system through various stages of market development. It controls cross country variables by specifically focusing on the case of Thailand and uses the AFC as a catalyst for change of development direction. Prior to the AFC, the Thai government adopted an expansive, aggressive, and outward looking agenda which resulted in both institutional and instrumental functions of law shaping the rapid financial growth in total disregard of other essential developmental criteria such as financial sustainability and resiliency. After the crisis, the financial development policy has drastically been altered such that financial expansion becomes conservative, domestically oriented, and self-contained. Such changes have been influenced both as a result of the government's conscious policy making process as well as by large local financial institutions which have lobbied for more time to become internationally competitive. As Thailand moves from the era of financial liberalization in the early 1990s to financial consolidation in the 2000s and now towards the dawn of financial integration with the ASEAN Economic Community (AEC), the current construction of finance will once again be put to test.

To that end, the structure of the dissertation runs as follows. Immediately after this introduction, Chapter 2 explores the legally constituted scaling mechanism of Thailand's domestic financial system. Specifically, the investigation plans to trace the building up of systemic vulnerabilities, explain why such vulnerabilities are found in law, and finally to demonstrate the disastrous consequences of LFP which manifested itself in the form of currency and banking crises. The assessment of the Thai experience of the AFC would not be completed without a section devoted specifically to the international aspect of the crisis. Chapter 3 shows that both the domestic scaling mechanism as well as the unraveling of the AFC shown in Chapter 2 had a mutually reinforcing impact with the international funding markets. In doing this, the chapter deconstructs the funding channel that linked up the Thai banking system through a group of destabilizing intermediaries incorporated in a third party jurisdiction (Hong Kong) with the sources of funding primarily in South Korea and Japan, two major investing countries in both the Thai economy and specifically

[63] A well-known example of this type of research is Carmen M Reinhart and Kenneth S Rogoff, *This Time Is Different: Eight Centuries of Financial Folly* (Reprint edition, Princeton University Press 2011).

its financial sector. The chapter argues that the volatility in the international funding market in this case came from the interaction between the institutional setups of the borrowing and lending financial sectors on the one hand and on the other hand the Hong Kong-based intermediaries' business strategy designed purely to take advantage of incentives and arbitraging opportunities present in their clients' jurisdictions. Chapter 4 critiques the AFC resolution management strategy of the international community spearheaded by the IMF. The analysis centers on the hierarchy of global finance which can explain, from the borrowing country's perspective, the harsh treatment imposed upon by the lending parties. Chapter 5 takes stock of the lessons learned from the LTF assessment of the AFC and attempts to predict the impacts of financial integration brought about by the AEC on Thailand's financial sustainability and robustness. The dissertation then concludes by summarizing its contribution to the academic literatures on the AFC, financial integration, and to the LTF framework itself. In addition, it proposes ways in which the insights from this project may inform future research endeavors on the related subjects as well as be beneficial to the current policy making frameworks of Thailand and the South East Asian region.

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