

From Financial Liberalization to Financial Integration:
A Legal Theory of Finance Reinterpretation of the Asian Financial
Crisis and the Implications for the Future of Thailand and South East
Asia

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ABSTRACT

From Financial Liberalization to Financial Integration: A Legal Theory of Finance Reinterpretation of the Asian Financial Crisis and the Implications for the Future of Thailand and South East Asia

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This dissertation explores the role of law in the financial development of an emerging economic country. Its main proposition is that law plays a fundamental part in both the construction and the subsequent failure of a financial system, in addition to the function of reducing frictions and distortions in order to maintain the orderly running of the market. The dissertation illustrates the aforementioned proposition with an in-depth case study of the Asian Financial Crisis (AFC) which was initially rooted in the Thai financial sector. Aided by the analytical paradigm offered by Legal Theory of Finance, it parses the legal and institutional aspects of the rapidly developing financial markets in Thailand and her investing partners. This allows the ensuing Crisis to be seen from the previously underexplored institutional underpinning of the volatile financial cycle which characterized the region at the time. Subsequently, the dissertation employs the same intellectual framework in order to explain the post-crisis reform initiatives and their systemic implications for the regional financial architecture under the auspices of the Association of the South East Asian Nations. This dissertation cuts across a number of disciplines: law and finance, law and economic development, financial and banking regulation, international financial law, to name but a few.

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List of Abbreviations

| | |
|-------|---|
| ADB | Asian Development Bank |
| AEC | ASEAN Economic Community |
| AFC | Asian Financial Crisis |
| AMF | Asian Monetary Fund |
| ASEAN | Association of South East Asian Nations |
| BIBF | Bangkok International Banking Facility (Thailand) |
| BIAC | Bond Issue Arrangement Committee (Japan) |
| BIS | Bank of International Settlement |
| BTA | the Bank of Thailand Act of 1942 (Thailand) |
| CBA | the Commercial Banking Act of 1962 (Thailand) |
| CD | Certificate of Deposit |
| CMI | Chiang Mai Initiative |
| CMIM | Chiang Mai Initiative Multilateralization |
| FIBA | the Financial Institutions Business Act of 2008 (Thailand) |
| FIDF | Financial Institutions Development Fund (Thailand) |
| FSCFA | the Finance, Securities and Credit Foncier Act of 1977 (Thailand) |
| FSF | Financial Stability Forum |
| IASC | International Accounting Standards Committee |
| IAIS | International Association of Insurance Supervisors |

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| IMF | International Monetary Fund |
| IOSCO | International Organization of Securities Commissions |
| IPA | the Investment Promotion Act of 1979 (Thailand) |
| LTF | Legal Theory of Finance |
| MRR | Minimum Retail Rate |
| OECD | Organization of for Economic Co-operation and Development |
| PIBF | Provincial International Banking Facility |
| PFIL | Peregrine Fixed Income Limited |
| SBA | Standby Agreement (IMF) |
| SET | Stock Exchange of Thailand |
| SICAV | Societe d'Investment a Capital Variable (Luxembourg) |
| UCITS | Undertaking for Collective Investment in Transferable Securities (EU) |

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This dissertation would not be possible without the guidance and support of Professor Katharina Pistor, the supervisor of this doctoral project. Her Legal Theory of Finance illuminates readers including myself to contemplate the construction of contemporary finance with a new perspective and to strive every day to remain ever so curious about the world in which we live. In addition, I would like to place my sincere gratitude for constructive comments and words of encouragement of my committee members: Professor Robert Jackson Jr., Professor Dan Awrey, and Professor Anna Gelpern. I am truly proud and humble to be in company of these four learned legal scholars.

I was barely 12 years old when the Asian Financial Crisis struck Thailand. Yet even for a small child, the scenes of devastation were not difficult to perceive. A number of motionless tower cranes filled the Bangkok skyline. On the street, there was a sea of desolated faces of both white- and blue-collar workers who had just been made redundant. In the countryside, paddy fields were left unattended because farmers had lost hope for a better future. Evidently, the Asian Financial Crisis is far more than just an academic topic. A repeat as a result of failure to heed the lessons from such a historic event would be catastrophic. In a way, this dissertation, which was partly funded by Thai taxpayers' money, was written in honor of that lost generation of Thai people and as a proof that their hardship did not go in vain.

Last but not least, this doctoral project is a culmination of a 30 year long journey, which started from a sleepy town on the southeastern coast of Thailand and ended in Morningside Heights of New York City. It owes so much to so many people along the way, both personally and professionally. As this journey concludes, a new one begins boosted by a dash of optimism in meaningful changes that tomorrow will bring.

For Mom and Dad

Chapter 1 - Paradigm Shift: Exploring Law in Finance through the AFC

1. Introduction

Amidst a typical downpour of the gloomy monsoon season in July 1997, the Bank of Thailand governor announced that the Bank would cease its open market forward swaps operation in the currency market. This announcement meant that for the first time in the country's history, the market force would determine the price of Thailand's national currency, the baht. While this dramatic move by the central bank had been widely anticipated, its significance can never be understated. The Asian Financial Crisis (AFC) thus represented the death of one of the so-called Asian Tigers.

Thailand had seen an extended period of economic expansion, representing one of the fastest growth rates in the world. During this remarkable rise, millions of people were lifted out of poverty while Thai corporations and industrial manufacturers had gained enough confidence and expertise to compete on the international level. Furthermore, the financial sector went through a complete transformation from a group of small, trade-oriented merchant banks to an industry full of sophisticated financial institutions raising billions of dollars and investing in various large-scale economic projects, ranging from housing developments to industrial parks. Even by 1996, the bullish sentiment could still be felt along the government building corridors, in corporate boardrooms, and among stock brokers on the trading floor. After that faithful morning in July 1997, the Crisis left a trail of socio-economic destructions, which have scarred the country until today. Corporate bankruptcy across all economic sectors inevitably caused widespread layoffs leading to a spike in the national unemployment rate. Many construction projects were abandoned,

remnants of which can still be witnessed throughout Bangkok and in major provincial cities. The ultimate question to ponder therefore is what caused the Crisis of this historic magnitude in a country that had been, up until that point, lauded as a prototypical example of the Asian Miracle.

This dissertation revisits the historic phenomenon through a new perspective of Legal Theory of Finance. LTF observes the reality of contemporary finance as a social system that is constantly suffered from fundamental uncertainty, and liquidity constraint. This chapter introduces three major issues that inspire the dissertation. Firstly, it states the research puzzle it tries to solve. In gist, the dissertation proposes a new explanation of the AFC by analyzing the legal structure of the Thai financial system and its implications for the AFC. Secondly, it lays out the building blocks of LTF and demonstrates the way in which the analytical framework provided by LTF offers a new interpretation of the cause and mechanism of the AFC. Lastly, it surveys a range of existing explanations of the AFC. While these conventional theories have advanced the understanding of the financial systems and crises in various ways, none of them have attempted to directly resolve the research question of this dissertation. Nevertheless, it should be stated from the outset that this research project does not directly address the theoretical inquiry into the ultimate merit or validity of the intellectual school of thought underpinning the mainstream theory of the AFC. Such a topic is outside the scope of this dissertation, although some passing references may be forthcoming but only for the purpose of clarification.

2. The Institutional Autopsy: a missing link

The primary objective of the dissertation concerns the analysis of the legal structure of financial systems and the implications for financial crises. Adopting the qualitative research methodology to explore the aforementioned connection, it chooses the AFC as a case study to investigate the legal and regulatory underpinning of the Thai financial system and its role in instigating the AFC.

To this end, it is submitted that what the current explanations of the AFC have been missing is an in-depth institutional assessment of the construction of both Thailand's domestic financial system and the international capital market. Furthermore, the institutional approach provides a new dimension to the study of the AFC primarily by answering three important questions regarding the causes and effects of the AFC that have so far been left largely unanswered.

In the first place, it is unclear why Thai banks had suddenly overextended themselves in the early to mid-1990s. The said development was hardly based on the economic fundamentals. The banking sector did not grow at such an exceptional rate during the peak of economic expansion in the late 1980s, compared to what happened in the first half of the 1990s. In addition, the fact that the government encouraged the external capital flow represented just the demand-side explanation without the supply-side story. Even though some commentators have identified the linkage between the financial crisis and a bubble in the property market¹, the historical record tends to show that the inflated real estate market is a symptom rather than the underlying cause of the ensuing crisis itself.²

Secondly, the evidence of the significant amount of capital inflow into the Thai financial system in the early 1990s requires an explanation. In contrast with the situations in neighboring countries, Thailand experienced a disproportionately high volume of external short-term lending in the same period of time. The mere fact of lifting capital control was thus too crude a measure to account for the reality of the situation since it did not help us differentiate the types of capital inflow. Nor did it explain why the AFC started from the factors internal to the Thai financial sector as opposed to

¹ Mr A Senhadji Semlali and Mr Charles Collyns, *Lending Booms, Real Estate Bubbles and the Asian Crisis* (International Monetary Fund 2002).

² Charles P Kindleberger and Robert Z Aliber, *Manias, Panics and Crashes: A History of Financial Crises*. (Palgrave Macmillan 2011).

the factors associated with other subsectors in the economy. While some recent academic writings have made an attempt to rationalize the attractiveness of short-term lending in the financial sector³, they tend to focus solely on either the firm-level analysis⁴ or the monetary policy distortion⁵. Despite the aforementioned body of scholarly work, little has been explored regarding the institutional structure of both the domestic Thai financial system and the foreign counterparts along the channel of capital flow.

This lack of a more detailed institutional analysis connects neatly with the third observation of the underlying causes of the rapid buildup of liquidity surplus in the international capital market prior to the AFC. Most of the works on the capital flow volatility concerned themselves primarily with the measures of volatility.⁶ Even when attempting to deduce the determinants of the phenomenon, they tend to consider the nature of volatility as a type of external shocks such as a global oil price spike or a sudden change in the macroeconomic policy of the US Federal Reserve, or an outbreak of a global violent conflict.⁷ Rather than observing the capital flow from this perspective, the dissertation proposes an alternative approach, which is to try to make sense the institutional origin of the global capital surplus as related to Thailand prior to the AFC.

³ For instance, Kanit Sangsubhan, 'Managing Capital Flows: The Case of Thailand' [2008] ADB Institute Discussion Paper Series. at 2-3.

⁴ 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.

⁵ Valentina Bruno and Hyun Song Shin, 'Capital Flows and the Risk-Taking Channel of Monetary Policy' (2015) 71 *Journal of Monetary Economics* 119.

⁶ Maria Sole Pagliari and Swarnali Ahmed Hannan, *The Volatility of Capital Flows in Emerging Markets: Measures and Determinants* (International Monetary Fund 2017).

⁷ *ibid.*

In addition to the three observations of the current theory of the AFC above, the dissertation also invites the readers to pause and reconsider the classic notion that the financial market, if left by itself, will eventually right its course as well as whether the state has a role to play in maintaining financial stability.

In the context of economic development, the governments in developing economies are typically advised to deregulate and retreat from the market. In addition, the role of the government is believed to be limited to reducing transactional costs, enforcing legal obligations, and lifting existing market restrictions.⁸ Yet, if the construction of financial market is more complex than merely horizontal aggregation of offers and acceptances, the role of the central authority or state has to extend beyond providing validation and correcting market frictions. Surely, the foreign capital did not flow into the Thai financial system simply because the Thai government lifted the capital control. A mere fact of liberalization does not explain either the amount or type of inflow. Nor does it give us any hints regarding the identities of domestic borrowers and foreign creditors. All market actors operate under the legal and regulatory conditions imposed by public authorities in their respective jurisdiction. Consequently, their business strategies are shaped as much by the profit maximization objectives as the needs to avoid being subject to unnecessary regulatory burdens. In other words, contemporary finance evolves as private actors innovate new practices and products to circumvent the restrictive governance structure. In response, the state reacts to those innovations in so far as they pose a significant risk to the systemic stability. To this end, it is imperative that an analysis into the nature of contemporary finance, the AFC included, must treat both institutional and transactional aspects as constitutive parts of the story.

⁸ World Bank, *The East Asian Miracle: Economic Growth and Public Policy*. (Oxford University Press 1993).

3. Recent Trends and Developments in the Asia Pacific region

In addition to the proposed new approach to the study of financial crisis, the recent financial and economic progress in the Asia Pacific region in the past two decades have given a contrasting picture to the situation in the previous decade. There are at least two significant issues emerging in the intervening time period.

The first key development is unfortunately another major crisis in the Global Financial Crisis in 2008-9. Prior to 2008, the Asia-Pacific region experienced a renewed round of intensified cross-border capital inflow, prompting leading economists in the field to label this decade a period of extreme capital flow volatility.⁹ Had the history repeated itself, Asia should have followed the US and Europe into a deep financial trouble. Yet, even with the cataclysmic disruptions to the international capital market brought after 2008, many developing countries in the region, notably Thailand – the epicenter of the previous crisis – fared far better than other more advanced neighbors such as South Korea and Singapore.¹⁰ The post-2009 turnaround was quite remarkable considering the fact that all three countries encountered sudden reversals of foreign capital inflow.¹¹ Overall, despite slumps in the GDP growth particularly as a result of collapses in international trade, the emerging Asian economies have recovered more quickly than their

⁹ Kristin J Forbes, 'Capital Flow Volatility and Contagion: A Focus on Asia' (2012) MIT Sloan Research Paper <<http://papers.ssrn.com/abstract=2185011>> accessed 7 March 2016; Kristin J Forbes and Francis E Warnock, 'Capital Flow Waves: Surges, Stops, Flight, and Retrenchment' (2012) 88 *Journal of International Economics* 235.

¹⁰ 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.

¹¹ Fernando Broner and others, 'Gross Capital Flows: Dynamics and Crises' (2013) 60 *Journal of Monetary Economics* 113.

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.¹² On the other hand, the literature on international financial contagion suggested that developing East Asian countries were more internationally connected through trade linkages. By contrast, the more developed Asian financial systems were exposed to the US and European markets through investments in toxic assets such as subprime mortgage backed securities, money market funds, and sovereign bonds.¹³ The discussion in the subsequent chapters of the dissertation on the impact of the Global Financial Crisis in Asia helps build two contrasting pictures of the two crises, which contributes to a better understanding of both destabilizing factors and the mechanism of the crisis itself.

Another important consideration arising from the most recent crisis is the way in which the international community intervened to support developing countries that had been exposed to the torrent of international finance. While the economically advanced nations may have a large enough balance sheet to absorb any contingent liabilities and losses sustained during the crisis, smaller countries restricted by “harder” budget constraints were suddenly faced a balance of payment.¹⁴ In other words, they were no longer able to provide financial subsidies or other supporting instruments to domestic enterprises. They also needed to acquire other foreign currencies to support the unaffordable external debt incurred by the private firms that were not allowed to fail. Despite the different geographical context, the following comparable case illustrates this point. The Eastern European bloc, notably Hungary and Romania, encountered this very problem in 2010

¹² Forbes and Warnock (n 9).

¹³ 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.

¹⁴ Janos Kornai, “‘Hard’ and ‘Soft’ Budget Constraint’ (1980) 25 *Acta Oeconomica* 231.

when Austrian and German banks decided to recapitalize divesting themselves of their local subsidiaries.¹⁵ Likewise, a number of East and South East Asian governments had to grapple with sudden currency depreciations as foreign investors took a flight back to the safety of US dollar and the US government bonds. Inevitably, some of these governments became beholden to the willingness of the great financial powers to provide emergency support. This reality bears a striking similarity to the conundrum facing Thailand during the previous crisis. Notwithstanding any reforms to the international financial governance framework, the vulnerability of emerging economic nations with hard budget constraints during a turbulent time has unfortunately not changed significantly in the past 20 years.

The second key development is the regionalization of financial sectors, especially in the South East Asian bloc. The AFC has had a direct impact on the approach to financial reform in many East and South East Asian countries. The financial integration under the umbrella of the ASEAN Economic Community (AEC) could arguably prevent a future crisis or at least to lessen any negative impacts. The AEC was primarily inspired by the idea that economic and financial integration could curtail the likelihood of financial crises through multilateral cooperation with a view to enhance market efficiency and regulatory standards. An economic union would allow capital to flow to capital-poor economies. Capital-poor economies have a higher return because there are more investment opportunities than in the increasingly saturated markets of developed member states. Furthermore, a single market in banking and financial services provides opportunities for investors to conveniently and cost-effectively diversify their portfolios, thus becoming less exposed to localized financial disruptions. In addition, less developed member

¹⁵ Katharina Pistor, 'Governing Interdependent Financial Systems: Lessons from the Vienna Initiative' (2011) 2 *Journal of Globalization and Development*.

states would benefit from regional coordination, support, and resources to strengthen local institutions and expand their capacity to absorb inflows of capital without jeopardizing the systemic viability of the entire region. It remains to be seen whether the promise of a regionally integrated financial system will eventually materialize. There are causes for concerns in the light of the subprime crisis in the US and the Eurozone crisis.¹⁶ 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 potential contributions toward the overall regional systemic stability.

Ultimately, the AFC remains a topic that can invoke intellectual curiosity and attract considerable interest from the professional and policy-making circles. Indeed, there are a lot of unanswered questions regarding its origin and propagation to other countries and regions. A good place to start the exploration is to embrace, as opposed to abstract from, the institutional framework and the constitutive components underpinning the Thai and regional financial systems. This Crisis, like all modern financial crises, signifies an implosion of a complex social construct. 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, enforcement and adjudicating authority. Private institutions such as banks and insurance companies can operate with business offices scattered across various national jurisdictions. They are therefore constantly seeking the most efficient strategies to

¹⁶ 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.

minimize their compliance costs, as a way to maximize profit. Furthermore, the system of global finance is buttressed by an ever-entangling governance structure of international institutions, intergovernmental agenda-directing forums, and various non-governmental standard setters. This elaborate public-private hybrid organization of contemporary finance must be taken into account. If not, it is impossible to develop a theory of the AFC that sufficiently explains this historic incident and creates a path to financial development for the sustainable future.

4. Legal Theory of Finance: the analytical framework

Cognizant of insufficiency of the current explanations of the AFC as articulated above, the origin and unraveling of the AFC must be viewed through a new lens. Consider first the inherent nature of financial transactions, which accumulatively make up the financial system.¹⁷ Each individual transaction is essentially a legally enforceable contract for cash or capital today at a cost of future payments – in other words an IOU.¹⁸ The problem is that these contracts are drafted in an environment of uncertainty which prevents market actors from stipulating every possible outcome, particularly the inability to *ex ante* engineer a non-zero-sum game when encountering liquidity constraints. In other words, there is no contractual provision, regardless of how carefully drafted it is, that has sufficient allocative efficiency such that the crisis can be averted all the time. Liquidity is not an issue during good times, when the ability to supply capital in the market exceeds or meets adequately the existing demands. However, the large number of enterprises in the system becomes highly dependent on refinancing to service the interest due without paying down the

¹⁷ Hyman Minsky observed that “Capitalism is essentially a financial system, and the peculiar behavioral attributes of a capitalist economy center around the impact of finance on system behavior.” See Hyman P Minsky, ‘Financial Intermediation in the Money and Capital Markets’ [1967] *Issues in banking and monetary analysis* 31. at 33.

¹⁸ Katharina Pistor, ‘A Legal Theory of Finance’ (2013) 41 *Journal of Comparative Economics* 315. at 317. Perry Mehrling, *The New Lombard Street: How the Fed Became the Dealer of Last Resort* (Princeton University Press 2010). at 11.

principal, the trigger provisions in their borrowing contracts could become the source of financial instability.

Contemporary financial systems are inherently unstable due to fundamental uncertainty and the constant struggle of market participants to leverage their non-cash assets to fund their liabilities.¹⁹

Fundamental uncertainty refers to the impossibility to foresee the future. It should be considered in contrast with a state of high information costs, in which the likelihood of risk is nevertheless quantifiable. Due to future uncertainty, no market actor is able to obtain all relevant material information or possesses the decision-making capacity except to extrapolate 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.²⁰ When considering the aggregate balance sheet of the financial sector, the funding strategy often involves loading up the liability side of the balance sheet with debt liabilities so that the sector can continue expanding the asset side with new loans and investments. One of the sources of systemic vulnerability can be found in certain contractual provisions in the common type of debts that the sector has incurred. Upon pre-specified contingencies which are materialized in a financially unfavorable context, debtors might find it

¹⁹ 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.

²⁰ Pistor, 'A Legal Theory of Finance' (n 18). at 316.

difficult to accommodate the payment obligations consequential of the triggering of these contingent provisions in the financing contract.

In an idealized world with no future uncertainty, the parties could write a contract that is able to account for all future contingencies and risks. Therefore, parties could manage potential funding problems that arise on an *ex ante* basis. In the imperfect and highly uncertain world in which we live, the readjustment by the private parties cannot be anticipated before the fact, i.e. at the time that the contract was written. Hence, in such a world, the contract drafting that accounts for all eventualities is simply improbably and unfeasible.

From the discussion above, there is no denying that contractual provisions that make up financial instruments can be a source of vulnerability. Yet the role of law is often ignored or overlooked during good times since debtors generally have no difficulty in meeting the payment obligation either by drawing from their own reserves, rolling over the existing liabilities, or seeking additional financing from other creditors in the market. During the bad time, market participants often find it extremely difficult to access the capital market for additional funding. As a result, unless they build up a sustainable level of capital reserve during the good times, they would not be able to honor the outstanding contractual obligations and would have to face the prospect of insolvency. This scenario demonstrates the inherent destabilizing nature of law in contemporary financial systems.

Against this backdrop, LTF proposes four interconnected propositions, which further enhance our understanding of the relationship between law and finance.

First, law is a source of financial instability. The destabilizing role of law in a microeconomic relationship will be examined first. The rigid enforcement of contractual rights and obligations, during the time of crisis, exacerbates counterparty risks especially the risk of default and

subsequent insolvency. One way in which a financial system may be vulnerable to a widespread triggering of a contractual provision is when a large group of depositors simultaneously decided to invoke their right to withdrawal on demand against a private bank, creating a phenomenon called a bank run. As it shall be demonstrated in the next chapter, a run can be organized against a particular currency when a large enough amount of short selling orders is placed in favor of a more stable, and safer currency. More crucially, law can also scale up a microeconomic risk into a system-wide vulnerability through the adoption of standard contractual terms, some of which have a systemically destabilizing impact. Often, these contractual clauses were devised by legal professionals to assist their clients in avoiding some costly regulatory requirements. This effect of law has far-reaching global implications. As the regulatory techniques are being harmonized, transplanted, and copied in the major financial systems, transnational law firms leverage their networks and connections to provide corresponding cost-effective compliance solutions to market actors around the world.

Second, law is endogenous to finance. In other words, contemporary 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 the court of law. Virtually all financial claims, once stripped off their complex language, can be reduced to private contracts, often referred to as equity, debt, or derivatives.

The construction of finance is a dynamic interaction between private parties and public agents. Private parties rely on private law, notably laws of contract, trusts, agency, and property, to create a network of binding relationships in order to finance their economic activities (the liability side of the balance sheet) or invest in other assets or enterprises (the asset side of the balance sheet).

In addition to this, the role of public law, which governs relationships between individuals and the government, should not be understated. Related to the role of private law, both the judiciary and some government agents, such as the financial regulator and the police, help enforce the privately negotiated arrangements. Furthermore, the socio-economic development depends in no small part on the smooth functioning of the financial system. Its failure could potentially lead to a widespread economic disruption and other undesirable consequences. As a result, finance is a heavily regulated industry. An implementation of financial law and regulation forces corresponding changes to the regulated entities, their counterparties, and sometimes to the structure of the market itself. Since regulatory compliance incurs additional costs, private parties who are subject to the regulation will try to react with financial innovations designed to minimize the costs of compliance. A case in point is Thailand's highly competitive non-bank financial sector, which was born out of a legislative reform to the banking law itself in the 1970s. We shall see in Chapter 2 how such a change became a precursor to the AFC two decades later.

Precisely due to the fast-paced evolution of finance, public law needs to remain forever evolving in order to contain any emerging potential detrimental effects. For instance, every new iteration of the Basel Accord has led to new forms of financial products. For example, collateral swaps and synthetic exchange-traded funds, designed specifically to minimize the impact of the regulatory capital requirements.²¹

In short, LTF claims that a contemporary financial system cannot possibly naturally occur. To the contrary, finance was made and is bound by an evolving set of rules.

²¹ Dan Awrey, 'Toward a Supply-Side Theory of Financial Innovation' (2013) 41 *Journal of Comparative Economics* 401.

Second, financial markets are always both privately and publicly constituted. This hybrid property of financial system can be observed from almost every facet that is fundamental to the structure of a financial system. The presence of public inputs can be observed throughout the financial system: 1) lending legally recognized private arrangements the binding force; 2) providing a regulatory and governance scaffolding for the system to grow; 3) instituting a dispute resolution platform to settle the conflicts that arise out of the contractual relationships. In addition, the government, through a delegated agency such as the central bank, issues and administers the currency which private parties use as a medium of exchange and mean of settlement. In the time of crisis, the government also stands behind and effectively guarantee all private liabilities to the extent that a widespread default could have serious systemic consequences to the financial system. Importantly, the role of lender of last resort cannot be effectively performed by any private agents since they are bound by hard budget constraints.

Third, finance is inherently hierarchical. This point echoes the nature of finance as observed earlier in subsection 2.c. LTF takes the proposition further by asserting that the hierarchy is manifested in the interplay between law and power. Throughout the system, the binding force of legally recognized financial instruments is strictly observed. This rigid enforceability of law is indispensable to all contemporary financial markets since it is the basis of an arm's length transaction. At the center of the system however, law is not applied as strictly as when it is imposed against those in the peripheral space of the hierarchy. The government may decide to intervene in the market to suspend the force of the law in order to protect certain financial institutions deemed systemically important to the viability of the financial system. In other words, law at the apex of the system is more elastic.

The elasticity of law is a function of power in finance and 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.”²² Elasticity can be achieved by design through statutory incompleteness and regulatory and judicial interpretive discretion,²³ 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 otherwise contemplate. 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 the entire system. Ironically, the legal enforcement to ensure the latter’s insolvency is critical in order to preserve the credibility of law.

In addition, the hierarchy of finance can be flattened and re-established depending on the condition of the market at the time. When funding options are ample or when there is no shortage of market-based takers for non-cash assets, the hierarchy appears flat. In other words, the strict enforcement of financial contracts is not the main consideration. Creditors may be happy to receive a commercial paper or other privately issued instruments as a form of payment or collateral.

During the time of crisis, creditors are expected to insist upon the form of payment, usually US dollar or other major currencies, as stipulated in the contract. The problem for debtors is that viable funding availabilities are extremely limited in the market situation plagued by uncertainty and

²² Pistor, ‘A Legal Theory of Finance’ (n 18). at 320.

²³ Annelise Riles, ‘Managing Regulatory Arbitrage: A Conflict of Laws Approach’ (2014) 47 Cornell International Law Journal 63. The author argued that the court and regulatory authorities should be afforded necessary discretion to apply the conflict of law methodology to preempt or counteract harmful regulatory arbitrating practices.

liquidity constraint. As a result, the rigid enforceability of law resurfaces. The solvency of debtors depends on the decision of third parties to step behind their outstanding liabilities and provide financial assistance. A large private financial institution may decide to intervene and provide funding to or absorb outstanding liabilities of its counterpart. However, it could only do so to the extent that its own survival is not at risk because, regardless of how big the size of its reserve capital, it is still not able to create state-backed money or control the money supply (thus bound by a hard budget constraint).

5. The Asian Financial Crisis from the purview of LTF

The LTF framework can be applied to the case of the AFC. LTF views the AFC as endogenous to the construction of the Thai financial system itself. Law and its institutions scaled up the scope of the Thai financial market, allowing a network of financial transactions to be created in support of the aggressive expansion of the Thai financial sector. Legal instruments govern and enforce commitments to make future payments regardless of whether the parties have the sufficient financial capacity to honor the *ex ante* obligations. To this end, there are two considerations that must be highlighted.

First, the AFC is a result of a gradual process of institutional changes. In addition, such changes were not readily observable from headlines economic indicators. Indeed, the Thai economic fundamentals, such as the unemployment rate, GDP growth rate, and trade account balance appeared head and shoulder above other emerging economies in the region.²⁴ Systemic instability in the Thai financial system was accumulated over time through changes in public law and corresponding developments in the financial sector, which created the precarious situation

²⁴ Steven Radelet and Jeffrey Sachs, 'The Onset of the East AFC' (National Bureau of Economic Research 1998) Working Paper 6680 <<http://www.nber.org/papers/w6680>> accessed 14 December 2013.

manifested by wholesale financial institutional collapses. Second, the evolution of the Thai financial system, from a small conservative industry into an internationalized, highly competitive sector, occurred as a result of a combined effort by Thai private banks and the Thai government. The former looked to take advantage of the regulatory loopholes while the latter sought to sustain the economic growth beyond the level that can be reasonably supported by the banking sector alone. With the rate of growth in the financial sector in the latter half of the 1980s through to the beginning of the 1990s, there ought to be some other factors accounting for the rapid expansion in both bank and non-bank financial sectors in Thailand.

The LTF explanation of the AFC is also cognizant of the peculiar position in which the Thai financial system situates in relation to the global financial landscape. The analysis so far commences with a case of a closed financial system which the government (and thus its central bank) sits at the apex of the hierarchy. The central bank remains in full control of the country's aggregate balance sheet since it is responsible for creating money and managing the money supply. As financial institutions face liquidity problems, the central bank can confidently step in and lend freely at a penalty rate in order to normalize the situation.²⁵ In the present case however, the Thai state did not occupy the summit of the hierarchy of finance. This is because a vast amount of external liabilities incurred by the domestic financial sector was denominated in foreign currencies beyond the remit of Thailand's financial sovereignty. The analytical framework explaining the Crisis must therefore adjust to account for this added complexity.

To this end, the LTF account of the AFC proceeds in the following manner.

²⁵ Walter Bagehot, *Lombard Street: A Description of the Money Market* (Kegan, Paul & Trench 1888).

a. The origin of the Crisis

The origin of the Crisis is traced back the transformation of the Thai financial sector. The Crisis in Thailand started off in the financial sector when highly leveraged banks and finance companies were unable to meet their foreign debt liabilities as they became due. Consequently, the investigatory focus concentrates on these two variables of the Crisis

i. The evolution of local financial institutions

As the Crisis unraveled, 56 finance companies were closed down, while 8 banks were either taken over by foreign banking institutions or brought under state receivership. From these statistics, it is evident that private banks and finance companies were by far the most exposed and susceptible to collapse. The pertinent question therefore is what factors in their respective developmental paths had shaped the growth of both industries to a point which they virtually monopolized the market share in the financial system. It is submitted that the problem goes far beyond market domination. Both banks and finance companies seemingly had strong appetite for funding themselves with short-term liabilities long before the influx of foreign capital in the early 1990s.²⁶

If the prediction based on LTF is true, the said business strategies should be deep-rooted in the structural components of the bank and non-bank financial industries. To this end, the dissertation explores the institutional origins of banks and finance companies. Banks have had presence in the Thai economy since the end of the First World War. On the other hand, specialized non-bank financial institutions, known as finance companies, are of a much more recent origin in the 1970s. Essentially, they both performed the same functions in the economy. Namely they raised funds from the public and institutional investors before investing in economic activities in return for

²⁶ Siamwalla (n 4). at 5-6.

profit. The dissertation asserts that this functional overlapping could potentially explain their subsequent excessively competitive nature.

Like many Asian countries in this period of time, the Thai government had its hand directing the economic development as formally set out in the 5-year National Economic and Social Development Plan. The banking system naturally became a key development tool. The government could use various legal and regulatory measures to encourage credit extension to the strategically placed sectors of the economy. Alternatively, banks could assist the state in mobilizing national savings in order to connect more people outside Bangkok and major provincial cities to the financial system. It is likely that banks could not perform the tasks or at least underperform such that the government decided to institute a new type of financial institutions outside the governance structure of the banking sector. While the initial objective of the changes might not be to create direct competition against banks, the structural framework of both industries heavily influenced the business strategies of these institutions such that they became dominant powers in the domestic financial market during the best period of economic expansion in the country's history.

ii. Torrent of global capital inflows

The second primary driver of the AFC is the influx of foreign capital into the Thai financial system. The financial sector did not receive significant funding from external sources until around 1994 when the amount stood at just under \$ 30 billion compared to just over \$ 10 billion in 1993, and barely \$ 5 billion in the year prior.²⁷ Since 1994, the financial sector's reliance on foreign debts

²⁷ Source: Bank of Thailand.

exploded and peaked in 1996 at over \$ 40 billion.²⁸ More importantly, between 1994 and 1996, the larger component of the inflows was short-term liabilities of maturity less than one year (typically three to six months).²⁹ Arguably, this factor has always been the most misunderstood part of the story, especially, when we assess the statistical data alone out of its proper context. Nearly all commentators on the Crisis studied these numbers and immediately concluded that the underlying problem was the premature liberalization program installed by the central bank and Ministry of Finance in the early 1990s.³⁰ However, this conclusion would not be able to explain why there was an unprecedented amount of surpluses in the international capital market in the first place. More significantly, what might be the reasons behind the attractiveness of the Thai financial system when the financial markets in neighboring countries never received the same level of interest from international institutional creditors?

LTF urges us to look beyond the liberalization policy since the function of law and regulation in a finance system is more institutional than simply to eliminate market distortions. To deal with the origin of capital inflows, we need to examine not only their sources but the mechanism which enabled the capital to flow into Thailand and contributed to the AFC. Here is where statistical data can be helpful. By the end of 1996, the biggest claimants against the Thai financial sector were Japanese financial institutions which owned 53 percent of the total external debts.³¹ Moreover, European and American banks invested significantly in the sector with the former taking up 27

²⁸ Ibid.

²⁹ Ibid.

³⁰ For instance, Steven Radelet and Jeffrey D Sachs, 'The East Asian Financial Crisis: Diagnosis, Remedies, Prospects' (1998) 29 Brookings Papers on Economic Activity 1.

³¹ Stephany Griffith-Jones, Ricardo Gottschalk and Jacques Cailloux (eds), *International Capital Flows in Calm and Turbulent Times: The Need for New International Architecture* (University of Michigan Press 2003) <<http://www.jstor.org/stable/10.3998/mpub.17835>> accessed 6 May 2017. at 49-74.

percent and the latter 7 percent of total foreign liabilities.³² Consequently, the inquiry focuses on the institutional changes in these three important financial systems that could have significant implications to the increase in surplus capital in the international market.

First, it is important to understand the underlying factors which influenced the permissible range of business activities that banks in each of the source countries may legally undertake. In addition, we need to know if any of the three countries had in place a form of capital control which was then subsequently lifted allowing their financial companies to look abroad for investment opportunities. With regard to the first consideration, the governance structure of Japanese financial institutions is of considerable importance here. In the 1980s, the Japanese government made a number of strategic legislative and regulatory moves which gradually erode the structural separation between the business of banking and non-bank financial services such as securities investment. Furthermore, in the same time period the Japanese central bank also readjusted the cross-border capital control regime such that they no longer posed significant burdens to outward financial investments. It should be noted that at the end of the 1980s the Japanese domestic economy started experiencing the effect of economic bubbles, which were most visible in the real estate sector. This adverse domestic macroeconomic condition also drove the Japanese authorities to make certain changes in their regulatory rulebook. As a direct consequence, Japanese banks which in effect retreated from these overheating domestic sectors were compelled to look for an alternative source of revenue.

In addition to the presence of international capital surpluses, the analysis of the AFC also concerns two other issues: namely, the quality or type of these investments; and, why the Thai financial

³² *ibid.*

system stood head and shoulder above its rival markets in the region in attracting international capital surpluses. While a noticeable amount of financing was for long term, it was clear that the vast majority of them were on a short-term basis. The dissertation's thesis on this point asserts that the cause was primarily structural. During this period of study, we witness the implementation of the first international capital adequacy requirements, known as the Basel Accord. Crucially, the first iteration of the prudential standard offered a set of incentives such that banks were encouraged to load up their balance sheet with short-term liabilities from non-OECD countries. The underlying rationale for assigning zero risk weighted ratio to this type of assets was that their short-term nature presented a sufficient safeguard against market and counterparty risks. The problem though is that the architects of the Basel Accord did not evaluate the potential implications of the capital rules from the perspective of the borrowing countries, but rather from the creditor's vantage point. Arguably, this presents a piece of evidence showing inherent bias in favor of the more powerful actors in the global financial community.

Furthermore, the role of law and regulation in constructing a governing framework for the capital inflow was an essential factor contributing to the attractiveness of Thailand as a destination of international capital surpluses. A prime case in point is the Bangkok International Banking Facility (BIBF), which offered a set of regulatory and tax benefits to qualified foreign financial institutions so that they could invest on a cost effective basis through this facility. Interestingly, several testimonies by members of the senior management team revealed that the Thai central bank did not envisage that the BIBF operate as a gatekeeper for the Thai financial system.³³ The initial objective was to develop an offshore banking center for financial investments in the South East

³³ *Nukul Commission Report: Analysis & Evaluation on Facts Behind Thailand's Economic Crisis* (Thailand's financial Ministry 1998). at 10-11.

Asian region. Yet, quite the opposite result happened. An overwhelming amount of financing transactions that were approved under BIBF came into the Thai financial system. The LTF account of the Crisis suggests that the underlying reason lurks underneath the construction of the BIBF. In other words, we should look beyond the façade of this special facility and critically examine the set of incentives and deterrents devised as part of this special facility. If the LTF prediction is true, the BIBF's regulatory structure should not reflect or advance the officially proclaimed objectives set out *ex ante* at all.

The analysis of the origin of the AFC sketched above hopefully demonstrates that the mainstream theories which attribute the causes of the Crisis to market failure and/or systemic inefficiency have missed the crux of the story. In many instances, problems emerged precisely because the system worked too efficiently and was allowed to exploit the business opportunities arising from the gaps or loopholes in the structural characteristics of finance. In other words, financial instability can only be articulated with an institutional assessment of the peaks and troughs in the financial system. Furthermore, instability is caused by the constant reciprocal reactions between changes in public rules and corresponding private actions.

b. The mechanism of the Crisis

The first part of the framework which proposes an account of financial instability in the Thai financial system tees up nicely the discussion of the mechanism of the Crisis. Following the LTF building blocks, there are three following components, which make up a financial disaster. First, we need evidence of outstanding and enforceable contractual rights or other strict legal mechanism to demand full payment of the principal plus accrued interest. In addition, these legal instruments must be in place and ready to be exercised against systemically important financial institutions. Finally, the strict execution of the said contractual performance must coincide with liquidity

shortage. Alternatively, liquidity shortage could very well be a result of the legal construction of the Thai financial system or the international capital market. In other words, borrowers could not foresee, or did not prepare for the situation in which they could no longer find any taker in the market for their non-cash assets in exchange for cash or cash-like assets without substantial haircut.

The dissertation shows that these ingredients of crisis were present in the Thai financial system particularly in the second and third quarters of 1997. It can also demonstrate that the inelastic quality of debt contracts manifested in two ways. For short-term loan transactions, the timing of the performance according to predetermined contractual obligations was governed by the maturity clause. In general, the creditors had the contractual right to stop rolling over financing and instead demanded a full payment in every three or six months. With regard to longer-term contracts, creditors were protected by various contractual devices; for instance, the clause which allowed them to call on specific performance from borrowers upon certain triggering events. It was clear that these contractual devices worked to protect financial interests of the creditors. However, when they were exercised nearly simultaneously throughout the financial system, the widespread collapse of highly leveraged institutions inevitably led to a financial crisis.

It will be demonstrated in the next chapter that the same stylized model of the mechanism can explain the currency crisis as well. As explored earlier in this section, the added complexity of this particular Crisis was that foreign debts taken on by Thai banks and finance companies were denominated in other currencies, mostly the US dollar and Japanese yen, both of which were beyond the sovereign control of the Thai state. One way to stop the propagation of the crisis in the financial sector was for the central bank to step in and maintain the exchange rates between Thai baht and major currencies. However, an intervention in the open currency market committed the central bank to contingent liabilities which it could not afford. Ultimately, it lost the country's

foreign reserves *and* failed to prevent the depreciation of the baht. Rather than containing the private sector crisis, the failure in the currency market effectively doubled down on the increasing amount of privately held foreign debts due to the worsening exchange rates.³⁴

Two implications can be observed from this episode of the Crisis. In the international currency market, the central bank relinquished its capacity as an agent of a sovereign state and assumed a role of currency trader with hard budget constraint. This means that it too became exposed to the full force of the law if it could not meet the repayment responsibility as stipulated in the swap contracts. Furthermore, when the country's outstanding liabilities were foreign-denominated, it no longer controlled its own financial autonomy. The central bank paid in full all contingent liabilities arising out of its forward swap operation. Subsequently, the Bank could neither commit any more cash in the currency market nor provide much-needed US dollar to Thai financial institutions in trouble, having exhausted the US dollar reserves. The upshot of this so-called twin crisis was the Thai government must rely on the international community for financial assistance.

c. Short-term and long-term implications of the AFC

The analysis of the AFC does not end with the account of its origin and mechanism. A comprehensive assessment of the phenomenon must be able to account for its repercussions and implications as well. The dissertation dissects these issues into short-term and long-term impacts. Regarding the former, the focus is on developing an analytical framework that can justify the way in which the crisis resolution arrangement was put together, especially in the context of the global

³⁴ To which some commentators referred as the “twin crisis”. See for example Itay Goldstein, ‘Strategic Complementarities and the Twin Crises*’ (2005) 115 *The Economic Journal* 368; Graciela L Kaminsky and Carmen M Reinhart, ‘The Twin Crises: The Causes of Banking and Balance-of-Payments Problems’ (Board of Governors of the Federal Reserve System (US) 1996) *International Finance Discussion Paper* 544 <<https://ideas.repec.org/p/fip/fedgif/544.html>> accessed 11 February 2015; Hyun Song Shin, ‘Liquidity and Twin Crises’ (2005) 34 *Economic Notes* 257.

financial architecture. The latter highlights the ever-lasting legacy of the AFC which continues to influence structural reforms of the financial markets in the Asia-Pacific region.

The global financial system is not flat. Rather, it is organized around the parties that manage the global reserve currency, in the present time, the US dollar.³⁵ In the recent financial history of the world, it has been universally used for invoicing and settling cross-border financial transactions even though they do not at all involve a US national or corporation. The LTF analytical framework informs us to examine the interplay between law and power in order to rationalize actions and behaviors of international financial institutions and foreign governments when they came together to negotiate the financial assistance package for Thailand. The analysis inspects each individual stakeholder in turn. LTF expects the power dynamics to be exercised solely to further and protect the interests of the parties at the apex of the system. In other words, the welfare of the parties atop the hierarchy is prioritized at the expense of the long term prospect of crisis-hit nations, especially when the latter occupy the peripheral surrounding of the governance structure.

The law and power dynamics played itself out quite conspicuously when observing the contrasting roles played by Japan and the US respectively on the negotiating table. Initially, Japan assumed the leading role in the discussion, however the Japanese officials were clearly reluctant to commit themselves to any form of unilateral intervention. The US on the other hand remained watchful on the sideline since the Treasury and the Federal Reserve deemed the crisis posed minimal to no threat to the US interests. Yet, when the Japanese Finance Minister floated the idea of the Asian Monetary Fund (AMF), the US and European representatives reacted strongly against the proposal.

³⁵ See Barry Eichengreen, *Exorbitant Privilege: The Rise and Fall of the Dollar and the Future of the International Monetary System* (Oxford University Press 2011). for a comprehensive overview of the rise and fall of the US dollar as the world reserve currency after the Global Financial Crisis in 2008.

A regional alternative would directly compete and could potentially compromise the influence of the IMF, an international institution which was structurally Euro-American centric. Ultimately, the immediate aftermath of the AFC revealed for the first time Thailand's position in the global financial governance framework. The inherent hierarchy might not be so relevant during the good times. Nevertheless, in the time of crisis the power may allow the rigidity of the law to play out against beleaguered parties at the periphery. In good times, foreign creditors and Thai borrowers shared slices of prosperity among themselves. Yet, in bad times, Thai taxpayers were compelled to pick up the tap and suffered the consequences of many counterproductive reform measures forced upon them by the international community.

The sobering conclusion of the AFC lends itself to the beginning of a new chapter of financial development in Thailand and the neighboring countries in the region. Domestically and regionally, there have been many significant developments in direct response to the experiences they encountered in the 1990s. The LTF theory of the AFC can be adapted to make a preliminary investigation of these recent developments and their potential susceptibility to financial instability. Interestingly, the domestic reform initiatives undertaken in Thailand in the past 20 years will be tested as the government slowly internalizes the regional commitments under the ASEAN Economic Community (AEC). One of the overarching goals of the AEC is to bring about financial integration in order to support the common economic market for goods and services of the member states. It remains to be seen whether the financial integration framework would allow for the same kind of destabilizing products and practices to creep back. To that end, the LTF analysis helps identify potential pitfalls in the existing arrangements. Lastly, the dissertation ends with an appraisal of the regional safety valve which has been developed to guard against sudden liquidity shortages, the so-called Chiang Mai Initiative Multilateralization (CMIM). While the facility is

still very much a work in progress and not yet able to provide the effective financial support against future international financial crises, the dissertation offers a set of options that can make CMIM realize its full potentials.

6. Surveying the Existing Explanations of the AFC

Given its unprecedented scope and gravity, it is not surprising that in the past twenty years the AFC has generated a considerable amount of scholarly works, especially works theorizing plausible causes and the mechanism of the Crisis. While the conventional explanations of the AFC has been revised and revisited over the year, they still tend to abstract from the legal and institutional structures. While, it is helpful to understand the mainstream explanations adopted by various groups of academic literature, the readers are kindly reminded that a thorough theoretical critical assessment is beyond the remit of this dissertation. This brief survey is merely an illustration to provide a contrasting picture of the AFC. LTF, as demonstrated above, complements these mainstream accounts by highlighting the legal and institutional transmission mechanisms of instability that eventually instigated the AFC.

a. The efficient market model of finance

Under this rubric, finance is considered a form of competitive market, distinguishable from corporate organizations.³⁶ A market is a network of horizontal relations of exchange in which a competitive price is determined by everything that can be known about the market discounting for the future and disregarding any past price movements.³⁷ On the other hand, a corporation achieves

³⁶ Richard A Posner and Kenneth E Scott, *Economics of Corporation Law and Securities Regulation* (Little, Brown and Company 1980) <<http://chicagounbound.uchicago.edu/books/87/>> accessed 24 May 2017. at 155.

³⁷ Paul A Samuelson, 'Proof That Properly Anticipated Prices Fluctuate Randomly' (1965) 6:2 *Industrial Management Review* 41. at 44.

organizational efficiency through imposing a hierarchical structure in order to allocate authorities and responsibilities among its employees.³⁸ As a result, the market arises out of a complex network of human action rather than human design. The rules of the operation emerge first out of custom or trading pattern which then may or may not be validated by a central authority such as the state. However, not all markets are competitive or efficient. Fama proposed the definition of an “efficient” market as the one that is occupied by “*large numbers of rational, profit-maximizers actively competing, with each trying to predict future market values of individual securities, and where important current information is almost freely available to all participants.*”³⁹

Given that market efficiency is defined as a function of information availability⁴⁰, efficiency causally depends on the costs of informational distribution.⁴¹ Although there are a wide variety of market techniques that can be adopted to deal with aspects of the problem, such as periodical investor meetings, credit ratings, and professional or expert advisory services, all of these techniques have limitations, such as agency costs and opaque market structures and instruments.⁴² For a long time, legal scholars, most prominently Gilson and Kraakman, have observed that law and regulation provide one of the most cost effective ways to deal with most problems of market

³⁸ Ronald H Coase, ‘The Nature of the Firm’ (1937) 4 *Economica* 386.

³⁹ Eugene F Fama, ‘Random Walks in Stock Market Prices’ (1965) 51 *Financial Analysts Journal* 75. at 76.

⁴⁰ The efficient market hypothesis essentially concerns the mechanism which allows information to be reflected into price. Proponents of this hypothesis propose at least three forms: strong, semi-strong, and weak forms. See further Michael C Jensen, ‘Some Anomalous Evidence Regarding Market Efficiency’ (1978) 6 *Journal of financial economics* 95; Joseph E Finnerty, ‘Insiders and Market Efficiency’ (1976) 31 *The Journal of Finance* 1141; Burton G Malkiel and Eugene F Fama, ‘Efficient Capital Markets: A Review of Theory and Empirical Work*’ (1970) 25 *The Journal of Finance* 383.

⁴¹ The distributional problem can be divided into three categories: costs of acquisition, costs of processing information, and costs arising from the problem of verification. See further Armen A Alchian and Harold Demsetz, ‘Production, Information Costs, and Economic Organization’ (1972) 62 *The American Economic Review* 777.

⁴² Ronald J Gilson and Reinier H Kraakman, ‘The Mechanisms of Market Efficiency’ (1984) 70 *Virginia Law Review* 549. at 602-604.

frictions.⁴³ Rules such as mandatory disclosure and bank stress tests arguably have a direct consequence on reducing costs of information. In addition, if the existing framework is found to hamper the aggregation and distribution of market-wide price and volume information, a market structural reform may be necessary.⁴⁴

Consequently, a financial crisis according to Gilson and Kraakman stems primarily from gross systemic inefficiency driving asset prices away from the fundamentals. Distortions may occur in both micro- and macroeconomic scales. Agents may opt to borrow in order to invest such as margin lending or mortgages for houses.⁴⁵ When the rate of return misses the forecast, these agents run a risk of default resulting in a rapid plummet in the value of the assets they hold. Financial professionals are rewarded on the upside far more than on the downside. As a consequence, there is an entrenched bias in their portfolio towards riskier assets. Some structural adjustments or policy shifts, notably financial liberalization, can, if done in a wrong sequence, cause an asset price bubble that makes the financial system vulnerable to external shocks.⁴⁶ The role of frictions in the credit market has been largely accepted in the macroeconomic mainstream as acknowledged by Bernanke, Gertler, and Gilchrist.⁴⁷ The information asymmetries become highly salient in the decision making of financial intermediaries. They generally tend to prefer investing in debt instruments. In the normal state of the world when the risk of default is minimal, debts are low-

⁴³ *ibid*; Ronald J Gilson and Reinier Kraakman, 'Market Efficiency after the Financial Crisis: It's Still a Matter of Information Costs' [2014] *Virginia Law Review* 313.

⁴⁴ Gilson and Kraakman, 'Market Efficiency after the Financial Crisis' (n 43). At 351, 357, and 368.

⁴⁵ Franklin Allen and Douglas Gale, *Understanding Financial Crises* (Oxford University Press 2009).

⁴⁶ 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 4 May 2016.

⁴⁷ Ben Bernanke, Mark Gertler and Simon Gilchrist, 'The Financial Accelerator in a Quantitative Business Cycle Framework', *Handbook of Macroeconomics*, vol 1 Part C (1999). at 1344.

information sensitive since they require little analysis of the underlying asset value.⁴⁸ Ironically, as soon as the information and agency problems worsen as a result of sudden shocks to the macro-economy, debts suddenly become high information and agency-cost sensitive. In other words, the financial crisis occurs as asset prices across the entire market move adversely away from the fundamentals in the way that significantly heightens the risk of default. Such detrimental market development is primarily rooted in information discrepancies that exist in the market itself.⁴⁹ Consequently, financial contracts take the forms that they do in order to contain or offset the costs of lack of information and to circumvent the principal-agent problem in the credit market.

b. The mainstream explanations of the AFC: an assessment

It was this fundamental concept of finance and financial crisis that provided a springboard for the mainstream accounts of the AFC which has in turn dominated both academic and policy making circles in the region in the past two decades. In all, the common explanations come into three major strands: (1) industrial policy mismanagement; (2) corruption and crony capitalism; (3) poorly designed and sequenced financial liberalization. No one denies the fact that Thailand at the time was facing some, if not all, aspects of these challenges.⁵⁰ However, the problems that plagued the economic and political development in the pre-crisis era did not necessarily give rise to a major financial disruption of a historic scale. This subsection thus assesses the three major claims

⁴⁸ Gary Gorton and Guillermo Ordonez, 'Collateral Crises' (2014) 104 *American Economic Review* 343.

⁴⁹ Burton G Malkiel, 'The Efficient Market Hypothesis and Its Critics' (2003) 17 *The Journal of Economic Perspectives* 59. at 72-73.

⁵⁰ See, for instance, Phongpaichit Pasuk and Chris Baker, *Thailand: Economy and Politics* (2 edition, Oxford University Press 2002); Duncan McCargo, 'Network Monarchy and Legitimacy Crises in Thailand' (2005) 18 *The Pacific Review* 499.

regarding the premises that they were solely responsible for the advent of the Crisis and also the subsequent escalating episodes.

The first candidate of the mainstream arguments itself has two additional layers. On one level, the critics of the Asian development model contended that there was nothing miraculous about such a model. The strong economic growth could be attributed to a more efficient allocation of resources as the developing Asian economies learned how to better employ the available factors of production.⁵¹ Stepping up a level, the Thai government was singled out for its industrial policy mismanagement. Heavy-handed interventions to promote certain industries or products undermined both price and allocative efficiency, especially in the banking sector.⁵²

Obviously, the two layers of the theory are examples in contradiction and cannot both be true. If better use of resources caused the growth phenomenon preceding the Crisis, the same factor, i.e. an improvement in the economic system, cannot be the underlying modality for the subsequent financial disaster. Taken separately, neither theory sounds more convincing. As the economy approaches full capacity, we should expect a slowdown in the growth rate rather than a widespread disruption of an extraordinary scale. Furthermore, it shall be seen in subsequent chapters, particularly Chapter 2, that while the changes to the banking regulatory rulebook did alter the bank's behavior, it did not do so in such a way that rendered the financial system less effective. If anything, the banking sector had never been more productive at any other time in Thailand's

⁵¹ Paul Krugman, 'The Myth of Asia's Miracle' (1994) 73(6) *Foreign Affairs* 62; John Page, 'The East Asian Miracle: Four Lessons for Development Policy' (1994) 9 *NBER macroeconomics annual* 219; Jong-Il Kim and Lawrence J Lau, 'The Sources of Economic Growth of the East Asian Newly Industrialized Countries' (1994) 8 *Journal of the Japanese and International Economies* 235.

⁵² Siamwalla (n 4); Sheng (n 4). at 5-6.

financial history, raising an unprecedented amount of deposits and extending credit to finance a vast array of industrial projects and beyond.

The second facet of the common arguments highlights the problems of corruption and crony capitalism.⁵³ In gist, the cozy tie between politics and state bureaucracy on the one hand, and the business sector on the other, was thought to create moral hazard, which was a market friction exacerbated by the information asymmetry and agency problem. Proponents of this argument pointed out to the comprehensive privatization program in the 1980s and 1990s, which revealed evidence of previously state-owned assets being funneled to elite families and politically well-endowed companies.⁵⁴ Private actors were thus incentivized to seek political connections, rather than to enhance their competitiveness. Being connected with politics either through familial ties or business relationships also gave an implicit expectation that the government would be ready to stand behind them during troubling times. The complacency generated in this kind of counterproductive atmosphere influenced businesses to make riskier business decisions than they would have otherwise. In addition, lenders naturally saw corporations that were empowered by inside connections with state institutions as having no downside risk. Thus, they were willing to lend in excess of what they might have otherwise and inflated bubbles that led to the Crisis.⁵⁵

⁵³ 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; Ronald I McKinnon and Huw Pill, 'International Overborrowing: A Decomposition of Credit and Currency Risks' (Stanford University, Department of Economics 1998) Working Paper 98004 <<http://ideas.repec.org/p/wop/stanec/98004.html>> accessed 14 December 2013; Paul Krugman, 'What Happened to Asia?' <<http://web.mit.edu/krugman/www/DISINTER.html>> accessed 13 December 2013.

⁵⁴ John W Head, 'The AFC in Retrospect-Observations on Legal and Institutional Lessons Learned After a Dozen Years' (2010) 5 *E. Asia L. Rev.* 31. at 39-40.

⁵⁵ Krugman, 'What Happened to Asia?' (n 53).

If crony capitalism is defined as the government providing guarantees to industrial and financial enterprises against the logic of the market, the historical account of economic development in the region makes it extremely difficult to establish a causal relation between cronyism and the Crisis. An obvious problem to this narrative is that cronyism, in one form or another, has been part of the developmental path in Thailand and arguably throughout the region for a long time, at least since the beginning of the industrialization era from the 1970s to the early 1980s.⁵⁶ Some might then argue that the form of corruption changed shortly before the Crisis, such as the increasing dominance of rent-seeking provincial politicians which seemingly exacerbated the problem of pork-barrel politics.⁵⁷ Even if the observation was well-founded, it did not present a significant leap in the chain of causation between corruption and the Crisis. Considering the following illustrative facts. The presence of cronyistic behavior alone could not have explained the exponential growth of foreign liabilities on the balance sheet of the Thai financial sector in the early 1990s. By contrast, the two decades earlier there was a negligible presence of external debt on the private sector's balance sheet. It should also be noted that the "corruption perception index", compiled by an independent international anti-corruption watchdog, showed that corruption was perceived to be diminishing in the 1990s compared to the situation in any preceding decades.⁵⁸ Ultimately, the internal logic of cronyism, which by definition has to be selective, cannot support the claim that it was a major explanation of the crisis.⁵⁹ In other words, it is not plausible to claim that all Thai

⁵⁶ Pasuk and Baker (n 50). at 72.

⁵⁷ Pasuk Phongpaichit and Chris Baker, 'Thailand's Crisis: Neo-Liberal Agenda and Local Reaction', *Financial Liberalization and the Asian Crisis* (Springer 2001) <http://link.springer.com/chapter/10.1057/9780230518629_6> accessed 24 May 2017.

⁵⁸ Ha-Joon Chang, 'The Hazard of Moral Hazard: Untangling the Asian Crisis' (2000) 28 *World Development* 775. at 780.

⁵⁹ *ibid.*

banks and finance companies made reckless business decisions *because they all* had political or bureaucratic connections.

The third explanation places blame on the untimely sequencing of the financial liberalization policy implementation. Thailand's financial governance structure was not sufficiently developed and modernized to deal with the unpredictability of foreign capital volatility.⁶⁰ In the early part of the decade, Thailand and its neighboring countries weathered a series of macroeconomic shocks, which exposed fundamental weaknesses in the domestic financial system. Upon an advent of triggering events, such as a collapse of a major financial institution or a sharp stock market crash, a sudden reversal of capital induced a run against the Thai financial sector back to safer assets in the advanced jurisdictions. More precisely, proponents of this theory argued that Thailand, unlike nations with advanced economies, lacked the regulatory and legal infrastructure to support highly liberalized cross-border transactions.⁶¹ Proponents argued further that the Thai government should have instituted a lender of last resort capable of handling a rapid run against its own financial system by foreign investors.

Admittedly, there are some truths in the aforementioned line of thought. It is true that the Crisis propagated because the Thai government lacked the financial capacity to support the financial sector. However, that single factor did not cause the crisis. In an interconnected world, in which financial transactions are denominated in foreign currencies, the state cannot provide a completely effective safety net. It does not control the final means of settlement of the majority of the external liabilities incurred by the financial sector. In the current global financial system, the US dollar is

⁶⁰ Radelet and Sachs (n 30); Joseph E Stiglitz, 'Capital Market Liberalization, Economic Growth, and Instability' (2000) 28 *World development* 1075.

⁶¹ Radelet and Sachs (n 30). at 18. For a more recent update on the subject, see Head (n 54).

prevalent even in financial transactions that do not involve an American party. This means that the US administration, through the Treasury and the Federal Reserve, is the only government that can effectively perform the role as the lender of last resort.⁶²

Relating to the issue of lender of last resort, it was claimed that both the inflexible bankruptcy law and overstretching of the judicial system put panicked foreign creditors on alert that the only way to get their investments back was to stop rolling over the financing.⁶³ In reality, the situations were more complicated than that. Even though the Thai bankruptcy law did not have a provision for restructuring debt until after the Crisis, the absence of the provision did not deter foreign creditors from investing in the Thai financial sector. This does not mean that reorganization and liquidation procedures had no influence on the Thai financial sector's cost of finance. Rather, it is argued that there might be other counterbalancing factors, which effectively neutralized the heightened risk profile associated with the absence of an internationally recognized bankruptcy regime. As stated above, it is submitted that the detailed assessment of the Thai domestic financial sector and the state of the international capital market in the early 1990s help identify the aforementioned counteracting factors.

Last but not least, the ten year period prior to the crisis saw the most extensive modernization of the Thai legal and regulatory framework, primarily because of pressure and advice by the IMF, and World Bank. Most noticeably, the Bank of Thailand first implemented the capital adequacy requirements based on the Basel Accord (Basel I) in the early part of the 1990s, raising the prudential standard of the banking sector to the internationally recognized level. Following the

⁶² Eichengreen (n 35). at 2-3.

⁶³ 'The Living Dead' [1998] *The Economist* <<http://www.economist.com/node/603660>> accessed 24 May 2017.

logic of the argument, it is highly doubtful that the previous era's inferior governance framework provided a foundation for extended economic prosperity, while a supposedly superior infrastructure of the 1990s led to the most disastrous financial incident of Thailand's history. Instead of focusing on the sequencing of capital-account liberalization and capital controls, it is argued that another important concern is the internal misalignment of the incentive structure of the prudential regulatory framework adopted by both the debtor countries (such as Thailand) and the creditor countries (such as Japan, and the US, to name just a few).

In response to some of the criticisms and in the light of more recent debates on the subject, the current explanations of the AFC evolved into a narrative containing just one sequence of causal factors, as opposed to the three major claims explored above.⁶⁴ They all point to certain market or regulatory weaknesses or shortcomings in the government's monetary policy management in the crisis-hit nations, which were exposed when global liquidity excess was allowed to flow into the domestic financial system and subsequently to other economic sectors. Localized episodes of the AFC spread throughout the region and beyond through a number of interconnected channels, both on the supply and demand sides, such as trade as well as financial linkages, and sudden flight to safety and quality by large institutional investors, to name but a few.⁶⁵

Specifically on Thailand, the contemporary AFC literature pointed to the fact that the inadequate banking regulation and lax supervision were thought to induce a flourishing of undercapitalized banks with an unsustainably high exposure to the ailing property market and the bubbled stock

⁶⁴ Adam S Posen and Changyong Rhee (eds), *Responding to Financial Crisis: Lessons from Asia Then, the United States and Europe Now* (Peterson Institute for International Economics 2013); Head (n 54); Sheng (n 4); Morris Goldstein, *The Asian Financial Crisis: Causes, Cures, and Systemic Implications*, vol 55 (Peterson Institute 1998).

⁶⁵ Forbes (n 9).

market.⁶⁶ It was argued further that a disruption in such a domestic setup however would have been contained but for the government's mismanaged monetary policy and botched financial liberalization program. Ultimately, the overly rigid currency exchange regime, coupled with the deregulated cross-border capital regime, resulted not only in the government's inability to provide an adequate support to the financial system in the time of acute liquidity shortage, but also in essentially giving foreign investors a free put option on their capital investment in the domestic market. As the AFC deepened and the investors rushed to the exit in massive number, the domestic asset prices as well as the value of Thai baht faced an unassailable downward pressure, which broke not just the foreign reserves held by the Thai central bank, but also brought about the widespread institutional collapse in the banking and financial sector.

If we only needed to gain an understanding of the crisis-triggering events that occurred in the immediate run up to the financial disruption in 1997, this narrative may have been sufficient. It is an observable fact that the modern financial system is always vulnerable to high information costs and liquidity shortage. The Thai story is clearly a case in point. During the boom years, the problem of information costs was not an issue because banks had plenty of refinancing options such that the banks' creditors, especially those from overseas, were prepared to overlook the risks associated with the former's risky business practices. Liquidity in the system quickly dried up as soon as it became clear that the balance sheet problem in the banking sector was endemic.

7. The Structure of the Dissertation

The dissertation divides into two parts. Part I examines the causes and mechanism of the AFC. Chapter 2 investigates the domestic aspect of the Crisis. It traces the institutional development of

⁶⁶ Head (n 54); Sheng (n 4).

banks and finance companies. Specifically, it investigates the competitive dynamics between these two types of financial institutions and shows how the competition intensified as they reacted to changes in the legal and regulatory framework that governed their conducts. In addition to the narrative of financial instability, the chapter explained the mechanism of the incident using the LTF theory of AFC expounded above. It should be said at this point that Chapter 2 assumes the presence of foreign liabilities in the aggregate balance sheet of the financial sector. Chapter 3 lays out a context to the influx of cross-border capital investments to the Thai financial sector, showing that the assumption is well founded. The chapter demonstrates that the governing framework in the source countries played a primary role in determining not only the amount but also type of capital surpluses that were available in the global market at the time.

Next, Part II critically examines the aftermath of the AFC from the perspective of the Thai financial system. Chapter 4 critiques the crisis resolution management strategy of the international community spearheaded by the IMF with the US administration puppeteering in the background. The analysis centers on the hierarchy of global finance which can explain, from the borrowing country's perspective, the unbalanced treatments imposed upon by the international community. Chapter 5 takes stock of the lessons learned from the LTF assessment of the 1997 Crisis and attempts to assess 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. Last but not least, it proposes the ways in which the insights from this doctoral 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. The dissertation concludes with an Epilogue pondering several ways in which it informs the lessons learned from

the Crisis, a set of suggestions to further improve the LTF as an analytical framework, and a sobering observation of the future of finance.

Part I: The LTF Analysis of the AFC

Part I consists of Chapters 2 and 3 which tackle the issues of the cause and the mechanism of the AFC. It is impossible to understand the AFC without exploring both domestic and international institutional developments pertaining to the Thai financial system. This is precisely because the Crisis in Thailand was preceded by a systemic overhaul of the legal and regulatory framework governing the Thai economy. As we shall see throughout both chapters, the main theme of Part I is that the financial market is necessarily and always a hybrid construct made up of a network of legally enforceable relationships framed by public rules as well as private orders. Consequently, a market outcome cannot be reasonably predicted or expected from the perspectives of either state direction or private spontaneity alone. In many ways, the Crisis in Thailand could be said to result from a misunderstanding that the economy would have been better off, had the state systematically retreated from interfering in economic activities so that both price and allocative efficiency can be achieved through the market force. Crucially, this conventional principles omitted the role of law and its institutions in determining the market outcome. The two following chapters demonstrate: firstly, why such an omission made the Crisis so difficult to foresee; and secondly, how law and regulation provided the framework as well as the tools of interaction to public authorities and private actors such that the dynamic web of their actions instigated changes in the structural integrity of the system. In our case, such changes unfortunately led to an international financial crisis.

Chapter 2 explores the building up of systemic vulnerability in the pre-crisis Thai financial system as well as the transformative process turning a structurally unstable financial system into a

financial crisis. The crux of the story is in fact quite simple. It gives an account of the Thai government's overzealous desire for a rapid and sustained period of economic growth. To that end, the government provided a unique legal and regulatory landscape that nurtured the rise of two highly competitive systems of financial intermediary: commercial banks and finance companies. Fueled further by the reform package opening up the domestic market to the current of international capital flows, they together created systematically destabilizing conditions in which accumulative external debts of their respective sectors became too overwhelming for the national authorities to contain. The Crisis thus ensued. Yet, Chapter 2 also asserts that this narrative can never be completed without understanding the institutional skeleton as well as legal devices that made it happen.

Chapter 3 addresses the topic which Chapter 2 takes as a given – the influx of foreign capital into the financial system. Specifically, it attempts to investigate the following issues. Firstly, how did capital surpluses “travel” from the originating countries to borrowing entities in other jurisdictions? The circumstances, conditions, and requirements of cross-border capital movement were dictated by relevant legislations and regulatory instruments promulgated by the source and destination nations. In addition, the chapter reveals that the governing frameworks of capital flows also influenced the kind of funding the borrowers are likely to receive. In good times, the type of financing hardly matter because creditors are willing to roll it over if need be. In bad times however, the details embedded in the fine print of financing contract will be scrutinized and strictly enforced.

Chapter 2 - The AFC: the Origin and the Mechanism

1. Introduction

This chapter explores the origin as well as the mechanism of the Thai episode of the AFC. Let us first start by parsing the meanings of these two terms. The chapter defines the origin of the crisis as the process of building up systemic instability in the financial market. One should be mindful however that instability is inherent in the DNA of any contemporary financial system. Banks typically retain merely a fraction of total reserves as cash on hand to meet the withdrawal demand of their depositors while lending the rest to income-generating economic projects. It is clear to see that the fractional reserve banking model is in and of itself unstable. Yet not only does the banking sector hardly collapse, but it has also developed into one of the most important financial subsectors that manage extremity in the economy by increasing and contracting money supply.⁶⁷ Admittedly, the society has built in several layers of safety valves to protect the banking sector from failure, most notably the deposit guarantee scheme. Consequently, it must take more than what natural instability of the contemporary financial structure entails to instigate the necessary conditions for crisis.

In the mainstream economic literature that deals with widespread financial failings, the reference to financial instability has become a recurrent theme after the Global Financial Crisis of 2008-9. Discussing the foreign reserve development in emerging economies, Obstfeld et al. suggested that instability be the likelihood of a run against a local currency which could result from sudden shocks

⁶⁷ M McLeay, R Amar and R Thomas, 'Money Creation in the Modern Economy, Bank of England's Monetary Analysis Directorate' [2014] Quarterly Bulletin Q1.

in one or more key sectors of the economy.⁶⁸ These abrupt interventions break down the functioning of the financial system because, according to the conventional theory, they disrupt informational flows necessary to maintain both price and allocative efficiency.⁶⁹ On the other hand, Keynes and Minsky argued that instability arises from the inherent nature of capital development in the real time economic cycle, as opposed to the allocation of resources among alternative employments.⁷⁰ Over periods of prolonged prosperity, the capitalist economy transits from financial relations that are stable to those that make for an unstable system.⁷¹ Contrary to the first model, it does not rely on external shocks to generate financial volatility of varying severity. Rather, it tells a story of the internal dynamics of capitalist economies. As it was alluded to in the introductory chapter and will be substantiated in Part I of the dissertation, the factual examination of the financial development in Thailand prior to the AFC dovetails better with the Keynes-Minsky model of instability. The LTF framework adopted here takes the analytical groundwork a step further. It essentially peels through the mechanism that creates volatility in order to unveil its underlying components, which are essentially legally constructed. To prove this point, this chapter highlights the institutional account of the competition between banks and finance companies. Only by parsing through the legal structure and regulatory scaffolding laid out for these two subsectors can one understand the increasingly aggressive and reckless behavior of banks and finance

⁶⁸ Maurice Obstfeld, Jay C Shambaugh and Alan M Taylor, 'Financial Instability, Reserves, and Central Bank Swap Lines in the Panic of 2008' (National Bureau of Economic Research 2009) <<http://www.nber.org/papers/w14826>> accessed 17 May 2017.

⁶⁹ Frederic S Mishkin and others, 'The Causes and Propagation of Financial Instability: Lessons for Policymakers' [1997] *Maintaining financial stability in a global economy* 55. at 62.

⁷⁰ Hyman P Minsky, 'The Financial Instability Hypothesis' [1992] *The Jerome Levy Economics Institute Working Paper* <<http://papers.ssrn.com/abstract=161024>> accessed 12 February 2015. at 3.

⁷¹ *ibid.* at 8.

companies as well as the changing economic paradigm during the period studied. In other words, the dissertation's interpretation of "systemic instability" concerns the institutional development of the financial system.

Our clarifications regarding the term "the origin of the crisis" developed above should provide a guidance to the interpretation of the second key phrase "the mechanism of the crisis". Essentially, it refers to the process of transforming a highly destabilizing financial system into a system in crisis. This refers the period in which economic units in the system rely on rolling over their existing liabilities or are compelled to increase liabilities and the prior commitment of future incomes. Crucially, the debt creation and enforcement are technically both legal creations and cannot be abstracted from the analysis of the crisis. Parties enter into a binding relationship by specifying their respective rights and responsibilities. The binding force is derived directly from the legal institutions to which the contract is subject. In the time of crisis especially, creditors protect their own financial interest by electing to enforce strictly the terms of the contract previously agreed during the good times. As a result, the mechanism of the crisis in this chapter is framed in term of the repercussions of various contractual enforcements entered into not only by private domestic banks but also by the government agencies (crucially the central bank). The timing issue though is admittedly difficult to predict precisely because debtors in the aforementioned situation are facing with the problems of liquidity constraint and fundamental uncertainty i.e. inability to allocate risk in every potential outcome of the world.⁷²

The rest of the chapter is organized according to the preceding logic. First, it discusses the legal architecture that gave rise to two fiercely competitive subsectors within the financial system –

⁷² Pistor, 'A Legal Theory of Finance' (n 18). at 316.

commercial banks and finance companies. It then traces the market reform program implemented between the late 1980s and the early 1990s. It demonstrates that while this set of initiatives followed obediently the conventional market-oriented principles, the outcome of the reform did not correspond to how that framework theorized.

2. Finance Development in the Industrialization Era: 1962-1989

Just like many other countries in Asia in the post Second World War era, the Thai government had a direct hand on running the economy. As the economy expanded beyond Bangkok, it started building various economic institutions so to remain in control over the developmental agenda. The commercial banking sector was one of the important early initiatives and tasked to support the state-issued plan by providing funding to strategic industrial sectors. This section first explores that building process which witnessed the government's failure in nurturing a strong banking sector which could help speed up credit allocation in order to support the transformation from an agriculturally based society to an industrialized nation. Precisely because of the underperforming outcome, the government decided to create a new type of financial entity, finance company, to complement the underwhelming banking sector. In reality however, the two subsectors ended up fiercely competing against each other. Initially, the sign was positive since Thailand in the early 1980s was one of the fastest growing economies in the world. However, excessive competition inevitably led to an increasing number of institutional failures. The crisis resolution system that was put in place at the time could barely contain sporadic collapses. It became clear that it was not equipped to deal a systemic, wholesale financial crisis. The following investigation plays out this narrative through the legal and regulatory development pertaining to commercial banks and finance companies.

a. The legal reforms: the modernization of the banking sector between 1962 and 1972

The situation drastically changed in the late 1950s and early 1960s. The First National Economic and Social Development Plan (1961-1966) – the government’s five-year development agendas – stated that the relevant government agencies had to aggressively promote private investments in the manufacturing industry, especially those sectors that consumed domestic factors of production and served domestic demand. Not only did the government established the Board of Investment of Thailand to handle the implementation of the investment promotion law, but it also manipulated the institutional setup of the commercial banking sector so that additional credit could be extended to the strategic industries accordance with the official development agendas. The four following steps explain the transformation of the Thai banking sector from the trade-based model of the previous era to the modern banking framework.

First, the Ministry of Finance declared it would stop issuing new bank licenses by the late 1950s, signaling that the authorities were content with the number of banks in the economy.⁷³ The government also limited the presence of foreign banks to one bank per one country.⁷⁴ By the end of the 1970s, they became significantly less important, representing merely five per cent of total commercial bank assets as their primary business was still concentrated in trade-finance.⁷⁵ Consequently, there were 14 Thai-charted banks and 11 foreign incorporated banks at the end of

⁷³ Karel Jansen, *Finance, Growth and Stability: Financing Economic Development in Thailand, 1960-1986* (Ashgate Publishing, Limited 1990). at 68-69.

⁷⁴ From 1962 onwards, branches of foreign banks had to seek a banking license to operate in Thailand. Section 4 of the Commercial Banking Act of 1962.

⁷⁵ Michael T Skully, *ASEAN Financial Co-Operation: Developments in Banking, Finance, and Insurance* (Macmillan 1985). at 128.

1962. From then until the 1990s, the Finance Ministry issued only one additional bank license to Asia Trust Bank in 1966.

As the number of banking institutions stabilized, the second priority was to strengthen the safety and soundness of the sector and to provide the Bank of Thailand with the regulatory and supervisory authority over the banking sector.⁷⁶ This was accomplished first and foremost through the most comprehensive banking legislative reform of the pre-crisis era. The Commercial Banking Act of 1962 implicitly transferred de facto regulatory authorities over commercial banks from the Ministry of Finance to the Bank of Thailand, even though the Ministry retained de jure powers as a supervisory agency of the central bank.⁷⁷ There was a wide array of control measures entrusted upon the central bank to manipulate the behavior of banks, yet most of them were left unused, for instance, the powers to set the ratio of selected assets to capital⁷⁸ and the maximum exposure to one borrower and his affiliates.⁷⁹ The former, especially, could have been used to direct banks to lend to certain industries or selected types of borrowers as the central bank (or the government) saw fit. The contemporary commentators speculated that the primary reason was that these control measures did not provide “sweet enough carrots” that were appealing enough to banks and at the same time the central bank was not prepared to use “sticks” to enforce such rules.⁸⁰

⁷⁶ In the early 1960s, bank failure had emerged as a cause of concern since three major banks collapsed within the space of ten years between 1959-1969.

⁷⁷ Section 50.

⁷⁸ Section 10(2).

⁷⁹ Section 13.

⁸⁰ Alek A Rozental, *Finance and Development in Thailand* (Praeger 1970). at 228.

Nevertheless, the 1962 Act offered some regulatory tools that the Bank of Thailand did in fact enforce extensively in order to strengthen the sector's safety and soundness. The following three prudential requirements brought the governance of Thai banks in line with the standard of the international modern banking system and in the process increased liquidity in the system multifold. Firstly, banks were required to maintain the ratio of capital funds to risky assets.⁸¹ The capital funds were the sum of paid-up capital and reserves including other reserves from net profit and undivided profit.⁸² Initially, the banking industry warned the compliance with this new rule meant that banks would be forced to reduce their holdings of earning assets such as loans to manufacturing industries which were considered risky asset.⁸³ In other words, it could potentially reduce banks' ability to serve the government's industrial development goals. Owing to the restriction on the entry of new banks, such fear was however never materialized since banks found it relatively easy to raise additional capital necessary to satisfy the rule.⁸⁴ As a consequence, the ratio was initially set at six per cent but raised to nine per cent by 1971.

The second is the legal reserves. This rule dictated that banks were required to maintain a portion of their total deposits in cash deposited with the Bank of Thailand or in the forms of qualified government securities.⁸⁵ Initially, the ratio was set at six percent and then raised to seven percent by 1969. The law allowed up to one half of the reserves to be made up of government bonds. The implication of the legal reserves was that banks piled up their portfolio with government bonds,

⁸¹ Section 10(1).

⁸² Section 4.

⁸³ The Bank of Thailand Notifications Implementing the Commercial Banking Act of 1962, various issues.

⁸⁴ Rozental (n 80), at 111.

⁸⁵ Section 11.

which were appealing to them for many reasons. Chiefly, they carried low credit as well as market risks but still paid out relatively high returns compared to other riskier commercial lending. To prevent banks from stocking up government bonds far above the legal threshold and thereby reducing their portfolio of private lending, the central bank reduced the interest paid on government bonds but most crucially it allowed banks to use government bonds as collaterals against their liabilities with the central bank.⁸⁶ In reality, even though this regulatory tool helped strengthen banks' reserves, it did not represent a sufficient incentive for banks to lend more to private borrowers. By the end of the 1960s, banks held 35 per cent of all government bonds whereas merely 12 per cent of total debts incurred by the banking sector came from the Bank of Thailand.⁸⁷

The third and final noteworthy prudential rule was the proportion of cash *on hand* and cash balances with the Bank of Thailand to total deposit. This ratio decreased dramatically towards the beginning of the 1970s but well within the legal requirement.⁸⁸ While this ratio might not be familiar to western banking regulatory experts, its continued declines revealed the transformation from a trade-focused model to the credit-based banking model. It should also be noted that Thai banks traditionally advanced credit to borrowers by way of overdrafts or credit lines. Thus throughout the period, the proportion of loans, overdrafts and discounts remained nearly 100 per cent of total deposits.⁸⁹

⁸⁶ The Bank of Thailand however allowed commercial banks to borrow up to 70-90 per cent of the full face value of the bond, depending on the length of maturity, in order to prevent banks from making a business out of borrowing money from the central bank. See Rozental (n 80). at 213.

⁸⁷ Source: Bank of Thailand.

⁸⁸ Section 11.

⁸⁹ Rozental (n 80). at 107.

As the central bank was satisfied with the strength of Thai banks' balance sheet⁹⁰, it then switched focus to try to encourage more savings, especially time deposits by the household sector. This represented the third stage of the modernization process. A combination of factors contributes to the government achieving this goal in a spectacular fashion. The Ministry of Finance entrusted Bank of Thailand to encourage bank branching by using the statutory power to generously approve new applications. The interest rate banks paid to depositors had been attractive throughout the period. Most importantly, the gross national income rose dramatically during this period⁹¹, meaning the household surpluses increased such that more people naturally turned to the formal financial sector and away from their traditional subsistent method to store their wealth. Consequently, 352 commercial bank branches grew to 647 by 1970. By 1978, there were over 1,270 Thai banks across the country. While some researchers were not totally impressed with the national distribution of branches⁹², the rapid growth could not be lightly dismissed. Private residents' demand deposits held at commercial banks increased almost twofold between 1961 and 1967 while time deposits rose remarkably from 1,485.3 million baht to 10,979.4 over the same period, representing a 739 per cent growth.⁹³

Finally, the fourth stage of transformation was to encourage banks to extend credit to productive business ventures and industrial sectors with high potential for growth. Significantly, here is where

⁹⁰ There had been no bank failure at all in the 1970s until the global oil price crisis.

⁹¹ Between 1962-1968, Thailand lifted 18 per cent of its population out of poverty. See 'Poverty and Income Distribution in 1999' (National Economic and Social Development Board 2000) Indicators of Well-Being and Policy Analysis Newsletter 4(1).

⁹² For instance, VIRACH APHIMETEETAMRONG, 'The Contribution of Financial Institutions to Thai Economic Development' (PhD, University of Illinois at Urbana-Champaign 1980) <<http://search.proquest.com/docview/303018714/abstract?accountid=147016>> accessed 24 April 2014; Jansen (n 73).

⁹³ Source: Bank of Thailand.

the banking sector underperformed the most. It could be said that the government authorities, especially the Bank of Thailand, could have been more rigorous in exercising their statutory power to force banks to lend when the sector as a whole clearly had a sufficient amount of capital on hand to do so without compromising the safety and soundness of the system.⁹⁴ The accelerated rural development program (1968), which guaranteed all loans that banks made to farmers, never went beyond a pilot stage even though the record showed that it increased the volume of the loans by 37.5 per cent.⁹⁵ The Bank of Thailand had a legal authority under Section 11 to add agricultural papers to the admissible securities qualified for the legal reserve requirements. Yet it remained one of the few central banks in the developing world that was not actively engaged in agricultural credit. Not only did the government fail to be more assertive with its authority afforded by the law, but the banks also had to take responsibility for the inefficient credit extension system as well. Banks never encountered the need to venture into the lending operation that, despite their potentially high return on investment, could also be extremely risky. Firstly, the banking industry had been well protected from new entrants by the government's order since the late 1950s. Secondly, there were already various other highly profitable businesses, namely urban enterprise and consumer finance. As a result, while banks sought to expand their deposit base nationally, they were not generally interested in growing their lending businesses outside Bangkok and major manufacturing bases.⁹⁶

⁹⁴ On one calculation, banks could have accommodated an addition of 85 billion baht worth of earning assets. Rozental (n 80). at 141.

⁹⁵ *ibid.* at 88.

⁹⁶ In 1970 for instance, the ratios of commercial bank credits to deposits in the North Eastern and the Southern regions were 41.5 and 49.4 whereas such ratios in the Central region and Bangkok, where commerce and industrial hubs were congregated, were 96.8 and 105.4 respectively. Source: the Department of Economic Research, Bank of Thailand.

b. The emergence of new non-bank financial institutions

The development of non-bank financial institutions had been under the government's consideration since the mid-1960s. With a rapid growth in manufacturing and industrial ventures, the Second National Economic and Social Development Plan (1967-1971) admitted to the need of finding new financing channels that could mobilize private sector savings and invest in the productive businesses more efficiently than the banking sector did. After the failure of the private-sector initiated Bangkok Stock Exchange, the government, with advice from the World Bank, hired Professor Sydney M. Robbins, a finance professor from the Business School of Columbia University, to study the development of the Thai capital market.⁹⁷ His comprehensive report "A Capital Market in Thailand" was a basis on which the Bank of Thailand relied to produce its master plan for both the developments of non-bank financial institution and the future government-backed stock exchange. It was during this formative years (1966-1972) that the authorities started to observe a new breed of companies, which performed both financial and investment banking activities, were established. They simply registered themselves as limited companies under the Civil and Commercial Code, and thus were subject to no regulatory or supervisory standards, even though both financial and securities undertakings had serious negative implications to the whole economy. The protection of the general public therefore became an official *raison d'être* for the legislative interventions that came in 1972 and 1979.⁹⁸

⁹⁷ "History of the Stock Exchange of Thailand", The Stock Exchange of Thailand website, <http://www.set.or.th/en/about/overview/history_p1.html>.

⁹⁸ The subsequent section demonstrates that the authorities' determination to protect the public at all costs, especially by implicitly guaranteeing bailouts for any financial institutions that failed in the subsequent years, left the Thai financial sector exposed to a situation of moral hazard.

This section explores the regulatory framework of the finance company in comparison to that of the commercial bank. It asserts that the institutional dynamics between the two species of financial institutions mean that a limited amount of highly profitable targets were prioritized and competed for. This created a structural imbalance in the economic development as well as in the accumulative balance sheet of the financial sector. The overreaching business model of many finance companies was exposed for the first time in the late 1970s when the world economy was beset by the Global Oil Crisis. Nevertheless, the crisis management efforts by the authorities, especially the Bank of Thailand were unfortunately shortsighted. The government was arguably beholden by public sentiment and thus tried to do everything it could to maintain the momentum of the economic transformations, particularly of the newly formed Stock Exchange of Thailand on which stocks of large banks and finance companies were listed and traded.

In 1972, the government replaced the 1928 Act with the Revolutionary Council Announcement No. 58 Regarding the Control of Commercial Undertakings Affecting Public Safety and Welfare.⁹⁹ The new law designated non-bank financial activities as one of the commercial undertakings that required licenses and had to be regulated by the Ministry of Finance, which, in turn, deferred most of its regulatory authorities to the Bank of Thailand. Seven years later, all military junta legislations and secondary instruments issued previously regarding non-bank financial institutions were codified and updated in the Finance, Securities and Credit Foncier Act of 1979. The regulatory framework and incentive arrangements built into the legislation allowed finance companies to be more risk tolerant than banks.

⁹⁹ The Thai Supreme Court of Justice ruled in one of its seminal cases in 1953 that the Announcements, issued by a military junta government after a coup d'état, ain an equivalent legal status and authority with the Acts of a democratically elected parliament. Supreme Court Judgement No. 45/2496.

In the first place, finance companies may, upon obtaining appropriate licenses, invest in any businesses that fall into one of the following categories:

1. finance for commerce, which usually means short-term lending;
2. finance for development, which include medium- and long-term lending to industrial, agricultural or commercial borrowers;
3. finance for disposition and consumption, and;
4. finance for housing.¹⁰⁰

Furthermore, a majority of non-bank financial institution registered themselves as “finance and securities companies”. In other words, in addition to the financial business licenses, they also held a securities license, which authorized them to perform as;

1. securities broker;
2. securities dealer;
3. investment advisor, and;
4. securities underwriter.¹⁰¹

This universal business structure is rather unique in the Thai context due to the historical circumstance in which most of the early finance companies helped underwrite and act as dealers for issuing companies listed on the defunct Bangkok Stock Exchange. In line with the capital market development master plan devised in the late 1960s, the Bank of Thailand allowed the dual licensed model to be legally recognized under both the 1972 and 1979 regulatory regimes.¹⁰² With

¹⁰⁰ Sections 4 and 20, the Finance, Securities and Credit Foncier Act of 1979.

¹⁰¹ Ibid.

¹⁰² Under the capital market development master plan, finance or finance and securities companies may also open branches in any part of the country upon permission granted by the Bank of Thailand, the authority of which was

regard to the fund raising issue, finance companies were explicitly prohibited to accept deposits; rather they could issue promissory notes, the face value of which was required to be equal to or exceed 50,000 baht (approx. \$ 2,000) if issued in Bangkok and 10,000 baht (approx. \$ 4,000) in other provinces.¹⁰³ The minimum threshold, relatively high in term of the then cost of living, presumably targeted experienced investors, while precluding the investing public, who would be better protected under the heavily regulated structure of the commercial banking sector. Furthermore, finance companies were free to set the interest rates they paid to the holders of the promissory notes. By contrast, banks were subject to the borrowing rate ceilings imposed by the banking law.¹⁰⁴ This regulatory discrepancy evidently afforded finance companies more flexibility with their business model and thus competitive edge over banks. Last but definitely not least, while banks had to comply with at least five different prudential rules regarding the capital adequacy requirements, finance companies were subject to just two following requirements: the capital-to-risky-assets ratio and the liquid-assets-to-outstanding-loans-from-the-public ratio. What is more, the concepts of risky assets and liquid assets were more liberally defined than the terms used under the banking regime.

vested upon by the Ministry of Finance. See Section 5, the Ministerial Notification on the Conditions Necessary for the Operation of Finance Businesses of 1972 (and its subsequent amendments).

¹⁰³ Section 2, the Bank of Thailand Notification on the Maintenance of Liquid Assets and Borrowing Limits of 1973.

¹⁰⁴ The usury law in the Civil and Commercial Code placed a statutory bar of 15 per cent for all cases, at least until 1980.

Table 1: Summary of the legal frameworks for commercial banks and finance companies, as of 1980

| | Commercial Banks | Finance companies |
|----------------------|---|--|
| Entry requirements | <ul style="list-style-type: none"> - From 1979, public company limited registration with strict ownership concentration rules, including foreign ownership restriction - Branching allowed - Banking license requirement | <ul style="list-style-type: none"> - From 1979, public company limited registration with strict ownership concentration rules, including foreign ownership restriction - Branching allowed - Specific license requirement for each type of financial or investment banking activities |
| Sources of funds | <ul style="list-style-type: none"> - Deposits (both demand and time-limit) - Loans from the Bank of Thailand, other banks or abroad | <ul style="list-style-type: none"> - Promissory notes with minimum thresholds for Bangkok and provinces - Loans from other companies both domestically and abroad |
| Operating activities | <ul style="list-style-type: none"> - Traditional banking activities | <ul style="list-style-type: none"> - Wide ranging of financial and investment banking activities, |

| | | depending on the type of license obtained |
|---|---|--|
| Prudential regulation and other Bank of Thailand's (BoT) control measures | <ul style="list-style-type: none"> - Borrowing and lending rate ceilings, limits on commissions - Capital-asset ratios include capital-risky asset ratio, capital-specific asset ratio and capital-contingent liability ratio - Legal reserve ratios include ratio of cash to outstanding liabilities and also ratio of liquid assets to outstanding liabilities - Obligations to write off non-performing assets | <ul style="list-style-type: none"> - <i>Extremely liberal</i> borrowing and lending rate ceilings - Capital-risky asset ratio - Ratio of liquid assets to outstanding loans obtained from the public - Obligations to write off non-performing assets (but not until 1984) |
| Sanctions against noncompliance | <ul style="list-style-type: none"> - Criminal and civil sanctions for negligent conducts | <ul style="list-style-type: none"> - Criminal and civil sanctions for negligent conducts |

The end result of this new institutional landscape within the Thai financial system was that the non-bank financial sector became the fastest growing industry throughout the 1970s and the beginning of the 1980s. In 1973, a year after the first regulatory framework for finance companies were put in place, there were 13 finance companies and 41 “dual licensed or universal” finance

companies. By 1977, the number grew rapidly to 28 and 85 respectively.¹⁰⁵ In term of total assets, the finance company industry accumulated 26.443 billion baht, representing 230 percent growth, within the same time frame.¹⁰⁶

Interestingly, commercial banks were arguably responsible for this explosive transformation from a small industry into the second largest subsector within the Thai financial system within a short space of time. Bank managers saw the regulatory discrepancies between the banking regime and the non-bank counterparty as a potentially lucrative arbitraging opportunity. As a result, they ended up sponsoring or even founding most of the largest finance companies themselves.¹⁰⁷ While remaining legally separated entities, banks could escape the stringent bank rules and pursue highly profitable business ventures such as short-term consumer financing, check-discounting activities and margin loans for securities transactions. This explains why the authorities failed to persuade a vast majority of finance companies to grant medium- and long-term financing, which was better structured to support capital intensive manufacturing and industrial projects. Moreover, there was no incentive for them to expand their presence beyond the commercial and industrial hubs in Bangkok and its vicinity in which more than 110 finance companies congregated. At the end of 1977, there were only still 21 finance businesses in other areas of the country.¹⁰⁸ Thus, because of its extremely concentrated nature, the sector was vulnerable to shocks both by random institutional failures or economy-wide distress. In addition, the fact that by the 1980s, finance companies provided as much as 20 percent of total credit extended by the financial and mobilized over 15 per

¹⁰⁵ Source: Bank of Thailand.

¹⁰⁶ Ibid.

¹⁰⁷ APHIMETEETAMRONG (n 92). at 37-38.

¹⁰⁸ Source: Bank of Thailand.

cent of total financial savings means the government had to contemplate also the linkage between the sector weaknesses and the systemic implications.

A case in point is the collapse of Rajah Capital, one of the biggest independent short-term finance companies, in 1979.¹⁰⁹ The firm was highly leveraged, surviving on borrowed money from institutional creditors to pay interest charges on its promissory notes the company held by individual investors. During the second energy price shock, both domestic and international credit channels dried up. As the news of liquidity shock spread out, the company's stock price, which was at the time astronomically overvalued, plummeted. It became clear that its underlying business of short-term consumer finance was also losing money, the liquidity problem thus quickly turned into an insolvency problem. The company was shut down in the middle of 1979. The failure of Rajah Capital caused disastrous ripple effects in the secondary market for debt instruments issued by finance companies as well as to the newly established Stock Exchange of Thailand.

This could have been an opportune moment for the Bank of Thailand, as the regulator of finance companies, to send out a strong message disapproving of the business practices adopted by a vast majority of finance companies, as well as to propose a legislative reform correcting the incentive structure imbedded in the legal framework of the industry. Unfortunately, the central bank did neither of those things. With regard to Rajah, it revoked the license and closed the company without holding the owners accountable for its reckless conducts. Instead, the people, who invested in the company's promissory notes, were punished and recovered merely 20 percent of its face value.¹¹⁰ Additionally, its crisis policies of 1) discounting any promissory notes issued by finance

¹⁰⁹ 'One Decade: the Financial Institutions Development Fund (1985-1995)' <www.bot.or.th> accessed 19 April 2014. at 13-16.

¹¹⁰ There was a discussion at the time of introducing a legislative bill that would establish the National Deposit Guarantee Agency for both banks and finance companies. Nevertheless, nothing came out of it and depositors and

companies it deemed credible and 2) reducing the value of collateral required for margin loans in securities transactions essentially amounted to affording the financial system an official stamp of approval for their careless behaviors. No legislative reforms were forthcoming until six years later. Even then, it was too little too late.

c. Initial signs of troubles in the financial sector: failure of legislative reforms

The unraveling of Thailand's first financial crisis in the contemporary financial history, which immediately followed the collapse of Rajah Capital, revealed the common pattern. After building up a portfolio full of loss-making assets, finance companies handled the pressing liquidity problem on their asset side of the balance sheet by leveraging themselves out of trouble. When the plan failed as it often did, the management personnel fled the country. From 1979-1990, the total of five banks and 22 finance companies sought financial assistance from the government. The fact that only one of each went completely out of business did more to expose the inherent problem of the Thai financial system at time than to show the ability of the authorities in dealing with the crisis situation. Consequently, this section contends that the authorities' crisis management measures introduced in this period did not make the financial system sufficiently resilient to fend off global liquidity volatility that would become a decisive factor in the following decade.

There were three major legislative reforms in the latter half of the 1980s, concerning banks, non-bank private financial institutions together with a new master law governing the powers of the Bank of Thailand in the time of crisis.

investors in the financial sector were left exposed without any sort of deposit guarantee scheme until the Deposit Protection Agency Act was enacted in 2008.

The 1985 amendments to the Commercial Bank Act of 1979 conferred a number of new powers to the Bank of Thailand to intervene in the normal business operation and internal management of commercial banks under certain specified circumstances. The banks were obligated to review their portfolio biannually for non-performing assets, which had to then be written off or supported by additional capital.¹¹¹ Nevertheless, the revisions arguably did not go far enough to coerce banks into changing their risky behaviors. Each individual banks were allowed to make a determination as to which assets should be classified as non-performing.¹¹² The law simply outlines a list of factors that they *should* take into account. Even though the Bank of Thailand could still override their decisions¹¹³, the central bank's limited supervisory resources meant that excessively risky assets were kept on banks' book longer and exceeded the threshold that would be considered healthy.¹¹⁴

The rest of the legislative updates involved strengthening crisis management tools available under the Bank of Thailand's disposal. In order to verify any suspicious behaviors, appointed special supervisors were given a clear and expansive authority to interview any bank employees, enter the premise for the purpose of obtaining necessary information, and to investigate employees or records held by debtors of the banks.¹¹⁵ The new section 24(ii) of the Commercial Bank Act granted the Bank of Thailand the broadest statutory authority to date. It could order commercial

¹¹¹ Section 15(ii) of the Commercial Banking Act of 1972.

¹¹² Section 5, the Notification of Bank of Thailand on non-performing assets or assets that are likely to be non-performing (1986).

¹¹³ Section 22 of the Commercial Banking Act of 1972.

¹¹⁴ The same definitional problem applies to the law applicable to finance companies. See section 23(ii) of the Finance, Securities and Credit Foncier Act of 1979 and section 2 of the Notification of Bank of Thailand on non-performing assets or assets that are likely to be non-performing (1984).

¹¹⁵ Section 35 of the Commercial Banking Act of 1972, as amended in 1985.

banks to commit to any courses of action it deemed necessary to protect the public interests. Interestingly, if the orders by the central bank fall into the type of decision-making that needs consent from shareholders, the law treated the central bank's decisions as if it were the decision reached by the shareholders themselves. The most interventionist power afforded by the 1985 amendments was that the Bank of Thailand could unilaterally remove the board of directors or any responsible managers on two grounds; firstly, the removal had to be deemed necessary to protect the public interests; secondly, the troubled bank failed to act upon the central bank's section 24(ii) order.¹¹⁶ The law also strengthened the sanctions against individual bank directors and managers, for instance, swift personal asset confiscation and foreign travel restriction.¹¹⁷ While the aforementioned legislative changes sounded comprehensive in toughening up the crisis management toolkit available to the authorities, nevertheless the reform did not address the fundamental issue directly concerning the operation of the systemically destabilizing businesses themselves. Significantly, the 1985 reform and its subsequent statutory instruments seemed to have taken the deferral approach, leaving virtually all important supervisory decisions to the Bank of Thailand; and in doing so, they moved the regulatory framework away from the rule-based, descriptive approach. The former method required a great deal more expertise as well as human and capital resources than the latter. The Bank of Thailand was left exposed when it possessed neither requisite expertise nor adequate resources to lead the financial system through the pivotal period of financial liberalization.

The legislative amendments to the Finance, Securities and Credit Foncier Act of 1979 followed the similar pattern to that of the banking reform, but arguably in a less comprehensive scale. For

¹¹⁶ Section 24(iii), the Commercial Banking Act of 1972.

¹¹⁷ Section 46(x), the Commercial Banking Act of 1972.

instance, while the new banking law prohibited any person and his affiliates from owning more than five per cent of any given banks, the law applicable to finance companies allowed the concentration of ownership up to ten per cent.¹¹⁸ The Bank of Thailand was authorized to make an intervention in the management of finance companies if it deemed necessary to protect the public interests in the same fashion as the amendments to the banking law as discussed above.¹¹⁹

A noteworthy change appeared in the new statutory instrument aiming at preventing the kind of panic run on finance companies similar to what happened with the Rajah Capital debacle a few years earlier. Prior to 1985, holders of promissory notes could elect to redeem the notes with the issuing institutions at any time before the maturity date given that a reasonable notice was made. Effectively, the ability to tender a promissory note at will in return for the principal amount was tantamount to elevating the contractual claim that the note holder could exercise at the maturity date (either to call for the total repayment or to roll over the debt) to a property right claim over the sum owed by the finance company.¹²⁰ This caused a great deal of havoc as it enabled a run-like phenomenon against the entire financial system.¹²¹ As a consequence, the Bank of Thailand prohibited finance companies from honoring the redeeming obligations under the promissory notes prior to the due date.¹²² This revision to the law was significant in affording additional time to the

¹¹⁸ Section 14 of the Finance, Securities and Credit Foncier Act of 1979, as amended in 1985.

¹¹⁹ Sections 26(iv) and 57, *ibid.*

¹²⁰ Jongchul Kim, 'Money Is Rights in Rem: A Note on the Nature of Money' (2014) 48 *Journal of Economic Issues* 1005; Jongchul Kim, 'Identity and the Hybridity of Modern Finance: How a Specifically Modern Concept of the Self Underlies the Modern Ownership of Property, Trusts and Finance' (2014) 38 *Cambridge journal of economics* 425.

¹²¹ 'One Decade: the Financial Institutions Development Fund (1985-1995)' (n 109). at 19.

¹²² Section 2(3), the Notification of Bank of Thailand on the requirements on public borrowing and setting interest or discount rates that finance companies may pay to their creditors or charge against their debtors (1985).

financially healthy institutions to manage their liquidity risk more efficiently, especially during the time of liquidity crunch.

The final important piece of legislative changes in this period was the establishment of the Financial Institutions Development Fund (FIDF). The FIDF was a pre-funded scheme in which both the Bank of Thailand and financial institutions contribute.¹²³ The law did not specify the level of fund that needed to be maintained. Instead, the fund management team determined the appropriate amount based on the prevailing macroeconomic circumstances as well as the size of the financial sector. Organizationally, the FIDF is a separate legal entity from the central bank's governing structure with its own financial book and budget. Nevertheless, it is clear that it was set up as an extending arm of the Bank to manage financial institutions in trouble in the way that the Bank of Thailand could not legally have done so itself.¹²⁴ This reflected in both its mandate and legal authorities bestowed by the law. With regard to the mandate, the FIDF was given free rein "to do whatever it takes that would recover and protect the systemic stability of the Thai financial sector".¹²⁵ In order to achieve such a broadly worded mission, section 29(viii) afforded a number of powers beyond the legal purview of the Bank of Thailand. The most used authorities were the following;

¹²³ Sections 29(v) and 29(vii) of the Bank of Thailand Act of 1942. The contributing financial institutions are defined as any institutions that raise funds from the public in their ordinary course of business, either by way of taking deposits or borrowing from the individual members of the public. The statutory maximum contribution is limited at 0.5 per cent of total deposits in any given year (section 29(v)); however, the Bank of Thailand set the contribution ratio at 0.1 per cent, as of December 31st, 1994.

¹²⁴ It was founded by the 1985 Royal Decree amending the Bank of Thailand Act of 1942 and thus legally, it is part of the same primary law governing the operation of the central bank. Furthermore, the governor of the Bank of Thailand sits as the president of the FIDF board on an ex officio basis. The rest of the board members consist of senior officials from the central bank, the Ministry of Finance, and from the government's legal and legislative drafting agency, the Office of the Council of State.

¹²⁵ Section 29(viii) of the Bank of Thailand Act of 1942.

1. To lend to financial institutions against collaterals as it sees fit;
2. To help depositors and individual lenders of failed financial institutions;
3. To deposit its funds at any financial institutions;
4. To purchase shares of any financial institutions.

The merit of the FIDF as a crisis management tool is clear to see. Nevertheless, not only was the Fund tasked to “rehabilitate” the financial system from the crisis, but it was also entrusted to “develop and contribute to” the strength and stability of the sector.¹²⁶ The mechanism devised in the law to achieve the latter objective was however reactive, bureaucratic and possibly costly. The FIDF typically took the controlling ownership of the institutions that, if collapsed, could have adverse systemic effects. It then appointed its own management team as well as continued providing cheap financial support. When the financial status of the institutions return to the acceptable level, the FIDF would seek appropriate buyers and then sell its block of shares, usually at a cost or at a marginal profit.¹²⁷ If it could not find the right buyers in time, the Bank of Thailand usually order a merger with Krung Thai Bank – a government-controlled commercial bank.¹²⁸ While the approach might be wholly appropriate as part of the rehabilitation program of troubled financial institutions, it did not do enough to punish excessive risk taking behaviors on an *ex ante* basis. The result was an endless loop of fixing one failing financial institution after another without addressing the root cause of the problem.

In all, apart from the revised laws governing non-performing assets and the redemption rights of the holders of promissory notes, no substantive legislative reforms squarely tackled the prevalence

¹²⁶ Section 29(iii) of the Bank of Thailand Act of 1942.

¹²⁷ 10 out of 19 troubled finance companies were sold to new investors.

¹²⁸ This is the case of Asia Trust Bank in 1985.

of risk-taking behaviors in the financial sector. In the early 1980s, various structural problems were overlooked due to the impressive performance of the real economy. The authorities were busy promoting their various new capital market initiatives, notably, the establishment of the government-backed Stock Exchange of Thailand in 1975. Surpluses mobilized by financial institutions were channeled to highly risky and economically unproductive products, notably, short-term consumer loans and unsound business projects.¹²⁹ By 1988, Thailand faced a serious structural problem in which the private sector's rate of spending first exceeded its rate of saving.¹³⁰ In other words, it invested more than it could save. Even though the government's conservative fiscal policy boasted by booming tax revenue from very healthy economic expansion helped partly fund the deficit¹³¹, the private sector was increasingly looking for new sources of funds, especially from abroad.

d. Thailand's foreign exchange and capital control between 1962 and 1989

This section outlines the legal infrastructure that shaped capital flows between Thailand and the international market, with the primary focus on the regime applicable to foreign transactions by banks and finance companies. On the whole, the legal barriers that existed throughout the period played an influential role in the decision making of financial institutions, especially with regard to their fund raising strategy. The legal hindrances were part of post-colonial prudent financial policy framework that had been kept since the first generation of financial regulation. *They were*

¹²⁹ The inefficiency of the Thai financial system in financing productive capital investment required to in order to further the economic growth was acknowledged elsewhere. See Siamwalla (n 4). at 5-6.

¹³⁰ In 1988-1990, the saving-investment gaps in the private sector were 0.64, 4.03 and 10.07 per cent of GDP. See Table 1.7 in Pakorn Vichyanond and Sussangkarn Chalongphob, 'Mobilization of Domestic Savings' (Research and Information Development for Macroeconomic Policy Formulation, Pattaya, Thailand, February 1994).

¹³¹ *ibid.* at 3.

originally designed specifically to prevent the country's finance from becoming beholden to foreign creditors. Towards the end of the period, these protective mechanisms were gradually weakened as the pressures to integrate the internal financial market with the international community mounted from within the financial industry itself and from Thailand's powerful global "so-called allies".

For the most parts, Thailand has always been an international trade friendly country. Up until 1977, it employed the so-called import-substitute trade regime in which high tariffs and strict regulation of imported goods were observed for certain government-designated products that could have been manufactured with comparable quality within the country. With the enactment of the Investment Promotion Act of 1977 (IPA), Thailand adopted a more aggressive export-oriented strategy. The IPA provided legal facilitations for foreign companies that directly invested in the country's long-term capital, particularly the industrial and manufacturing sectors. One of the important financial incentives under the IPA regime was that banks were exempted from seeking authorization from the Bank of Thailand for foreign direct investment or loans to affiliated foreign companies abroad not exceeding \$5millions per year. In addition to providing foreign-trade-related services, the financial sector occasionally borrowed abroad. For a long period in the 1970s, financial institutions' net external borrowing was negative. Even though, the financial sector started obtaining more money from abroad than it acquired foreign assets in the 1980s, the figures were grossly insignificant.¹³² In 1983 for instance, 16 per cent of the sector's total liabilities came from foreign loans while 76 per cent of which were drawn from domestic savings and credits.¹³³ By

¹³² Jansen (n 73). at 138.

¹³³ National Economic and Social Development Board (NESDB), Flow of Funds Accounts of Thailand, the 1983 edition.

1991, banks, in particular, relied on deposits for over 90 per cent of their total funding whereas foreign debts accounted for a merely 1.8 per cent.¹³⁴

The following four areas of law had significant implications on the extent to which financial institutions would resort to foreign borrowing in order to bridge their temporary liquidity gaps. Firstly, it was the exchange rate control system. The Bank of Thailand exercised its powers to maintain the value of Thai baht against other major currencies under the Exchange Control Act of 1942 and various subsequent Ministry of Finance's Notifications implementing the Act. Thailand was forced to adopt the single exchange rate system soon after the government signed up for the Bretton Woods system in 1955.¹³⁵ In order to maintain the official rate within a plus or minus one per cent of the market rate, the Bank of Thailand became actively engaged in the international money market through its exchange stabilization fund.¹³⁶ There were a few incidents, such as in the aftermath of the global oil price shock in 1979 and in the mid-1980s, in which the central bank yielded to the international pressures, especially from the US and the International Monetary Fund (IMF), to devalue Thai baht. Nevertheless, the bank kept the baht pegged at a stable rate throughout the period, even after the major economies abandoned the Bretton Woods system in 1971. In the

¹³⁴ NESDB, Flow of Funds Account of Thailand, the 1991 edition.

¹³⁵ By enacting the Act Enabling Actions According to the International Monetary Fund and the World Bank of 1951, Thailand formally accepted the rights and obligations as a member of the international financial system. However, it took the Bank of Thailand until 1963 to establish a single equilibrium rate at which was to be maintained. See Rangsun Tanapornpan, *Process of Devising Thai Economic Policies (1932-1987): a political economic approach* (Thammasart University Press 2001). at 26.

¹³⁶ The exchange stabilization fund was founded under the Royal Decree on Currency Reserves In Excess of Bank Notes in Circulation (1955). The statutory objective of the fund was to maintain the exchange rate at the level appropriate to the national economic and financial affairs and to invest for profits. Although the fund was established as a separate legal entity, it was the personnel appointed by the central bank who effectively took charge of fund administration. There are two other sources of reserves upon which the Bank of Thailand could draw to manage the value of the baht: the currency reserves and the general account fund of the Bank of Thailand. The former is the reserves fund that the Bank of Thailand needs to maintain to support the money in circulation while the latter is part of the central bank's financial reserves.

1980s, the issue of a strong and stabilized Thai baht had become something of a national pride and thus politically sensitive. From the financial institutions' perspective, a stable value of the local currency virtually eradicated the costs of currency risks that came with borrowing from abroad. While the exchange rate stability played a crucial role during the financial liberalization era in the early 1990s, other countervailing factors still prevailed prior to that.

The restrictions imposed upon both current and capital accounts provide another prohibitive barriers for foreign borrowing by banks. The Ministry of Finance's Notification No.13 of 1954 was an important instrument on which the Bank of Thailand relied to control capital flows. It authorized the central bank to refuse to allow any outflow transactions without having to give a justification (in other words, a pure discretionary power). Furthermore, neither Thai citizens nor corporations could be in possession of deposits denominated in foreign currencies or purchase foreign currencies for the purpose of investing overseas. Specifically applicable to commercial banks, they were prohibited from holding net future and/or foreign exchange-denominated positions greater than 20 percent of their total capital. In other words, the ability of banks (and finance companies) to profit from trading in the international money market was extensively curtailed.

The imposition of domestic interest rate ceiling was the third variable that affected the amount of foreign liabilities incurred by financial institutions. The Bank of Thailand attempted to set the optimal level of the domestic rates based on three factors: "the need to mobilize savings, the need to stimulate investment and the need to prevent too wide a gap between domestic and foreign interest rates".¹³⁷ Nevertheless, the central bank found it difficult to achieve all three policy goals

¹³⁷ Jansen (n 73). at 217.

all at once. Moreover, the interest rate management was criticized as ineffective and irresponsible to the fast changing financial circumstances.¹³⁸ The Parliament passed the Lending Rates of Financial Institutions Act of 1980 in response to the spikes in foreign interest rates during the international oil price crisis. Effectively, the law aimed to realign the domestic rates with the sharp rise in the international counterparts by exempting financial institutions from complying with the strict usury law in the Civil and Commercial Code, which limits the domestic lending rate to no more than 15 percent. All local financial institutions, banks and finance companies included, were allowed to offer up to 20 percent interest rate on the loans they took out from certain qualified foreign creditors.¹³⁹ While the deposit rates (banks) and the rates paid to the holders of promissory notes (finance companies) were both adjusted upwards, effectively increasing their costs of operation, they were still considerably lower than the rates they paid to foreign creditors.¹⁴⁰ In other words, the domestic borrowing cost was lower than the foreign cost. In addition, this meant the rate ceiling remained one of the major regulatory obstacles for both banks and finance companies in the 1980s if they wanted to mobilize more funds from abroad.

Last but definitely not least, it should also be mentioned that the legal reserve requirement and tax implications from borrowing in the international market also played into the decision making of banks and financial companies. The Bank of Thailand strongly encouraged commercial banks to

¹³⁸ *ibid.*

¹³⁹ Section 2, the Ministry of Finance's Notification regarding qualified foreign financial institutions and the ceiling of lending rates the qualified foreign financial institutions may charge on the borrowers (3rd issue, 1982). The qualified foreign financial institutions were defined as 1) any international financial institutions of which Thailand is a member; 2) any other foreign financial institutions that were registered and incorporated abroad. Section 1 of the same ministerial notification.

¹⁴⁰ Banks paid zero interest payment to demand depositors and from 1988 onwards were free to set any deposit rates they saw fit for time depositors whose accounts were for longer than 12 months. See the Bank of Thailand's Notifications of 1985 and 1988. On the other hands, finance companies could not pay their note holders more than 13.5 per cent. See the Bank of Thailand Notifications on Borrowing from the Public of 1981 and 1986.

hold reserves at the level that far exceeded the legal threshold, even though banks strongly disagreed with the policy. An increase in the capital adequacy requirements effectively reduces the amount of investable assets and consequently lowers the revenue and profit.¹⁴¹ Nevertheless, the excess reserves helped banks through patches of liquidity shortages throughout the 1980s without having to dip into the international borrowing market for costly short-term loans. The problem was the level of additional cushion decreased towards the end of the 1980s and the trend continued into the 1990s as the banking sector became overly competitive. Lastly, all short-term foreign borrowings (the maturity date of less than one year) were subject to a ten per cent withholding tax, which was specifically aimed to increase the costs of volatile short-term foreign funding.

To summarize, while it is true that financial institutions, particularly commercial banks, had resorted to foreign borrowings occasionally since the 1960s, the amount was barely significant in comparison with other sources of funding, particularly domestic savings. Furthermore, in this period, commercial banks were told to set aside on average a high level of reserves as a cushion against liquidity crunches. During the crises of the early 1980s, the government stepped in and pumped liquidity into the financial system in order to keep it afloat. The fact that the financial sector was relatively foreign-debt free was one of the major reasons why the government bailout package was successfully carried out. Nonetheless, as the economy hit its strides again in the second half of the decade, foreign funding became ever more significant than before as financial institutions looked to expand and compete both against each other and also the incoming international competitors as well.¹⁴²

¹⁴¹ Jansen (n 73). at 217.

¹⁴² This trend was evidenced in the sharp increase in the net capital inflow from just one per cent of the GDP in 1987 to eight per cent in 1990. Source: Bank of Thailand.

3. The Legal and Regulatory Scaffolding of the Thai Financial Bubble: 1990-1996

The aforementioned development of the Thai financial market shows that the law contributed significantly not only to the evolution from a primitive to a contemporary system of finance but also in shaping the opportunities and limits in which financial institutions to take risk. Towards the end of the 1980s, the government was keen on moving away from the conservative setup of the financial system: strict foreign exchange controls, hands-on interest rate management, demanding liquidity reserve requirements, to name just a few. The pressure for change came in various directions – from the financial sector itself, the powerful international allies who stood to benefit from investing in a rapidly industrialized economy at the time, and also from within the government. The financial liberalization program was envisaged in the 6th National Economic and Social Development Plan, in which the government laid down an ambitious plan to elevate Thailand to the regional financial center on par with Singapore and Hong Kong.¹⁴³

This section presents the way in which this set of initiatives was transposed into the legal construction of the Thai financial system. The analysis is divided into three areas: the laws of banks and finance companies, capital market laws including the regulation of the Stock Exchange of Thailand and most importantly the laws regulating capital flows in and out of the country. While it is true that most of the vulnerabilities, which caused the Thai Financial Crisis in 1997, were instigated by the legal and regulatory inputs in this era, the story of the path to crisis is never completed without an understanding of the institutional analysis of the previous time period.

¹⁴³ The 6th National Economic and Social Development Plan was in operation from 1987 to 1991. However, a bulk of financial liberalizing reforms was executed between 1990-1995.

a. Relaxation of the regulation of banks and finance companies

Although the overall legal structure that governed the operation of banks and finance companies remained largely intact through the period of 1990-1996, certain changes brought about by both the primary laws and implementing instruments had both failed to curb the increasingly risk-taking behaviors and instilled a new competitive paradigm in which encouraged speculative or even Ponzi finance.¹⁴⁴

The first two adjustments to the banking regulatory rulebook are singled out since it failed to curtail the consequences of the overly competitive environment in the banking industry. The first of which was specifically designed to deter the accumulation of assets in jeopardy of default but it is argued that the draftsmen failed to live up to such a legislative objective. The new paragraph two of section 15(ii) introduced by the Commercial Banking Act (3rd Amendment) of 1992 allowed commercial banks to keep the portion of non-performing assets or to delay setting aside extra capital cushion in so far as doing so would reduce their capital adequacy requirement below the statutory threshold required by section 10 of the Commercial Banking Act. Even though the law also gave the Bank of Thailand special powers to impose any corrective actions as it saw fit, this legislative change conveyed a wrong kind of signal to the market regarding the proper treatment of non-performing assets in the financial books. The fundamental problem of the law, as it stood before the 1997 crisis, was that the central bank could defer to the banks' liberal interpretation of the phrase "assets in jeopardy of non-payment or default" in section 4(3) of the Bank of Thailand's Notification regarding non-performing asset of 1986. This meant many banks held on to bad loans for far too

¹⁴⁴ Speculative and Ponzi finance in the Minskyan sense. In other words, the former refers to an economic unit of which cash flows are merely sufficient to cover the interest payment but not the principal amount of outstanding liabilities, while the cash flows of the latter could not fulfil either the interest or principal payment, and thus such units need to borrow more and roll over their liabilities. See Minsky, 'The Financial Instability Hypothesis' (n 70).

long (in many cases, years) without building up a sufficient capital cushion to support potential losses. The necessary fix was never put in place until December 1997. Of course by that time, the Crisis was already in full swing.¹⁴⁵

Another major development was the central bank's decision to lift its control over domestic interest rates.¹⁴⁶ This was initially envisaged as a way to encourage the mobilization of domestic savings. The rate of savings in Thailand at the time was thought to fall far behind other newly industrialized rivals in the region.¹⁴⁷ In a series of regulatory instruments issued by the Bank of Thailand in 1992, the ceilings on saving deposits, short-term time deposits, and the ceiling for loans that were due in five months or later were removed. By June 1, 1992, all interest rate ceilings were abolished for commercial banks and finance companies. The rates from then on were determined by financial institutions themselves.¹⁴⁸ Some contemporary commentators observed that the liberalization coupled with the abolition of foreign exchange controls allowed for a greater mobility of capital across borders and thereby reduced the spread between domestic and foreign interest rates.¹⁴⁹ The reality however was somewhat more complicated than the policy makers and the conventional theoretical framework initially foresaw. Despite the newfound freedom, the deposit rates remained

¹⁴⁵ Section 6(1) of the Bank of Thailand Notification (1997) stated that an asset is in jeopardy of non-payment or default when the debtor stopped honoring their interest or principal payments *for six months or more*.

¹⁴⁶ The central bank did retain its ability to influence interbank rates through the public repurchase market. It did intervene in this market diligently from 1995 until just before the crisis in 1997 in order to calm the economy from overheating, albeit unsuccessfully. See *Nukul Commission Report: Analysis & Evaluation on Facts Behind Thailand's Economic Crisis* (n 33). at paragraph 34-37.

¹⁴⁷ In 1990, Thailand's savings accounted for 23 per cent of the GDP where as the figures were 43 per cent in Singapore, 36 in South Korea and 33 in Indonesia. See Vichyanond and Chalongphob (n 130).

¹⁴⁸ In October 1993, the Bank of Thailand partially reintroduced the loan rate control, requiring commercial banks to set the minimum retail rates (MMR), based deposit rates and operating costs, for small and medium retail borrowers as a consumer protection measure.

¹⁴⁹ Yos Vajragupta and Pakorn Vichyanond, 'Thailand's Financial Evolution and the 1997 Crisis' [1998] Macroeconomic Policy Program, Thailand Development Research Institute. at 8.

exceedingly high by international comparison since banks were still well insulated from the foreign markets but at the same time remained competitive against each other. A case in point is the Minimum Retail Rates (MMR). In its bid to reduce the loan rate for retail borrowers which stood at around 15-16 percent at the time, the Bank of Thailand effectively set a guideline for interest rate calculation in order to reduce the financing costs for borrower with an excellent track record of repayment. Nevertheless, the banking industry never seriously considered the proposal. Even KTB, the government-controlled bank, managed to reduce the rate by a mere 0.25 percent (from 16 to 15.75 percent. In sharp comparison, major US banks had just lowered their rate to around 2-3 percent. In other words, instead of making the financial system more efficient by narrowing the interest rate spreads, the abolition of the interest rate ceilings left banks free to exert their influence on the market rates so much so that they could benefit from the arbitrage opportunities that were brought about by the new offshore banking facilities, the BIBF and PIBF.¹⁵⁰ These are the two important pieces of legal engineering in the Thai financial market prior to the Crisis and will be discussed at length later on.

The shakeup of the liquidity reserve requirements concludes the three major changes to the banking regulatory framework in the early 1990s. In support of the Bank of Thailand's initiative to mobilize savings, the requirement to hold government bonds in order to open new bank branches was reduced in steps from 16 per cent before 1988 to zero in May 1993.¹⁵¹ Furthermore, commercial banks' obligations to extend credits to agriculturally related rural borrowers were also

¹⁵⁰ 'MMR (Minimum Retail Rates) ... An Early Sign' [1994] *Manager Magazine* <<http://info.gotomanager.com/news/printnews.aspx?id=35693>>.

¹⁵¹ Vajragupta and Vichyanond (n 149). at 6.

expanded to encompass a wider range of occupations and geographical areas.¹⁵² In its attempt to modernize the Thai regulatory rulebook, the Bank of Thailand adopted the new capital adequacy requirements heavily influenced by the Bank of International Settlements' Basel Accord. On the one hand, the Basel I offered a sophisticated, internationally recognized standard, which took into account the perceived riskiness of different types of assets and thus prioritized the safety and soundness of banks. By contrast, the Thai-style capital to asset requirement was designed partly as a prudential regulation and partly as a development policy tool allowing the Bank of Thailand to indirectly influence the credit allocation process.¹⁵³

On the other hand, the new capital adequacy ratio underestimated several asset types, which turned out to carry greater procyclical risks than it did on an initial estimation. Specifically, contingent liabilities arising out of currency or interest rate futures and swaps carried extremely low risk weights.¹⁵⁴ For instance, banks were only required to maintain “one” percent of contingent liabilities arising out of privately negotiated currency contracts that are mature within a year and required to maintain no capital at all of this type of contracts that became due within two weeks. One plausible conjecture would be that the currency risk was perceived as negligible since the Bank of Thailand maintained a stable and fixed exchange rate system, which up until the 1997 Crisis had worked relatively well. In a float exchange rate regime however, the currency risk would

¹⁵² *ibid.* See also section 3(28) of the Bank of Thailand's Notification on Capital to Asset Ratio (1983, amended in 1986).

¹⁵³ For instance, the Bank of Thailand excluded 1) loans extended to the rice mills that were qualified under the rice promotion scheme and 2) investments in the government-backed Small Enterprise Insurance Fund from the calculation of total assets for the purpose of the capital-to-asset ratio requirement. In other words, the Bank of Thailand encouraged banks and finance companies to invest in these strategic industries designated by the government. See the Bank of Thailand's Notification on the capital-to-asset ratio (4th issue, 1985 and 6th issue, 1986).

¹⁵⁴ Sections 5 and 6 of the Bank of Thailand's Notification on the capital reserve requirements (1992).

have been much greater as the central bank encountered after it decided to float the Thai baht in July of 1997. This action had a disastrous repercussion among Thai banks and corporations, which borrowed heavily from foreign creditors but did not hedge against future currency fluctuation.

Lastly, the legal definition of “liquid assets” that banks needed to preserve was redefined in such a way that the law lost its purpose of providing an adequate liquidity cushion against any unforeseeable acute liquidity crunches. Prior to 1990, banks were obligated to keep at least seven per cent of its total assets in cash deposits at the Bank of Thailand and cash on hands in the proportion specified in the regulation.¹⁵⁵ These two cash assets were most liquid and could be instantly used to honor virtually all domestically denominated liabilities that might suddenly become due during the liquidity crisis. In September 1991, the central bank broadened the definition of liquid assets to also include its own and state enterprise bonds, as well as debt instruments issued by qualified financial institutions or other government agencies.¹⁵⁶ Furthermore, the new regulation allowed commercial banks to satisfy the liquid asset requirement by accumulating up to five per cent of the total assets in the aforementioned non-cash government-backed securities. The timing of this “de-regulatory” adjustment is noteworthy since it came down when liquidity in the market was plentiful.¹⁵⁷ In other words, the Bank of Thailand might have inadvertently further fueled the procyclical effect of credit supplies in the Thai financial market and was thus partly at fault for a series of bank collapse during the 1997 Crisis.

¹⁵⁵ Section 2, the Bank of Thailand’s Notification on the liquid asset ratio (1990).

¹⁵⁶ Section 2(3), the Bank of Thailand’s Notification on the liquid asset ratio (1991).

¹⁵⁷ The M2 money supply grew on average 19.5 per cent every year from 1990 to 1993. Source: Bank of Thailand.

b. The securities and stock exchange regulation

Thailand's stock market boom and bust were arguably the most recognized signs of the country's so-called economic miracle and its subsequent devastating financial turmoil. While the global appetite for Thai stocks and bonds could be caused by a multiplicity of factors¹⁵⁸, it is argued that it was the legal and regulatory reforms during this financial liberalization program that made it happen. The law provided a conduit channeling foreign liquidity into the exuberant domestic market as well as allowing the reversion of the hot money inflows following the 1997 Crisis.

In addition to the liberalization of current and capital accounts, most of the capital market reforms came together with the foreign investment promotion package in the late 1980s to the early 1990s. The foreign business law was amended so that restrictions on foreign investors taking up an equity ownership of export-oriented companies were relaxed. The government also granted special tax incentives to foreign companies for their direct investment in the strategic sectors. Directly related to the capital market development, there are two types of reforms: 1) foreign investment incentives and 2) the regulation of new financial products. To attract international interests especially from institutional investors, the government reduced taxes on dividends remitted abroad and allowed the investment funds, loan repayments and interest payments to be repatriated freely. It should be noted also that foreign portfolio investment restriction was relaxed as early as 1985 well before the stock market booms in the late 1980s. With regard to product development, the Ministry of Finance allowed for the first time Thai companies to register and issue closed-end mutual funds and foreign-denominated debenture. With regard to institutional reforms, there was a move towards the universal banking model as commercial banks and finance companies were authorized

¹⁵⁸ For discussions on the determinants of foreign demand for Thai equities and debts in the late 1980s and early 1990s, see for instance Kindleberger and Aliber (n 2). at 177-178; and Sheng (n 4). at 133-136.

to engage in investment banking activities such as securities underwriting and fund management.¹⁵⁹ Lastly, the Securities and Exchange Act of 1992 created the Securities and Exchange Commission, a dedicated government agency with legal powers to regulate and supervise both securities companies and the stock exchange.

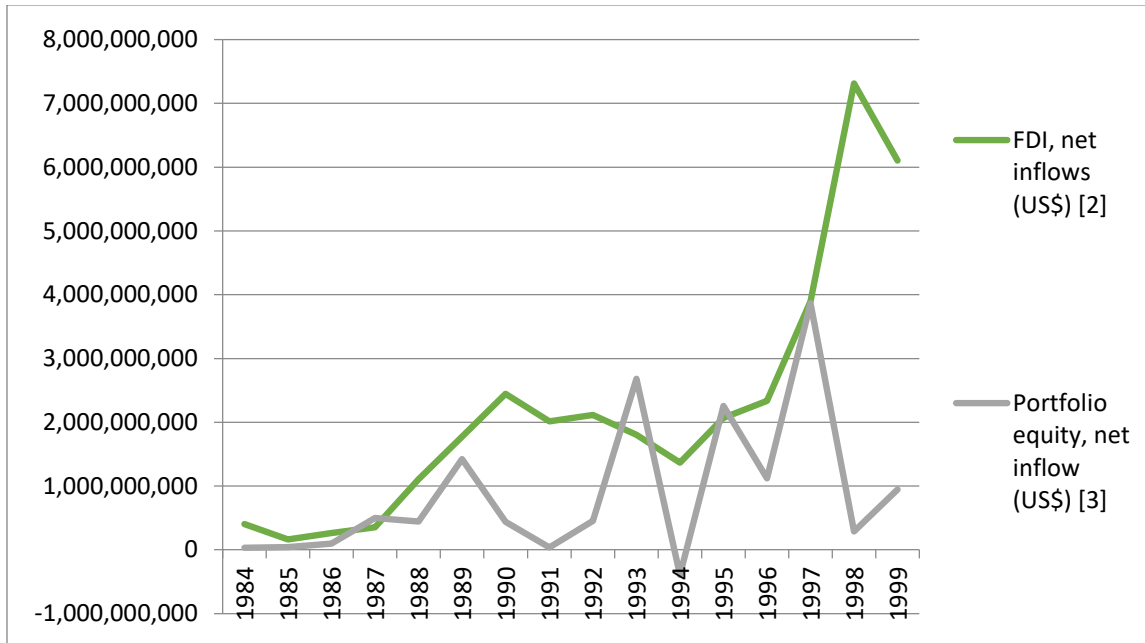
Nevertheless, it is argued that the volatile stock market movements during this period, while devastating in many ways, were correlated to rather than causally linked with the Crisis. It must be noted that Thailand's stock market at the time traded only plain vanilla instruments such as stocks, bonds and warrants. There was neither demand nor regulatory infrastructures necessary for sophisticated products, particularly securitized assets, even though the technique was introduced to Thai investment bankers as early as 1993.¹⁶⁰ Even short selling of stocks and margin loans were not widespread and only became formally recognized *after* the Crisis in the Financial Market Development Roadmap, authored by the Bank of Thailand under guidance of the IMF as part of the financial restructuring plan.¹⁶¹

¹⁵⁹ Vajragupta and Vichyanond (n 149). at 6.

¹⁶⁰ 'What Happened to Securitisation in Thailand?' [2001] *Manager Magazine* <<http://info.gotomanager.com/news/details.aspx?id=810>> accessed 12 May 2014.

¹⁶¹ Private Repurchase Agreement, Bank of Thailand, available at <http://www.bot.or.th/Thai/FinancialMarkets/Fin_Mkt_Development/DocLib/%E0%B8%95%E0%B8%A5%E0%B8%B2%E0%B8%94%E0%B8%8B%E0%B8%B7%E0%B9%89%E0%B8%AD%E0%B8%84%E0%B8%B7%E0%B8%99%E0%B8%A0%E0%B8%B2%E0%B8%84%E0%B9%80%E0%B8%AD%E0%B8%81%E0%B8%8A%E0%B8%99.pdf> accessed 12 May 2014.

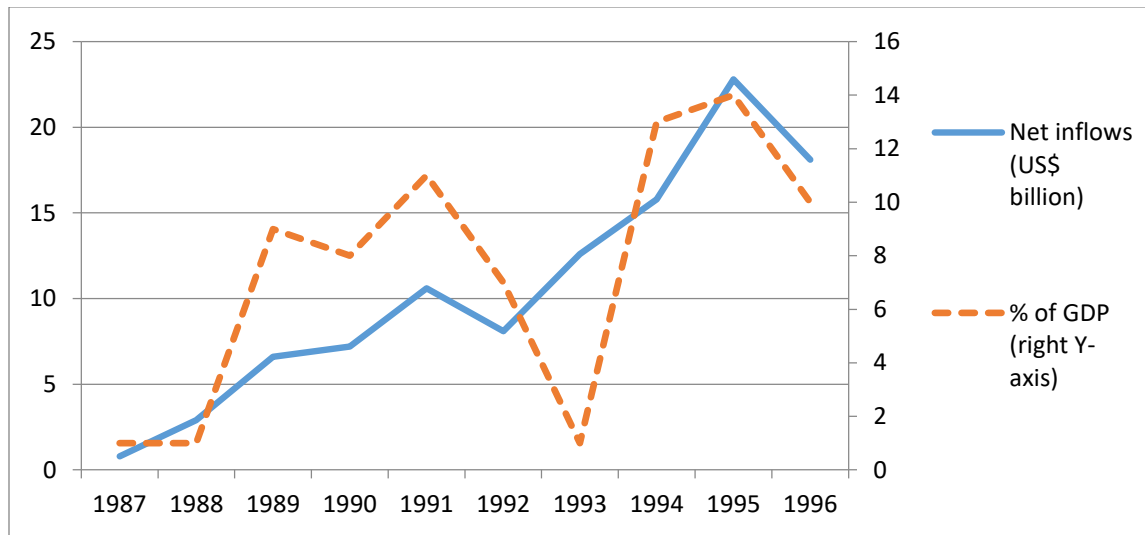
Chart 3: Net Inflows of FDI and Portfolio Equity (1987-1999)



Source: Bank of Thailand

What is more, the data, as seen from Chart 3, shows that the two biggest foreign equity investment withdrawals took place prior to 1997. The former was in 1991 in response to the start of the first Gulf War and the military coup in Thailand whereas the latter, which saw the net equity inflows turned negative, happened in 1994 as Western investors fled the entire emerging market during the so-called Mexican tequila crisis. Between 1995 and 1997 on the other hand, the stock market rebounded strongly, and appeared oblivious to the initial wave of financial collapses. While the Thai bourse experienced a sharp drop in foreign investment in 1998, the international demand for Thai securities remained positive and at the level comparable to that of 1987, which was the beginning of the bull market.

Chart 4: Total Net Capital Inflows to Thailand (1987-1996)



Source: Bank of Thailand

Secondly, the majority of the equity inflow (as reported in Chart 3) came in the form of FDI into developing industrial parks or infrastructural projects. This kind of investment tended to be long-term, betting on the underlying potential of the Thai economy as opposed to the short-term financial gain from the stock market bubble. Furthermore, portfolio flows, which generally tended to be considerably more sensitive to short-term volatility, had arguably a limited consequence to the advent of the AFC. At worst, portfolio investors, who invested during the peak of the market bubble, stood to lose their investment from adverse market movement away from their positions. They had two options: (1) liquidating the Thai assets in their portfolio and cut loss while they still could; and (2) holding on to their investment in the hope that the Thai Stock Exchange would rebound soon after. Evidently from both Charts above, foreign investors took the first option and limit their potential loss by moving the investment back to US dollar-denominated assets.

From the perspective of Thai publicly listed corporations, the stock market crash was clearly devastating. International credit rating agencies as well as foreign creditors themselves could

potentially rely on the stock prices as an indicator for future debt roll-over or credit extension. A dramatic market-wide plummeting might be seen as a sign of macroeconomic uncertainty against further investment in these Thai corporations. Those that had heavily leveraged themselves during the good times found it extremely difficult to service their outstanding liabilities. This could potentially lead to insolvency or even bankruptcy.

c. [The re-engineered financial border: capital flow as a legal construct](#)

The LTF account of the international capital flows in East Asia prior to the AFC concludes with the reform of Thailand's cross-border capital control regime. Thailand, in the late 1980s to the early 1990s, had gone through a period of domestic institutional transformation. According to technical staff dispatched by the IMF and World Bank to advise the Thai government at the time, the reform program would modernize the Thai economic and financial infrastructure to the international (read, Western) standards. The country would then be able to attract more foreign capital and thus sustain the rapid economic growth it had achieved during the industrialization period of the decade earlier. This subsection illustrates the importance of the institutional analysis offered by LTF and it sets out to complete the following tasks. Firstly, it explains the failings of the conventional theory of financial globalization. To that end, it highlights the detrimental and unexpected consequences of the special regulatory conduit installed by the Ministry of Finance and the central bank. Secondly, it carefully peels off the institutional makeup of the said infrastructure in order to understand the real incentive structure it offered to the stakeholders, particularly large foreign banks looking to invest in the fast growing Thai banking sector.

One of the most significant aspects of the government's plan to transform Bangkok into a competitive regional financial center was to connect the domestic market with its foreign counterparts in such a way that Bangkok would become a global one-stop shop for all financial

services including intermediary, fund raising, trade finance and currency exchange. In other words, the internationalization of the Thai finance system was the centerpiece of the financial liberalization program. This must evidently be accomplished through law. The correspondence between the governor of the Bank of Thailand and the Finance Minister at the time revealed the strategy in which, they envisaged, could achieve the aforementioned goals and at the same time strengthen the country's financial sector and the economy. They believed that "the approach to financial regulation had to be the least restrictive in order to facilitate and support capital flows into the economic sectors in the region".¹⁶² Furthermore, they agreed that the financial infrastructure was outdated and remained an obstacle. The Bank of Thailand should therefore work with the Ministry of Finance in order to deregulate the financial system and relax the existing uncompetitive rules.¹⁶³ Clearly, the government officially departed from its long-held principle of "free trade but restrictive cross border capital control", which was observed in the first two eras of the financial regulation in Thailand.

There was one crucial omission from the Bank of Thailand's mission to lift capital and financial controls: the fixed exchange rate regime. A strong and stable exchange value of Thai baht was an extremely politically sensitive issue. The government often defended its stance on the fixed rate of the domestic currency a matter of national pride. Yet as a matter of fact, there were a lot of interest groups benefiting from the currency regime, not least the financial institutions. A stable currency value saved them from incurring extra costs of hedging against inevitable volatility of the exchange market. The discussion among senior government officials on the possibility of currency devaluation arose again in the aftermath of the Mexican Debt Crisis in 1994 when

¹⁶² *Nukul Commission Report: Analysis & Evaluation on Facts Behind Thailand's Economic Crisis* (n 33). at para 1.

¹⁶³ *ibid.*

Thailand observed a spike in capital inflows sparking a concern over the overall fundamentals of the economy.¹⁶⁴ The IMF representatives, who had observed the implementation of the financial liberalization program, wrote twice in their concluding statements of the 1994 and 1995 missions that they advised the Bank of Thailand to adopt a more flexible exchange rate regime in order to relieve the pressure from relentless capital inflows off the economy.¹⁶⁵ Regardless of the merits of the IMF's overall approach to financial development, it was clear that the foreign exchange policy later became a crucial causal link that determined the extent and magnitude of the ensuing crisis. As a result, the Bank of Thailand ruled out any radical overhaul of its currency exchange mechanism on the ground that any unwanted currency arbitraging and manipulative activities could be best managed through other regulatory tools.¹⁶⁶

i. The liberalization of the capital control regime

That regulatory solution appeared to be the liberalization of capital control, which was done in two steps. The first phase aimed at amending the existing laws and regulations in order to eliminate all barriers against financial integration between Thailand and the international market. The first round commenced in May 1990 when commercial banks were allowed to authorize foreign exchange transactions in trade related activities without prior approval from the Bank of Thailand. Furthermore, the limit on foreign exchange purchases, which could then be taken in and out of the country, was lifted in order to facilitate transfers and travel expenses. This initial reform package was carried out immediately after the Bank of Thailand recommended that the government accede

¹⁶⁴ One indicator of capital inflows, the net portfolio equity investment, saw a swing from a net outflow of \$393 million in 1994 to a net inflow of \$2.253 billion in 1995. Source: Bank of Thailand

¹⁶⁵ *Nukul Commission Report: Analysis & Evaluation on Facts Behind Thailand's Economic Crisis* (n 33).

¹⁶⁶ *ibid.* at 50-51.

to Article 8 of the Agreement of the IMF on liberalizing current payments, foreign exchange discriminatory practices and free convertibility of foreign-held balances.

The second round of the first phase taking place in the second quarter of the following year addressed the deregulation of controls related to capital account transactions with some reservations. Crucially, banks were permitted to facilitate the remittance of debt, proceeds of stock sales, or of liquidation of business with a more liberalized set of limitations than before. To encourage the fledgling mutual fund industry, unincorporated Thai entities were able to open foreign currency accounts in Thailand for the first time provided that the funds originated abroad. In addition, foreign organized funds were free to invest in Thai stocks and debt instruments, but locally issued mutual funds were restricted to investing their portfolio in the domestic market.¹⁶⁷ The Bank of Thailand remained in control over a number of areas, specifically the purchases of securities and real estate abroad. The third round focuses on popularizing the usage of Thai baht as a regional currency. From February 1994, the amount of bank notes that could be brought to the neighboring countries was substantially increased whereas Thai residents and corporations could use foreign exchange proceeds from their export sales to service their external payments. In other words, they no longer required an approval from the Bank of Thailand to do so. It could be said therefore that the regulatory changes in this phase were necessary to delegate certain powers over the financial market from the government authorities to the private parties, collectively referred to as market force.¹⁶⁸ While the lifting of the state-imposed rules led to an increase in financial

¹⁶⁷ R Barry Jonston, Salim M Darbar and Claudia Echeverria, 'Sequencing Capital Account Liberalization: Lessons from the Experiences in Chile, Indonesia, Korea and Thailand' (1997) WP/97/157 IMF Working Paper. at 32.

¹⁶⁸ Pistor, 'A Legal Theory of Finance' (n 18). at 321.

activities from abroad, it could also mean that the limitations and weaknesses of the existing domestic safety net mechanism could be exposed from the influx of foreign capital.

iii. The Bangkok International Banking Facility (BIBF)

The second phase of the project was designed to specifically attract capital inflows into the Thai financial system. After the modifications to the regulatory infrastructure had been addressed in the first phase, the Bank of Thailand devised a number of strategic moves, which were proved integral to transform Bangkok into a regionally competitive financial center. This subsection asserts that the new facilities and related institutions was a legal construct and became a fundamental component of the pre-crisis Thai financial infrastructure.

a) The governing framework

The *Bangkok International Banking Facility or BIBF* was initially created to provide a special conduit for an offshore financial center. It operated under Thai jurisdiction but received a variety of preferential regulatory structure and tax benefits which were not available to other banks and financial institutions licensed to do business in Thailand. In authorizing the BIBF initiative, the Ministry of Finance relied on its statutory power to regulate branches of Thai and foreign banks under sections 5 and 6 of the Commercial Banking Act of 1962. It then delegated the primary regulatory and supervisory authorities to the Bank of Thailand.¹⁶⁹ Since the BIBF was defined as an extension of the banking operation and relied on the Thai banking law for its legal justification, only authorized banks under the banking law could take advantage of this offshore facility. In other words, finance companies, which were regulated under the Finance, Securities and Credit Foncier Act, were not eligible to apply for the necessary license, even though they themselves sought

¹⁶⁹ Section 2, the Ministry of Finance's Notification on the Bangkok International Banking Facility (1992).

foreign capital in the same way as Thai banks did. It is therefore not hard to foresee that the banking industry heavily lobbied for the BIBF. In term of the institutional dynamic between banks and finance companies, the BIBF afforded banks a competitive advantage over their competitors in the following ways.

The law categorized the permitted activities under the BIBF into three separate classes: 1) the business of foreign lending, 2) the business of domestic lending and 3) other BIBF-related activities.¹⁷⁰ A BIBF-licensed bank was in the business of foreign lending when it meets certain conditions. Firstly, it either borrowed or acted as a financial conduit channeling foreign currencies or Thai baht from foreign investors or creditors, including foreign branches of Thai banks and other offshore banking facilities. Second, such activity had to be carried out with an objective to lend either foreign currencies or Thai baht to foreign borrowers who were not established or did not do business in Thailand. On the other hand, the business of domestic lending was defined as when a BIBF-licensed bank borrowed or performed an intermediary service so that foreign currencies or Thai baht originated from foreign creditors would be loaned to qualified borrowers based in Thailand. Informally, the former type of BIBF business was often referred to as the “out-out market” whereas the latter was known as the “out-in market”. Finally, there were four BIBF-related activities envisaged by the law.¹⁷¹ They represented the four most popular international financial transactions in the region at the time. The BIBF-licensed banks were permitted to guarantee loans and service letters of credit, even though the parties to such loans or letters of credit had no connection with Thailand. Notably, BIBF-licensed banks could trade in non-baht

¹⁷⁰ Section 1.

¹⁷¹ Ibid.

foreign exchange transactions (cross currency) and arrange foreign-denominated loans or syndicated loans with other banks.

In comparison to the onshore banking regime, the Bank of Thailand adopted a totally different approach to regulation and supervision for BIBF businesses. The regulation was designed to ensure that the BIBF remained both practically and legally offshore with the slightest possible interaction with the Thai domestic financial system. In other words, the central bank hoped that the framework put in place would “ring fence” any possible risks associated with any volatile characteristics inherent in the BIBF transactions which could lead to adverse systemic impacts upon the safety and soundness of the national financial market and the Thai economy.

First and foremost, BIBF-licensed banks had to re-arrange their business organization such that their onshore banking operation and their BIBF facilities became legally two distinct legal entities.¹⁷² Evidence of business segregation includes maintaining separate financial books, documents and other proofs of operation. Nevertheless, an incidental connection with the domestic financial sector was tolerable. Licensed banks may accumulate no more than 100 million baht worth of assets in Thailand in the forms of 1) real estates used as their BIBF business offices; 2) government securities; 3) non-convertible private debentures; and 4) deposits at Thai banks.¹⁷³ The BIBF businesses were permitted to deal in Thai baht originated within Thailand but only for the

¹⁷² Section 2, the Bank of Thailand’s Notification on the Regulation, Procedure and Conditions of Operating an Offshore Banking Facility (1993). This Notification superseded the 1992 original version and became in force until 1998.

¹⁷³ Section 8.

purpose of remitting profits back to foreign headquarters or for purposes incidental to the BIBF businesses as stated in section 8.¹⁷⁴

There was also a requirement that the out-out and out-in operations be conducted separately, yet unlike section 2 the law did not demand separate legal personalities. In other words, it was perfectly lawful for the out-out and out-in operations to run under the same roof as long as they work from different departments or divisions.¹⁷⁵ An out-out operation may not lend foreign exchange or Thai baht to any out-in counterpart either in the same bank or across banks and vice versa.¹⁷⁶ Nor could they settle any contingent liabilities for one another.¹⁷⁷ Finally, the funds that come through BIBF had to be originated abroad.¹⁷⁸ With regard to the out-out market, the withdrawals *and* repayments of loans and interests were required to be conducted outside Thailand whereas the out-in borrowers might withdraw the funds domestically but were still required to carry out their repayment obligation abroad.¹⁷⁹

In addition to the ring-fencing framework outlined above, only two other rules govern the operation of BIBF businesses. This reflected the hands-off approach and the major attractions of BIBF envisaged by the Bank of Thailand. The law laid down a set of transparency rules in place to preempt BIBF from being used for illegal purposes. BIBF-licensed banks were required to verify

¹⁷⁴ Section 9.

¹⁷⁵ Section 3.

¹⁷⁶ Section 4.

¹⁷⁷ Section 5.

¹⁷⁸ Section 6(1).

¹⁷⁹ Section 6(2).

and obtain correct and up-to-date names and addresses of their clients.¹⁸⁰ They could not conceal the biographical information in any of the documents. Finally, the law imposes a minimum withdrawing amount for the out-in market, the threshold of which was raised from US\$500,000 to US\$2 million in 1995.¹⁸¹

The success of the BIBF should be judged on the ground of its overall contribution to the initial objective: to transform Bangkok into the regional funding center directly competing against the likes of Singapore and Hong Kong. To this end, the BIBF ought to promote purely international transactions, i.e. the out-out market, rather than to attract additional money inflows into the out-in sector. With an emphasis on the former, Bangkok could be seen as *the* place through which foreign funding was channeled to advance valuable ventures and capital-intensive projects throughout South East Asia. On the other hand, the latter simply increased the level of external debts burdened by the domestic financial system.

Unfortunately, this noble goal never materialized. To the contrary, the exact opposite outcome arose exacerbating the country's financial systemic stability. The reasons for such failure can be attributed to two major factors: 1) volatile market conditions; and 2) the incentive structure of the BIBF rulebook and the regulator's supervisory behavior. Both taken together created an ideal condition for opportunistic foreign banks to arbitrage this new regulatory framework.

Let us start with the problems associated with the incentives embedded in the BIBF regulatory infrastructure. The major draw of this funding facility was preferential tax treatments. The BIBF arranging banks were exempted from any liabilities that would otherwise arise from special

¹⁸⁰ Section 6(4).

¹⁸¹ Section 6(3), as amended in 1995.

business tax and stamp duty tax, both of which would have otherwise been applicable to banks' ordinary fund raising activities.¹⁸² Furthermore, the Revenue Department also lowered banks' corporate tax liability from 30 percent to 10 percent for the portion of net profits emanated from their BIBF operations.¹⁸³

Here, however, is where the uniformity of tax treatments between the out-out and out-in markets ends. On top of these already generous tax exemptions and reductions, lenders in the out-out market were also exempted from the 10 percent withholding tax on interest payments received from their BIBF arrangements.¹⁸⁴ Effectively, this meant that end borrowers did not have to incur an additional borrowing cost arising from the withholding tax liability, which would have been passed on from the lenders upstream. By contrast, foreign creditors were still liable to pay the 10 per cent withholding tax. In reality, it was the borrowers who had to be responsible for the tax burden in the form of rising borrowing costs. Reading the rules literally, this arrangement seems to reflect well the objective set out by the Thai government to promote the out-out market and to protect the fledging Thai financial system from capital volatility associated with cross-border capital flows.¹⁸⁵

¹⁸² Sections 4 and 5, Royal Decree Enacted According to the Revenue Code Regarding Exemptions (Issue No. 259, 1992).

¹⁸³ Section 3, Royal Decree Enacted According to the Revenue Code Regarding Exemptions (Issue No. 260, 1992). In order to claim the lowered rate, banks had to calculate net profits from their BIBF operation and ordinary banking business as distinct and separate from one another. Losses from one side could not be carried to the other side as tax credit. See generally, the Notification of the Director of the Revenue Department Regarding Income Tax (Issue No. 47, 1993).

¹⁸⁴ Section 3, Royal Decree Enacted According to the Revenue Code Regarding Exemptions (Issue No. 259, 1992).

¹⁸⁵ It should be noted that the tax disparity ignited some sharp criticisms from BIBF operators who argued that the tax arrangements made BIBF less attractive than other rival offshore markets such as Singapore and Hong Kong. Such disapproving voices were so influential that the responsible senior central bank figures pondered lifting the withholding tax liability altogether. See 'Siam Panich Leasing (SPL) Trailblazing BIBF Funding under Thai Law' [1995] *Manager Magazine* <<http://info.gotomanager.com/news/details.aspx?id=4945>> accessed 11 May 2014.

Summary of BIBF regulatory framework

| | The out-out BIBF | The out-in BIBF |
|--|---|-----------------|
| Enabling legislation | - Sections 5 and 6 of the Commercial Banking Act of 1962 | |
| Permissible activities | <ul style="list-style-type: none"> - External lending - Domestic lending - Other BIBF-related activities | |
| Ring-fencing requirement | - Yes, periodically reported to the Bank of Thailand | |
| Corporate tax | - 10% | |
| Other special tax e.g. stamp duty | - Exempted | |
| Withholding tax | ○ Exempted | ○ 10% |

b) The BIBF and regulatory arbitrage

Despite its decent setup which offered a slightly sweeter deal to promote the out-out market, the reality however was that the out-in market was responsible for staggering 96 per cent of the funding raised through BIBF in the first two years.¹⁸⁶ This subsection asserts that the distortions occurred precisely because the financial market is not constructed solely by either public laws or private

¹⁸⁶ *ibid.*

ordering alone. It is essentially and always a hybrid entity of both. In the present case, the private reactions to the new paradigm of offshore facilities did not support the objective the government initially set out to achieve.

The first decisive factor undermining the effectiveness of the BIBF was the apparent conflict of the reform initiatives, which allowed private actors to capitalize on the cracks in the system. In addition to enhancing international competitiveness¹⁸⁷, the financial liberalization program served the national development goal set out in the 7th National Economic and Social Development Plan (1992-1996) – to achieve better income distribution between urban and rural areas. At the forefront of this mission were the plans to encourage more credit extension by domestic and international financial institutions as well as more equity investment by investors from upcountry.¹⁸⁸ The Bank of Thailand instituted a new banking facility in support of the rural financial development called the Provincial International Banking Facility or PIBF. This new funding channel allowed fund raising denominated in either Thai baht or foreign currencies from a qualified group of foreign and Thai creditors in order to lend to the borrowers outside the Capital.¹⁸⁹ PIBF received similar preferential regulatory and tax treatments to BIBF. Thus, it is argued that this dedicated funding

¹⁸⁷ See further in Chapter 2: fiscal, financial and capital development, the 7th National Economic and Social Development Plan (in Thai), available at <http://www.nesdb.go.th/Portals/0/news/plan/p7/m2_1.doc> accessed 11 May 2014. See also ‘Thailand to Be the Regional Funding Center’ [1992] *Manager Magazine* <<http://info.gotomanager.com/news/details.aspx?id=31416>> accessed 11 May 2014.

¹⁸⁸ Chapter 5: fiscal and financial policy guidelines for efficient income distribution, the 7th National Economic and Social Development Plan (in Thai), available at <http://www.nesdb.go.th/Portals/0/news/plan/p7/m3_1.doc>.

¹⁸⁹ Foreign creditors may be 1) natural persons who are not Thai nationals and resident abroad; 2) legal persons incorporated under foreign jurisdictions and carrying no business in Thailand; 3) foreign branches of Thai banks, foreign branches of, or the headquarters of foreign banks; 4) other legal persons as subsequently denoted by the Bank of Thailand. Domestic creditors may include 1) other international banking facilities; and 2) exporters who are subject to the Bank of Thailand’s export payment regulation. See section 1, the Bank of Thailand’s Notification on the Provincial International Banking Facility of Commercial Banks (1994).

facility was merely a modified rendition of BIBF's out-in market, albeit with a geographical preference.

To reiterate, the LTF theoretical framework suggests to us that financial markets be developed with every additional wave of interactions between public rules, private orders, and innovations stemming out of both public and private reactions to the changing of the rules. The situation here dovetails neatly with this facet of the theory. Considering the BIBF framework, the arranging banks and end borrowers came up with their own way to maximize this new paradigm presented by the offshore banking facilities in order to serve their interests. Their calculation was heavily influenced by a certain market condition regarding the disparity between foreign and domestic interest rates. The Bank of Thailand argued the liberalization policies, including the establishment of the BIBF, were part of the national strategy to enhance the competitive efficiency of domestic financial institutions.¹⁹⁰ As Thai banks and finance companies were able to compete with their regional counterparts, the market conditions in both domestic and regional financial systems should have theoretically converged due to a more level playing field. Nevertheless, even after the lifting of the interest rate control, there was not a lot of foreign competition against Thai banks in the Thai domestic market. Still insulated from international competition, these domestic financial institutions colluded with each other and persisted with their high rates relative to the international rate. As a result, they could maintain their profit margins with the artificially widened spread. The interest rate factor together with the fixed currency exchange regime created a unique profitable opportunity for Thai banks with comparatively minimal downside risks.

¹⁹⁰ Annual Economic and Financial Report of 1993, Bank of Thailand, at 58-59.

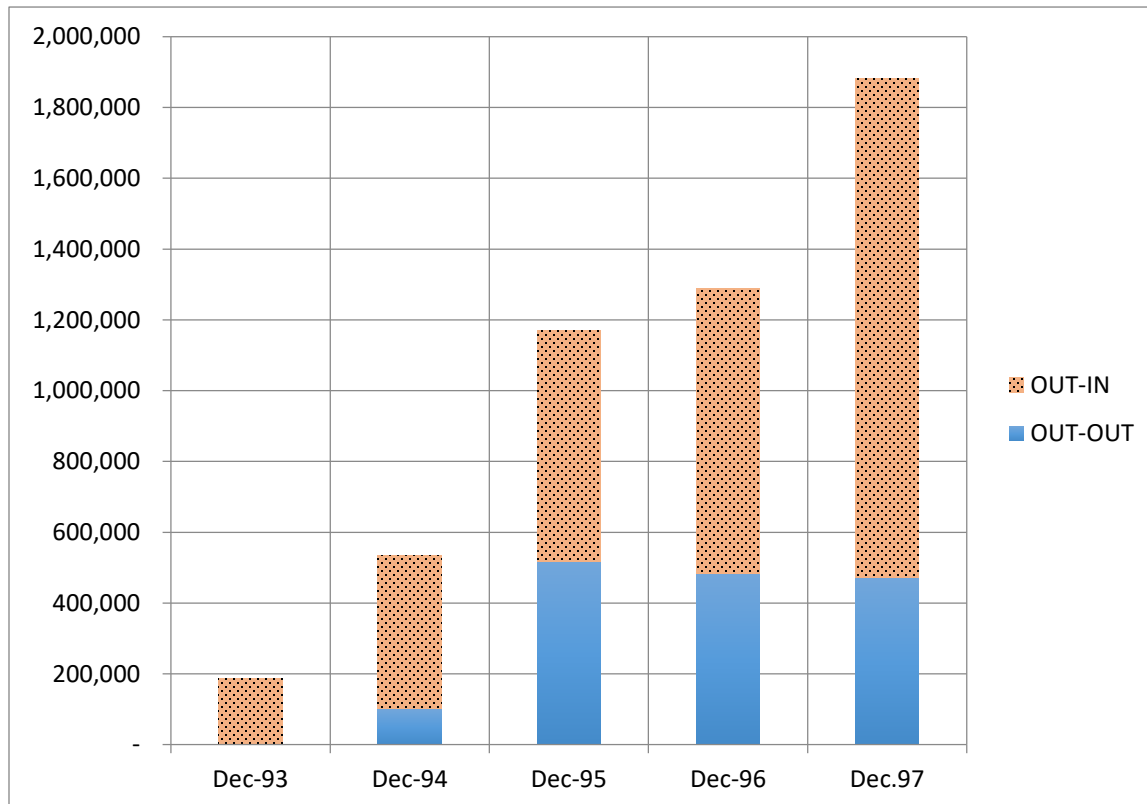
The second factor concerns the way in which BIBF participants utilized certain legal techniques to circumvent the expensive Thai tax regime – specifically the jurisdiction and choice of law clauses. An out-in transaction would be subject to the Thai Revenue Code only if the parties chose to carry out their contractual obligations under the Thai substantive law and to settle any disputes that may arise under Thai jurisdiction. Otherwise, the contract was treated as an alien activity in the eyes of the Thai law and thus did not trigger any liabilities under the Thai Revenue Code. The effect of appropriate choice of law and jurisdiction was that the end borrowers did not have to burden themselves with the 10 per cent withholding tax. In other words, with some clever contractual drafting, out-in borrowers were able to exploit the loophole in the law by getting treated in a similar way to out-out debtors for tax purposes. It should be noted however that arranging banks were still subject to the Thai corporate tax, albeit at an extremely competitive rate of 10 per cent. The Bank of Thailand could have intervened and barred the BIBF transactions that were governed by foreign law and jurisdiction. Rather the central bank chose instead to promote the appeals of Thai law and jurisdiction but unsurprisingly to no avail.¹⁹¹ As a result of this get-around, *none* of nearly 100 BIBF contracts concluded in the first two years of its inception was governed by and carried out according to Thai law, most of which opted for either Singaporean or Hong Kong laws.¹⁹² By the end of 1997, the out-in market still controlled 75 per cent of all BIBF

¹⁹¹ In mid-1995 (over two years after BIBF was established), Siam Panich Leasing (SPL) became the first domestic end borrower that decided to pick Thai law as the governing law and thus subject itself with extra tax liabilities. The major reason for such a move was the heavy involvement of the Bank of Thailand in the deal, which partly contributed to SPL obtaining a low borrowing rate (LIBOR plus 0.09 per cent). See ‘Siam Panich Leasing (SPL) Trailblazing BIBF Funding under Thai Law’ (n 185).

¹⁹² *ibid.*

transactions.¹⁹³ Chart 1 clearly displayed the staggering contrast in performances between the out-in and out-out markets in the first five years of the BIBF project. The vast majority of the combined BIBF sector was still governed by the law of foreign countries.

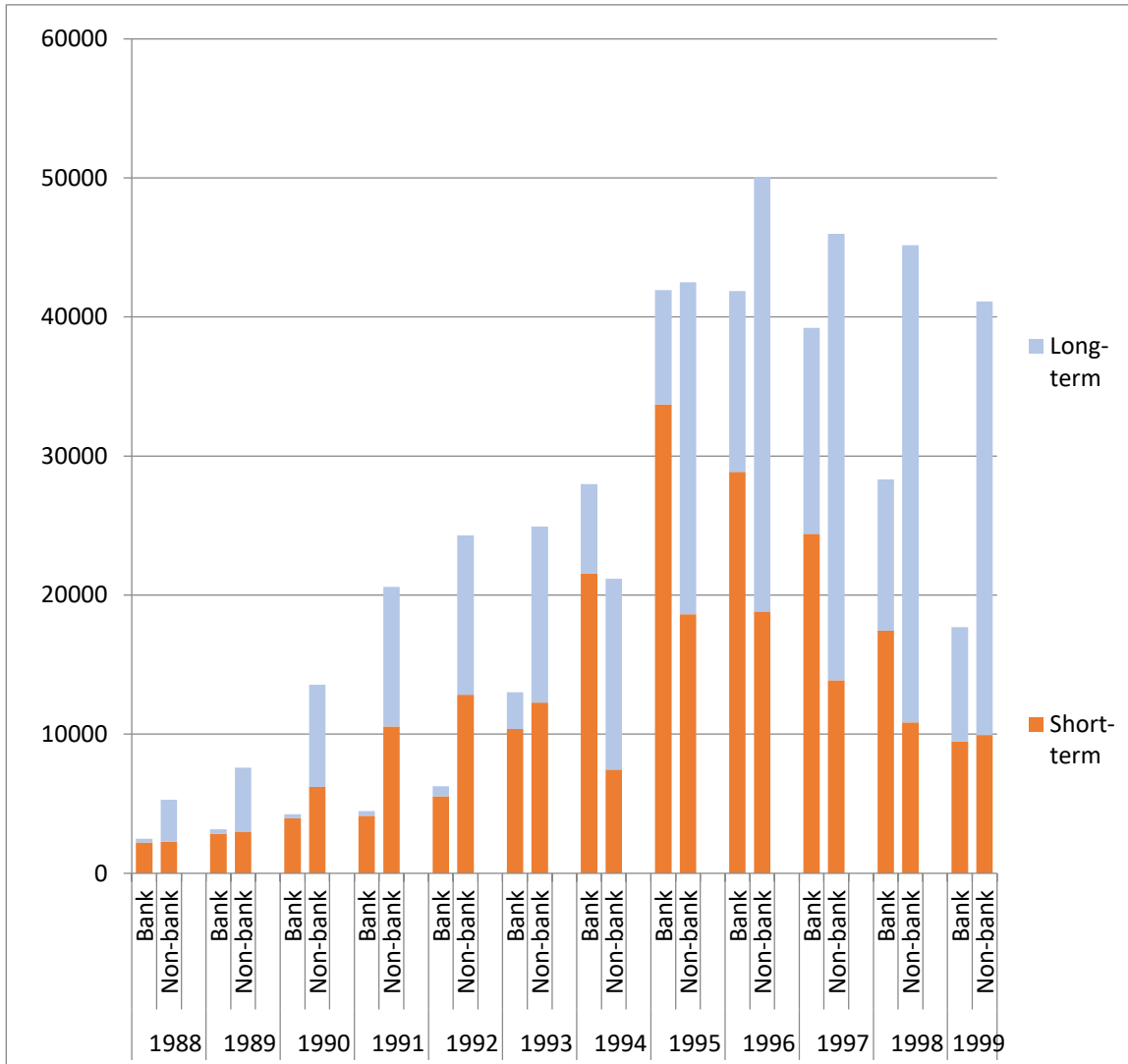
Chart 1: Total Credits Extended by BIBF in million baht (1993-1997)



Source: Bank of Thailand

¹⁹³ 1,411.4 billion baht worth of credits was extended by the out-in market whereas only 471.1 billion baht could be attributed to the out-out market. Source: Bank of Thailand.

**Chart 2: External Debts Incurred by the Banking and
Non-Bank Corporate Sectors in \$US Million (1988-1997)**



Source: Bank of Thailand

In addition, Chart 2 presents another perspective on the growth of external liabilities incurred by the domestic private sector. As clearly observed, the banking sector had dramatically increased the share of foreign debt in the accumulative balance sheet, particularly from less than \$ 5 billion in 1992 to over \$ 40 billion in 1996. Significantly, this 4-year period coincided with the inception of

the BIBF. In addition, the vast majority of the sector's external liabilities were short-term, compared to the non-bank corporate sector which saw roughly an equal share of short- and long-term liabilities. It can therefore be concluded that the BIBF played a major part in bringing systemic instability into the Thai financial system by attracting short-term external debts to the already vulnerable Thai banking sector.

As soon as the Bank of Thailand lifted the restrictions on current and capital accounts as well as loosened its control over the interest rate adjustment, the Thai financial system had evolved from a state-directed development model to a more market-oriented one. Nevertheless, the evidence put forward in this section suggests that we cannot analyze the outcomes by considering separately either public or private inputs. Neither did not always get it right and mostly their views can be myopic, restricted by their own self-interests. The one example, we can always point out to, is the incorrect assumption made by the central bank when it predicted that the domestic interest rate spread would become tighter than the spread during the pre-liberalization era was. Furthermore, the market again did not play by the script of the government when it exploited the governing framework of the BIBF using strategic contractual drafting. Unlike the portfolio investment, which is discussed briefly above, debt financing produces deep and interconnected systemic effects. Not only were the upstream creditors, intermediating banks and downstream debtors causally linked, but the financial network also extended to other related activities such as guarantees and collaterals, creating a chain reaction or domino effect throughout the system.

4. The Mechanism of the AFC: An LTF Story

The analysis elaborated in this chapter thus far highlights the institutional development path of banks and finance companies, which by the early 1990s had become two highly competitive subsector in the financial market and engaged in various systemically destabilizing activities. By the end of 1994, there were 29 commercial banks and 91 finance companies licensed to do business in Thailand.¹⁹⁴ Except for small grass-root co-operatives and pawnshops, they were the most numerous financial institutions in term of physical presence. In addition, their combined total assets accounted for 86.64 percent of the total assets held within the Thai financial system at the time. In term of total credits extended, banks and finance companies were responsible for over 90 percent of all financing activities in the economy between 1989 and 1996.¹⁹⁵

To make it worse, the new reform initiatives, which were implemented in half a decade prior to the crisis in 1997, exacerbated, rather than contained, the problem. In the past, the Thai authorities managed to tackle and managed sporadic incidents of institutional collapses because the problems were strictly localized without any implications from foreign factors. However, the situation changed drastically after the internationalization program was completed in 1993 exposing the already vulnerable financial system to an influx of foreign investment, mostly in form of short-term loans. The institutional analysis of capital inflows is the main topic of Chapter 3. For the present purpose, the said influx is taken as a fact since the focus of examination is on the mechanism which transformed systemic vulnerability into a crisis.

¹⁹⁴ ‘One Decade: the Financial Institutions Development Fund (1985-1995)’ (n 109). at 12.

¹⁹⁵ Vajragupta and Vichyanond (n 149). at 13.

This section discusses the mechanism of financial crisis using LTF as its theoretical benchmark. To recap, LTF offers an intellectual paradigm of finance as internally constructed by law. Nevertheless, unlike other law-and-finance theories, LTF is a theory that can explain the structural dynamics of finance during both good and bad times.¹⁹⁶ The analysis of the Thai financial development thus far demonstrated that financial instability built up in the institutional foundation of the system during the good times. With regard to the advent of a financial crisis, LTF postulates that the foundation of the financial system rests upon uncertainty about future outcomes as well as liquidity volatility. Crucially, LTF asserts that crises is endogenous to the construction of financial system, as opposed to a force majeure or an exceptional and unexplainable event in an otherwise good equilibrium.¹⁹⁷ The differentiating factor that sets LTF apart from other theoretical frameworks which shared common intellectual ancestors however is its insights on the legal anatomy of financial crisis.

According to the LTF framework, the rigid and consistent application of legal instruments is explains one of the primary roles of law in finance. Law and its institutions provide a system of enforcement and adjudication to every financial transaction concluded under its jurisdiction. To this end, market participants can enjoy predictability and credibility brought to the system by internalizing their business transactions in the form of legal instruments. Yet, it is it is also the source of financial instability. The previous sections of this chapter demonstrates this side of the story. The exponential increase in short-term foreign debts in the banking sector was enabled by the legal and regulatory framework of the Thai banking system. In this section we focus on the

¹⁹⁶ Pistor, 'A Legal Theory of Finance' (n 18). at 325.

¹⁹⁷ The proposition that the financial crisis is a norm, not an outlier is well substantiated by various historical accounts. See for instance, Kindleberger and Aliber (n 2); Carmen M Reinhart and Kenneth S Rogoff, *This Time Is Different: Eight Centuries of Financial Folly* (Reprint edition, Princeton University Press 2011)..

legal (precisely, contractual) instruments that were exploited by banks and finance companies to take advantage of the highly profitable (but also systemically destabilizing) business opportunities made available by the aforementioned legal and regulatory reform program.

Under this rubric, the section's thesis asserts that a financial crisis occurs when a large number of financial intermediaries, particularly banks, fails to meet their outstanding liabilities because they either do not have enough cash on hand to honor the presently due obligations or cannot raise sufficient funds from selling their illiquid assets in time to settle the contractual requirements. However, it is clear that the strict application of law is not the only factor at play during the time of crisis. Rather, LTF recognizes during crisis the interplay between law and power becomes more salient.¹⁹⁸ Let us go back to our stylized model of financial crisis. If a crisis is defined as the failure to meet outstanding liabilities which become due, all it takes for the crisis to be averted is an injection of cash or liquid assets in the form and amount required by the creditors. This is where the power comes in. At such time, the financial system can only be rescued by those in a position of high power who can act without being legally required to do so. The more desperate the situation is, the more salient the power becomes. As the discretion is exercised to save the system, the strictness of legal rules is relaxed and law appears elastic.¹⁹⁹

There are a few stakeholders who can exercise discretion or power to intervene with the legally binding force of law. The first group is the creditors themselves. They could potentially elect not to demand the outstanding principals and interest payments during the time of crisis. In other words, they may continue to roll over the existing liabilities or not trigger the early release clauses

¹⁹⁸ Pistor, 'A Legal Theory of Finance' (n 18). at 323.

¹⁹⁹ *ibid.*

such as the changes-in-circumstances clause, the events-of-default clause, to name just a few. The problem remains however that in an arms-length financial market, in which trust and personal relationship does not factor into the decision making of the counterparties²⁰⁰, powerful creditors will seek to protect their own financial interests in complete disregard to the risk of counterparty insolvency or even the collapse of the financial system.²⁰¹

The second stakeholder that can potentially step in to avert the crisis is private third party institutions that manage to remain untangled with the kind of financial transactions that causes the widespread institutional collapse. Nevertheless, any private institutions are similarly restricted by hard budget constraint and thus cannot step in when their own financial survivability is at stake. As a result, the government usually through its central bank provides the last resort support to its financial sector in trouble. Each country has its own approach to the crisis management mechanism. Later on, this subsection explores the measures adopted by the Bank of Thailand in its attempt to save its banking sector by intervening to support the currency value and at the same time provided financial assistance to some strategically important banks. Both of the measures however failed to avert the crisis.

a. The Thai private sector's foreign debt crisis

Sections 2 and 3 above demonstrates that Thailand's financial system in the early 1990s was extremely fragile and unstable. The banking sector relied on foreign creditors to raise capital to

²⁰⁰ While trust is essential for the contractual promise to be of any value, in an arms length contractual situation, trust was created by availability of legal sanctions rather than by the counterparties' past dealings. See Ian R Macneil, 'Contracts: Adjustment of Long-Term Economic Relations under Classical, Neoclassical, and Relational Contract Law' (1977) 72 Nw. UL Rev. 854. at 858.

²⁰¹ Pistor, 'A Legal Theory of Finance' (n 18). at 323.

continue their aggressive lending operation in various sectors of the economy. In the context of cross border finance in which creditors knew very little of their end borrowers, the former generally make their investment decision based primarily on wider financial and economic indicators, rather than relying exclusively on financial soundness of their contractual counterparties.²⁰² In the immediate period before the crisis, the Thai economy suffered from the following setbacks. Firstly, long sustained double-digit export growth had turned into double-digit contraction by mid-1996. As a result, a growing concern over the fast-deteriorating current account deficits led to a rumor of currency devaluation. The real estate development boom came to an end with a repercussion of sharp stock market slump. Problems in the export and real estate sectors put great strain on the balance sheet of domestic banks, further dampening foreign investors' confidence in the Thai economy. The impending crisis was just a matter of time after the authorities failed in its attempt to rescue the Bangkok Bank of Commerce, which prompted a short term debt rating downgrade by Moody's in September 1996.

It was not surprising therefore that this series of events, which hit both the capital market itself and the economy as a whole, literally wiped out foreign investors' bullish plan to continue investing in the financial sector. Thailand's capital account swung over 30 percentage points from a surplus of about 22 percent at the end of 1995 to a deficit of 10 percent at the end of 1997, signifying the unprecedented scale and pace of capital withdrawal from the financial system.²⁰³ Such a

²⁰² Sonsoles Gallego, A García Herrero and Cristina Luna, 'Investing in the Financial Sector of Emerging Countries: Potential Risks and How to Manage Them' [2003] *Revista de Estabilidad Financiera* <<https://www.bis.org/publ/cgfs22bde1.pdf>>. at 5.

²⁰³ Annual Economic and Financial Report 1998, Bank of Thailand.

phenomenon had, contrary to the popular belief²⁰⁴, been carefully manufactured by the parties who wanted to protect their own financial interest and thus shifted “the burden of dealing with future uncertainties to their counterparties”²⁰⁵. There was a range of legal or more accurately contractual devices that could help facilitate such arrangement. For the present purpose, the analysis divides into two parts: short term and long-term contracts. Both featured almost equally prominently in this episode of the AFC and thus merit close scrutiny.²⁰⁶ The information on short-term contracts includes both official data and secondary sources while the insights on long-term debt contracts (usually longer than one year) were derived from both sample contracts and interviews with legal counsels directly involved in contractual negotiation at the time.

It is a well-rehearsed narrative that the short-term debt problem was chiefly to blame for setting off the crisis. This accusation was especially applicable to the commercial banking sector and transactions taking place through the Bangkok International Banking Facility (BIBF), where short-term loans accounts for over two third of the total loans.²⁰⁷ The legal technique employed to manage uncertainty in this case is simply the maturity date itself. As short-term debts generally became due in less than one year (typically within 3 or 6 months), foreign creditors are entitled to reassess their investment decisions relatively frequently. If uncertainty materializes into adverse financial and economic incidents, which convince the creditors to protect their interests rather than to seek further profits, they can simply refuse to roll over the debts. Consequently, the debtors (in

²⁰⁴ Many existing theories proposed to explain the reasons behind the reverse capital inflow during this period, particularly the role of herd behavior or panic-induced crisis. See a critical evaluation of its merit in section 2.2.

²⁰⁵ Pistor, ‘A Legal Theory of Finance’ (n 18). at 323.

²⁰⁶ At the end of 1996, the private sector burdened itself with \$36.1 billions of long-term debt and \$37.5 billions of short-term debt. By the end of 1997, the long-term liability rose to \$38.1 billions while the short-term loans shrank slightly to \$29.2 billions. Source: Annual Economic and Financial Reports 1996 and 1997, Bank of Thailand.

²⁰⁷ The following chapter deals specifically with how the BIBF attracted short-term financing to the banking sector.

our case, predominantly local banks) will be required to perform their part of contract i.e. handing over the principal plus interest as agreed upon at the time of contractual negotiation.

In addition to assessing the viability of the targeted investments, the creditors took into account a wide array of other factors to form their investment soundness assessment. These factors apply across the financial sector, in addition to the microeconomic analysis of any given debtor's business status. These market-wide determinants can be triggered by various incidents, such as a collapse of a large, high profile domestic financial institutions, or even an exogenous shock created by financial turbulence in other region but of a similar risk profile. As a result, only financial institutions that relied heavily on the continuity of external finance inevitably collapsed, even though they held a relatively healthy portfolio of (illiquid) assets on their balance sheet.²⁰⁸ In other words, it was the case of contractual design turning a liquidity crisis into a solvency crisis.²⁰⁹ On the other hand, the drying up of foreign funding in a lot of cases was justified because many small and medium-sized Thai banks and finance houses had run an extremely reckless business model loading the balance sheet with an unsustainable amount of non-performing loans (NPLs). Here, foreign creditors no longer dealt with uncertainty but they were concerned with cutting the losses from investing in their borrowers which had been badly managed.²¹⁰

²⁰⁸ Sources: various news outlets in Thailand at the time. See, for instance, the Special Report on the 15th Anniversary of the 1997 Crisis, ThaiPublica Online News, accessible at <<http://thaipublica.org/2012/11/series-15-year-crisis-siriwat-1/>>. Texts are in Thai.

²⁰⁹ Some commentators referred to this phenomenon as “debt run” or “rollover freeze”. See Haw Cheng and Konstantin Milbradt, ‘The Hazards of Debt: Rollover Freezes, Incentives, and Bailouts’ (2012) 25 *Review of Financial Studies* 1070.

²¹⁰ Contrary to some literature, which argued that short-term rolling finance can be used as a discipline device for moral hazard, the situation with debt-ridden, poorly governed Thai banks demonstrated to the contrary. If the prospect of rolling over was satisfactorily positive, the length of maturity would have no bearing on corporate governance. See for instance, Charles W Calomiris and Charles M Kahn, ‘The Role of Demandable Debt in Structuring Optimal Banking Arrangements’ [1991] *The American Economic Review* 497; Anil K Kashyap and

Let us turn now to the problem surrounding long-term debt contracts. The mainstream analysis of the Thai crisis generally overlooked the contribution that long-term debt made to Thailand's foreign debt crisis in the late 1990s. The legal devices in question were contractual clauses that, upon an occurrence of certain conditions, make the debtor's primary obligation more onerous than what was originally envisaged at the time of contractual negotiation. There are two notable examples of the clauses in question. They were both prevalent the standard debt contract template adopted by Thai financial institutions and their foreign lenders during the period.

1. Events of Default: This clause confers the right upon the creditor to demand the immediate payment of the entire unpaid principal amount outstanding, accrued interest up to the date of payment, and all other amounts owing under the agreement when one or more of pre-specified events has occurred and continues to occur past the grace period. The creditor usually is the party who have the final say over what is included in the list of events that trigger the debtor's payment obligation. It represents a paradigmatic example of how the creditor transfers the burden of dealing with uncertainty to the debtors in the contract. The more wide-ranging and extensive the list of events is, the more systemically destabilizing the clause becomes. Most standard events of default clauses at the time specified the following events as their trigger: late payment past the grace period, breach of representations, warranties or covenants under the agreement, termination or dissolution of the debtor's business. In some cases, the list includes the events of the guarantor and/or affiliated companies, both of which were not legally part of the agreement. Furthermore, it

others, *Rethinking Capital Regulation* (publisher not identified 2008)
<<https://www.kansascityfed.org/media/files/publicat/sympos/2008/kashyaprajanstein031209.pdf>>.

might encompass an event that the debtor defaults on other loan agreements between the debtor and his other creditors (i.e. cross default).

2. Changes of Circumstances: This type of clause also shifts the responsibility of shouldering future uncertainty to the debtor. Here the debtor is liable to make up for any increase in costs or loss of profit suffered by the creditors due to unforeseen circumstances. Consequently, unlike the events of default clause, the debtor does not even have to commit any wrongdoings to be liable for additional payments. Its inclusion in the contract demonstrates that the creditor's financial interests will be prioritized and protected over and above that of the borrower. Moreover, it is also extremely systemically destabilizing because the rigid application of the clause cast a wide net covering over-extending borrowers and potentially many false positives, thus exacerbating negative systemic effects. There is however one similarity to the events-of-default clause. The broader and more exhaustive clause give the creditor greater protection against any unexpected changes in circumstances, the greater the risk to both the debtor and the financial system as a whole. One qualified changes of circumstances worth noting is the market disruption subclause. In a nutshell, it asserts that the lenders are, given adequate notice, entitled to abandon the LIBOR reference and charge a new rate of interest if "there is no reasonable means to ascertain LIBOR because of circumstances in the London inter-bank market".²¹¹

Additional issues regarding the wider systemic implication of these contractual provisions should be further emphasized. In the first place, leading law firms as well as certain industry associations responsible for updating the standard contract template universally adopted these clauses. If simultaneously and widely triggered, they could instigate a chain reaction that brings the financial

²¹¹ Clause 11.3 of a sample contract, on file with the author.

system to its knees. Moreover, certain sub-clauses could possibly be procyclical. Take the market disruption clause for example. The interbank lending market has been known to spike up during the time of financial distress.²¹² Thus by affording the lenders the right to raise the interest rate, the borrowers could well be forced into insolvency, having already been battered by an already financially dire situation.

Having said that, it should be pointed out that the creditor has a right rather than an obligation under the contract to call for specific performance from the counterparty. Indeed even if a certain event arises or some changes to the surrounding circumstances of the contract occur, the creditor can still decide against invoking these systemically destabilizing clauses especially if they can be ascertained of the future conduct of the other party.²¹³ To put it differently, should there be a device or evidence that helps reduce the degree of future uncertainty, the lenders will be less inclined to insist upon strict contractual performance. This could be a valuable lesson for the future reform. In other words, it might be advisable that the government devises a coordinating framework for all stakeholders including creditors allowing them to assess their individual situation as against the whole credit market. And if necessary, the authorities may be wise to make available an emergency

²¹² Many theoretical papers have recently argued that the market would have frozen entirely, had the lenders could not assess bank-specific risks or fear liquidity shortages. See, for instance, Franklin Allen, Elena Carletti and Douglas Gale, 'Interbank Market Liquidity and Central Bank Intervention' (2009) 56 *Journal of Monetary Economics* 639; Ricardo J Caballero and Arvind Krishnamurthy, 'Collective Risk Management in a Flight to Quality Episode' (2008) 63 *The Journal of Finance* 2195. Nevertheless, other opposing views proposed a counter-observation that in fact the interbank lending market does not close up but merely shrinks as banks refuse to meet growing demand. See Gara Afonso, Anna Kovner and Antoinette Schoar, 'Stressed, Not Frozen: The Federal Funds Market in the Financial Crisis' (2011) 66 *The Journal of Finance* 1109. Regardless of whom wins the debate, it only goes to confirm the extreme volatility of the interbank market during the crisis.

²¹³ A managing director of a large conglomerate in Thailand, pointed out that, during the height of the AFC, his company successfully persuaded its creditors against triggering these rather oppressive clauses since they had long had an experience of past dealings. They were confident that the borrowing firm could turn the situation around. The interview transcript is on file with the author.

fund to keep up the confidence in the credit market, thus reducing uncertainty in the lenders' decision making process.²¹⁴

b. An LTF analysis of the Thai currency crisis

The currency crisis took place concurrently with as well as reinforced the foreign debt crisis in the private sector. As a result, various prominent economists described the Thai episode of the AFC as an example of the third generation currency crisis or “twin crisis”. Krugman (1999) proposed a model of currency crisis with credit friction.²¹⁵ He argued that a sharp depreciation caused firms to suffer acute currency mismatch having borrowed in foreign currency but earned their income in local money. The ensuing widespread corporate insolvency, or the imminent risk thereof, drove away foreign investors and as a consequence the domestic credit market dried up. On the other hand, Chang and Velasco (2001)²¹⁶ as well as Goldstein and Pauzner (2005)²¹⁷ proposed a competing model of currency crisis and bank run. In short, the prospect of currency collapse created a run on local banks by foreign creditors who feared banks would fail due to a sudden and considerable increase in the liability side of their balance sheet.

However, this section asserts that these mainstream theories of the AFC simply explain the effects or consequences of the application of contractual clauses such as those explored in the early subsection. And to briefly recap the institutional story developed early in the chapter, banks and

²¹⁴ Cheng and Milbradt called this emergency financing a form of “bailout” for the credit market. Cheng and Milbradt (n 209).

²¹⁵ Paul Krugman, ‘Balance Sheets, the Transfer Problem, and Financial Crises’, *International finance and financial crises* (Springer 1999) <http://link.springer.com/chapter/10.1007/978-94-011-4004-1_2> accessed 27 May 2016.

²¹⁶ Roberto Chang and Andres Velasco, ‘A Model of Financial Crises in Emerging Markets’ (2001) 116 *The Quarterly Journal of Economics* 489.

²¹⁷ Itay Goldstein and Ady Pauzner, ‘Demand–deposit Contracts and the Probability of Bank Runs’ (2005) 60 *the Journal of Finance* 1293..

finance companies were made exposed to these highly destabilizing financial transactions primarily due to the way in which the legal framework and regulatory scaffolding were set up to encourage these kinds of behavior. Instead of focusing on the manifestation of the crisis in term of asset price movement, this section proposes that the Crisis be better explained and understood from examining the underlying financial transactions that caused the valuation of the Thai baht to collapse.

The analysis here moves on from external debts incurred by the banking sector to foreign liabilities to which the Bank of Thailand subjected itself during its operation to defend the value of Thai baht. The crux of the story centers on the premise that the Thai currency crisis should be considered under the same analytical framework as the banking crisis above. In other words, it is an account of an entity committing itself to contingent liabilities which became due at the time that it encountered a hard budget constraint problem. These contingent liabilities arose as a condition of a series of financial transactions it entered into in order to support the price of an asset, Thai baht. Specifically, the contingent liability imposed an obligation to honor the contractual promise to pay a predetermined sum in US dollar at a specified time in the near future. At the time of the contract, neither parties knew the relative prices of the two assets involved. Yet they were bound by contractual obligations to honor their parts of the agreement.

We have touched upon the underlying reasons behind the central bank's policy of fixed exchange rate (patriotism, political lobbying, and targeted industrial development). Nevertheless, the Bank was not required to defend the currency value at all costs or to the point of running down the entire foreign reserves. There were a few legal instruments governing the manner in which the country's foreign reserves could be utilized. Firstly, the Currency Act required the national currency be backed by the Currency Reserves, which, at the beginning of 1997, accounted for 55.2 percent of

the total reserves.²¹⁸ The portion of foreign reserves specifically designated to the maintenance of the exchange rate was called the Exchange Equalization Fund which stood at a mere 1.8 percent while the remaining 43 percent was the general reserves, entrusted upon the central bank to use under its discretion. Thus only the last two components of the foreign reserves may be deployed to defend the exchange rate. Yet by the end of June 1997, the total foreign reserves, net all contingent liabilities, dwindled to about 10 percent of the February 1997 level. It could therefore be argued that the Bank of Thailand had acted beyond its legal power in committing the country's foreign reserves exceeding the limit set by law.²¹⁹ Had it stayed within the legal boundary, the outcome might have been somewhat different. The Bank would probably have realized that the available reserves were extremely unlikely to be adequate to successfully defend the exchange rate. As a result, this might have coerced the Bank's senior figures into floating the baht sooner than when they actually made the decision. Although in that alternate reality, the financial crisis could still be expected due to the tumbling of an overpriced currency which was traded freely for the first time during the worst financial crisis in the nation's history.

To exacerbate the matter further, the Bank of Thailand adopted a self-defeating protective measure to support the value of the baht. The Bank's traditional policy, whenever some exchange rate readjustment needed to be made, had always been through repo transactions in the government bond repo market. The government bonds were issued by the Ministry of Finance, in the local

²¹⁸ *Nukul Commission Report: Analysis & Evaluation on Facts Behind Thailand's Economic Crisis* (n 33). at 37.

²¹⁹ More than ten years after the crisis, the Bank of Thailand finally brought a civil lawsuit against the former governor, Mr. Rerngchai Marakanond, for his grossly negligent conduct in approving currency transactions that led to the loss of national reserves. The case is now pending in the Supreme Court of Thailand after the Bank of Thailand appealed against the Court of Appeal's decision to clear his wrongdoing. See

<<http://edition.cnn.com/2005/BUSINESS/05/31/thai.banker/index.html>>, updated on August 22, 2013.

currency, and governed by Thai law. In other words, it was the market over which the central bank had virtually monopolistic control.²²⁰ Instead, the senior management within the central bank elected to intervene in the forward baht market over which it had no influence.²²¹ This was primarily because the liberalization policy in the early 1990s gave rise to a large offshore forward baht market. Nukul Commission Report on the Thai Financial Crisis (1998) shed some light onto the rationale behind this strategic maneuver.²²² Unlike an intervention in the repo market, forward swap transactions left behind a relatively low footprint. In other words, the Bank was legally obligated to report its financial statement every month. An intervention in the repo market would have to be recorded and open to public scrutiny because it would have been carried out on an on balance sheet basis. By contrast, future contingent liabilities created by swaps were off the balance sheet (until they became realized) and thus for some time could go undetected by the watchful public eyes. Furthermore, swaps did not affect the monetary base, at least not immediately. Conversely, an intervention via repo transactions had an unpleasant side effect of draining money from the system in order to raise the interest rate and stabilize the exchange rate. As every central banker knows, an increase in the interest rate could be politically unpalatable and thus attracts public attention.

The fundamental problem with the forward swap is that it imposes the central bank an obligation to deliver the amount in US dollar as agreed in the contract at a specified date in the future, usually within 3 months, regardless of the exchange ratio between the baht and dollar. Here is precisely

²²⁰ *Nukul Commission Report: Analysis & Evaluation on Facts Behind Thailand's Economic Crisis* (n 33). at 45.

²²¹ The Bank of Thailand fixed the spot exchange rate, not the forward rate. See David F DeRosa, *Central Banking and Monetary Policy in Emerging Markets Nations* (Research Foundation of CFA Institute 2009). at 67.

²²² *Nukul Commission Report: Analysis & Evaluation on Facts Behind Thailand's Economic Crisis* (n 33). at 41.

the reason why LTF put emphasis on the contractual mechanism of the underlying financial transaction at play. The central bank in this instance engaged in the open market with currency traders. In the global currency exchange market, Thai baht was considered simply just another financial asset, as opposed to a national currency of a country. Its price moves in reference to the price of the world currency, US dollar. As a result, the Thai central bank was no longer an agent of a sovereign nation with full autonomy over her own national currency. In the international exchange market, the Bank was merely treated as another currency trader. In addition, like all currency traders, it had a budget constraint. In this case, its budget was unfortunately also the country's foreign reserves. Crucially, the nature of forward swap contract was such that contingent liabilities arising as a result of the future delivery of US dollar could potentially claim the entire foreign reserves (which were conveniently the central bank's balance sheet). Furthermore, it had no way to ascertain that at the time of delivery, the exchange rate would be more favorable than the level at the time of transaction, i.e. there would be less shorting pressure on the baht. It should be noted however that while the central bank had no way to know the accumulative budget of all speculative currency traders combined on the other side of the transactions, the amount of the Thai foreign reserves was public information and updated regularly. In other words, we could say that the currency battle was lost even before it commenced.

DeRosa (2009) proposed an alternative explanation of the situation by arguing that the tactic of buying baht forward was not the problem per se. In a crisis situation, an unpredictable movement in forward prices means shorting the currency requires a great deal of skill and luck. A speculative trader may belatedly short the baht after the forward rate has already moved higher than the pre-crisis level, costing him more in dollar to buy baht. Moreover, there is also a risk that the baht interest rate will drop after the trader sells his baht forward, making the entire enterprise

unprofitable. Rather the ensuing currency crisis was, he argued, primarily down to “inept policy measures” by the Bank of Thailand itself.²²³ In a desperate moment, the Bank decided to buy the baht forward at an off-market rate (over the prevailing market rate), effectively overpaying in the swap market. In other words, the Bank was selling US dollar at a cheaper price than the market rate. Presumably the central bank did this in order to express confidence in the underlying value of the currency, to display its financial muscle and to threaten against any additional shorting pressure. In fact, what the Bank did was effectively subsidized anyone wanting to short the baht and, in turn, erased all the downside risk associated with the speculative attack against the baht.

We can certainly rationalize DeRosa’s theory through the LTF lens. Instead of assessing the swap transaction from the central bank’s point of view, DeRosa invited us to take the speculator’s perspective. In normal circumstances of the currency exchange market, it would be extremely difficult for the speculator to sell the baht forward at the price level that would make the transaction profitable. In other words, he would not be able to predict the movement of the currency value in the market with a sufficient degree of certainty. The forward swap to short the baht is an incomplete contract that cannot possibly cover the speculator’s exposure to adverse movement of the price of currency. There is simply too much uncertainty and missing information to safely engage in the transaction. However, the Bank of Thailand’s inadvertent subsidies by paying over the top for the baht *reduced uncertainty* in the baht forward market and as a result invited more traders in the coordinated shorting attack against the baht. Nevertheless, if there is one thing we can agree on is that the Thai episode of the Crisis was not caused, but rather exacerbated, by the bank’s forward baht purchases.

²²³ DeRosa (n 221). at 83.

In short, the anatomy of the currency crisis resembles that of the foreign debt crisis in the banking sector in many ways. Both crises contained contractual parties which had between themselves a creditor-debtor relationship or a contractual condition that eventually gave rise to a creditor-debtor relationship.²²⁴ The said relationship was legally based or emanated from a legally binding contract. In the case of currency crisis, the Bank of Thailand played a dual role: as a state authority in charge of currency stability and as a trader in the open baht forward market. The Bank's circumstance in the swaps market was, metaphorically speaking, like that of a fish out of the water. In other words, it was no longer assumed the status of an agent of a sovereign state but rather a trader in the market no longer at the apex of the hierarchy of the Thai financial system. In the currency swap market, the central bank became a peripheral figure essentially beholden to discretion and power of the party who has autonomous control over US dollar, the Federal Reserve. In Chapter 4, we will consider this very juncture where law and power interface in the context of the IMF financial assistance program.

5. Conclusion

Under the LTF analytical framework, the 1997 Crisis is a simple story often misunderstood. Contrary to the mainstream theory which depicted the incident as an extreme manifestation of inefficiency in the system, the LTF theory of the AFC asserts that it was all inherent in the fabric of the Thai financial system. Over two decades, the Thai government had incrementally created a governance structure of the financial sector such that two types of financial institutions were incentivized to heavily compete against one another for both funding as well as business opportunities. The competition went out of hand when the government decided to open up the

²²⁴ The creditor-debtor relationship in the foreign debt crisis vis-à-vis the baht forward buyer-seller relationship in the currency war.

financial sector to the influx of foreign capital. Both banks and finance companies loaded up their liability side of the balance sheet with systemically destabilizing assets. The contractual analysis of these assets demonstrate that the source of instability arose directly from certain clauses, particularly term to maturity in the case of short-term debt and default clause as well as changes-of-circumstances clause in the case of long-term debt. The then ongoing banking crisis put an incredible amount of pressure on the value of Thai baht such that the central bank needed to intervene. Nevertheless, not only was the intervention unsuccessful, but it also exacerbated the already difficult situation in Thailand and also created a ripple effect throughout the region.

The depiction of the AFC painted above is only one half of the story. What is missing is the international side of the story. Specifically, we must now tackle the origin and framework of cross-border capital flows that flew into the Thai financial system in the early 1990s. Chapter 2 explores this very issue at length.

Chapter 3 - The Institutional Origin of International Capital Flows in Asia-Pacific

1. Introduction

Part I of this dissertation, comprising the previous and current chapters, attempts to answer the simple question of “why Thailand?” In other words, what made the Thai economy so susceptible to crisis that it became the epicenter of the AFC. Applying the LTF theory of the AFC, Part I explores the construction of the Thai financial system as well as the fundamental instability resulting from the institutional skeleton that buttressed the economy. Since the Thai financial system opened up to foreign financial institutions in the late 1980s, a comprehensive assessment must consider both the domestic and international aspects equally. This chapter thus focuses on the institutional origin of foreign capital influx.

While it amounts to only one half of the story, the domestic narrative in Chapter 2 supplies the crucial context for the analysis in this chapter. It informs us the underlying driver of the inflows from within the economy. As a result, a recap of its main points is a helpful springboard to our investigation of the international story of the Crisis. Chapter 2 is to show how domestic law and legal institutions played a decisive role in triggering the AFC as well as determining the scope and gravity of this devastating phenomenon. Chapter 2 offers an LTF analysis focusing on explaining two things. Firstly, it shows that the changes in the institutional setup of the Thai financial system in the late 1980s and early 1990s exacerbated the problems associated with fundamental uncertainty and liquidity constraint. Secondly, it explains that incomplete laws, including both private contracts and public regulations that underlay virtually all financial transactions, could and did trigger the onset of the Crisis particularly since the financial system is always subject to the condition of fundamental uncertainty.

Rapid financial expansion, primarily signified by the increasing role of financial institutions in growing the economy²²⁵, grabbed hold of the Thai economy from the end of the 1980s and early 1990s. On a superficial level, one can simply rationalize the phenomenon by focusing on the spread of neoliberal ideas²²⁶ which were obsessed with achieving the so-called efficient market.²²⁷ Chapter 2 shows that the standard analysis fails to clearly account for the process through which this very development contributed to systemic instability in the Thai financial system. If we consider the evidence embedded in the changes in the relevant Thai laws and legal institutions at the time, we may observe that various state-promulgated instruments as well as privately created contracts together inadvertently instigated the destabilizing conditions that sharply raised the external costs of enforcing financial agreements. This new unstable equilibrium was especially precarious when faced with the risk of acute liquidity constraints after the Thai financial system became overly reliant on the continued supply of foreign capital.

Chapter 2 points out the proliferation of new classes of domestic financial institutions – finance companies. These non-bank finance companies were incentivized by changes in the legal and regulatory infrastructure underpinning the Thai financial system at the time to expand their lending operations as fast as possible through offerings of new financial products to new categories of borrowers. While finance companies had never exceeded the banking sector’s market share (not

²²⁵ Gerald A Epstein, *Financialization and the World Economy* (Edward Elgar Publishing 2005). at 3.

²²⁶ The conventional explanations of financialization rest on two prongs. First, developing countries sought better relationship with foreign investors by appointing US- and European trained economists. Secondly, they followed the neoclassically oriented policy advice of the international financial institutions, notably the IMF. This set of recommendations derived from the principles of the so-called Washington Consensus was at the time universally regarded as the gold standard of economic and development policy among the emerging market governments. Only after the crisis struck did opposing voices start to emerge. See for instance, 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 177.

²²⁷ Epstein (n 225). Part 4.

even by the dawn of the Crisis in the early part of 1997), their breakneck expansion and aggressive lending practice heavily influenced traditional banking institutions to compete for borrowers, both institutional and retail, with comparable financial products and tactics. The most crucial part of such a disruptive strategy is to keep lending regardless the deteriorating quality of the domestic loan portfolio. Again as shown previously, they were able to carry on lending due to the way in which the relevant authorities (particularly the Central Bank and the Ministry of Finance) interpreted and enforced the governing legal framework that was imposed upon this new, highly lucrative sub-sector. Faced with a diminishing domestic saving pool, Thai financial institutions lobbied the government for new sources of funding. This resulted in a series of structural changes to the fundamental construction of the Thai financial market. The issue of internationalization is the main subject of this present chapter and will be explored at length subsequently. Regarding the triggering mechanism of the Crisis, the dissertation again emphasizes that both state- and non-state instruments were heavily involved, especially when scrutinizing the actions of the Bank of Thailand in response to the widespread collapse of domestic financial institutions.

Ultimately, Chapter 2 demonstrates that financial expansion, as it occurred in Thailand during the pre-crisis period, was driven by legally-constituted actions and behaviors instigated by both public and private actors. These activities were themselves a source of systemic instability. In sum, the chapter documents a real world example of the legal construction of the Thai financial market. In addition, it identifies the institutional changes that transformed the centrally controlled, primarily trade-oriented financial model of the pre-1980s era to the market-based, expansionist setup of the pre-crisis era.

To put the aforementioned story in the perspective of the LTF framework, the onset of the AFC can be analyzed through the two main components of the LTF's building blocks. Firstly, it shows

that the Crisis exposed the paradoxical nature of a legally constructed financial system. On the one hand, the exponential growth of the Thai economy in the late 1980s to early 1990s was premised upon banks and finance companies being able to utilize existing legal devices to safeguard their financial interests against counterparty and market risks. This factor was unique to the case of Thailand and did not exist in any other crisis-hit Asian nation.²²⁸ Yet as the crisis deepened, there was growing uncertainty over the drying-up of international capital pool. This triggered the network of *ex ante* contractual obligations between foreign investors and Thai institutional debtors, forcing the latter to honor their contractual duties regardless of the fact that they were not in a financially viable position to do so. To put it differently, the unyielding enforcement of contracts across the financial market instigated and further reinforced the Crisis. In addition, the chapter also details the relationship between the financial sector and the relevant public authorities during the Crisis, demonstrating both the inherently hierarchical nature of the Thai financial system and the fact that legally constructed systems of finance as we know them today are necessarily always both public and private. In other words, the primary reason why the Thai financial system was not able to rely on a privately organized bailout arrangement to stifle the brewing crisis was that none of the private institutions at the time had sufficient financial capacity to absorb the foreign liabilities which were outstanding across the market. As documented in Chapter 2 and later in Chapter 4, it turned out that even the Thai state was unable to shoulder the external liabilities of the financial sector. This was because the means of settlement required by these outstanding debts were strictly payable in the foreign-denominated currencies (primarily US dollar and Japanese yen). The

²²⁸ For South Korea, it was a case of severe government intervention in the banking and industrial sector. In the Indonesian case, it was a total failure of the corporate sector. While Malaysia encountered a bad case of real estate bubble, its financial system was regarded as sufficiently resilient and self-reliant. See for instance, Sheng (n 4); Ha-Joon Chang, *The East Asian Development Experience: The Miracle, the Crisis and the Future* (Zed Books 2006).

examination of the development of the Thai financial system thus far maps out to the analytical framework based on the LTF building blocks.

Even if we limit our analysis of the AFC to its outbreak in Thailand and not to the subsequent contagious events in neighboring countries, there is still no denying that the crisis was significantly influenced by developments in both the domestic and international financial architectures. This present chapter highlights the latter element and argues that the systemic vulnerability in the Thai financial system (signified by fundamental uncertainty and an increasing risk of sudden liquidity shortage) in the run up to the Crisis was a function of the liquidity supply available on the global market. This chapter submits further that the size of the said international liquidity pool depends considerably on the relevant legal and regulatory changes in the jurisdictions with which the investors/creditors had to comply. Assessing the situation from the perspective of liquidity providers, the international components of the crisis can therefore be seen as the supply side of the narrative. Together with the domestic factors explored in the previous chapter (i.e. the perspective of liquidity takers or the demand side), this analysis completes this dissertation's investigation of the onset of the AFC.

The analysis in this chapter commences with the institutional origin of the unprecedented amount of foreign capital inflows into the Thai financial sector during the first half of the 1990s. It aims to answer two primary questions on this issue. Firstly, the chapter explains what caused regional capital movements at the time to flow into Thailand in such a large amount, especially when compared to neighboring countries with a similar economic and financial profile.²²⁹ The scale of

²²⁹ The statistics have shown that among ASEAN countries, Thailand was the largest recipient of capital inflows between 1988 and 1996. Yet, with the AFC, the inflows into Thailand became outflows by 1997. See Takatoshi Ito, 'Capital Flows in Asia' (National bureau of economic research 1999) <<http://www.nber.org/papers/w7134>> accessed 3 October 2016. at 44.

capital inflows was not the only significant variable in the onset of the AFC. The unraveling of the Thai financial system was, in large part, owing to the specific contractual structures of the inflows. As discussed in detail in the previous chapter, the private foreign debt incurred by Thai financial institutions can be categorized into two types.²³⁰ The first is relatively short-term foreign-denominated debt with a maturity period of up to and no more than one year. A primary piece of evidence to support this claim is the establishment of the special banking conduit by the Thai authorities. The preconditions pertaining to the grant of the license meant that the vast majority of the financing transactions carried through the conduit were on a short-term basis. The second is the foreign debt with a maturity period longer than one year also contained some form(s) of termination clause which could trigger an obligation of repayment upon occurrence of certain predetermined events, regardless of whether the maturity period was due or not. The previous chapter discussed the consequences of enforcing these classes of cross-border financial transactions for the systemic viability of the Thai financial system. This chapter asserts that the structural developments that led to the aforementioned capital inflows also contributed to these two types of capital inflows. Additionally, a series of drastic reforms of the East Asian financial governance frameworks as well as the emergence of transnational broker-dealer firms based in Hong Kong in the early 1990s also contributed to the amount and makeup of capital inflows into the Thai financial system.

To this end, the chapter is organized into five sections. Following this introductory part, the chapter sketches out the LTF analytical framework specifically to analyze the phenomenon of the international capital movements which occurred in the early 1990s. Subsequently, the chapter

²³⁰ In 1996, the private sector accounted for \$US 73.7 billion or 81.4 percent of the total external debt of Thailand. The financial sector (both banking and non-banking subsectors) represented over half of that amount. Source: Bank of Thailand.

discusses the influence of the international financial institutions, particularly the International Monetary Fund (IMF), the World Bank, and the Asian Development Bank (ADB) in shaping the economic and financial infrastructure of East Asian countries. This can be seen from the structural adjustments in the Japanese financial system which had direct repercussions for the regional capital market. Ultimately, it should be noted that the period of the late 1980s to the early 1990s was the time when these East Asian countries were trying to compete with the developed Western nations through investing in the new frontiers of the relatively underexplored Asian markets. The analysis runs full circle with the examination of the creation of the South East Asian sub-investment bond market by prominent Hong Kong-based investment firms. Taken altogether with the previous chapter, Part I therefore offers the complete LTF interpretation of the onset of the AFC. The chapter concludes by offering some implications of the analysis for the resolution of the Crisis, the central topic of investigation in Chapter 4.

2. The Construction of the International Financial Architecture: an LTF perspective

One of the extremely powerful ideas dominating the international financial community in the second half of the 20th century was the concept that surplus capital should be allowed to travel across jurisdictional boundaries, with minimal or no unnecessary control and regulation, in order to achieve maximum allocative and productive efficiency.²³¹ The literature argues further that any potential problems that may arise from financial globalization can be sufficiently addressed by deep institutional reforms such as modernizing the legal system, investing in protecting property

²³¹ Major and notable proponents of this forceful idea are Stanley Fischer, Robert Lucas, Maurice Obstfeld, Kenneth Rogoff, and Larry Summers. See for instance, Stanley Fischer, 'Capital Account Liberalization and the Role of the IMF' (*International Monetary Fund*, 19 September 1997) <<https://www.imf.org/en/News/Articles/2015/09/28/04/53/sp091997>> accessed 2 February 2017; Stanley Fischer, 'Globalization and Its Challenges' (2003) 93 *The American Economic Review* 1; Eric van Wincoop, 'Welfare Gains from International Risksharing' (1994) 34 *Journal of Monetary Economics* 175; Robert E Lucas, 'Why Doesn't Capital Flow from Rich to Poor Countries?' (1990) 80 *The American Economic Review* 92.

rights, enhancing accountability and transparency in corporate governance, and eradicating corruption in national politics. The previous chapter offered a fresh new perspective exploring the institutional underpinning of the Thai financial sector and how the way it was set up became systemically destabilizing.²³² The present chapter relies on the LTF framework to explain the following three issues relating to the construction of the international financial landscape in Asia prior to the Crisis. Firstly, the governing principles of financial globalization need to be transposed from the initiating agencies or bodies of the international community to member countries. Secondly, the national governments then had to come up with corresponding changes to either their own respective rulebooks or other infrastructural underpinnings of their financial system. Thirdly, market participants subsequently reacted to the said changes in both the international financial architecture and national framework, usually with new financial products or practices aimed to minimize their regulatory compliance costs.²³³

The international financial architecture has traditionally followed a different approach from the standard public international law regimes such as the United Nations, and the World Trade Organization.²³⁴ Conventionally, an international institution breaks ground with a founding international treaty signed by the states who agree to work out both their cooperation and disagreements over issues under the purview of the said treaties under the established institutional structure and its apparatuses. The so-called hard law instruments then set out the skeleton of classic

²³² In addition, there emerges a “revisionist” strain of literature with added nuances to financial globalization, essentially arguing that the more (investment) is not necessarily better for developing countries. See for instance Dani Rodrik and Arvind Subramanian, ‘Why Did Financial Globalization Disappoint?’ (2009) 56 IMF Staff Papers 112.

²³³ Awrey (n 21). at 410-411.

²³⁴ Chris Brummer, *Soft Law and the Global Financial System: Rule Making in the 21st Century* (Cambridge University Press 2012). at 61.

public international diplomacy, which details member states' rights and responsibilities in the form of international legal obligations.²³⁵ Subsequent legislative actions as well as rule interpretations are agreed by a plenary body of the full membership and/or a specialized adjudicating body. Finally, most traditional international organizations often make their important decisions through democratic means while consensus-based decision-making in which no formal voting takes place is rare. One primary reason for this particular setup of public international law institutions is it concerns solely the relations between states, not within them. In other words, the democratic governance of the traditional international community reflects its indifference to the internal governance of the member states.²³⁶

By comparison, the international financial community functions on an entirely different platform and serves a completely new set of objectives. To some extent, it still concerns itself with regulating inter-state relations, notably currency exchange management and the international payment system. The most famous attempt was the Bretton Woods Conference, the postwar initiative by world leaders to stabilize exchange rates as well as to streamline the payment system in support of international trade.²³⁷ Nevertheless, there is also a clear motive to intervene in domestic rules and regulations particularly when governing the conduct of private transnational financial institutions. Notably, these entities are incorporated and dissolved nationally, even though they operate internationally.²³⁸ As a result, the international financial architecture attains

²³⁵ Jose E Alvarez, *International Organizations As Law-Makers* (Oxford University Press 2005).

²³⁶ Gregory H Fox and Brad R Roth (eds), *Democratic Governance and International Law* (Cambridge University Press 2000).

²³⁷ Barry Eichengreen, *Globalizing Capital: A History of the International Monetary System, Second Edition* (Second edition, Princeton University Press 2008). at 91.

²³⁸ This quote is widely attributed to Mervyn King, the former Governor of the Bank of England, and Professor Charles Goodhart.

the following three attributes.²³⁹ Firstly, it does away with the rigid public international law institutional structure, preferring an informal mandate based on frequent cooperation and consensus-based decision-making. Secondly, rather than formal engagement among political representatives from member states, the international financial architecture put overwhelmingly significant emphasis on the participation of domestic regulatory agencies and their officials. Finally, the international governance framework is highly fragmented with the legislative as well as supervisory responsibilities shared among non-governmental cross-border organizations, national agencies, and the representative bodies of market participants themselves.

Without a well-defined and structured rule-adopting and -implementing process, why do countries still transplant the internationally derived principles and recommendations into their own respective regulatory rulebooks? The most widely held theory argues that the international financial architecture ought to be considered as a group of networks or webs connecting various stakeholders.²⁴⁰ On the international level, the approval procedure of a standard or proposed guideline requires constant persuasive discussions in order to achieve broad consensus among all parties involved. Crucially, the network theorists assert that in this setting, participating national agencies often use the likelihood of domestic implementation of international principles as part of the bargaining capital in order to manage both domestic special interests and strategic objectives abroad.²⁴¹ Moreover, as the network tightens up, personal relationships as well as reputation emerge as an important indicator of national implementation of the international principles and

²³⁹ Brummer (n 234). at 63-65.

²⁴⁰ Anne-Marie Slaughter, *A New World Order* (Princeton University Press 2005). See also Brummer (n 234). at 67.

²⁴¹ Tim Bütte and Walter Mattli, *The New Global Rulers: The Privatization of Regulation in the World Economy* (Princeton University Press 2013). at 42-59.

recommendations.²⁴² Building upon the network theory of international financial governance, a new group of legal scholars have emerged highlighting the inherent mechanism of “soft law” instruments as the main driver of international financial compliance. By stripping off “technical formality”, soft law instruments carry their compliance and enforcement power through alternative, more contextually aware means, particularly reputational effect, and market discipline.²⁴³ In addition, the international regulatory system may call for traditional international institutions, notably the IMF and World Bank, to exert hard discipline with their financial assistance programs and threat of membership sanctions.²⁴⁴

Both the network model and the soft law-based theory seemingly paints a rather flat landscape of the international financial architecture. In other words, they appear ambivalent to the relative bargaining power and the respective systemic importance of each individual stakeholder. Consensus is not in reality driven by negotiation and cooperation by every party on an equal footing basis. Rather, it reflects and entrenches the interests of the most dominant contingent in the community. It is clear that when facing a great international financial crisis, not all financial assets will be treated with the same level of creditworthiness, even if in good times most financial intermediaries accept their exchangeability as if they carried the identical underlying value. Without uncovering the true nature of this network of relationships created through trading financial assets, it is impossible to understand the reality of the international financial landscape.

²⁴² Robert D Putnam, ‘Diplomacy and Domestic Politics: The Logic of Two-Level Games’ (1988) 42 *International organization* 427.

²⁴³ Brummer (n 234). at 140-147.

²⁴⁴ *ibid.* at 147-155.

LTF asserts that the mismatch between the true value revealed during the crisis and the face value accepted during the good times are the direct results of a system coded in law.²⁴⁵ Hard legal commitments, created as part of every financial transaction, confer rights and responsibilities, which are placed upon contractual parties to be triggered at a vaguely determined point of time in the future. Together with the potential liquidity problems inherent in the contemporary financial system, the uncertain element built into virtually all financial contracts renders the system inherently unstable.²⁴⁶ The *ex ante* legal obligations coded in every major financial transaction require settlement in one of a very limited choice of currencies, primarily the US dollar.²⁴⁷ Consequently, some assets, and by logical extension their issuers, will be highly sought after. To put it differently, if there is a hierarchy of global moneys organized in law through their respective inherent value which is only revealed at the time of crisis, there is also another parallel hierarchy of issuing entities which issue and back their own assets as well.

Crucially, this chapter asserts that the LTF internal logic can be extended to explain the bargaining power of every stakeholder in the international financial architecture as well as the implementation of the strictly not legally binding international standards and principles into national regulatory rulebooks. While the hierarchy of global moneys may be flattened out outside the crisis times, the hierarchy of stakeholders persists and gains significance during the rule formulation and adoption process. The nation states as well as non-state institutions at the apogee of the hierarchy have every incentive to influence the formulation of the internationally accepted standards in order to further

²⁴⁵ Katharina Pistor, 'Money's Legal Hierarchy', *The Hierarchy of Global Money* (2016). On file with the author.

²⁴⁶ 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.

²⁴⁷ 'Capital Flight, by Darryl McLeod: The Concise Encyclopedia of Economics | Library of Economics and Liberty' <<http://www.econlib.org/library/Enc1/CapitalFlight.html#abouttheauthor>> accessed 5 May 2017.

entrench their positions at the top of the pyramid. On the other hand, those countries on the periphery are most likely inclined to adopt the aforementioned foreign standards because the evidence of bona fide strict compliance could potentially allow them to obtain a more favorable deal from the international community during times of crisis.

Interestingly, there is also a group of countries and institutions that have just started to gain prominence in the global arena. Their emergence may be due to their growing stature in international trade and/or the presence of their domestic financial institutions in the global financial market. In the context of the Asia-Pacific region in the last two decades before the millennium, this group included the largest regional financial markets such as Japan, South Korea, and Hong Kong. Regardless of other underlying factors, their likelihood of transplanting foreign rules, standards, and principles endorsed by the international financial community increases further if by doing so they can maintain their strong connections with the global hierarchy in order to continue benefiting from future rule changes as well as crisis resolution management.²⁴⁸ It is possible to point to a more contemporary instance of a regionally significant financial system that has maintained strong ties with the global apex. During the Global Financial Crisis in the 2000s, South Korea and Singapore successfully requested emergency lending facilities between their central banking authorities and the US Federal Reserve System while similar pleas from other South East Asian nations as well as Latin American countries were largely ignored.²⁴⁹ To reiterate, while it is true that the hierarchy of stakeholders in global finance on the surface echoes the political powers

²⁴⁸ The next chapter illustrates the proximity of Japan and its currency vis-à-vis the global hierarchy of finance in the context of post crisis resolution in the aftermath of the AFC.

²⁴⁹ Setser (n 10).

in the international polity, such hierarchy is rooted in the legal DNA seamlessly woven into the fabric of contemporary finance such that it is often taken for granted.

Consistent with the LTF depiction of a contemporary financial system proposed in Chapter 1, the changing institutional dynamics of law in finance inevitably provoke corresponding reactionary behavior of those market participants who are in some way affected by such changes. As argued above, the soft-law based strategic alliance network in and of itself does not directly interact with or causes transactional activities without additional steps being taken, at each individual state's own discretion, to fully internalize and implement the standards and guidelines formulated and agreed upon at the international policy coordination level. The disconnection between the so-called international financial soft law and state implementation is exemplified by the history of the adoption of the Basel Accords which, even though widely followed, has encountered delays, variations, and negative reactions from both member countries of the Basel Committee, as well as from many non-member countries.²⁵⁰ Consequently, it is submitted that all rules, standards, and principles that together form the body of international financial soft law may not be considered as part of the institutional structure of global finance without undergoing a necessary process of "domestication".

The point of the foregoing discussion is to substantiate the claim that the construction of the international financial system is, just like that of its national financial counterparts, hybrid. In other

²⁵⁰ Narissa Lyngen, 'Basel III: Dynamics of State Implementation' (2012) 53 Harv. Int'l LJ 519; Emily Lee, 'The Soft Law Nature of Basel III and International Financial Regulations' (2014) 29 Journal of International Banking Law and Regulation 603; Bandid Nijathaworn, 'Implementation of Basel II and IAS from A Regulator's Perspective' (ASEAN Bankers Association, 4 October 2007).

words, it requires both state and private inputs.²⁵¹ The hybridity of international finance goes beyond the neat dichotomy of the state's implementation of externally derived policies and the private parties' self-indulgent transactional activities. Hybridity in the LTF paradigm implies a complex collaboration between relevant state apparatuses and market participants in creating a new financial product, practice, and in certain circumstances a new subsector within the financial system.²⁵² Regardless of the rise of global policy coordination among various public and private stakeholders, the role of national laws and regulations will never be entirely neutralized.²⁵³ Before operating in the so-called international financial arena, a transnational financial institution requires an explicit authorization from the authorities within its own regulatory framework. The said public agency is often entrusted by law with issuing secondary legislative instruments setting out among other things the set of permitted financial activities in which all regulated and eligible financial entities are allowed to engage. Within the realm of permissible financial transactions, both home and host authorities could legislate such that they share regulatory powers especially when a given cross-border financial deal may yield potential negative impacts for their respective financial systems.²⁵⁴

²⁵¹ As opposed to the widely held belief that finance is a system of purely private commitments subject to external constraints designed to achieve maximum efficiency. See Gilson and Kraakman, 'The Mechanisms of Market Efficiency' (n 42); Gilson and Kraakman, 'Market Efficiency after the Financial Crisis' (n 16).

²⁵² Pistor pointed out some of the more important examples of the hybridity of finance in her paper such as the essential legal backing provided by the state to ensure the enforceability of certain eligible private commitment, the role of the state during the financial crisis when the private market simply ceases its operation, to name just a few. See Pistor, 'A Legal Theory of Finance' (n 18). at 322-323.

²⁵³ Riles (n 23). at 78.

²⁵⁴ For instance, the US Commodity Futures Trading Commission (CFTC) claim a regulatory jurisdiction over foreign brokers and dealers who do business with US-based clients on the ground that regulatory authority is allocated according to the domicile of the buyer. See Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations, 78 Fed. Reg. 45,292 (July 26, 2013).

The hybrid quality of international finance can also shine through in various contractual clauses designed by the parties to the agreement to afford credibility and enforceability to their financial arrangements. Firstly, they may elect to have the transaction governed and adjudicated by the law and jurisdiction that would best protect their financial interests and have the ability to enforce the specific terms of the contract.²⁵⁵ Not only is this issue concerning credibility and enforceability crucial to the prosperity of the financial market in good times, but the legal DNA embedded in each and every financial asset determines whether it would find any buyers during the time of crisis. Indeed, many institutional investors and lending financial institutions refused to continue loading up their balance sheet with any more debt instruments issued by South East Asian banks, even though they would have been settled in global currencies notably US dollars and Japanese yen. Inherent in the legal and political nature of these debt instruments is the support of their own respective central banks which unfortunately had only limited supplies of high-powered currencies. In other words, it can be said that behind every debt-based financial instrument, especially those traded in the secondary market and widely considered as private moneys, is always an implicit backing of the sovereign state whose currency is denominated as the means of final settlement. Therefore, regardless of how globalized a sector of the financial market may become, it will always be essentially both privately and state- constructed.

Although the global financial architecture has clearly become significant in shaping the governance structure of the global financial market, finance is still essentially locally regulated and supervised. In other words, the conduct of a transnational financial company will still be

²⁵⁵ Not only does the choice of forum and law afford the parties freedom of contract, but it is also oftentimes part of an elaborate market-based coordinating scheme designed to minimize the costs of regulatory compliance. See Riles (n 23). at 65. Furthermore, it is why a standard form of financial contracting such as the ISDA and the American Uniform Commercial Code (UCC) would be neither credible nor enforceable without prevalent national validation (and in the latter's case, widespread state adoption). Pistor, 'A Legal Theory of Finance' (n 18). at 321.

directly subject to the authorities of its home jurisdiction as well as other host nations in which it does business. With the added complexity that comes from each additional regulatory hurdle, the private financial company is incentivized to invest in innovations that would help it navigate the complex web of laws and regulations without incurring excessive expenses. This interplay between changes in domestic rules and market incentives to mitigate or circumvent those changes arguably provides the most forceful catalyst for financial and contractual innovations.²⁵⁶ However, the process is far from one directional. Public authorities are always wary of new products and novel practices, and thus constantly tweak their rulebook to curb any potential risks to the systemic stability associated with those unproven private developments.²⁵⁷ The remaining sections of this chapter demonstrate this very dynamic between public and private inputs in constructing the international capital flows in Asia and explain why certain types of financial transactions were siphoned into the Thai financial system creating the vulnerability which ultimately led to the AFC. To reiterate, the financial developments in the Asia-Pacific region in the 1980s and 1990s followed religiously the conventional free-market principles preached by the IMF and World Bank. Nevertheless no one expected the AFC as a consequence precisely because the essential hybridity of finance was entirely overlooked by virtually all stakeholders within the region and beyond.

3. Tracing the Construction of the International Capital Flows: from the Washington Consensus to the internationalization of the Thai financial system

With the analytical framework elaborated above in mind, we can now appraise the beginning of the international capital flows in the Asia-Pacific region through the said lens. From a basic

²⁵⁶ Awrey (n 21). at 410.

²⁵⁷ Awrey and Pistor (n 246). at 3.

demand-supply perspective, the account of the international capital flows could not be any simpler. There were countries looking to maximize the return on surplus capital preferably by investing in the economies that were enjoying an extended period of high economic growth. On the other hand, there were also emerging market nations that were running out of their domestic pool of capital to sustain the outstanding demand for investment in the economy. Assessing the situation under this rubric, the international capital market should thus be considered as a marketplace connecting the foreign supply of funds with local thirst for capital, ideally with minimal or no interference from regulatory authorities whatsoever. However, this very crude depiction fails to take into account the internal mechanics of channeling funds from upstream investors to downstream financial companies in the South East Asian economies. Participating countries constructed such channels by promulgating necessary changes in law and regulation in order to dovetail their national financial frontiers allowing eligible firms to operate on a cross-border basis.

This subsection looks at these developments in detail. First, it considers the drivers for change that emerged in the international polity in the 1980s as well as the rationales behind such movement. Secondly, the chapter proceeds to discuss the resulting legal and regulatory reforms pertinent to transnational Japanese financial institutions. Japanese banks were by far the largest creditors of the Thai financial sector with 53% of total international claims on Thai banks.²⁵⁸ In addition, the chapter also looks into the institutional constraints relating to European and US banks, which together represented 27% and 7% of total external claims respectively at the end of 1996.²⁵⁹ Next, the section pivots to discuss the regulatory landscape in Hong Kong which contributed

²⁵⁸ Stephany Griffith-Jones and Jacques Cailloux, 'International Bank Lending and the East Asian Crisis', *International Capital Flows in Calm and Turbulent Times* (University of Michigan Press 2003) <<http://www.jstor.org/stable/10.3998/mpub.17835.8>>. at 49-74.

²⁵⁹ *ibid.*

significantly to the rise of the South East Asian junk bond market, which supplied most of the lending capital through the special conduit constructed by the Bank of Thailand in the early 1990s. Last but not least, we dissect the regulatory skeleton of that special conduit, the so-called Bangkok International Banking Facility (BIBF) at length. At the end of the analysis, this chapter hopes to answer two primary questions: 1) why Thailand was the primary destination of international capital flows in the region, and 2) how the institutional setup of the international capital market influenced the kind of lending to which the Thai financial system was liable.

a. *The Washington Consensus, the Plaza Accord, and the dynamic of the global hierarchy of finance*

As briefly mentioned above, the main driver of changes in the governing framework and ideological model of Asian financial markets was the conventional wisdom devoted to complete and unfettered flows of capital movement. This extremely pro-market view was part of the so-called Washington Consensus and rooted in the mainstream Anglo-American intellectual tradition.²⁶⁰ In the early 1980s, the ideology eventually became the mantra of the two most powerful international economic organizations – the IMF and the World Bank.²⁶¹ Beyond free movement of capital across financial borders, some other important core elements are a range of social and economic policies including fiscal discipline, trade, investment, and financial

²⁶⁰ John Williamson, ‘What Washington Means by Policy Reform’ (1990) 7 *Latin American adjustment: How much has happened* 7.

²⁶¹ Ramgopal Agarwala and others, ‘World Development Report 1983’ (The World Bank 1983) 11119 <<http://documents.worldbank.org/curated/en/997591468322730301/World-development-report-1983>> accessed 7 May 2017.

liberalization, deregulation, decentralization, privatization, and a drastically reduced role for the state apparatuses in managing both social and economic development.²⁶²

Initially in the 1980s, the US government through the IMF's Article VI financial assistance program pushed heavily for the adoption of this neoliberal set of policy recommendations against those Latin American countries, which were at the time experiencing widespread economic collapses.²⁶³ The underlying assumption of crisis management was that the market is capable of self-correcting and would rise up spontaneously from progressive lessons learned from crises and shocks, thereby negating the need for heavy-handed government intervention. The legacy of neoliberalism in Latin America is even until today inconclusive and still invites regular commentaries from both the mainstream media as well as those in the academic circle.²⁶⁴

The adoption of this school of thought in East Asia was clearly a far more complicated venture than it was in South America. This is primarily because the Asia Pacific economies had been built on the intimate working relationship between the state organs and leading business conglomerates.²⁶⁵ The issue with East Asia however was that during the same time, most of the economies in the region were enjoying one of the longest stretches of economic successes in modern history. As a result, the countries in the region were neither interested nor required to make a fundamental adjustment to their respective economic model. To this end, the World Bank came

²⁶² Williamson (n 260).

²⁶³ Juan Carlos Moreno-Brid, Esteban Pérez Caldentey and Pablo Ruíz Nápoles, 'The Washington Consensus: A Latin American Perspective Fifteen Years Later' (2004) 27 *Journal of Post Keynesian Economics* 345. at 346.

²⁶⁴ See for instance, Tomás Undurraga and Tomás Undurraga, 'Neoliberalism in Argentina and Chile: Common Antecedents, Divergent Paths' (2015) 23 *Revista de Sociología e Política* 11.

²⁶⁵ For a comprehensive account of the role of private businesses and government agencies in Asian economic development, see Joe Studwell, *How Asia Works: Success and Failure in the World's Most Dynamic Region* (Grove Press 2013).

up with its major study, the so-called the East Asian Miracle²⁶⁶, which for the first time recognized the role of state in the neoliberal economic development model. Under this analysis, the state was thus considered as the “market facilitator”.²⁶⁷ Ultimately, the report conceded that the government had indeed intervened and strategically promoted the development of specific industries.²⁶⁸ Alternatively, the concession to the Asian model could be due to growing Japanese influence over the official position of both the IMF and the World Bank as there was a subsequent report that the Japanese government applied considerable pressure for the World Bank to reconsider its “one-size-fit-all” free market prescriptions.²⁶⁹

Undoubtedly, the attempt to internalize the Asian development model into the conventional framework was a conscious move to convince the “Asian Tigers” to embrace some, if not all, facets of the latter. Not only would the conversion from an unpredictable and frequently hostile state-centric system to an open, market-oriented, investor-friendly economic model be considered a diplomatic and political triumph for many ideologues in the West, but perhaps more importantly a new potentially lucrative business opportunity for transnational corporations and financial firms which lobbied intensely behind the scene for such changes. The expectation of financiers on global financial centers such as Wall Street and the City of London was that these emerging Asian countries would industrialize at a rapid rate, and thus corporate and investment profit would

²⁶⁶ World Bank (n 8).

²⁶⁷ Richard Robison and Kevin Hewison, ‘Introduction: East Asia and the Trials of Neo-Liberalism’ (2005) 41 *The Journal of Development Studies* 183. at 191.

²⁶⁸ World Bank (n 8). at 5-6.

²⁶⁹ Susumu Awanohara, ‘The Magnificent Eight—World Bank Seeks Lessons from East Asia’ (1993) 156 *Far Eastern Economic Review* 79.

surge.²⁷⁰ Consequently, an open-border policy for foreign companies as well as capital became one of the very first aspects of the Washington Consensus for which Western businesses lobbied. Despite constant calls by the international financial institutions notably the IMF, East and South East Asian nations had never been completely comfortable with a full-scale implementation of the neoliberal economic development agenda, preferring to maintain control of specific key industries such as banking, public utilities, and real estate. This half-hearted adoption conveniently led to many damaging post-crisis analyses and reports with a primary objective to discredit the Asian development model.²⁷¹ This dissertation proposes that the real driver of financial instability in the region in this period might be more fundamental than what was suggested by both sides of this debate. Regardless of the ideological premise of the governing framework, the reform of the Asian financial systems had to be transposed through legal and regulatory instruments which contained their own set of incentives and hindrances. As a result, it was extremely difficult to anticipate the reaction of the market to the changes. The following account of the Japanese financial overhauls in the 1980s and subsequently in the early 1990s, and the internationalization of the Thai financial sector provides a case in point.

²⁷⁰ Kindleberger and Aliber (n 2). at 177.

²⁷¹ First, some initial reactions: Krugman, 'The Myth of Asia's Miracle' (n 51); Stanley Fischer, 'The Asian Crisis: A View from the IMF' (Midwinter Conference of the Bankers' Association for Foreign Trade, Washington, D.C., 22 January 1998) <<http://www.imf.org/en/News/Articles/2015/09/28/04/53/sp012298>> accessed 8 May 2017. Then subsequently, an academic onslaught: Giancarlo Corsetti, Paolo Pesenti and Nouriel Roubini, 'What Caused the Asian Currency and Financial Crisis? Part I: A Macroeconomic Overview' (National Bureau of Economic Research 1998) <<http://www.nber.org/papers/w6833>> accessed 8 May 2017; Roberto Chang and Andres Velasco, 'The Asian Liquidity Crisis' (National bureau of economic research 1998) <<http://www.nber.org/papers/w6796>> accessed 8 May 2017; Radelet and Sachs (n 24). Some scholarly works in economics that pointed out the effects of constraints and rigidities set up by the legal construction of the Asian financial systems such as shortage of domestic collaterals against international claims. See Ricardo J Caballero and Arvind Krishnamurthy, 'International and Domestic Collateral Constraints in a Model of Emerging Market Crises' (2001) 48 *Journal of monetary Economics* 513.

If there was any clear indication of the hierarchical structure of global finance at play during this pre-Crisis period, it had to be the currency exchange agreement among the G-5 countries and their central banks, known as the Plaza Accord of 1985. The meeting at the Plaza Hotel in New York City in late summer of that year signified a major shift in the dollar policy of President Reagan's administration from a free-market proponent during his first term to a more pragmatic stance embracing the idea of more intervention in the international currency market. The background and effectiveness of the Plaza Accord is not a direct subject of this dissertation which at present focuses on Japan's interaction with other global powers at the top of the world's governance structure.²⁷² While many of the G-5 members, particularly the French and German officials, lobbied their US Treasury counterparts intensely in the run up to the September meeting, the Treasury chose instead to secretly approach Japan's Ministry of Finance with the possibility of concerted intervention.²⁷³ There are at least two ways to critically analyze Japanese participation in the international currency management concordat. First, this demonstrated Japan's growing stature in the world economy. We will be investigating this hypothesis further in Chapter 4 on the post-crisis resolution period. The deliberations on the failed initiative for the Asian Monetary Authority, as a regional equivalent of the IMF, demonstrated that it was the US, who held sway even on the relatively regional issue of the AFC. Consequently, we can rationalize Japan's position in the hierarchy of global finance through its interactions with the US. This is also reflected in the domestic regulatory developments which arose during the 1980s.

²⁷² For a retrospective assessment, see Jeffrey Frankel, 'The Plaza Accord, 30 Years Later' (National Bureau of Economic Research 2015) <<http://www.nber.org/papers/w21813>> accessed 9 May 2017.

²⁷³ Bai Gao, *Japan's Economic Dilemma: The Institutional Origins of Prosperity and Stagnation* (Cambridge University Press 2001). at 175.

b. The essential hybridity of finance and the origins of international capital surplus in Asia in the late 1980s and early 1990s

To recap, the essential hybridity is a direct reflection of a contemporary financial system constructed in law. Both public and private stakeholders in the market innovate changes to the status quo in pursuance of their own agendas and vested interests. Here we consider the evolution of the regulatory structure of three major investing countries in South East Asia, particularly in Thailand. As discussed in the immediately previous subsection, most of the following institutional developments were driven by a combined force of state representatives, non-governmental agencies, as well as private institutional participants. In turn, we shall see how the aforementioned changes to the domestic governance framework spurred innovative responses from the market.

i. Financial internationalization in Japan of the 1980s and early 1990s

Japan in the 1980s experienced extreme macroeconomic and financial conditions. Towards the end of the 1970s, the country witnessed a rapid growth of credit supplies due to the Japanese authorities maintaining an extremely favorable currency value compared to the US dollar and setting enticingly low interest rates. These internal factors coupled with the foreign influences detailed above pushed the Japanese government to react with a wide range of legal and regulatory tweaks incrementally introduced over the following next decade or so.²⁷⁴ For the present purposes, there are three key areas which directly contributed to the exponential growth of available Japanese capital ready to be invested in South East Asia – first, reactionary changes to global uncertainties in the late 1970s; second, responses to the real estate bubbles of the mid-1980s; third, the erosion

²⁷⁴ Akiyoshi Horiuchi, ‘An Evaluation of Japanese Financial Liberalization: A Case Study of Corporate Bond Markets’, *Financial Deregulation and Integration in East Asia, NBER-EASE Volume 5* (University of Chicago Press 1996) <<http://www.nber.org/chapters/c8562.pdf>> accessed 8 May 2017. at 168.

of the traditional segregation of institutions in financial subsectors. All of these reforms had significant effects on both sides of the balance sheet of the Japanese commercial banking sector. Collectively, the government afforded greater freedom to banks to raise capital from a wider variety of sources. In addition, they also expanded the types of assets in which banks were allowed to invest. Last but definitely not least, certain regulations towards the end of the 1980s, intended to curb excessive investments in the already bubbling real estate sector, had an inadvertent effect of encouraging financial institutions to seek new investment opportunities abroad.

Before exploring the changes made to the governance structure of the Japanese financial system in the 1980s, a brief historical context is helpful in order to understand the magnitude as well as the resulting behavioral adjustments of large Japanese banks. The modern foundation of Japan's financial system rested upon an important American legal experiment of the New Deal era. After the Second World War, the Japanese Securities and Exchange Act of 1948 came into force. In particular, Article 65 prohibited banks from participating in the securities business. In other words, this was very much a Glass-Steagall-inspired legal transplant. The compartmentalization of the financial industry took place in two ways: by kind and by conduct. All financial firms were required to hold a specific license to operate in each segment of the industry. Crucially they were not allowed to hold more than one license at a time. Within the banking industry, the regulators further subdivided the sector into short- and long-term finance. In addition, the authorities restricted competition by price through the regulation of deposit rates, stock brokerage commissions, and insurance premiums as well as competition by non-price methods such as tight regulation over branching and advertisement. Consequently, banks could not compete against each other by advertising a higher yield product than those offered by their competitors, for instance. In addition, due to a tight control of cross-border capital transactions as well as a closely managed

foreign exchange regime, financial firms were well insulated from the torrent of the international financial market. The regulators were traditionally compliant with this general principle in order to reduce the likelihood of institutional failure, and therefore had to protect the weakest members of the industry.²⁷⁵ Nevertheless, the protectionist nature of Japan's financial system was a subject of criticism from their international trading partners, most notably the US and European countries.²⁷⁶

This strict licensing system was designed in accordance with the embedded regulatory principle to reduce, rather than to expand, the number of licensed firms.²⁷⁷ Consequently, banks had over time become very powerful precisely due to this institutional barrier to entry. One byproduct of this legally constructed separation is that the dominant banking sector suppressed the development of securities and securities market activities. As a result, the corporate sector had relied almost exclusively on bank loans as their source of financing, while the household sector was left with few alternatives to bank deposits to maintain their savings. Prior to the reforms of in the 1980s when the aforementioned traditional separation between subsectors in the financial industry had been gradually lifted, there was virtually no need for Japanese banks to actively seek either their funding or investment opportunities abroad. The said institutional insulation coupled with the fast growing Japanese economy of the 1960s and 1970s provided a sufficient opportunities for business growth and expansion.

²⁷⁵ Curtis J Milhaupt and Geoffrey P Miller, 'Cooperation, Conflict, and Convergence in Japanese Finance: Evidence from the Jusen Problem' (1997) 29 Law & Pol'y Int'l Bus. 1. at 8.

²⁷⁶ Kenusuke Hotta, 'Deregulation of the Japanese Financial Markets and the Role of Japanese Banks' (Columbia Graduate School of Business 1992) Occasional Paper No.7. at 5.

²⁷⁷ Milhaupt and Miller (n 275). at 7.

The first sign of change presented itself in the period of global uncertainty in latter half of the 1970s which put pressure on the regulatory authorities to both loosen their control over the financial system as well as the currency exchange regime. The first wave of change began with freeing up of flows of money and capital across the Japanese financial border. Against the backdrop of the global oil crisis of the 1970s, Japan's domestic financial market heavily contracted as both consumer and commercial demand dwindled. In response, the long-standing general principle enshrined in the Foreign Exchange and Foreign Trade Control Law was completely reversed in December 1980. Gone was the era of prohibition unless specifically authorized by legislation or government directive, and in its place came the new principle which stated that foreign transactions were allowed unless otherwise prohibited.²⁷⁸ In other words, any cross-border capital transactions could be carried out with only prior notice to the Ministry of Finance, forgoing the requirement of a formal permit. This in and of itself did not directly result in any categorical relaxation of the foreign exchange controls, but rather was seen as a precursor to many incremental reforms that subsequently followed.²⁷⁹

The most influential policy direction came from the Japan-US Yen-Dollar Committee established in 1983 just before President Reagan's visit to Japan.²⁸⁰ It is worth noting that this was during the negotiating period leading up to the Plaza Accord of 1985. The report issued shortly after was instrumental in pushing through a series of reform agendas aiming at lifting the strict control over

²⁷⁸ Masahiko Takeda and Philip Turner, 'The Liberalisation of Japan's Financial Markets: Some Major Themes' <<http://www.bis.org/publ/econ34.pdf>> accessed 8 May 2017. at 17.

²⁷⁹ Horiuchi (n 274). at 9.

²⁸⁰ 'Chronology of the Internationalization of the Yen' (*Ministry of Finance*) <http://www.mof.go.jp/english/about_mof/councils/customs_foreign_exchange/e1b064c1.htm> accessed 9 May 2017.

foreign financial transactions. In June 1984, Bank of Japan ended another long-time restriction on the conversion of foreign currencies into yen. In other words, the repeal of the so-called “swap limit rule” allowed for Japanese banks to flexibly establish open short positions in foreign currency in the spot market and to obtain an unrestricted amount of yen by selling foreign currencies borrowed in the foreign markets. The upshot of these developments was a significant increase in financial dealings involving yen as at least one leg of the transaction²⁸¹, effectively elevating the yen as a major global currency and Tokyo as a premiere international financial center.

The liberalization of cross-border capital transactions was just one piece of jigsaw puzzle, albeit an important one. Subsequent important reforms focused on dismantling the compartmentalization of the financial system, which had significant implications for the accumulative balance sheet of the Japanese banking sector. Another important policy agenda of the reform package derived from the Yen-Dollar Committee’s report was to reduce the cost of raising money for Japanese corporations. The resulting initiatives were wide ranging but the most pertinent ones for the present purpose included 1) opening up the money market fund industry, 2) easing the barriers between banking and securities businesses, 3) gradually lifting interest rate controls on large deposits, and 4) establishing a bond futures market.

The promotion of the money market fund industry in Japan was a significant factor in changing the behavior of Japanese banks. For a long time, Japanese corporations depended primarily on banks for both financing as well as cash management purposes. Money market funds provided a potentially higher return alternative to bank deposits which up until the mid-1980s was still heavily

²⁸¹ The total amount of foreign exchange transactions rose from \$ 73 billion in 1975 to \$ 6 trillion. Moreover, by 1982 the Japanese capital outflow reached the new high in its financial history. See Takeda and Turner (n 278). at 18.

regulated by Bank of Japan. Corporate treasuries became attracted to the money market fund industry because the latter invests in safe, high-quality debt and monetary instruments while it also promises to maintain a constant net asset value as well as relative liquidity. In other words, it represented a better alternative to hoarding cash or holding bank deposits for large corporations.

At the other hand of the spectrum, the primary source of banks' revenue was potentially under threat from the maturing corporate bond market. By the second half of the 1980s, the two regulatory hurdles barring most potential corporate issuers were overhauled. First, the collateral rule required bond issuers to pledge other assets, usually real estate, as security for repayment. Second, the eligibility test effectively clouded out small- and medium-sized companies from the bond market. The stringent rules put in place prevented the development of the domestic corporate bond market and entrenched the role of banks in corporate finance as they were allowed to reap huge fees from indirect finance through the banking sector. The former was practically repealed by the Bond Issue Arrangement Committee (BIAC), a hybrid public-private entity comprising of representatives from the Ministry of Finance, the Industrial Bank of Japan, large bond underwriters, and major banks. Subsequently, the eligibility requirement had gradually been replaced by the rating system which went a long way toward relaxing the strict thresholds of the previous regime. As a result, the bond market witnessed a significant jump in the amount of corporate bonds from 8,670 billion yen in 1987 to 20,412 billion yen in 1989, after which the number dropped slightly but it has remained above the 1987 benchmark ever since.²⁸² The banking sector had long lobbied against the development of the domestic corporate bond market for

²⁸² Horiuchi (n 274). at 176.

decades. Once matured, the bond market could potentially offer a more cost-efficient alternative to traditional bank financing and thus erode one of the long-term cash-cow source of revenue.

Not all the reform initiatives went against the dominant position of the banking sector. To the contrary, two in particular afforded banks a new set of incentives to re-evaluate their traditional business strategy. First, Bank of Japan gradually loosened its tight controls over interest rate over time. Significantly, banks could for the first time offer large-lot time deposits (also known as certificates of deposit, or CDs) with the freedom to set the interest rates for qualified corporate investors. While the consumer banking side continued to be heavily regulated, Japanese banks were incrementally afforded more flexibility in dealing with their institutional clients. Second, the Glass-Steagall-like wall separating banking and securities businesses began to crack in the early 1990s when banks were for the first time allowed to establish subsidiaries that underwrote corporate bonds.

The shift away from Japan's traditional approach to financial regulation certainly created a new set of considerations for major banks. They could decide to remain with the business model to which they had been accustomed and was known well, but at the same time run the risk of missing out on the lucrative new developments in the bond market. On the other hand, they could explore new business opportunities which potentially offered an equivalent or even better return on investment but also carried a higher risk profile. The decisive catalyst for change came in the form of the real estate bubble which surfaced in the second half of the 1980s. The Japanese banking sector's corporate loan portfolio was highly correlated to real estate performance since a significant portion of its borrowers were real estate developers or investors. When the bubble reached its peak in 1989, the central bank came out with a new regulation which practically put a cap on the rate of growth of the real estate loans in order to keep the degree of exposure to a bubbled industry under

control.²⁸³ The uncertainty surrounding the new regulatory landscape as well as the precarious macroeconomic conditions in the domestic market thus pushed major banks in Japan to look for alternative sources of investment. After the internationalization of cross-border capital transactions, such opportunities in emerging, rapidly growing economies in the neighboring Asian countries became too enticing to turn down.

ii. The impacts of the 1988 Basel Accord on the banking sector's balance sheet of the borrowing countries

This subsection examines the common trend in regulatory reforms across three major financial markets, namely the US, Europe, and Japan. As pointed out earlier, these three countries represent the biggest claimants of the external liabilities of the Thai banking sector. Most of the post-crisis law and economic literature tended to focus on unearthing correlations between investment allocations and institutional reforms in emerging market countries.²⁸⁴ As explained in the previous chapter, the so-called quality of pre-existing legal and political institutions in Thailand, in and of itself, could not explain the build-up of systemic instability in the Thai financial system. In addition, there has been a scant amount of academic attention given to the institutional changes made in these home countries, from which foreign capital flows originated, as a push factor of such a phenomenon in Asia.²⁸⁵ LTF informs us that any fundamental changes in the financial

²⁸³ Kindleberger and Aliber (n 2). at 176.

²⁸⁴ For instance, Reena Aggarwal, Leora Klapper and Peter D Wysocki, 'Disclosure Quality and Emerging Market Mutual Fund Investment' [2004] The World Bank Research Paper 1; Li Ong and Amadou Nicolas Racine Sy, 'The Role of Mature Market Mutual Funds in Emerging Markets: Myth or Mayhem?' <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=588244> accessed 11 May 2017.

²⁸⁵ Kindleberger did touch upon the fact that in the late 1980s, index-based funds and mutual funds from the West were actively looking to Emerging Asia as a new asset class. However while the book is full of insights, it lacks the institutional analysis explaining the origin of such development. Kindleberger and Aliber (n 2). at 177.

infrastructure are not only derived from the public-private multidirectional interactions but can also potentially incentivize market participants to re-innovate either their products or practices in order to avoid the added costs of new regulatory hurdles. When it comes to the roots of the AFC, there were converging global regulatory trends that significantly contributed to the accumulation of international capital surpluses which flew across the Thai financial borders in the first half of the 1990s.

The adoption of capital adequacy rules by the banking sector influenced the type and amount of foreign liabilities incurred by the Thai banking sector. The Basel Accord was published in 1988. After the G-10 meeting in 1992, most of the advanced economies internalized the standards as part of their domestic regulatory rulebook.²⁸⁶ While the Accord aimed at harmonizing prudential standards across major financial markets to the internationally recognized level, Basel 1 arguably distorted creditor banks' incentives in favor of short-term lending. Under the Basel 1 capital adequacy requirements, inter-bank lending to non-OECD countries of a residual maturity of up to one year had a weighting of 20 per cent for capital adequacy purposes, while loans with a maturity of over one year carried 100 per cent risk-weighting.²⁸⁷ In other words, short-term lending to non-OECD banks only required 1.6 per cent capital cover against 8 per cent for longer-term lending. The rationale behind this distinction was that short-term placements were accepted by the Basel Committee as a method of managing liquidity in the interbank market and thus were perceived as

²⁸⁶ The European Union implemented the Basel Accord for the first time in 1993 not only for large banks operating internationally but also the entire banking sector within the EU. On the other hands, the US federal banking regulators fully adopted the Accord by the end of 1992, while Japan completed its own process at the beginning of the fiscal year 1992 and Japanese banks were afforded 5 years to adjust to the new rules prior to that.

²⁸⁷ Annex 2, International Convergence of Capital Measurement and Capital Standards (Basel 1), Basel Committee on Banking Supervision, July 1988, <<https://www.bis.org/publ/bcbs04a.pdf>> accessed 13 May 2017.

having a lower risk profile.²⁸⁸ On the other hand, the Committee judged that long-term cross border loans to banks were often associated with particular transactions and were thus subject to greater transfer and/or credit risk. While this underlying rationale might be true from the creditor bank's perspective, it could in fact shift the borrowing country's external balance sheet towards short-term. As demonstrated in the previous chapter, that was exactly what happened to the Thai banking sector in the run up to the Crisis. Not only were foreign banks willing to lend more on a short-term basis, it shall be seen from the following subsection that reforms to the cross-border capital control framework by the Bank of Thailand also contributed to the influx of systemically de-stabilizing capital. This assessment of the impacts of Basel 1 on borrowing countries was conceded by a series of the Basel Committee's post-crisis reports that came out in June 1999.²⁸⁹ A few concluding remarks from the report are of note. Firstly, the report observed that a change in the status from a non-OECD to OECD member reduced the proportion of short-term external liabilities on the balance sheet of the banking sector. Secondly, when controlling for the country credit rating score, the OECD members generally carried a smaller share of short-term debts on their balance sheet than the non-OECD members of comparable credibility.

Interestingly, there appears to be more nuances to the story than portrayed above, when considering solely the impacts on Japanese banks. Deteriorating macroeconomic conditions in the domestic economy meant Japanese banks had to abandon the aggressive growth strategies of the 1980s. The enforcement of Basel 1 presented them with a unique set of challenges. Typically, a

²⁸⁸ Basel 1, at 10

²⁸⁹ 'Capital Requirements and Bank Behaviour: The Impact of the Basel Accord' (10 April 1999) <https://www.bis.org/publ/bcbs_wp1.htm> accessed 13 May 2017; 'Supervisory Lessons to Be Drawn from the Asian Crisis' (Bank for International Settlements 1999) No.2-June 1999 <https://www.bis.org/publ/bcbs_wp2.htm> accessed 13 May 2017.

Japanese bank is structured as the so-called main bank of an industrial group with which it has cross-holdings.²⁹⁰ The tumbling of the Nikkei in the early period of the 1990s thus resulted in a higher cost of capital in the context of the Basel rules. This greatly limited the ability to maintain the global expansion policy of the 1980s. Consequently, most Japanese banks rethought their international expansion by drastically reducing their investment in lower yield US businesses in order to focus on the higher yield opportunities in Asia.²⁹¹ It has been argued that Japanese banks placed much less weight on the regulatory incentive structure offered by Basel 1. Instead, they went after the markets with the highest average returns. As a result, market observers reported a marked retrenchment by Japanese banks not only from the West but also from the safe but low-yield offshore inter-bank centers such as Hong Kong and Singapore, in favor of investing directly in emerging market economies particularly Thailand, Malaysia, and Indonesia.²⁹² Due to the way in which the Japanese banks were structured (as financier of a large industrial group), the main bank tends to behave similarly domestically and internationally. Unsurprisingly within an industrial group, short-term loans had been a common practice for Japanese banks since they can routinely be rolled over to ensure continuing financing.²⁹³ Last but not least, under the Japanese law which, as discussed above, was based upon the Glass-Steagall model of segregation of business practices, commercial banks could only lend short-term (less than a year), while longer-term loans had to be provided by special lending institutions with a separate banking license.

²⁹⁰ Griffith-Jones and Cailloux (n 258). at 15-16.

²⁹¹ *ibid.*

²⁹² Joe Peek and Eric S Rosengren, 'Bank Consolidation and Small Business Lending: It's Not Just Bank Size That Matters' (1998) 22 *Journal of Banking & Finance* 799.

²⁹³ Masahiko Aoki and Hugh Patrick, *The Japanese Main Bank System: Its Relevance for Developing and Transforming Economies* (Oxford University Press 1995)
<<http://econpapers.repec.org/bookchap/oxpobooks/9780198288992.htm>> accessed 13 May 2017.

c. The rise of portfolio investments in East Asia

The wave of foreign portfolio investments correlated with the performance of the Thai stock exchange which saw foreign capital flights twice in 1993 and 1994.²⁹⁴ Under the LTF framework and indeed based on how the crisis unfolded, sharp reversals of foreign equity investments in the stock market did not create the kind of negative systemic reactions which could rattle the entire financial system.²⁹⁵ A securities investment does not generally give rise to systemically destabilizing contingent liabilities, which could be called upon amid the uncertain situation over liquidity shortage. Nevertheless, the developments in the equity and bond markets are of interest because they provide context for the underlying cause of the Crisis. It demonstrates the growing interest in the emerging Asian region as a new investment opportunity for institutional investors in addition to leading international banks from advanced countries.²⁹⁶ Portfolio investors in the emerging markets tended to be fickle since they were capitalizing on breaking market news, and developing macroeconomic affairs. This explains the reason behind the Thai stock flight which occurred in 1993 and 1994. Institutional investors fled the emerging markets in Asia, even though the underlying rationale was the Mexican peso crisis which had nothing to do with the fundamental soundness of the Thai economy. This subsection discusses the institutional origin of the surges in portfolio investments in Asia in the early 1990s. To this end, this section tells a story of the emergence of the mutual fund industry in Asia. Firstly, it discusses the institutional origin of investments that flew from Europe and the US. Against that backdrop, the section finishes off with

²⁹⁴ Forbes (n 9). at 14.

²⁹⁵ Except when banks became major shareholders of publicly listed industrial corporations. In that case, falling stock prices would directly reduce banks' capital. However, that was not generally the case in Thailand in which banks had been prohibited from substantial investments in the stock exchange by Section 12, the Commercial Banking Act of 1962.

²⁹⁶ Kindleberger and Aliber (n 2). at 177.

an account of how a small dealer company in Hong Kong almost single-handedly created a bond market specializing in corporate bonds issued in South East Asia.

i. The institutional framework of mutual funds in Asia

The emergence of international mutual funds and their investment in emerging economies had a direct impact on the bubbles in both bond and stock markets across South East Asia. The total net private capital flows to the East Asia and Pacific region including Thailand exploded from less than \$ 20 billion in 1991 to \$ 120 billion in 1996.²⁹⁷ Three major developments from around the world contributed to this regional capital boom. First, the European Economic Community implemented the Undertaking for Collective Investment in Transferable Securities (UCITS) in 1985²⁹⁸ in order to harmonize a patchwork of national regulations and create a single European market for investment funds. This unifying regulatory framework effectively created a threshold, which the member states could apply to authorize UCITS' cross-border distribution. Luxembourg quickly realized the potential of creating a central location for this emerging fund market if it could attract fund managers from around the region with minimal added local regulatory layers and tax burdens. As a result, a type of open-ended company called Societe d'Investment a Capital Variable (SICAV) was created as a special vehicle under Luxembourg law to become a management company for an umbrella fund that could then establish several sub-funds, which might be either UCITS- or non-UCITS compliant. The Luxembourg Companies Law of 1915 affords considerable flexibility for the setting up of sub-funds under SICAVs such that the corporate governance structure may vary from one sub-fund to another (such as use of specific committees, investment

²⁹⁷ Graciela Kaminsky, Richard Lyons and Sergio Schmukler, 'Mutual Fund Investment in Emerging Markets: An Overview', *International financial contagion* (Springer 2001) <http://link.springer.com/chapter/10.1007/978-1-4757-3314-3_7> accessed 11 May 2017. at 318.

²⁹⁸ Directive 85/611/EEC.

managers or advisors). Under the special investment fund (SIF) law of 1988 (as well as three corresponding “circulaires” or secondary instruments), SICAVs were exempted from corporate tax liabilities including on income from interest payments and real estate related gains. Crucially the law also recognized the separation of assets and liabilities among each sub-fund. This meant that the rights and duties of the investors and creditors of a sub-fund were exclusively available to that particular sub-fund. In other words, there are no spillover effects to other sub-funds under the same umbrella SICAV. Not only were SICAVs an instant success among European fund managers and investors, they were also able to gain authorization from the Hong Kong financial authority and thus became an investment vehicle of choice for international investors to invest not just in European securities but also in the booming Asian equity and bond markets as well.

Collective investment funds or mutual funds have been a mainstay investment option in the American financial market since the enactment of the Investment Company Act of 1940, offering investors portfolio diversification and professional management at low cost. Yet, it was the 1990s which witnessed a period of historic growth. The total net assets of US mutual funds grew from \$ 1.6 trillion in 1992 to \$5.5 trillion in 1998.²⁹⁹ The 90s also saw the emergence of specialized funds focusing entirely on emerging market stocks.³⁰⁰ Many commentators attributed this growth to the decisive shift in American household assets from real estate investments and bank deposits as the baby boomers started preparing for their retirement.³⁰¹ Consequently, consumers were looking to

²⁹⁹ Leora Klapper, Victor Sulla and Dimitri Vittas, ‘The Development of Mutual Funds around the World’ (2004) 5 *Emerging Markets Review* 1.

³⁰⁰ The number of emerging market funds grew from nothing in January 1990 to 109 different funds at the end of 1999. Brian Reid, ‘The 1990s: A Decade of Expansion and Change in the US Mutual Fund Industry’ (2000) 6 *Perspective* p1. at 14

³⁰¹ *ibid.* at 6.

invest in tax-deferred alternatives outside of employer-sponsored retirement plans and, crucially for our purposes, to diversify their financial assets by looking to overseas options.³⁰²

ii. [The rise of the junk bond market in South East Asia](#)

Hong Kong would not have become the mecca of Asia's mutual fund industry but for the fraudulent activities in the financial market of the early 1980s.³⁰³ To afford better protection to investors, the Hong Kong Office of the Commissioner of Securities (Hong Kong's securities regulator at the time) responded by issuing, for the first time, guidelines allowing for the approval of funds for public authorization. Subsequently, the regulator also expanded its eligibility requirements for foreign domiciled funds to seek authorization in Hong Kong. One theory explaining the liberalization of the market proposed by a long-time industry expert is that a lot of fund managers were agitated by the prospect of the Chinese government taking over their investments after the British relinquished their sovereignty over Hong Kong.³⁰⁴ In the midst of the regulatory intervention and the industry pushback, arose a new kind of securities dealer focusing specifically on creating a market for low-grade corporate bonds issued by financial institutions and industrial corporations in fast-growing South East Asian countries. One firm stood out the most and was the subject of the following quote in the Wall Street Journal coverage at the time:

³⁰² *ibid.*

³⁰³ Stewart Aldcroft, 'The Asian Mutual Fund Story - Asia Asset Management - The Journal of Investments & Pensions' (2010) <http://www.asiaasset.com/15th2010_asian.aspx> accessed 12 May 2017.

³⁰⁴ *ibid.*

“In the boom years, Peregrine Investments Holdings Ltd. thrived off Asia, and much of Asia thrived off Peregrine. Now, the two are entangled in their misery.”³⁰⁵

In many ways, the story of Peregrine epitomizes the economic reawakening and subsequent demise of the Asia-Pacific region. Initially founded as a boutique investment firm, it billed itself as being an initial public offering specialist in the frontier markets, particularly Myanmar, Vietnam, and mainland China, which in the late 1980s were, from its Anglo-American competitors’ perspective, virtually untouchable, among other things, for their atrocious human right records. As the IPO market started to saturate in the early 1990s, Peregrine branched out its operation and founded a fixed income subsidiary called Peregrine Fixed Income Limited (PFIL). PFIL made pioneering endeavors in the pan Asia-Pacific debt market, acting initially as a broker seeking to match prospective investors and potential borrowers but subsequently increasingly working as a dealer trading debt securities off its own proprietary account. By the mid-1990s, PFIL raised more than US\$2.6 billion for Indonesian and Thai borrowers alone.³⁰⁶ In comparison, Credit Suisse, its nearest rival, only managed approximately US\$1.6 billion during the same period but for its entire Asian operation.³⁰⁷

The emergence of the first Asian bond market spearheaded by Peregrine corresponded with the meteoric growth in capital influx into the South East Asian nations, particularly into the Thai economy. The Thai financial sector in particular saw a multi-fold increase in externally originated debt liabilities on the sector’s accumulated balance sheet. PFIL was unsurprisingly involved in

³⁰⁵ Erik Guyot Staff Reporter of The Wall Street Journal, ‘Peregrine, Clients Share Pain Of Currency Troubles in Asia’ *Wall Street Journal* (8 January 1998) <<http://www.wsj.com/articles/SB884188720808036000>> accessed 25 March 2016.

³⁰⁶ *ibid.*

³⁰⁷ *ibid.*

many high-profile fundraising arrangements for Thai financial institutions which later collapsed during the AFC. As the crisis set in and capital flows took flight, the pressure began to mount on PFIL's balance sheet. Consequently, in January 1998, just over three years after its spectacular performance in the Asian debt market, Peregrine filed for bankruptcy as it was unable to offload US\$1.15 billion worth trading assets in order to fund its outstanding liabilities³⁰⁸ and, worse still, its Swiss and American financial backers pulled out of their respective proposed rescue efforts at the last minute leaving the company on the brink of insolvency.

There are at least two facets to the astonishing saga of Peregrine's rapid rise and abrupt demise. The first and oft rehearsed narrative tells of a thrilling high-stakes power play which emanated from the firm's early investment banking days when its senior management officers would carefully nurture ties with party officials in Beijing in order to gain business opportunities. A frequently cited example of the politically charged deal making style that pervaded PFIL was its involvement in Steady Safe, an ambitious Indonesian taxi company, whose owner had cozy access to the corridor of power in the then Suharto administration including a close business association with the President's eldest daughter.³⁰⁹ In other words, this narrative effectively argues that PFIL utilized its cronies as implicit guarantee for its investments or better still to acquire inside information regarding the country's economic and financial policies to assist with investment

³⁰⁸ Richard Henry Farrant, 'Report of Peregrine Fixed Income Limited (in Liquidation) and Peregrine Investments Holdings Limited (in Liquidation)' (Financial Secretary's Office, Government of the Hong Kong Special Administrative Region 2000) Government appointed report pursuant to the appointment as Inspector under section 143(1)(a) of the Companies Ordinance (Chapter 32). at 19.

³⁰⁹ Edward A Gargan, 'Hong Kong's Peregrine Soared Like a Falcon, Sank Like a Reckless Bank' *New York Times* (New York, 13 January 1998) <<https://partners.nytimes.com/library/financial/011398asia-hongkong-peregrine.html>> accessed 18 May 2016.

decision making. As a result, it could confidently price its competitors out of the market and sustain its dominant status.

Even though we have addressed the fallacy of the alleged causal linkage between crony capitalism and the AFC in the previous two chapters, a few specific remarks regarding Peregrine and its investment arrangements are still of note. Firstly, close ties between Asian state apparatuses and private institutions have been well documented for almost 150 years since at least late 19th century Japan.³¹⁰ At present, the symbiotic relationship between the state and big businesses is widely considered as part of the Asian recipe for economic success.³¹¹ In other words, the fact that the state would cherry pick its preferred economic sectors to promote and underwrite alone is not sufficiently consequential in explaining the timing and gravity of the AFC. As demonstrated at great length in Chapter 2, the primary reason for PFIL's unsold inventory was the contractual structure of the trading assets which extended a put option to the creditor in an untimely fashion, i.e. during the crisis. In the case of Steady Safe, it was the mismatch between the short-term nature of the promissory notes which afforded the investors an option to stop rolling over the contracts during the time of liquidity shortage.³¹² The issue of public guarantee, explicit or otherwise, came into play more significantly *after* it became clear that no private financial institutions would step in and support these expiring notes and other outstanding debt obligations. In reality, both Thai and Hong Kong authorities in particular purposefully let most of the financial firms including mutual funds and hedge funds go under during the crisis. What attracted them to Thailand and

³¹⁰ Studwell (n 265).

³¹¹ Joe Studwell for instance argued that the Asian success stories (Japan, South Korea, and Taiwan) have followed a simple three-stepped path – land reform, export-led state-backed manufacturing, and financial control. All of which involved the state taking control in the direction of the economy and financial system. See *ibid*.

³¹² Henry Farrant (n 308). at 83.

other countries of similar profile in the first place is better explained through the institutional development of cross-border capital movements and how some private participants rose above the rest to arbitrage the new regulatory paradigm as outlined above.

The market structural analysis continues the law in finance theory of the AFC developed in the previous chapters. By parsing the legal and regulatory infrastructure pertaining to the financial systems of the investing jurisdictions, the chapter demonstrates the forces inherent in these legal regimes that drove the volatility of international capital flows, dubbed the “hot money”. It also shows that the junk-bond market created by dealer firms such as Peregrine would not have been financially viable or appealing to their investing clients without the peculiar organizational structure of the financial industry both in Hong Kong and in surplus countries, notably Japan, the EU, and the US. In addition to the supply side story of the AFC, this chapter ultimately expounds the hybrid character of the Asian debt market. This market, like all subsectors in a contemporary financial system, cannot exist without necessary inputs from both the state and non-state stakeholders.

4. Conclusion

To say that cross-border capital flows simply followed the assets or economies that offered the highest returns on investment is an incomplete assessment of the situation. While the prospect of profitable business opportunities is clearly a factor, it is merely one half of the story, if not less. This chapter provides that missing piece of the jigsaw. It traces the institutional origin of the cross-border capital inflows, which flew into the Thai financial system in the early 1990s. It argues that the institutional structure governing the financial system in both the originating countries as well as the destination, i.e. Thailand, played a major part in dictating both the direction and types of financial assets crossing the Thai financial border at the time. As the single most important

investors in both the Thai economy generally and the financial sector in particular, the financial and monetary reforms enacted in Japan in the 1980s are of great interest. The most dramatic change we have observed was the gradual erosion of the early 20th century institutional separation between commercial banking business on the one hand and other securities and financial dealings. In addition, transnational banks during this time became subject to the new internationally harmonized capital adequacy rules, the Basel Accord, for the first time. Yet, instead of strengthening their prudential standards, the banks were incentivized to seek out short-term low quality loans. Consequently, they raced out to their fast-growing neighbors in the region for potentially high-yield investment opportunities, oblivious to the latter's heightened risk profile. Thailand stood out from the rest of the rival countries in South East Asia due to its newly constituted special offshore conduit which facilitated financial investment with relatively low tax liabilities and regulatory costs. In other words, the cross-border capital movement depended on both the push and pull factors in the home as well as host countries. However, those factors go far beyond simple price differentiation or quality of domestic institutions in the sense depicted by the conventional theory. LTF helps us achieve a comprehensive narrative of the phenomenon.

With the end of Chapter 3, we conclude Part I of the dissertation. To recap, it tells an LTF account of the AFC, specifically the Thai episode of it. Paradoxically, the Crisis was a complicated yet simple story. It was simple because it followed quite neatly the paradigm observed and proposed by LTF. It explains the construction of contemporary financial systems and significantly how law, legal institutions, and other secondary or supporting instruments become the primary source of financial instability. The story was complicated because in order to gain this big picture perspective, we had to go back to the background facts and re-evaluate the entire analytical framework that has been universally accepted for almost 20 years. As we move on to Part II, this

new LTF conceptualization of the AFC provides a background against which we can rationalize the crisis management mechanism as well as the state of the post-crisis global financial architecture.

Part II: Life after the Storm – Near Term and Long Term Legacies of the AFC

The AFC left Thailand with devastating economic and social repercussions which took a considerable amount of time to recuperate. Even then, some remnants of this painful past are still visible in Thai people's ways of life or more evidently in the skyline of Bangkok.³¹³ More deep-rooted and consequential legacies of the AFC were the changes it brought to the arrangement of the global and regional financial architecture, both from Thailand's perspective and that of the world superpowers. Not only does the dynamics of global financial governance dictate the formulation of the financial assistance package to countries in trouble, but it also informs us of the direction of the post-crisis reform agenda as well. To this end, the following chapters borrow the analytical lens from the building blocks of LTF. The near-term post crisis management was arguably caught at the intersection between law and power. Specifically, it is the point in which the role of law recedes to the background while we witness the wielding of political and financial powers by the actors that controlled a few certain financial assets which have become the global currencies. Because of this interplay between law and power, LTF posits that finance is inherently hierarchical, yet the hierarchy is a fluid one which may flatten out during the good times, and stack back up during the crisis.

Chapter 4 appraises the near term consequences of the Crisis, specifically the IMF financial assistance package. The negotiation of this bailout as well as the manner in which it was implemented reveals a glimpse of the hierarchy of global finance. The main objective of this

³¹³ 'A Ghost Tower in the Sky: Bangkok's Creepy Abandoned Skyscraper' (14 January 2016) <<http://www.themalaymailonline.com/features/article/a-ghost-tower-in-the-sky-bangkoks-creepy-abandoned-skyscraper>> accessed 19 May 2017.

chapter is to identify the operating rules that determine the hierarchy and to observe whether the application of such rules after the Crisis alter the landscape of the global governance community. Lastly, the chapter touches upon two important initiatives and make preliminary assessments of their respective chances of success, using the LTF framework.

Chapter 5 analyzes the ever-lasting legacy of the Crisis in the present day. In many way, it offers a synoptic overview of the dissertation. It uses the analytical method in the previous three chapters to investigate the current regional financial governing framework in South East Asia. Firstly, it determines whether the recent reform currently being implemented can potentially invigorate financial instability in the same manner the reforms in the 1980s and 1990s did to the Thai financial system. Secondly, it reassesses the hierarchy of global finance in the light of the new institutional mechanism put in place by South East Asian nations, particularly the effectiveness of future intervention in the next financial crisis in the region.

Chapter 4 - The Crisis Management Mechanism: An Intersection between Law and Power

1. Introduction

Part I demonstrates that the Thai financial system was completely shut down because of two incidents. Initially, Thai banks and finance companies were unable to meet their contractual obligations and pay down their debts as demanded by their foreign creditors. Subsequently, the Bank of Thailand committed virtually the entirety of the country's foreign reserves to purchase the baht in the forward swap market. Yet it was not enough to neutralize the shorting pressure and thus had to realize the contingent liabilities of selling back the US dollar in an extremely adverse market condition. After the baht plummeted, losing over 50 percent of its face value in the matter of hours, the amount of foreign-denominated debts incurred by the financial sector effectively increased substantially in the local currency. Thai banks and finance companies mostly earned and stored the majority of their reserved capital in the baht, however the outstanding contractual obligations legally require them to settle the claims in a few pre-determined foreign currencies, typically either Japanese yen or US dollar. The government was no longer in the position to intervene, having exhausted most of their own reserves in the currency market. As a result, both financial sector and crucially the Thai government were during that brief moment facing a real threat of systemic collapse and bankruptcy.

Chapter 4 of the dissertation tells the story of what came after "the penny dropped". Even though every student of the AFC should have already been aware that Thailand as well as many other crisis-hit nations in Asia was given financial support by the International Monetary Fund (IMF), the available academic literature on the subject has largely neglected the analysis the IMF intervention in the context of the global financial architecture. Instead, both contemporary and

recent studies chose to focus on criticizing the IMF's handling of the Crisis with its one-size-fit-all policy prescription.³¹⁴ Adopting the LTF framework which considers the construction of finance as hierarchical in nature, the chapter makes the following claims in relation to the crisis management mechanism and the landscape of the global financial community in the immediate aftermath of the Crisis. First, the structure of global governance of finance was not a neutral construction. In other words, the analysis of the negotiation running up to the IMF financial support revealed that the existing framework was biased towards the parties and financial assets at the summit of the international financial structure. In addition, the chapter also explains the options available to the countries at the periphery of the global financial system. As a result of what LTF terms "law and finance paradox", The Thai government was effectively forced to accept a set of drastic structural reform measures as a hard condition in return for financial support. Finally, the chapter asserts that two institutional developments on the international level after the crisis would, even without the benefit of hindsight, not be able to substantially change the structural prejudice against peripheral countries and institutions.

Chapter 4 is organized into 6 sections. Immediately after the introduction, the discussion focuses on developing the insights from LTF framework of the global hierarchy of finance in the context of financial crisis. Section 3 briefly outlines the state of international financial architecture prior to the AFC before the next section explores the IMF financial assistance package and its implication to Thailand and the Asian financial landscape. Section 5 reviews one notable global and one significant regional frameworks emerging after the dust of the crisis settled before the

³¹⁴ Radelet and Sachs (n 30); Sheng (n 4).

chapter concludes with some final remarks regarding the notion of justice and the torrent of global finance.

2. Conceptual Foundation of the Hierarchical Organizational Structure of Global Finance

LTF, among other things, sets out to demystify the prevailing economic notion that the market is flat. The generally agreed view tends to describe the organization of a market as a place of exchange which could potentially arise spontaneously without any sort of central decision-making authority.³¹⁵ And indeed, one could certainly misunderstand the nature of contemporary financial system as such especially when observed during the good times. As Part I explored in details, prior to 1997 Thai equities and bonds were not only traded in the secondary market but also accepted as collaterals to various financing deals. Moreover, foreign creditors happily rolled over existing debts incurred by Thai banks and finance companies even though in theory they could be exposed to currency risk. At the time, the exchange rate between Thai baht and US dollar appeared predictable, and stable – thus presumably (wrongly so as it turned out) carried merely an insignificant level of risk. In other words, in good times market participants were indeed prepared to forego the legal or contractual blueprint embedded in each individual financial assets and accepted them for their transactions at face value – hence the mistaken view that the financial market is just like an ancient Persian bazaar: flat, equal, and naturally instinctive.

However, the AFC again demonstrates to us quite evidently that not all securities, financial assets, and currencies are readily exchangeable, equal, or naturally occurred. During the Crisis, foreign creditors insisted on their contractual right to be paid in US dollar or other major currencies, not

³¹⁵ David Schmitz, 'Friedrich Hayek' in Edward N Zalta (ed), *The Stanford Encyclopedia of Philosophy* (Winter 2016, Metaphysics Research Lab, Stanford University 2016) <<https://plato.stanford.edu/archives/win2016/entries/friedrich-hayek/>> accessed 20 May 2017.

in Thai baht. Furthermore, the currency war between the central bank and speculative currency traders took place as the Thai authority was trying to maintain the façade of exchangeability between Thai baht and US dollar when the reality of macroeconomic conditions no longer supported it. If we are prepared to accept the hierarchical (or at least the unequal) nature of finance, especially credit finance which was the epicenter of the AFC in Thailand, the logical follow-up issue to tackle is what determines such a structure and what its consequences are, if any, to various financial assets, and parties inhabiting the system.

The concept of financial hierarchy has a reasonably long line of pedigree. Keynes pioneered the notion that money is a form of IOU³¹⁶, everybody could in theory create money.³¹⁷ In reality however, not all moneys carry the same weight since some are more credible and thus readily acceptable than others. Considering a simple domestic economic model, the form of money that factually needs to be the most desirable is the kind that the government accepts as a mean of settlement for tax purposes. Invariably, the creation and maintenance of this kind of money (banknotes and coins) is monopolized by the state.³¹⁸ From this point of view, the state thereby occupies the highest position in the hierarchy. More recently, Mehrling has coined the concept of inherent hierarchy of money. To him, the hierarchy arises from the structure of the system of central banking which practically stands behind the financial system in the capacity as the dealer of last resort and in normal times set the price (interest rate) of each financial asset it accepts as

³¹⁶ John Maynard Keynes, 'Treatise on Money: Pure Theory of Money Vol. I'. at 3 and 250.

³¹⁷ Pistor, 'A Legal Theory of Finance' (n 18). at 317.

³¹⁸ Georg Friedrich Knapp, 'The State Theory of Money' [1924] History of Economic Thought Books <<https://ideas.repec.org/b/hay/hetboo/knapp1924.html>> accessed 11 May 2015. at 95.

one of the eligible collaterals.³¹⁹ While his model is primarily based on the US Federal Reserve System, we can certainly make a theoretical extension to the global currency system in which the price of US dollar essentially sets the prices of virtually all other important currencies, including the Thai baht.

The inroad trail-blazed by the aforementioned economic thinkers reveals the institutional structure that buttresses the global financial system. LTF takes this proposition further by first, demonstrating that the said structure is rooted in the interplay between law and power³²⁰; and second, the hierarchy has serious implications to the strictness of public laws, private orders, and contracts pertaining to the financial system.³²¹ We may unpack the first claim using the case of national currency. The currency is a state-issued money. The national tax code requires its citizens to pay using cash denominated in the domestic currency as a mean of settlement. It can also be used to denominate the payment obligation of financial transaction. Since the state stands behind its own currency to perform the role as a lender or dealer of last resort, the most credible currency is logically that of the country that either has the largest reserves to back its financial sector or control the creation and management of the global currency. In the present era, the world currency is US dollar, and thus the values of all major currencies are adjusted relative to US dollar.

This has a direct and significant implication to the strictness or elasticity of contractual, legal, and regulatory enforcement.³²² At the bottom of the hierarchy, the enforcement is strict, especially

³¹⁹ Perry Mehrling, *The New Lombard Street: How the Fed Became the Dealer of Last Resort* (Princeton University Press 2011). at 136-7.

³²⁰ Pistor, 'A Legal Theory of Finance' (n 18). at 323.

³²¹ Awrey and Pistor (n 246). at 5.

³²² Pistor, 'A Legal Theory of Finance' (n 18). at 320.

during the crisis times. We have seen this rule of the hierarchy at play when we considered the mechanism of the AFC in Chapter 1. Thai banks and finance companies were liable under loan contracts they entered into with foreign creditors to settle their principal and interest payments in foreign currencies, typically either US dollar or Japanese yen. During the prosperous period of the pre-crisis early 1990s, the maturity date of these payment obligations were not taken serious as the creditors were happy to roll over the liabilities to extend their contractual relationship. Yet during the crisis, the latter insisted on the performance under the contract. At the top of the hierarchy though, the law is conveniently flexible. The ruler of the hierarchy is both the architect as well as the arbiter of the hierarchy. He decides the “rule of the game”. An example from a more recent global financial crisis helps illustrate this point. The US Federal Reserve made its own determination to accept or refuse requests by other central banks from around the world to establish emergency swap lines in order to maintain the supply of US dollar during the time of crisis.³²³ The further away from the apex, the less likely the request would be granted. Clearly, Thailand was among the unfortunate ones. After the Crisis, the Fed again led the group of C-5 representing 5 major central banks and converted the emergency facilities during the crisis into a permanent arrangement. The Fed’s authority to operate swap lines is governed by Section 14 of the Federal Reserve Act.

When we consider the hierarchy of finance and the nature of law and its instruments, we can better understand LTF’s notion that law maintains a paradoxical relationship with finance. Pistor defined the concept of this paradox as: “the situation in which law can lead to the system’s self-destruction from which it can be rescued only by the temporary suspension of the full force of the law.”³²⁴

³²³ Setser (n 10).

³²⁴ Pistor, ‘A Legal Theory of Finance’ (n 18). at 323.

This statement shall be broken down into two parts. Again with reference to Part I, both chapters examined at length the way in which law and legal institutions lent its many qualities to buttress the growth of the Thai financial system. The BIBF was essentially a regulatory construct which allowed foreign capital to flood the Thai banking sector. Furthermore, the creditor-debtor relationship between foreign investors and Thai banks was grounded in contract law of the jurisdiction chosen by both parties (typically English, Singapore, or Hong Kong law). During the crisis it was the unsympathetic enforcement of these outstanding contractual obligation that brought down not only individual debtors but also the entire financial system including its backer, the Thai government.

Ironically, one way to relieve the consequences of legal rigidity is to suspend the full force of the law.³²⁵ For instance, the party sitting at the apex of the hierarchy could potentially step in, even though he does not have an obligation to do so, and provide the crisis-hit nations with necessary financial wherewithal to weather the calls to settle outstanding liabilities. Here is where the implications of the hierarchy takes the center stage. If the insolvency of the party in trouble is in some way tied to the interests of the party at the top, or in other words if the former is connected to the summit of the hierarchy, not only could the suspension of the law be anticipated, but also the suspension would be forthcoming *at no or minimal cost* to the beleaguered party. By contrast, countries or entities at the periphery of the hierarchy can hardly enjoy the luxury of complimentary exemption to the outstanding obligations under the law. In addition, the financial support or intervention, if any, will only be forthcoming at great cost or with onerous conditions. As a result, it can be stated that the modern organization of finance is inherently prejudiced against the

³²⁵ *ibid.*

arguably inconsequential members of the community, while the rule of the game was set up such that the power will be entrenched and strengthened those at the top of the hierarchy every time a crisis occurs.

With this analytical framework in mind, we can now proceed to appraise the hierarchy of global finance and its impacts on Thailand during and after the AFC. The discussion begins with a brief survey of the international financial architecture in the period immediately prior to the Crisis, followed by the detailed discussion of the IMF financial assistance package including its background negotiation leading up to the signing of the agreement. In effect, this subsection uses Thailand as an explanatory case of the consequences of a peripheral member of the global financial system encountering a crisis.

3. The Pre-Crisis International Financial Architecture

A brief remark should be put forth with regard to the nature of the organization of the international financial community, which is in many ways distinct from the orthodox arrangement of classic international organizations. The international financial architecture comprises of both institutional arrangements as well as proclamations or standards issued by the apparatuses or agencies under the aforementioned arrangements. The nature of the governance structure of global finance reflects an observation about contemporary finance made by LTF and demonstrated extensively in Part I that the system is essentially hybrid, constructed and operated by a combination of public and private inputs. As a result, both the institutional structure and the guidelines or standards also retain this hybrid nature. Some scholars have already taken notice of this departure from the traditional setup of the public international law regime. International regulatory organizations are typically set up under informal bylaws, agreements, and declarations with no promise or expectation of

formal legal obligation or existence.³²⁶

Moreover, the international financial governance framework provides a meeting place for representatives from the public authorities and even leaders from the financial market to discuss their agenda and hammer out the course of action to tackle bad practices or systemic problems which require international coordination. Interestingly, the countries are not generally represented by political figures but regulatory agencies and officials. Financial diplomacy is conducted based on expertise rather than political mandate or seniority. In other words, an important set of banking regulation could potentially be drafted by mid- or low-ranked bureaucrats and published without being sent through the chain of command. In addition, there is technically no single governing body presiding over the international financial community. The works, be it surveillance, legislative, or advisory, are shared among small and focused organizations generally based on the sub-industry within the financial market by special objectives tasked to perform by the political leaders. Nevertheless, LTF would suggest that the agents of the countries at or near the top of the hierarchy be the ones with real influence over the design of future institutional reforms, or setting global standards. To this end, there are three pillars of the pre-crisis international financial architecture worth touching upon in relation to the Thai financial and economic development: the international monetary system, international financial regulation, and global framework for crisis management.

First, the global monetary system during the two decades prior to the AFC can be categorized as the dollarization of the post-Bretton Woods system. Countries were free to adopt any form of

³²⁶ Brummer (n 234), at 63.

exchange arrangement they so wish. Countries with largest financial markets such as the US and European countries chose to float their respective currencies³²⁷, while the majority of emerging market nations decided to impose a tight control over their currency exchange regime in order to eradicate the risk of currency volatility against their exports. Thailand in particular decided to peg the value of Thai baht to a basket of currencies consisting of 4-5 world major currencies weighted in favor of US dollar. The global monetary framework is probably the only part of the international financial architecture that is officially administered by a traditionally established international organization – the IMF. Specifically to the monetary policy management, the IMF in the early part of the period actively encouraged its member states to use the Special Drawing Right (SDR) as an alternative or supplementary international reserve asset in the wake of the collapse of the gold standard. Instead, the growth in international capital markets in support of the economic and financial expansion in the 1980s meant that the governments from around the world found it more convenient to accumulate US dollar as their reserve currency. Subsequently, even the value of the SDR itself has been determined in term of US dollar, even though its price is technically determined in relation to a basket of five major currencies.

The IMF together with its sister organization the World Bank in the late 1980s especially exploited its political influence and claimed technical expertise to push for the universal adoption of the so-called Washington Consensus which called primarily for the rapid modernization of financial systems, the generalization of the external convertibility of currency, and the liberalization of the modes in which interest rates are fixed, among other things. The implications of economic ideological transplant, which was arguably a top-down communication from the international

³²⁷ Eichengreen (n 237).

institutions backed by major financial superpowers, has been explored substantially in Part I. It suffices to say here that even before the AFC, the international monetary system had already revealed the inherent pegging order. It designated the world reserve currency following the decision by the US to no longer support par values and convertibility of the dollar to gold. Moreover, those at the top of the framework even sought to intervene in the reform of the domestic monetary arrangement of peripheral countries effectively in order to entrench their position of power.

Another area that saw some significant developments during this period is international financial regulation. Since the 1970s, the international community started coordinating among themselves to create universally agreed guidelines or standards which then became available for all countries to adopt in their own regulatory rulebook, regardless of whether or not they were involved in the drafting process. The standard setters can be categorized by the profile or type of their members. First, professional or trade associations have been major drivers in pushing for the adoption of private rules in certain key issues, notably International Accounting Standard Board and International Swaps and Derivatives Association. The International Accounting Standards and the ISDA Master Agreements have over time become the industry-wide authoritative guideline of practice in their respective fields. Harmonized rules, be it privately or publically legislated, reduce uncertainty, compliance costs while increasing predictability and promoting cross-border transactions. On the other hand however, LTF warns us that both public and private rules can potentially become sources of instability. Thus harmonization could in effect amplify or internationalize a local financial crisis through common usage of universally devised rules or standards. In addition to industry professional organizations, sectoral standard setters are typically congregations or institutionalized meetings of regulators or supervisors of certain subsectors of the

financial market, for instance, the International Organization for Securities Commissions (IOSCO) and International Association of Insurance Supervisors (IAIS). The most prominent institution is the Basel Committee on Banking Supervision. The work of the Committee in unifying the prudential standard of major banking sectors across the globe is admirable, yet as observed in Chapter 3, we witnessed the Basel Accord itself became the source of international instability when it encouraged major banks to load up their balance sheet with short-term non-OECD debt assets to avoid having to set aside additional reserved capital.

Lastly, an aspect of the international financial architecture pertaining to the Thai financial development is the global efforts in the emergency or crisis management. Interestingly, there was no single, unified emergency system per se on the international arena in the last two decades of the 20th century. Arguably there is still no such institution in the present day. The crisis-hit country could pursue a number of options but crucially not all may become available to them, depending on their proximity in the hierarchy of global finance. A country might arrange a bilateral support with a partner nation with whom she has had a deep rooted trade and/or financial linkage. A case in point is the US intervention in the Mexican Peso Crisis in 1994 with the enactment of the Mexican Debt Disclosure Act of 1995. Not only did the US have clear economic interests in supporting the Mexican peso having recently signed the North American Free Trade Agreement (NAFTA), but also the Clinton Administration feared social upheaval and political backlash from a potential surge in illegal immigration if the Mexican economy collapsed as a result of the crisis. Alternatively, a country in trouble might seek multilateral assistance. At the time before the crisis, there was no credible regional initiative available, certainly not in Asia. The IMF presented the only viable option, however as we shall see in the next section its financial assistance was far from a free meal particularly for those countries at the periphery of the global financial system.

4. The IMF Financial Assistance

a. Why did Thailand need an outside intervention?

Let us recap the situation on the ground during the peak of the crisis in Thailand. The challenge was simple yet insurmountable. All it took for the Bank of Thailand to thwart the incessant waves of speculative attacks on the national currency *and* stabilize the widespread institutional collapse in the financial sector was to maintain *an amount of foreign reserves exceeding the total aggregated outstanding claims* against the country (both public and private sectors) that became due. Here the data reveals the dire situation. Firstly, the ratio of short-term liabilities to cash and cash-like assets at the end of 1996 is 1.87.³²⁸ This information suggests that the banking sector likely face a credit squeeze, should all short-term liabilities be called simultaneously – the scenario which later materialized during the height of the crisis. The unhealthy status of the banking sector gave rise to the relentless shorting activities against Thai Baht in the international currency market. This so-called twin crisis rendered the task of saving both the fixed exchange rate and the viability of the banking sector virtually impossible.

The detailed account of the meeting among the Bank of Thailand's senior management team on May 14, 1997 reports that an unprecedented move to defend the official exchange rate band. After the market rate moved significantly away from the official exchange rate range³²⁹, the central bank on that evening sanctioned an *unlimited* intervention in both spot and forward markets to shore up

³²⁸ Short-term liabilities include money market instruments, loans, currency and deposits (Bank of Thailand). Cash and cash-like assets refer to cash and deposits at financial institutions and interest-bearing accounts with financial institution (Bank of Thailand). The exchange rates between Thai Baht and US Dollar were calculated as a period average and supplied by the International Financial Statistic of the IMF, available at <http://www.columbia.edu/cu/thai/html/financial_table1.html>, last accessed on May 16, 2015.

³²⁹ The value of the Baht against the US dollar during the business hours (GMT+7, Thailand time) of May 14 was weakened substantially and touched 26.10 baht/dollar whereas the upper level of the official range was 25.86 baht/dollar *Nukul Commission Report: Analysis & Evaluation on Facts Behind Thailand's Economic Crisis* (n 33). at 59.

any further selling activities against the local currency. At the closing of the New York market in the early morning GMT+7, the exchange rate returned to the level within the official band at around 25.85-25.90 baht/dollar. This success however came only as the central bank practically spent all of its total reserves.³³⁰ After this episode of open market intervention, the central bank resorted to an informal exchange control strategy by ordering Thai commercial banks to refuse any financial transactions with foreign counterparts, which would result in an outflow of the Thai baht, except to support real trades.³³¹ As the baht became scarce, its exchange and interest rates on the international market appreciated instantly while within the domestic market, both indicators remained largely unchanged. While this discrepancy offered the central bank some reprieve as it could then accumulate US dollar at a relatively low rate and inflicted some losses to hedge funds who could no longer borrow the baht from Thai commercial banks, it did not negate the fact that the country had lost its ability to save either its currency or the financial sector since it had practically depleted its entire reserves with an open market intervention on May 14.

Understanding the decision making process of such an action, which in hindsight could arguably be considered reckless, is a starting point in comprehending the subsequent seismic shift in policy from the pegged system to a managed floating arrangement. According to the relevant domestic laws at the time, only the Finance Minister had the authority to abandon the currency management policy, although the central bank retained a role of advisor.³³² Yet, once the decision was made,

³³⁰ On that night alone, the central bank spent over \$10 billion both selling their dollar reserves as well as shorting the US dollar in the forward swap market. The Nukul Commission reported that this is the most expensive currency intervention scheme in the Thai financial history, and arguably in the world. See *ibid.* at 60.

³³¹ *ibid.* at 60-61.

³³² The Minister of Finance's legal authorities to be in charge of the currency management regime came from 1) the Bank of Thailand Act of 1942; 2) the Currency Act of 1958; and 3) Emergency Decree Regarding Allocation of Money Over the Bank Notes in Circulation of 1955.

it was too little too late. There was a belief among senior figures in the central bank that maintaining the official exchange rate band was absolutely crucial to the viability of the country's important sectors of economy. The central bank's Director of Banking, responsible for the open forward swap market operation testified before the fact-finding Nukul Commission, set up shortly after the crisis. He recounted that the Bank management team then believed it was not feasible to change the exchange rate policy as it would destroy market confidence and worsen the crises in both financial and real estate sectors.³³³ In addition, the sentiment within the Bank and among cabinet ministers was that they were at war with predatory hedge fund managers whose inferior motives were to bully the country and profiteer on the aggressive depreciation of the Thai baht.³³⁴

| Date | Total Reserves (US \$) | Forward Obligations (US\$) | Short-term Liabilities (Banking, the 1997 average, US\$) |
|-------------|------------------------|----------------------------|--|
| May 1997 | 33,307.60 | (28,010.40) | (24,403.00) |
| June 1997 | 32,353.00 | (29,514.10) | |
| July 1997 | 30,424.20 | (29,279.90) | |
| August 1997 | 25,938.60 | (23,457.20) | |

Table 1: Thailand's outstanding and contingent liabilities as against total foreign reserves.

Source: Bank of Thailand. Unit: Millions US dollar.

³³³ *Nukul Commission Report: Analysis & Evaluation on Facts Behind Thailand's Economic Crisis* (n 33). At 87.

³³⁴ *ibid.* at 58. After May 14 when the Bank of Thailand successfully fended off one round of shorting attack on the Thai Baht, the Prime Minister, General Chaovalith Yongjaiyuth, congratulated the central bank senior officials upon "winning the war". See *ibid.* at 61.

The challenge was too overwhelming judging from the total reserves available and the outstanding obligations between May to August of 1997. The vast majority of forward obligations that the central bank took on in the open currency market would generally become due within one to three months from the conclusion of the contract. In addition, the Bank was effectively required to stand behind and back the short-term liabilities incurred by the financial sector especially in the banking industry through a special conduit notably the BIBF. There were defiant voices among the management team members within the Bank that it should have continued to stand by the currency value and kept buying the baht forward. While even as late as June 1997 the Bank did still have financial wherewithal to extend the operation, the real issue however was how many more shorting transactions were forthcoming. As discussed in Chapter 2 regarding the currency crisis, the fact that Thailand's foreign reserves were rapidly depleting was a public knowledge, nevertheless it was virtually implausible to ascertain the number of currency traders as well as their financial capital readily available to complete their mission. Ultimately, a simple fact of the matter was that once totaling up outstanding contingent liabilities from forward swaps and private debts, it became clear that the Thai government had to seek financial support from external parties.

b. The Malaysian experience: a comparison

By contrast, the way in which the Malaysian authorities dealt with the problem of sudden and acute capital inflows could not have been further from the predicament of the Thai government as outlined above. By September 1998, the Malaysian Prime Minister announced an imposition of capital controls on the sale of the Malaysian currency (the ringgit), becoming the first (and only) Asian countries to do so during the AFC. In gist, investors were banned from selling the ringgit for at least a year after the sale of Malaysian securities that were on their portfolio for less than a year. However, the restriction on cross-border capital movement was not applied to foreign direct

investment or the repatriation of profits by foreign companies operating in Malaysia (i.e. current account transactions). The primary objective behind the capital controls which represented a sharp departure from the orthodoxy crisis response measures advocated by the IMF was to end speculation against the ringgit.³³⁵ While the initial reactions to this policy choice were hostile,³³⁶ the Malaysian capital controls have since been generally regarded as having a positive effect on the country's economic recovery.³³⁷ Most importantly, it dried up the supply of the ringgit in the offshore market (mainly in Singapore), which was the base of the shorting activities against the currency. As a result, the Malaysian central bank was able to regain monetary independence without a negative repercussion on the value of the ringgit in the offshore market.³³⁸

Nevertheless, the situation the Malaysian government was facing in September 1998 cannot be compared with that encountered by the Thai counterpart in July 1997. Chiefly, Malaysian banks did not rely as much on foreign short-term debt as did Thai banks and finance companies. At the peak of the bubble in 1994-1995 for instance, Malaysian commercial banks ran a net capital inflow of -5.07 and 0.03 in US\$ billion, while during the same period, Thai banks amassed US\$ 13.27 and 10.48 billion.³³⁹ There were a couple of reasons for this discrepancy.

³³⁵ 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. at 9-10.

³³⁶ *ibid.* at 11-12.

³³⁷ *ibid.* at 13.

³³⁸ Bloomberg News, 'INTERNATIONAL BUSINESS; Malaysia Imposes Controls On Trading in Its Currency' *The New York Times* (2 September 1998) <<https://www.nytimes.com/1998/09/02/business/international-business-malaysia-imposes-controls-on-trading-in-its-currency.html>> accessed 10 April 2018.

³³⁹ Jomo Kwame Sundaram, *Malaysia's September 1998 Controls: Background, Context, Impacts, Comparisons, Implications, Lessons* (UN 2005).at 5.

First, Malaysia experienced a severe banking crisis in the late 1980s, following the mid-1980 economic recession, in which “non-performing loans” (defined on a six-month basis) reached 30 percent of the total lending portfolio of the banking sector. As a result, Malaysian domestic banks were not in the same financial cycle as their Thai counterparts, which experienced a long period of sustained rate of growth funded initially by the domestic saving pool and subsequently the foreign debt liabilities. Second, the Malaysian banking authority also consciously tried to limit the degree of exposure to short-term external debt by putting in place a set of cautious prudential regulations, contrary to the regional trend which focused on financial liberalization. For instance, in order to be allowed to increase its exposure to short-term external debt, a Malaysian bank was required to demonstrate that its foreign exchange earnings had surpassed a certain threshold.³⁴⁰

Supplementing the absence of bank borrowings, the Malaysian businesses actively promoted and were successful in attracting portfolio capital inflows, which, unlike foreign borrowing by banks, did not face a rigorous set of restrictions. In addition, the relevant government authorities put great efforts in supporting the Kuala Lumpur’s “newly emerging” stock market, as an alternative to the Singaporean rival.³⁴¹ The end result arguably means that Malaysia in September 1998 was facing a different kind of financial crisis to the one taking place in Thailand beginning in July of the year prior.

c. What were the financial assistance options readily available?

This brings us to the issue of crisis management. Recalling the discussion in the immediately preceding subsection, Thailand in theory had two options: bilateral and multilateral financial support. It was evident however that any dialogue between the Thai authorities and representatives

³⁴⁰ *ibid.* at 4.

³⁴¹ *ibid.* at 3.

of foreign creditors in order to restructure the outstanding liabilities of the domestic financial sector would have been infertile. In the climate of uncertainty over eventual outcomes regarding the crisis, private party logically wanted to hoard the safest possible assets preferably denominated in US dollar or other major currencies. In our case, they elected to exercise their right as creditors to demand the immediate principal and interest payments accrued as part of the debt contracts agreed prior to the crisis. Next, the Thai government might contemplate a bilateral intervention with one of its creditor countries. Nevertheless, the preliminary negotiation between the Japanese officials, as the single biggest investing country in the Thai economy, and their Thai counterparts made it obvious that while Japan would lead the setting up of the emergency response package, it would not do so outside the IMF Article 4 framework.³⁴² The following discussion thus illustrates the inherent bias of the global financial setup against countries and entities in the periphery.

d. Rationalizing the interplay between law and power in the crisis resolution process

It was evident from a series of negotiation between Thailand, the IMF, and Japan – Thailand’s most significant creditor country that Thailand had no bargaining power and most likely had to accept any deal eventually hammered out by the rest of her negotiating partners.

The IMF had been in contact with the Thai authorities as early as March 1997 in order to persuade Thailand to accept its restructuring package. At the time, the central bank had not yet accumulated contingent liabilities to an unsustainable level, thus was uninterested in what the senior management team members deemed an insulting gesture.³⁴³ After the largest open market intervention on May 14, 1997 which saw the country’s total reserves virtually vanished, the then

³⁴² Katada (n 226). at 174.

³⁴³ *Nukul Commission Report: Analysis & Evaluation on Facts Behind Thailand’s Economic Crisis* (n 33).

managing director of the Fund, Mr. Michel Camdessus, sent a letter to the Thai Prime Minister urging Thailand to adopt a set of austerity measures including currency devaluation of 10-15 percent, fiscal tightening, and strict monetary policy, to name just a few.³⁴⁴ Still the government did not budge, standing firm with the central bank governor's advice that the currency value could be stabilized without outside assistance. The previously steadfast stance of the Bank shifted dramatically after the downward pressure intensified again in the middle of June. This renewed attack was different because it came from within.³⁴⁵ In other words, Thai institutional investors and wealthy individuals were purchasing US dollar at an alarming rate, most likely in anticipation of the inevitable floating of the baht. It should be noted that the IMF had kept constant contact with the senior management team of the Bank of Thailand throughout this time. Crucially, the first deputy governor approached Stanley Fischer who was assigned to take over the Thailand brief for approval even before both the governor and the finance minister were informed of the decision to abandon the pegging system.³⁴⁶

The crisis of the lender of last resort following Thailand's decision to float its currency mirrors the reality of the global financial system described above, even though on the surface the US and major European countries appeared uninterested in engaging in the Thai bailout. The contributions to the IMF "rescue package", amounting to US\$17.2 billion, came from neither the US nor Europe with US\$ 10 billion from Asian countries (mostly from Japan), US\$ 2.7 from multilateral sources

³⁴⁴ *ibid.* at 67.

³⁴⁵ *ibid.* at 68.

³⁴⁶ *ibid.* at 69.

(the World Bank and the Asian Development Bank), and US\$ 4 billion from the IMF.³⁴⁷ By contrast, the US made a bilateral commitment to Mexico during the 1994 peso crisis. The official statement from the US administration at the time elaborated the reason for the US hand-off approach. It recommended that Japan take charge of bailing out Thailand since Japanese banks were Thailand's major creditors and Japanese corporations had a large investment stake in the Thai industrial sector.³⁴⁸ In addition to the publicly declared justification for its (in)action, there may just be other contributing factors. After the Mexican Crisis, the Clinton administration was facing widespread resentment from the American public against spending the taxpayers' money on helping foreign countries. Unlike Mexico whose financial crisis had a vast array of strongly negative socio-economic implications in the US, it was not at all clear to them if American interests were compromised or exposed in the Asian Pacific region as a result of the Crisis in Thailand.³⁴⁹ Nevertheless, the fact that the US administration did not actively participate on the negotiation table did not mean that it lost its political and financial power at the apex of the system. The following narrative demonstrates that quite the opposite was true.

Let us now move on to analyze those that did become involved directly in the bailout. In the first place, the Japanese government was not only actively involved in coordinating the international rescue package for Thailand, but it also made available the largest amount of financial support among all the contributors. As the US and Europe turned their attention to the growing concerns

³⁴⁷Source: IMF website at <<http://www.imf.org/external/np/exr/ib/2000/062300.htm#table1>>, updated August 23, 2013.

³⁴⁸ First Part of Thai Bailout Is Authorized by the IMF, The New York Times, August 21, 1997, <<http://www.nytimes.com/1997/08/21/business/first-part-of-thai-bailout-is-authorized-by-the-imf.html>>, updated August 23, 2013.

³⁴⁹ Of course, the US was wrong in believing that the Thai crisis was an isolated incident of currency crisis without only a small chance of contagion as proved by the fact that it made a U-turn and got involved in both Korea and Indonesia's case.

elsewhere³⁵⁰, Japan came up with the so-called “New Miyazawa Initiative”, a US\$ 30 billion package consisting of both long term financial support and short term trade finance and currency swap arrangements to six troubled countries in the region, Thailand included.

LTF provides an analytical framework to appraise the rationale behind the willingness of the Japanese negotiators to step in and resolve the Thai crisis. With the extensive network of industrial and financial investment in Asia and in particular Thailand³⁵¹, the regional systemic instability was undoubtedly of serious concern to Japanese investors and consequently their government. In addition, as the biggest economy and most advanced financial sector in the region, Japanese yen was widely adopted as the mean of settlement in international trade and cross-border financial transactions. Indeed, as discussed in Chapter 1, a significant portion of outstanding foreign short-term debts incurred by the Thai banking sector were denominated in Japanese yen. In short, Japan appeared well-placed to take the initiative and leadership in the crisis resolution process with or without the US participation. However, the hierarchy of global finance revealed itself when the Thai representatives approached the IMF senior officers as well as their main creditor country, Japan, for both technical and financial assistance. Initially, the contact was established discreetly in order to prevent further market panic and also to try to secure the best possible arrangement before lodging a formal application for financial assistance. In late July, Japan politely rebuked Thailand’s request of a bilateral financial assistance preferring that the country sought the IMF’s

³⁵⁰ The Russian and Brazilian financial crises blew up almost concurrently in the late 1998.

³⁵¹ SAORI N. KATADA, *Banking on Stability: Japan and the Cross-Pacific Dynamics of International Financial Crisis Management* (University of Michigan Press, 2001) at 187-190.

standby agreement (SBA). The Japanese practically insisted that any international bailout be forthcoming from an IMF-led collaboration.³⁵²

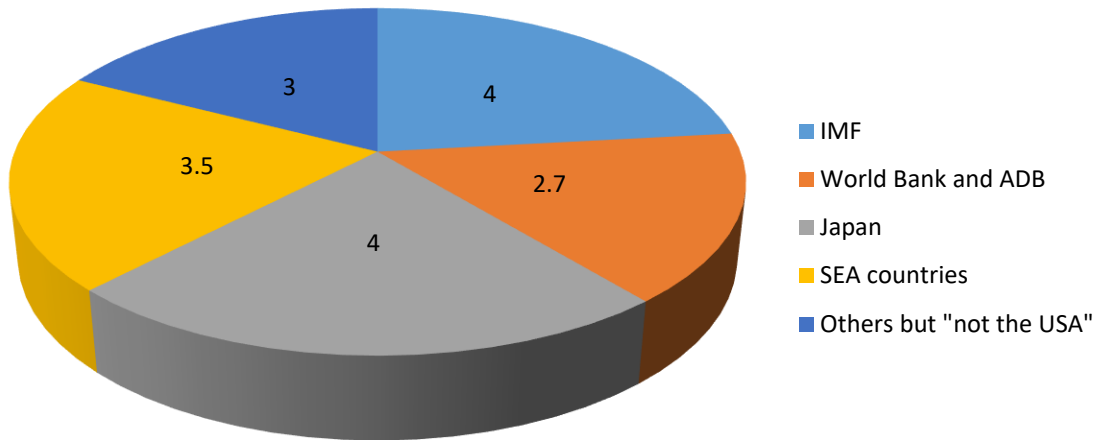
Japan's inclination to defer the leadership baton to both the US and the IMF is of noteworthy. This is a piece of evidence supporting the proposition that the US still has a final say on all systemically important matters which had global repercussions. Furthermore, Japan was willing to let the IMF take the lead in imposing loan conditions against Thailand even though the Japanese government made the largest financial contribution of any participating country, equal in size to that put forward by the IMF itself. It goes to show the political dynamics of the international financial community which centered around the Euro-American centric institutions notably the IMF and World Bank.

The negotiation which last until the end of July 1997 and produced no concrete result was a testament to the fact that the Thai state no longer controlled their own financial destiny as their budget constraint in relation to the US dollar reserves was exposed. On August 5, 1997, the Thai government announced that it was in the process of forming a financial assistance package with the IMF.³⁵³ The international conference was then held in Tokyo and a basic agreement between Thailand and the IMF was signed on August 4, 1997.

³⁵² *Bangkok Business Day*, July 31 1997 quoted in Katada (n 226). note 8, at 256.

³⁵³ Radelet and Sachs (n 24). at 140.

Financial Contributions to SBA by countries/institutions (Total of \$ 17 billion)



e. Inherent prejudice of the global financial hierarchy: against the periphery

LTF posits that during the crisis, law recedes to a supporting role while power moves saliently to the center stage. The exercise of power includes the determination whether to enforce or suspend the full applicability of the law. In two contrasting cases, we shall see the way in which the parties at the apex of the hierarchy wielded discretionary power in order to entrench their own influence and protect self-interests. The subsection first examines more closely at the arrangement made by the US to support its Mexican counterpart during the Mexican peso crisis of 1994. Subsequently, it will be put in sharp contrast with the details of the bailout package offered to Thailand some 3 years later.

The preceding section has already touched upon the deep socio-economic connections between the US and Mexico which became the underlying reason of the American intervention in support of the Mexican national currency. To this end, Congress passed the Mexican Debt Disclosure Act of 1995 delimiting the scope and remit of the assistance. In essence, the US established an

emergency stand-by currency swap facility in order to make sure the Mexican authorities had continued access to US dollar in order to support the predetermined level of exchange rate by intervening in the open currency swaps market. In addition, the US provided securities guarantees necessary for the continued functioning of the national government and its economy. Both of which together represented the amount of \$20 billion in financial assistance.³⁵⁴ In return, the Act stipulated certain conditions for the release of the fund including periodic report, a program of Mexican structural reform as advised by the IMF and other regional financial institutions and the assurance that the assistance was extended at no cost to American taxpayers.

There are a few noteworthy observations from this Crisis pertaining to the nature of the global financial hierarchy. Firstly, Japan and major European countries were reluctant to participate in the multilateral assistance package, considering the 1994 Crisis as an “American problem”.³⁵⁵ Yet, the Japanese government was obliged to support the American initiative commit not only the government fund through the BIS aid, but also encouraged four Japanese banks to take part in the campaign as well. Secondly, the structural reform program imposed upon the Mexican government was loosely and leniently observed.³⁵⁶ Fortunately due to improving macroeconomic conditions, particularly the booming US economy and the devalued peso, the Mexican external balance stabilized as early as 1996 and by early 1997, the Mexican President announced the full repayment of its debts back to the US Treasury. Nevertheless, Mexico was still at the time beset by many deeply rooted structural problems, particularly high unemployment.

³⁵⁴ The total multilateral assistance package reached \$ 48.8 billion.

³⁵⁵ Katada (n 226). at 148.

³⁵⁶ *ibid.* at 149.

Without a strong tie with the apex of the hierarchy, Thailand was not afforded such generosity and flexibility. Rather the country faced a set of strict conditionality in exchange for financial assistance of a much smaller size than that offered to Mexico. Thailand signed an emergency loan agreement with the IMF in August 1997. The basic goals of the program, enunciated in Article I(v) of the Articles of Agreement, include “to give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.” Specifically in the Thai case, the IMF’s immediate objective was to reestablish financial market confidence. The IMF insisted on the borrowing member state agreeing to the attached conditionality and to receiving tranches of the fund after satisfying the performance criteria.

Unlike the packages agreed with South Korea and Indonesia, Thailand’s bail out deal was considered the first line of defense against the total capitulation of the domestic banking crisis.³⁵⁷ The Thai central bank immediately injected the newly borrowed capital to the financial system in order to support the repayment of foreign debts. In reality, the government went further and publicly guaranteed all bank liabilities, thereby effectively pledging foreign exchange reserves to service bank debts. For the IMF however, restoring market confidence went much further than simply bailing out the domestic financial system,³⁵⁸ the requirements imposed on Thailand encompassed an overhaul of the macroeconomic governance framework, a program of drastic

³⁵⁷ While South Korea faced with a similar foreign debt crisis in the banking sector as in Thailand, the Korean government did receive bilateral credit lines from other nations in addition to the IMF assistance. On the other hand, the Indonesian crisis encountered a foreign debt problem in the nonfinancial corporate sector.

³⁵⁸ Indeed, during the negotiation for the financial assistance packages for all three countries, the IMF insisted repeatedly that the lending supports were intended to promote stabilization, rather than to bail out financial institutions (Radelet and Sach, 1998).

financial sector restructuring and an array of the so-called good governance and structure measures. These are in essence the IMF's off-the-shelf policy reform requirements.³⁵⁹ Regarding the macroeconomic prescription, Thailand had to return to budget surplus with high nominal interest rates and restrictive domestic credit in order to achieve exchange rate stability. Several financial precarious banks were shut down while the remaining institutions were put under intense supervision. The government was also required to put in place a variety of good governance measures and structural reforms in order to prevent the kinds of market abuses and undue interventions thought to have caused the crisis from repeating themselves in the future. Even though Thailand complied obediently with conditionality attached to the stand-by agreement, it was clear that by the end of 1997 the IMF program failed dramatically to restore market confidence. The exchange rate remained volatile while the official foreign reserves still fell rapidly. International investors remained unconvinced as to the economic fundamentals, and thus continued to demand the repayment of short-term loans as they became due. It was clear that the IMF's market restricting plan was not working. Three of which could be singled out as particularly disruptive and unhelpful in such an early and delicate stage of the financial crisis.³⁶⁰ Firstly, Thailand was ordered to immediately close down all financially troubled banks— an action, which further instilled panic in the market. Secondly, rapid recapitalization of the remaining banks was highly procyclical as it caused sharp contraction in lending at the time of liquidity shortage. Finally, the tight monetary policy goals including the quantitative credit targets and interest rate targets were highly problematic. The former directly undermined the Bank of Thailand's role as

³⁵⁹ Radelet and Sach (1998) at 25-27.

³⁶⁰ The authorities may precipitate a panic, to borrow Kindleberger's term, by "brusque action" in the early stages of distress. Here Kindleberger referred to the action by the Bank of England's refusal to discount any bills, especially of the so-called W banks. Such action immediately led to panic and the Bank of England was later forced to reverse its policies. See Kindleberger and Aliber (2011) at 103

the lender of last resort by restricting its ability to provide domestic credit while the latter contributed further to credit contraction.

One explanation for the failure could be that Thailand was not afforded as much time and flexibility to control the crisis before uprooting the existing financial governance structure. There is no reason to believe that closing banks and finance companies so suddenly and tightening supervisory standards would in fact restore market confidence in the time of great uncertainty and liquidity shortage. Perhaps, this unexpected outcome stemmed from the IMF's long standing belief that the deep and efficient market such as the global financial system should be left to correct itself. As a result of the failure, the IMF was widely criticized for exacerbating the crisis situation in Thailand – the accusation, which it later admitted by itself.³⁶¹

The failure of the IMF-led crisis management of the Thai crisis stems from a more profound origin than simply a result of policy insensitivity. It is arguably a consequence of the operating rules of hierarchy created by the countries and institutions at the summit of global finance. By design, there is no centralized framework for the international lender or dealer of last resort. Otherwise, such an organization could potentially democratize the crisis resolution process, although the practicality of having a global mega regulator or central bank is a highly debatable topic.³⁶² Under the status quo, the parties at the top of the system exercise their discretionary power. Those that are socially, politically, economically, or financially linked to the powerful nations are more likely to escape

³⁶¹ See the IMF Independent Evaluation Office Report 2003. See also SEAN HAGAN, *Reforming the IMF*, in MARIO GIOVANOLI and DIEGO DAVOS, editors, *International Monetary and Financial Law*, (Oxford University Press, 2011), at 2.46.

³⁶² See for instance, Dani Rodrik, 'A Plan B for Global Finance' (2009) 12 *The Economist* <http://www.jmhinternational.com/news/news/selectednews/files/2009/03/20090312_Economist_EconomicsFocusAPlanBForGlobalFinance.pdf> accessed 21 May 2017; Vanessa Blackmore and Esther Jeapes, 'The Global Financial Crisis: One Global Financial Regulator or Multiple Regulators?' (2009) 4 *Capital Markets Law Journal* S112.

the full force of the law and afforded the luxury of generous financial support without penalized requirements attached. On the other hand, the countries which are not systemically important to the viability of the current structure will not only be left to suffer the full force of the law, but also financially crippled so that the likelihood of them challenging this unbalanced and biased governance framework greatly diminishes.

f. Inherent prejudice of the global financial hierarchy: in favor the apex

The systematized prejudice of the global financial architecture goes both way. In the previous subsection, we discuss how it can work against the peripheral class of the system by allowing the full force of the law to play itself out. This subsection demonstrates another way in which the rule of the game operates in favor of those in power by neutralizing any coordinated efforts that are not considered to be in the long-term interest of the system or undermine the concentration of power at the apex in one way or another. A case in point here is the defeated proposal of the so-called Asian Monetary Fund by Japan that came out during the negotiation of the bailout package for Thailand. This particular episode of the story also reminds us that the US occupied (and still is) the position at the top of the hierarchy even though the US administration did not actively participate in the initial drawing up of the crisis resolution program for the region.

Even though the conditionality attached to the IMF financial assistance was a tough pill to take for Thailand and other crisis-hit countries in Asia at the time, the international conference on the AFC hosted by Japan was considered a successful collaborative action which pulled together representatives from all four corners of Asia. The success was hailed as a “precursor of future standard arrangements.”³⁶³ This led Japan and crisis-laden Asian nations to moot an idea of setting

³⁶³ Katada (n 226). at 175.

up the Asian Monetary Fund which would be initially funded by creditor countries in the region (principally Japan) and run by Asian countries themselves.

In planning for a long-term stability of the region, Japan, backed by most Asian countries, proposed an idea of the Asian Monetary Fund (“the AMF”) to the World Bank/IMF meeting in Hong Kong in September 1997, even though the plan was eventually shelved due to strong resistance from the Western coalition who feared that an emergence of a regional financial institution as a rival entity to the IMF would fragment the international financial governance. The regional fund, as formulated in August 1997, would have been a \$100 billion pre-funded facility composed of ten members from East and South East Asia including Japan and Thailand. The original policy memo suggested that the AMF be not necessarily operate in unison with the IMF.³⁶⁴ In other words, the AMF in theory could intervene in a future crisis when the determination of the situation suggests that the regional systemic stability be at risk, even though the IMF does not reach the same conclusion. The trails of devastation after the IMF deep structural adjustments were implemented left many countries question both the merit and intent of its financial assistance program.³⁶⁵ To this end, it was clear that the AMF proposal was born out of the shared frustration of the IMF’s financial assistance program which many Asian leaders as well as regional legal and economic experts believe to be working not for the best interest of the region.

Unsurprisingly, such a proposal was heavily reproached by the US administration and its European counterparts. The official rationale of disapproval offered by the US Treasury focused on two key

³⁶⁴ Phillip Y Lipsey, *Japan’s Asian Monetary Fund Proposal* (Stanford University 2003) <http://web.stanford.edu/~plipscy/lipscy_amf.pdf> accessed 22 May 2017.

³⁶⁵ Chalongphob Sussangkarn, ‘Chiang Mai Initiative Multilateralization: Origin, Development, and Outlook’ (2011) 6 Asian Economic Policy Review 203.

factors: moral hazard and duplication.³⁶⁶ It argued that a new additional layer of regional backstopping mechanism skew the market to even more reckless behaviors. In other words, Asian banks and other financial institutions could count on a more lenient and sympathetic regional financial organization to more readily provide assistance during the crisis than the tougher, more unforgiving global institution like the IMF. In addition, there were concerns that the close proximity between executives of large financial institutions and Asian political leaders could lead to a sub-optimal decision making against the long-term interest of the region. Ultimately, the Treasury believed that the proposed AMF would be an unnecessary and wasteful international organization whose tasks have already been adequately performed by the IMF.

While the same moral hazard concern was similarly applicable to the crisis intervention mechanism instituted in the IMF Agreement, the Americans and Europeans were still prepared to tolerate, seeing it as a necessary evil. Arguably, the real issue is not so much the so-called market distortion concern, but rather which party calls the shot – i.e. who would be in charge of disbursing the funds and setting the requirements for financial assistance. To this end, LTF offers a political economy framework as a new pair of lens to analyze the failure of the scheme and the reactions by American and European leaders. In short, the hostile reaction could be anticipated because both the US and European countries considered the AMF to potentially become an undermining force against the current hierarchy of global finance.

It should be noted that the Anglo-American led bloc of developed economies had been promoting the neoclassical economic and financial development model to various Asian governments as well as to the governments in other parts of the world for a long time. To this end, they strongly

³⁶⁶ Katada (n 226). at 195-198.

advocated a much more free market-oriented approach and were keen to severely limit the role of the state in the economic and financial development. The IMF structural adjustment program could arguably be seen as a “stick”, which they can force upon crisis-hit developing countries in order to gain future influence over the latter’s development strategies. On the other hand, Japan, which would become the de facto champion of the AMP, had aligned the economic development path more closely with the Asian model despite many legal and institutional transplants from the US and Europe.³⁶⁷ As a consequence, the Japanese authorities did not see any significant structural adjustments to the previously successful economic model, preferring to establish and maintain supporting funds in order to stabilize the vulnerable financial systems in Thailand.³⁶⁸ Had the AMF been established, these conflicting models of developments could potentially mean that the two international financial organizations would end up disagreeing over what would be the right course of action for the future crisis. Furthermore, although the US and Japan accounted for about the same share of trade with Thailand, Japan consistently ran a trade surplus while the US ran a large trade deficit, making Japan more vulnerable to an economic slowdown.³⁶⁹ Therefore, the Japanese government aspired to establish a regional mechanism that could preempt any signs of instability, even if it means catching more cases of false positives than the IMF framework did.

From an institutional competition perspective, the US representatives argued that the world did not need regulatory competition in the area of crisis resolution management.³⁷⁰ Resolving a crisis

³⁶⁷ World Bank (n 8). at 8.

³⁶⁸ Katada (n 226). at 188.

³⁶⁹ Lipsey (n 365).

³⁷⁰ Obviously, there are dissenting voices from the academia. See for instance, 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.

requires a decisive, clear, and united measures by the international community. With the presence of the AMF, one possible implication could potentially be that the IMF conditionality attached to its financial assistance package would not be as effective as intended to fix the fundamental problems with the economy and the financial sector of the country in trouble. Asian nations could simply turn away from the IMF to their regional organization for alternative support. Nevertheless, the merits of the IMF reform measures came under heavy scrutiny after the AFC to a point in which the Fund itself was subject to a comprehensive root and branch overhaul in the mid-2000s.³⁷¹ Unsurprisingly, the proposal failed in the face of such opposition and lack of strong support from major countries in the region, particularly China. This strategic move by the US further exemplifies the behavior of the apex of the hierarchy, which can choose to act to protect its own sphere of influence. Eventually, the rescue package was reformed under the “Manila Framework” which provided that any emergency funding scheme should be based *solely* on the IMF and any further financial assistance would only be forthcoming after the financially distressed countries satisfy the IMF conditionality.³⁷²

5. Post-Crisis Reform Initiatives of the International Financial Architecture

The AFC cast a long shadow over the continued existence of the international financial architecture as it then was. Robert Rubin, the US Secretary of Treasury during the second Clinton Administration, spoke at the Brookings Institution in April 14, 1998 stating that the new financial architecture did not need an institutional innovation comparable to that which took place after 1945, since it was only a question of consolidating and extending to emerging countries the

³⁷¹ Sean Hagan, ‘Reforming the IMF’ [2010] International Monetary and Financial Law 40.

³⁷² Anthony Rowley, ‘International Finance: Asian Fund, Rest in Peace’ (1997) 2 Capital Trends 1.

architecture of the financial systems of modern countries. Since Mr. Rubin was then one of the most senior American political figures, his speech revealed several crucial reform agendas for the international financial architecture in the post AFC era. On the intellectual level, the US did not believe that the foundation of the current global financial landscape need a conceptual overhaul. Secondly, the AFC represents the consequences of total market failure instigated by unwarranted meddling in the free flow of economic activities by the states, particularly the exploitation of the banking systems to achieve the industrial development goals. The implication of the speech therefore was to further pursue the liberalization program and prohibit the Asian governments in particular from continuing their allegedly unnecessary intervention in their own economies. In other words, this is, as Mr. Rubin saw it, an easy case of implanting the blueprint tried and tested by advanced financial markets onto the crisis-laden nations of East Asia.

Previous chapters in this dissertation has already questioned the merit and plausibility of Mr. Rubin's theory of AFC as well as of many other mainstream economists, particularly in the context of the Thai episode of the Crisis. Rather than repeating what has already been discussed, this chapter explores the immediate evolution of the international financial architecture and its influence in managing the aftermath of the Thai Financial Crisis.

a. [A shift in the conceptual foundation of the global finance governance framework?](#)

The AFC was an opportune moment for international policy makers to undergo a complete overhaul of the premise of the international financial architecture. It presented a chance to retest whether the efficient market hypothesis was really reflective of the reality of contemporary finance. First of all, the notion that professional investors should be trusted to assess risks and allocate resources to the most productive assets on the market even when material information seemed prevalent and fairly accurate ought to be put under a microscope. At the time, foreign

investors appeared to lose confidence in the so-called Asian Tigers, although the macroeconomic fundamentals of these countries were not out of line.³⁷³ Furthermore, the Thai episode of crisis questioned the causal direction between the accumulation of saving and the amount of economic and financial investment. In an era of financial exuberance (i.e. the time and space occupied by speculative and Ponzi financiers as put it by Minsky), banks commit to raising extra funds to invest in expanding their business portfolio even though new liabilities they take on (i) far exceed their current incomes and (ii) induce exuberant expectations of future returns. Due to the positive economic climate, lenders disregard the underlying risks, instead choosing to rely on their contractual rights as creditors to protect their financial interests against future uncertainty. The result is an investment boom, which could suddenly turn into a bust as soon as an enough number of economic projects begin to fold.

In other words, the end of the 1990s was the high time for the international community to consider replacing the building block of the global financial system with a new framework that is established upon a more realistic theoretical foundation. Regardless of the academic debates, this subsection observes that the actual reforms that were implemented did not meaningfully alter the landscape of global finance from the status quo prior to the crisis.

b. The post-crisis reform: the rules

The first point to note is that the basic structure of the international architecture of finance did not encounter a major overhaul. The global agenda on financial reform was driven solely by the Group of 7 (G-7) representing the seven most financially and industrially advanced nations, in other words those occupying the apex of the global financial hierarchy.

³⁷³ Radelet and Sachs (n 24).

In the first G-7 summit after the AFC in Birmingham, the UK (May, 1998), the G-7 released a communique backing the use of the IMF's financial assistance programs as well as the attached conditionality to all requesting countries in Asia. Specifically, the member states gave their explicit support to the conventional reform prescriptions, namely the modernization of banking and corporate laws and regulations to ensure transparency, good governance and free competition in the financial market. Later on that same year, the G-7 met again in Cologne to announce the recommendations for the reform of the global financial governance structure. While 15 crisis-hit nations including representatives from Thailand were invited to the Cologne summit, their presence was a vanity rather than a necessity. In other words, even though their appearance added a sense of unity and solidarity over a common set of strategy in combating the most devastating financial crisis in the decade, the G-7 dictated the shape and form of the initiatives.³⁷⁴ In other words, the meeting of this kind by the most powerful nations demonstrate just how the global financial system reveals its hierarchical structure. Their released statements or communiques can be considered as much an exercise of political might as the agenda for improving the international financial governance framework.

In gist, the overwhelming concerns among the G-7 members were the quality as well as quantity of information from the developing economies in order to improve the efficiency of the global financial market. Specifically, they called for international financial institutions to collect more data on the macro-economic situations of developing countries in terms of short-term currency commitments or exchange reserves and also the information relating to financial intermediaries

and the non-financial corporate sector. It could be argued that in both academic and policy circles the previously unyielding support for economic and financial globalization started to waver.³⁷⁵ On the one hand, the world leaders had become suspicious of the capacity of international investors especially in calculating investment risks and forecasting future market trends. To this end, various international institutions were asked to contribute to attaining this goal. The IMF was assigned to lay down a set of practices for central banks to monitor macro-economic risks posed by the financial and banking sector. Moreover, professional associations such as the IOSCO, IAIS and IASC had to modernize their members' domestic rulebooks. If one may recall from the discussion above, some of the guidelines or recommendations which are considered privately legislated rules of international finance have gained the recognition and status once they were adopted by domestic regulators, practicing lawyers, and other financial professionals. The Basel Accords for instance have become the universal standards for prudential regulation. Virtually, all central banks rush to implement the latest iteration of the Accords regardless of any political pressure from either external sources or within.

c. The post-crisis reform: the institutions

The AFC had reminded the global leaders that in an era in which financial activities became increasingly transnational, a localized disruption can potentially transform into an international incident via various channels of financial interconnectedness. In other words, financial governance was no longer an issue that concerned a small group of advanced countries but rather it had developed into a global affair just like international trade, and world peace and security. Another

³⁷⁵ See these examples of “revisionist view” of globalization for instance: M Ayhan Kose and others, ‘Financial Globalization: A Reappraisal’ [2009] IMF Staff Papers 8; Pierre-Olivier Gourinchas and Olivier Jeanne, ‘Capital Flows to Developing Countries: The Allocation Puzzle’ [2013] The Review of Economic Studies rdt004; Eswar Prasad and others, *Effects of Financial Globalization on Developing Countries: Some Empirical Evidence* (Springer 2005) <http://link.springer.com/chapter/10.1007/978-0-230-50575-9_9> accessed 11 February 2016.

related concern was the vastly different levels of financial development among financial markets from around the world. In order to reconcile this shortcoming of international finance with the goal of creating a globalized financial system, the IMF has now formally accepted that some capital control measures may be adopted in limited circumstances so that developing countries may better manage the cross-border capital flows especially during the time of heightened uncertainty.³⁷⁶.

In order to achieve the aforementioned objectives, some institutional reforms were advanced in the aftermath of the crisis in order to strengthen our ex-ante preparations for future crises. Firstly, the establishment of the Financial Stability Forum (FSF) provided a way to enhance cooperation among the various national and international supervisory bodies and international financial institutions so as to promote systemic stability in the international financial system. The FSF brought together national authorities, sector-specific international groupings of regulators and supervisors as well as committees of central bank experts together to both monitor the wellbeing of global finance and develop standards and codes of good practice. Furthermore, the international community saw an urgent need to reinforce supervisory surveillance and insurance regulation measures in order to reduce adverse incentives leading to excessive risk-taking. To this end, the Basel Committee on Banking Supervision was tasked to come up with a series of proposals regarding the evaluation of credit risk and the limitation of banking commitments granted to highly leveraged financial institutions. With the benefit of hindsight, the implementation of Basel 2 was

³⁷⁶ KEVIN P GALLAGHER, 'The IMF, Capital Controls and Developing Countries' (2011) 46 *Economic and Political Weekly* 12. at 12.

thought to increase financial procyclicality which in turn exacerbated the Global Financial Crisis in 2008-9.³⁷⁷

Considering the animosity among East Asian countries including Thailand toward the IMF over its handling of the AFC, they were again left rueing the missed opportunity to see an overhaul of its Articles of Agreement on both its governance structure and lending instruments. The IMF argued that it had for the first time since 1979 revised its guideline on conditionality attached to the stand-by agreement issued to a requesting member state according to Article I(v). The new principles were designed to be sensitive to each individual crisis and circumstance. Yet, the major problem with the IMF's lending instruments is that they have been seen as a stigma rather than a soothing factor in the eyes of market participants. In other words, the intervention by the IMF signals to the market that the situation has already deteriorated beyond control and, rather than calm the market, it triggers further panic and instability. Superficial rewriting of the conditionality requirement arguably could not fix the fundamental issue without reviewing the basis upon which the IMF's financial assistance program rests. In other words, the Fund should instead focus on the theoretical foundation of its reform guidelines which may help reprioritize certain measures necessary during the crisis over the other areas which can wait until the financial system has been stabilized.

In term of organizational governance, the IMF did carry out a substantive reform which was aimed to revise its quota formula. The pre-crisis framework allowed for the overrepresentation of Europe and North America while the rise of new economic powers of Asia and Latin America as well as

³⁷⁷ Adair Turner and others, *The Turner Review: A Regulatory Response to the Global Banking Crisis*, vol 7 (Financial Services Authority London 2009)
<http://finra.complinet.com/net_file_store/new_rulebooks/f/s/FSA_at_slides.pdf> accessed 22 May 2017. At 59.

to be attuning to the needs of low-income members.³⁷⁸ While the reform was initiated relatively early in the 2000s, it took the Global Financial Crisis in 2008 to further shift the voting in favor of the reform proposal which only came into force in October 2009.

In sum, the post-crisis global financial system reform may be described as “pragmatic incrementalism”.³⁷⁹ The international financial architecture still respect national sovereignty and prerogatives of private investors. Instead, it shifted the focus towards harmonization of standards and norms which were considered important to the advancement of the international financial system. This period also witnessed a rise in coordinated networks which were believed to offer greater efficiency to the existing institutions in the event of a crisis. The constitution of the Financial Stability Forum and the recognition of various professional and sectoral associations spring into mind. This minimal strategy was also a subtle way to preserve the governing structure of international finance. Any proposals to found new heavy supranational institutions had all encountered fierce oppositions from the parties that controlled power. Any changes both at the global as well as on the regional levels must be done without fundamentally altering the existing architecture if they were to stand a chance of success.

d. The post-crisis reform: Chiang Mai Initiative (CMI)

After the failed attempt to establish the Asian Monetary Fund coupled with a hostile attitude towards radical reforms expressed by the group of countries that dominated the international financial architecture during the period between the AFC and the Global Financial Crisis, East

³⁷⁸ Hagan (n 372).

³⁷⁹ See generally, Barry J Eichengreen and others, ‘Toward a New International Financial Architecture: A Practical Post-Asia Agenda’ [1999] Peterson Institute Press: All Books <<https://ideas.repec.org/b/iie/ppress/51.html>> accessed 22 May 2017.

Asian nations must rethink the strategy that would be political palatable as well as enhance their resiliency for the next crisis. To this end, the Association of South East Asian Nations (ASEAN) established a regional swaps facilities with its affiliating countries in East Asia, namely China, Japan, and South Korea (ASEAN+3). The so-called Chiang Mai Initiative (CMI) became the first currency swap arrangement in the region in May 2000. CMI facilities encompass the ASEAN Swap Arrangement among ASEAN member states, and a network of bilateral swap arrangements with the ASEAN+3 nations. However, the effectiveness of CMI especially in its early years was very much curtailed due to the institutional limitations imposed by the architects of the scheme in order to be palatable to the players at the top of the global financial hierarchy.

CMI was conceived out of the need for greater cooperation in the region after the regional leaders realized they had very limited influence on shaping the IMF crisis resolution measures. As discussed at length above, these measures were largely dictated by the IMF with the US Treasury and the Federal Reserve exerting control from behind the scene. Immediately after the crisis, Japan continued to play a pivotal role in the recovery process through various initiatives.³⁸⁰ The most prominent program was the \$30 billion New Miyazawa Plan which split in half between medium- and long-term financial support and short-term trade finance and currency swap arrangements.³⁸¹ After this fund dried up in May 1999, the Japanese government injected further \$2.4 billion as well as announced its new bond guarantee program worth \$16 billion to support Asian governments

³⁸⁰ After implicating in the rescue plans for Indonesia and South Korea, the US and her European partners turned attention away from Asia, choosing to focus principally on the Russian and Latin American crises. This returned Japan to the role she assumed during the negotiation for the bailout package for Thailand in August 1997 Katada (n 226). at 183-184.

³⁸¹ Other Japan-led initiatives designed to stem any further deterioration of the crisis include the Japan-US Asia Growth and Recovery Initiative (\$10 billion), A special framework for yen loans (\$5 billion), the Japan-ASEAN solidarity fund (\$20 million seed money), to name just a few.

issuing yen-denominated bonds.³⁸² While the post-crisis capital injecting schemes were certainly crucial during the time when the market could not provide sufficient liquidity, the East Asian nations realized the ex-ante preemptive framework that could stifle any potentially major credit contraction before it morphs into a full blown crisis would reinforce overall systemic resilience.³⁸³

Nevertheless, the CMI was institutionally crippled from the very beginning. With attendance of US and IMF representatives in the regional summit hosted by the Asian Development Bank, the ASEAN nations released an official statement on establishing the new regional facilities stating in parts:

*“...This framework, which recognizes the central role of the IMF in the international monetary system, includes the following initiatives: (a) a mechanism for regional surveillance to complement global surveillance by the IMF; (b) enhanced economic and technical cooperation particularly in strengthening domestic financial systems and regulatory capacities; (c) measures to strengthen the IMF’s capacity to respond to financial crises; and (d) a cooperative financing arrangement that would supplement IMF resources...”*³⁸⁴

The incorporation of the role of the IMF was prominent in the arrangement of the bilateral swaps agreements among ASEAN+3 nations. Under the terms of these agreements, only 10% of the agreed amount could be utilized without any linkage to an IMF program for 180 days. To invoke any further amount of funds from the network, the requesting country must first be under the IMF financial assistance program or could demonstrate the willingness to participate in such a program

³⁸² Katada (n 226). at 185.

³⁸³ Sussangkarn (n 366). at 2.

³⁸⁴ The Official Summary of the Discussions, the Manila Framework: A New Framework for Enhanced Asian Regional Cooperation to Promote Financial Stability”, November 18-19, 1997.

in the near future.³⁸⁵ A senior Thai economist who at the time covered the proceeding explicitly stated that the linkage to the IMF program was meant to ease concerns regarding potential conflicts with IMF conditionality and moral hazard problems. Both of which are exactly the same reasons raised by the US and Europe in opposing the establishment of the AMF.

It is not hard to see why CMI was at best a work in progress and largely ineffective. By October 2003, a combined total size of the bilateral swaps network was roughly \$ 35 billion. Even if one could draw on the entire pool, the unrestricted portion of the funds would have been only \$ 3.5 billion. The meagre amount was hardly enough to support the outstanding short-term debts that became due during the three months of April to June 1997 at the peak of the AFC in Thailand. Since its inception, the CMI has never been utilized. The former governor of the Bank of Thailand once gave a remark that the facilities might not be needed any more in the age in which all members of the agreement are themselves hoarding an unprecedented amount of foreign reserves, mostly in US currency and Treasury bonds.³⁸⁶ Nevertheless there was a renewed regional coordinating effort to strengthen the existing bilateral framework after the Global Financial Crisis disrupted the Asian capital and financial markets, even though the epicenter of the Crisis was in the American subprime mortgage industry and European sovereign debt market. The following chapter analyzes, the CMIM, the reincarnated version of the CMI, in details with a view to assess the readiness of the regional safety net measures against future crises.

³⁸⁵ Sussangkarn (n 366). at 5.

³⁸⁶ Questions and Answers Session, “Living with Capital Flows: An Emerging Market Perspective”, Dr. Prasarn Trairatvorakul, School of International and Public Affairs, Columbia University USA, May 6 2015.

6. Conclusion

This chapter of the dissertation reveals the critical juncture at which the operation of law ends and the wielding of power begins. Contemporary finance has been able to flourish across the continents primarily because law lends its inelastic structure, internal working mechanism and enabling institutions to financial transactions, allowing for a largely predictable, enforceable, and reliable system of economic interactions. The preceding two chapters deal, firstly, with how the legal construction of finance brought about the systemically destabilizing inflows of foreign capital into the Thai financial system and secondly, with how rigid enforcement of legal obligations instigated a mismatch on the aggregate balance sheet of the financial sector and thus triggered the crisis. Unlike the mainstream theories of the historic disaster which put the blame squarely on the public intervention in the economy, and the inefficient regulatory framework which was unable to deal with the torrent of capital inflows, the dissertation asserts and articulates in the previous two chapters that the Crisis was in fact part of the financial cycle brought about by the unprecedented convergence of the legal and regulatory frameworks in Thailand and the creditor countries especially Japan, Europe, and the US.

In contrast with a more legalistic analysis found in the foregoing chapters, this chapter deals with the political economy aspect of the global financial system. Facing with outstanding external liabilities, it could be argued that the Thai government had two options – either defaulting on the foreign debts or requesting financial assistance from the international community. With the volatile political environment both domestically and internationally at the time, the government sought a bailout from the country's main creditors and the IMF. This decision effectively subjected Thailand to the hierarchy of global finance under which the enforcement of law is at the discretion of those who commanded the authority in relation to the countries in the periphery of the global

financial system. As a result, the representatives of the Bank of Thailand first approached their Japanese counterparts to try to negotiate both financial assistance and debt restructuring deals. Japan was Thailand's largest trading partner and crucially primary creditor country of the Thai financial system. Nevertheless, it became clear that Japan was reluctant to intervene unilaterally and preferred to act in concert with the IMF-led international community. Crucially, the international conference on the AFC hosted by Japan would not have gone ahead without an approval of the US. This episode of international crisis management demonstrates the political economy of global finance in which the US with its financial might and prevalence of US dollar as the global currency in cross-border financial transactions sits at the top of the hierarchy.

Consequently, Thailand had no choice but to accept the financial assistance and the attached conditionality set forth in the IMF Articles of Agreement. This chapter argues that such process was designed to be applicable only to the countries designated to be at the periphery of global finance. The rigidity of the IMF assistance program thus worked to protect the Fund's financial interest and pursue the economic developmental agenda promoted by the parties at the top of the hierarchy. It should therefore be to nobody's surprise that Thailand and virtually all requesting Asian nations that were badly affected by the Crisis found the IMF conditionality counterproductive or in some cases backfired. The next chapter takes us some 20 years forward to the present time and uses all the insights offered by the LTF assessment of the AFC to see if any lessons have been learned.

Chapter 5 - Assessing Thailand and the Implementation of ASEAN Banking Integration Framework: New Fault Lines in the Fledging Regional Banking Industry?

1. Introduction

Thailand and the ASEAN³⁸⁷ neighbors have arrived at a critical juncture of their financial and economic development. With the past experience of the AFC still fresh in mind, each country constantly monitors the ongoing precarious and unsettling global financial situations and thus has been individually prepared for the worst ramifications of negative shocks emanated from other parts of the world. Collectively, they are forging ahead with the ASEAN Economic Community (AEC), an ambitious economic union project, which entails among other things financial integration and regionalization within the bloc itself, and with the affiliated countries in East Asia. Not only would various financial integration initiatives fundamentally alter the architectural framework of the participating domestic financial systems in the region, but also by definition create a new institutional paradigm which could potentially be vulnerable to new types of systemic risks. Despite its 5-year delay beyond its inception date of December 31 2015, pan-ASEAN financial integration remains an essential component of the economic union as it will support and facilitate intra-ASEAN trade and investment.³⁸⁸ The pace of integration will be dictated by readiness of each individual member state, there is a legitimate concern of whether, and if so to what extent, institutionalized financial interconnectedness created by the new regional structure

³⁸⁷ Association of South East Asian Nations.

³⁸⁸ See the AEC Blueprint 2025, at 7-8. Available at <<http://www.asean.org/asean-economic-community/>> accessed 10 February 2016.

would do to long-term sustainability of each individual ASEAN financial market and by extension the systemic viability of the entire economic bloc.

Under the overarching theme of financial integration lies the ASEAN Banking Integration Framework (ABIF). With a number of largely under-developed capital markets across the region, the banking system continues to be the most sophisticated financial sector in virtually every ASEAN member state, making it a cornerstone of the AEC financial integration. As a result, from the official announcement of the AEC in 2003, banking integration was included in the one of the three pillars of ASEAN financial integration.³⁸⁹ It took almost five years of negotiation from its conception in 2011 before ASEAN Finance Ministers agreed the final details of ASEAN Banking Integration Framework (ABIF) paving the way for the first phase of integration. Under this initial process, any pair of member states is encouraged to enter into bilateral agreements based on the principles of mutual recognition and reciprocity.³⁹⁰ While the incremental and somewhat fragmented approach to financial integration offers a compromised approach to accommodate a group of nations with the vastly varying levels of financial advancement, the implementation of ABIF could end up leaving the member states more vulnerable to systemic risks than the current domestic and regional financial architecture. This is especially the case when the regional safety net system is still in its embryonic stage of development and thus seemingly not ready to provide adequate support when needed.

³⁸⁹ The Roadmap for Monetary and Financial Integration of ASEAN elaborates three pillars of financial integration, namely 1) capital market development; 2) financial services liberalization under which the banking integration project falls; and 3) capital account liberalization.

³⁹⁰ Joint Statement of the 1st ASEAN Finance Ministers' and Central Bank Governors' Meeting (AGMGM), Kuala Lumpur, Malaysia, March 21, 2015.

Thailand presents an interesting case study to investigate the aforementioned proposition for two primary reasons. Firstly, the country has achieved relative financial stability after the AFC in the 1990s principally through consciously control both public and private exposure to external finance. Arguably the 2000s can be seen as the time in which the Thai state took back the autonomy over its own financial system after the legal and regulatory changes of the previous era left it beholden to foreign nationals. Nevertheless, it remains to be seen how this financially restrictive approach that Thailand has adopted in the past 20 years align with the ASEAN's model of structural integration across the region. Secondly, Thailand is the second largest economy of the region and home to one of the region's major financial centers, therefore its financial robustness is of systemic concern to the entire bloc. A deepening of financial interconnectedness could exacerbate contagion.

This chapter uses the LTF framework developed throughout this dissertation and examines the domestic and regional financial architecture and governance structure in the post-crisis era South East Asia. The underlying objective of the chapter is to demonstrate how LTF could potentially be used to critically assess potential systemic vulnerability embedded in the legal construction of a financial system.³⁹¹ Furthermore, the chapter observes that the new regional structure introduced by the ASEAN framework places an extra layer of the hierarchy of the Asian financial community.

The chapter is divided into six parts, beginning with this introductory section and the following section discussing the methodological framework. The third part, which briefly explains the current state of the Thai financial development together with its subsequent section on the operating framework of ABIF, sets up the detailed examination of anticipated changes to the Thai

³⁹¹ Pistor, 'A Legal Theory of Finance' (n 18).

financial system brought about by forthcoming implementation of ABIF. The chapter parts with conclusory remarks and brief future policy and research direction.

2. Legal Theory of Finance as an Analytical Framework

The need for an entirely fresh analytical lens was born out of the fact that the current stream of literature on financial globalization does not reflect the reality and thus cannot fully explain the nature of the ASEAN project. It has been observed that the new world financial order relegates the role of the states in organizing, regulating, and supervising finance and handovers such functions to privately arranged entities³⁹² and non-traditional technical institutions³⁹³ whose legal entities do not depend on treaties or other public international law instruments.³⁹⁴ Deregulation refers to the elimination of state-enacted laws in favor of a more flexible, almost organically and spontaneously created set of rules which better supports free flows of capital, instantaneous financial transactions, and proliferation of transnational corporations.³⁹⁵ The only meaningful function of the state and

³⁹² For instance, International Swaps and Derivatives Association (ISDA), and the Bank for International Settlements.

³⁹³ Notably, International Accounting Standards Board (IASB), and International Organization of Securities Commissions (IOSCO).

³⁹⁴ Geoffrey Rd Underhill, 'Markets beyond Politics? The State and the Internationalisation of Financial Markets' (1991) 19 *European Journal of Political Research* 197; Stephen L Harris, 'Regulating Finance: Who Rules, Whose Rules?' (2004) 21 *Review of Policy Research* 743. M Ayhan Kose and others, 'Financial Globalization: A Reappraisal' [2009] *IMF Staff Papers* 8.

³⁹⁵ Susan Strange, *The Retreat of the State: The Diffusion of Power in the World Economy* (Cambridge university press 1996); Ken'ichi Ōmae, *The End of the Nation State: The Rise of Regional Economies* (Simon and Schuster 1995); 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. Also there are also scholarly works which recognize the roles of state in economic and financial globalization, though such roles are restricted to either as a gate keeper or market failure intervenor. See Joseph E Stiglitz, 'The Role of the State in Financial Markets' (1993) 7 *The World Bank Economic Review* 19; Eric Helleiner, 'Explaining the Globalization of Financial Markets: Bringing States Back in' (1995) 2 *Review of International Political Economy* 315. There are a few works that openly question the mainstream literature and focuses the center of discussion on globalization on how the state enables, shape, and limits such process. See Ha-Joon Chang, *Globalization, Economic Development and the Role of the State* (Zed Books 2003).

by logic its operative instruments, laws and regulations, is merely liberalization which allows for an imparting of competitiveness, innovation, and efficiency.

While various empirical studies have since questioned the real benefits of financial globalization³⁹⁶, the problems with the existing framework lie in its depiction of the role of the state and the ultimate objective of financial development. The significance of the state in constructing a globalized market is oftentimes overlooked because of the complex private-public collaboration necessary to the construction of a sophisticated internationalized marketplace.³⁹⁷

Nevertheless, the ASEAN member states have been upfront about the intention to keep their respective governments fully engaged in all of the future undertakings. In conducting any affairs involving ASEAN, the governing charter demands respect for among other things sovereignty, territorial integrity, and independence of all member states.³⁹⁸ This consensus-based rule of engagement, known colloquially as the ASEAN Way³⁹⁹, dictates the manner of financial integration as seen by various initiatives in the AEC Blueprint 2025 which differs significantly from the integration approach adopted by other regional blocs such as the European Union. Particularly, the ASEAN banking integration is based principally on the principle of mutual recognition and requires each individual member state to enter into a bilateral agreement with one

³⁹⁶ Kose and others (n 376).

³⁹⁷ See an example of such collaboration in the context of the foreign exchange market. Rachel Harvey, 'The Legal Construction of the Global Foreign Exchange Market' (2013) 41 *Journal of Comparative Economics* 343. at 345.

³⁹⁸ Article 2(a) of the ASEAN Charter. See <<http://www.asean.org/asean/asean-charter/>> accessed on 11 February 2016.

³⁹⁹ Logan Masilamani and Jimmy Peterson, 'The "ASEAN Way": The Structural Underpinnings of Constructive Engagement' (*Foreign Policy Journal*, 15 October 2014) <<http://www.foreignpolicyjournal.com/2014/10/15/the-asean-way-the-structural-underpinnings-of-constructive-engagement/>> accessed 11 February 2016.

another as and when they are so ready.⁴⁰⁰ The unified ASEAN banking sector can thus be achieved through a network of bilateral relationships administered by a collegiate of relevant national regulators. With the construction of the ASEAN financial market, the role of the member states therefore is strategically central to the plan and cannot be dismissed simply as an enabler of liberalization.

Furthermore, it is unclear whether the goals of the stylized model of financial globalization and the actuality of ABIF are ultimately compatible. With the devastating experience of the AFC still fresh in their minds, the architects of the ASEAN framework may be excused for prioritizing systemic stability over the prospect of rapid financial expansion which could potentially be achieved by creating a single unified financial market for South East Asia. Indeed, the AEC Blueprint insists on building regional capacity to withstand both global and internal challenges.⁴⁰¹ From the perspective of individual member states as demonstrated with the case of Thailand below, the primary agenda of national financial development is to continue strengthening the domestic market as well as protecting consumers from any potential disruptions.

LTF provides a frame of reference on the subject. In the previous chapters, the analysis focuses on the institutional origin of the Crisis in the 1990s. To that end, LTF shows that the root cause of the Crisis went beyond a simple story of corruption, collusion, and mismanagement. Rather it represents an adverse manifestation of a financial system that had been influenced by mutual reinforcing changes between public law and contractual innovations. In addition to the domestic construction of the Thai financial market, both political and legal developments in the international

⁴⁰⁰ ASEAN Economic Community Blueprint 2025, para 17(b).

⁴⁰¹ AEC Vision 2025, para 10(10.1).

governance structure and in the major creditor countries are critical in understanding not only why there was an unprecedented amount of foreign capital flowing into Thailand, but also that the how the construction of the regional capital market at the time attracted the particular types of foreign investments which eventually contributed to the downfall of local banking and non-bank financial institutions.

It is submitted that the same analytical framework can be used to appease the post-crisis regional initiatives and their potential impacts to Thailand's long-term financial resilience. For a start, LTF is conscious of the distinctive partnership between state and private actors in carving a new financial product or an entire market. It reminds us of the important role banks and non-bank financial institutions play in creating various types of money, and arranging new markets such as the Asian Bond Market Initiative.⁴⁰² In addition, LTF contends that the states through their legislative and administrative action, have increasingly been able to influence and shape the development of their own financial market. In the previous chapters, the dissertation also shows that these wholly domestic moves could did have extraterritorial effects, especially when there are financial linkages between the concerned countries.⁴⁰³ Understanding the fundamental nature of finance as a hybrid public-private construct is thus crucial in order to appease the systemic effects

⁴⁰² Perry Mehrling, 'Essential Hybridity: A Money View of FX' (2013) 41 *Journal of Comparative Economics* 355; Anna Gelpern and Mitu Gulati, 'The Wonder-Clause' (2013) 41 *Journal of Comparative Economics* 367; Geoffrey M Hodgson, 'Observations on the Legal Theory of Finance' (2013) 41 *Journal of Comparative Economics* 331; Michael G Plummer and Reid W Click, 'Bond Market Development and Integration in ASEAN' (2005) 10 *International Journal of Finance & Economics* 133.

⁴⁰³ Some mainstream scholars have started to observe a more nuanced role of the state beyond correcting market failure. Professor Brummer observed that international financial law which differs from the traditional treaty-based international trade law: "[T]rade law almost presupposes that government is the problem, as states create seemingly insanely inefficient barriers that choke off growth. Financial regulation, by contrast, sees government as a necessary partner in preventing crises and protecting investors in the world of intermittent market failure." See Chris Brummer, *Minilateralism: How Trade Alliances, Soft Law and Financial Engineering Are Redefining Economic Statecraft* (Cambridge University Press 2014). at 96.

of legislative and regulatory interventions, but also any potential private law initiatives that may arise in response to changes in the public law. To this end, deregulation, understood simply as a process of removing state regulations, is a misnomer and reflects a lopsided interpretation of sophisticated rearrangement of responsibilities among the states, representatives of significant private interests, and perhaps non-state transnational technical bodies or experts.⁴⁰⁴

This unique governance system of finance requires a novel set of rules that are specifically catered for the flexible, fast-paced, and complex nature of cross-border transactions and institutions. On this particular subject, the commentators in the field have begun to recognize the principles of international financial law as a distinct branch within the growing body of international law – characterized by its unconventional legislative, transposition, and enforcement techniques.⁴⁰⁵ The assessment of this process from the apex of rule-making to the low-lying plateau populated by rule adopters is crucial in depicting the hierarchical nature of international finance during the good times. The added nuances introduced by the regional governing framework do not take away the fact that, ultimately, it is the member state government who must first internalize and subsequently enforce such rules upon the regulated entities registered in its jurisdiction. As a consequence, the international financial law concepts such as mutual recognition, and compliance-based soft law instruments among other things play a strikingly similar role to the much older legal discipline of conflict of law which has been used to determine whose national laws shall be applied in a given case.

⁴⁰⁴ Pistor, 'A Legal Theory of Finance' (n 18). at 321.

⁴⁰⁵ Pierre-Hugues Verdier, 'Mutual Recognition in International Finance' (2011) 52 *Harvard International Law Journal* <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1757259> accessed 13 May 2015; Brummer (n 234); Benedict Kingsbury, Nico Krisch and Richard B Stewart, 'The Emergence of Global Administrative Law' (2005) 68 *Law and contemporary problems* 15.

Creditors with experienced legal counsel seek to shield themselves from future uncertainty and adverse effects of liquidity constraint. In order to protect their financial interests, they can insist upon certain *ex ante* contractual clauses demanding their legal rights to be honored regardless of potential systemic ramifications. The example of the Crisis in Thailand in 1997 illustrates well this destabilizing nature of law in finance.⁴⁰⁶ As the Thai economy was booming and its financial assets became desirable to foreign investors who were seeking high yield with tremendous potential upsides, these assets found easily secondary and tertiary takers on the international capital market. As a result, in a deceptively stable environment with seemingly ample liquidity, the emerging market asset class including junk-graded Thai bonds were widely sought after as if they acquired a similar risk profile to those asset classes originated from the advanced financial markets or backed by the developed countries' governments. Yet, during the crisis, the hierarchy among different asset classes was restored as observed resulting in the widened spread and inconvertibility between Thai baht and US dollar. In other words, in the bad times the bundle of rights and obligations that constitute a financial product demand a reinstatement of different classes of money separating US dollar, Thai baht, and IOUs issued by private companies. To this end, LTF argues that one of the determining factors for the hierarchical organization of global finance is the contractual clause which determines the final mean of settlement. Equally if not more importantly, the currency and settlement clause invariably found in every cross-border financial transaction also dictates the involvement of the state as the currency issuer and regulator. Again, this reaffirms LTF's main building block that finance is necessarily public and private.

⁴⁰⁶ Pistor, 'A Legal Theory of Finance' (n 18). at 323.

A common but significant challenge facing any architects of cross-border financial integration is to construct an effective safety net mechanism to deal with emergency, particularly future crises. In relation to the ASEAN context, there are several factors to consider which might in some way complicate the task at hand. Currently, ASEAN comprises of ten separate financial systems of diverging levels of development as well as different regulatory and supervisory cultures and experiences. The integration project could potentially create fault lines that would end up threatening the entire regional systemic viability.⁴⁰⁷ As already discussed, the fact that the undertaking must be carried out under the overarching philosophy of “ASEAN Way” negates the possibility of supranational regulatory or supervisory authority. Instead, the efforts are directed to achieving enhanced coordination and cooperation among national regulators.⁴⁰⁸

This hand-off, gradual approach to creating an economic and financial union also means that each member state has substantial discretion to set what it believes to be the right balance between embracing advantages (and risks) of the unified ASEAN financial market on the one hand and on the other hand keeping its own system robust and resilient against any potential unexpected disruptions. The following sections of the article demonstrate this infrequently discussed tension between the priorities of reform adopted by the member state (in this case, Thailand) and the free market-oriented agenda of ABIF. The LTF’s appeal lies in the explanatory power which will be used to predict what could be the eventual outcome in case a crisis of similar or greater magnitude than the AFC hit the region. In other words, the question is whether the new safety net regime

⁴⁰⁷ Fina Astriana, ‘Challenges Facing ASEAN Banking Integration | THC ASEAN’ <<http://thcasean.org/read/articles/175/Challenges-facing-ASEAN-banking-integration.html>> accessed 12 February 2016.

⁴⁰⁸ *ibid.*

under the ASEAN financial architecture differs in some ways to the system in place during Asia's last great financial tragedy.

3. Financial Development in Thailand from 2001 to 2016: the Objective, the Progress, and the Future

Thailand placed financial robustness, stability, and resilience as its all-encompassing priorities when the government embarked upon overhauling the financial system after the crisis in the late 1990s. The long-term structural reforms bore fruits and manifested in the relatively minimal and transient impacts of the Global Financial Crisis of 2008 on the systemic viability of the Thai economy.

a. Thailand and the Global Financial Crisis of 2008-9

Considered the epicenter of the 1997 Crisis, Thailand was deafeningly quiet in the world financial news since the eruption of the GFC. While the country, together with the rest of the region, had to contend with the negative impact of both global financial and economic contraction, the Thai banking sector remained robust throughout the first three quarters of 2009.⁴⁰⁹ The ratio of net non-performing loans to total loans on the sectoral balance sheet remained low and constant at around three per cent. The delinquency rate slightly declined from four to three and a half percent. Although the sector's net profit expectedly plummeted, its capital adequacy ratio far exceeded the regulatory threshold at 16.5 per cent as of the third quarter of 2009, of which 12.9 per cent was classified as the Tier 1 capital according to Basel II. The healthy capital cushion represented a significant jump from 13.1 per cent in 2004 (of which ten per cent belong in Tier 1). The

⁴⁰⁹ Source: Bank of Thailand. See Bank of Thailand, 'The International Banking Crisis: Impact on Thailand's Financial System and Policy Responses' (Bank for International Settlements 2011) BIS Papers chapters <<http://econpapers.repec.org/bookchap/bisbisbpc/54-24.htm>> accessed 4 September 2014.

aforementioned adverse effects, though telling, were rather transient. The growth rate for corporate loans declined by 6.5 per cent, whereas that of consumer loans grew at a lower rate of 7.3 per cent. The value of Thai baht tumbled between the end of 2008 and 2009 due to the hoarding of US dollars on the international FX market. The THB/USD exchange rate nevertheless swiftly recovered as the global demand for Thai export bounced back. Both domestic secured and unsecured lending markets coped valiantly in the light of the structural surplus made available in the Thai financial system. The Bank of Thailand wrote in 2011 that while several reactionary measures were initiated in response to the 2008 Crisis, the solid foundation was laid down in the preceding period inspired by the lessons learned from the 1997 crisis.⁴¹⁰

| Thailand's profile³ | | | |
|---------------------------------------|--------------------|-------------|----------------|
| | 1996 | 2001 | Q3/2009 |
| L/D ratio of banks | 129.0 ¹ | 84.8 | 85.4 |
| Corporate D/E ratio ² | 1.4 ¹ | 0.8 | 0.8 |
| External debt (bn USD) | 108.7 | 67.5 | 65.9 |
| Of which, short-term | 47.7 | 13.4 | 24.1 |
| Of which, banking system | 41.9 | 9.4 | 7.7 |
| % total bank assets | 18.8 | 6.3 | 2.5 |
| | 50.1 | 29.9 | 44.8 |

⁴¹⁰ *ibid.* at 377.

| | | | |
|---|------|------|------|
| Of which, non-banking system ⁴¹¹ | | | |
| External debt (% GDP) | 65.9 | 56.1 | 25.8 |
| Reserve to short-term debt (times) | 0.8 | 2.5 | 5.5 |

¹ Q2 1997. ² The median of D/E ratios of non-financial institutions listed on the Stock Exchange of Thailand. ³ Data compiled by the Bank of Thailand and presented in *The International Banking Crisis: impacts on Thailand's financial system and policy responses*, BIS Paper 54, 377.

It is argued that strong fundamentals of Thailand's financial system, during the recent crisis, owes significantly to the shift in the rationale of financial development from a bullish, outward-looking standpoint in the early 1990s to a sober, conservative, and ultimately inward-looking agenda of the post-crisis reform. The initial period between 1998 and 2001 focused on immediate post-crisis responses including recapitalization of the banking system, consolidation of financial institutions, and corporate debt restructuring with the goal to have a functioning financial system that could support the economic recovery.⁴¹² After three years expended on formulating the strategy, Thailand had for the first time a comprehensive development plan for its financial sector. Realizing the inevitability of globalization as an important external force for change, the Financial Sector Master Plan Phrase 1 (2004-2008) aimed to equip the financial sector with *sufficient resiliency to withstand new competitive forces brought by liberalization and appropriation of traditional*

⁴¹¹ The term was used in the official statement put forth by the Bank of Thailand but it is ambiguous as to what it means. The author's own interpretation taking into account other sources submits that "non-banking system" refers generally to the non-financial sector of the economy.

⁴¹² Leslie Teo and others, 'Financial Sector Crisis and Restructuring: Lessons from Asia: Lessons from Asia' (International monetary fund 2000) <<https://ideas.repec.org/p/imf/imfocp/188.html>> accessed 16 February 2016. at 93-101.

*banking services by non-bank entrants.*⁴¹³ Furthermore, the basic premise of this phrase of adjustment was that urban and rural customer groups, both corporate and personal, were previously underserved and thus Thailand needed, so the argument goes, a reorganization of the types of licensed financial institutions in order to provide sustainable means to financial services for these segments of the population.⁴¹⁴

b. Case in point: International Banking Facilities after FSMP

The most outstanding outcome of this sectoral rearrangement is the root-and-branch reform of international banking facilities (IBFs) which offered a special regulatory regime for licensed financial transactions with lenient supervision and at relatively minimal costs. Prior to the 1997 crisis, all IBFs enjoyed not only little or no regulation and supervision, but also government tax breaks and other indirect subsidies.⁴¹⁵ Interestingly, even though the IBFs were treated from both legal and accounting purposes as *off balance sheet conduits* of the sponsoring institutions, the practices that affected the commingling of funds such as cross pledging, intra borrowing, and simple transfer of funds were tolerated. The complete amalgamation of balance sheets and operations of the sponsoring commercial banks and IBFs was prohibited by the 2002 Notification issued by the Bank of Thailand.⁴¹⁶ This set the tone for the fundamental reform package contained in FSMP which took effect from the mid 2004 onward. First, it required all stand-alone IBFs or in other words the IBFs that were operated by foreign financial institutions under the IBF license to

⁴¹³ Bank of Thailand, the Financial Sector Master Plan (2006), at 6.

⁴¹⁴ Ibid. at 10.

⁴¹⁵ For commercial bank-sponsored IBFs and provincial IBFs, the law even allowed for them to receive deposits from the public and lend abroad or domestically.

⁴¹⁶ The Notification of Bank of Thailand Re: Rules, Procedures, and Conditions for the Operating International Banking Facilities by Commercial Banks, July 15th, 2002.

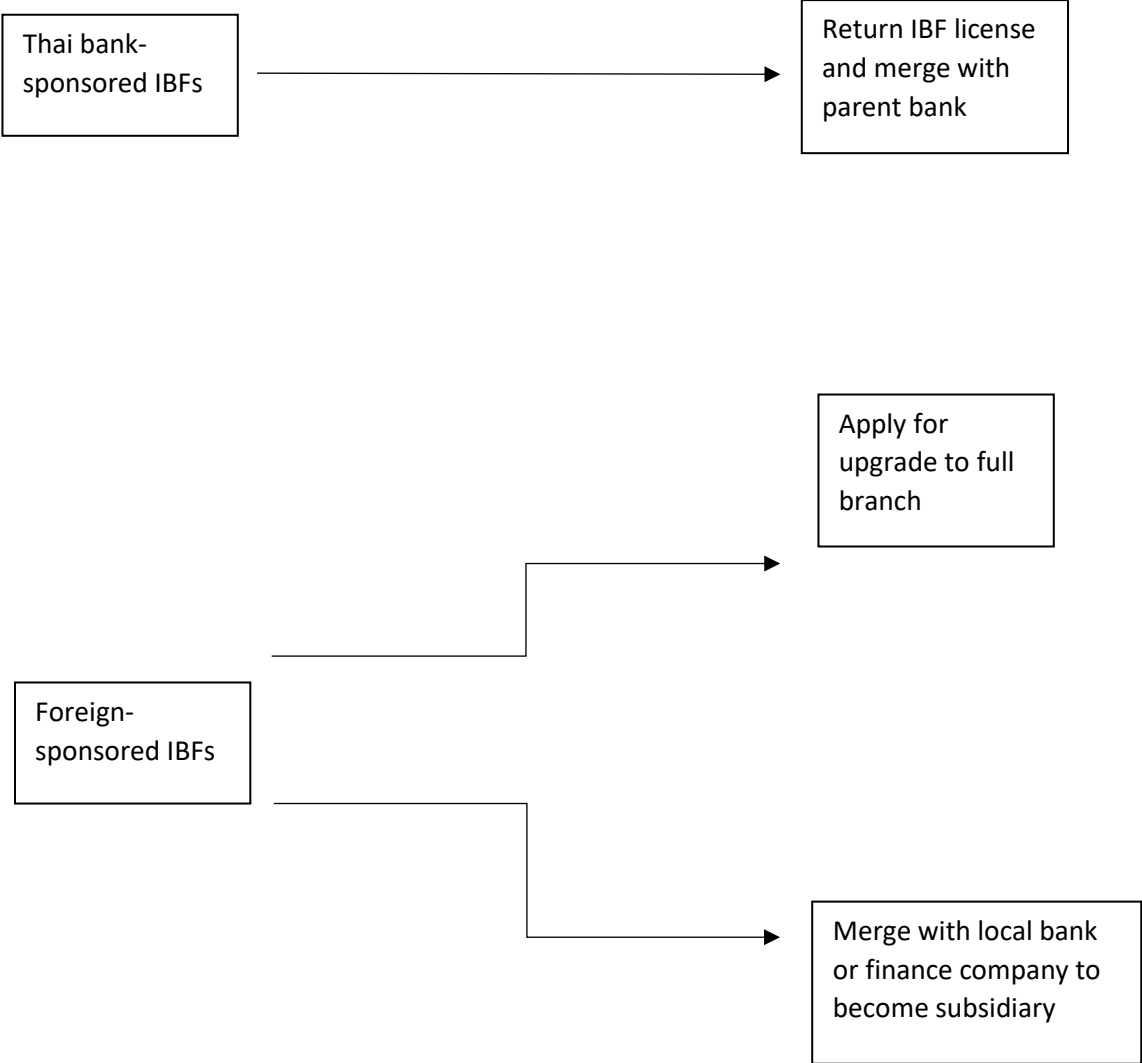
either re-apply as branches of foreign banks or alternatively they could also apply for full subsidiarization through a merger with another existing finance or credit foncier company and become a retail or commercial bank under the one-presence policy.⁴¹⁷ This new consolidating licensing initiative also applied to commercial-bank sponsored IBFs which were ordered to give up its IBF license and be regulated together with other bank groups on a consolidated basis.⁴¹⁸ After the six-month grace period, all previously tax-exempted IBF activities were treated as normal banking transactions and subject to the same regulation and tax treatment.⁴¹⁹ As a result, after the enactment of the Financial Institutions Business Act of 2008, IBFs as a stand-alone legal entities ceased to exist as legally recognized financial institutions under Thai law. In other words, the reformed IBF regulatory landscape represents a complete U-turn of the financial development direction from the early 1990s, when the ambition of the Thai government was to transform Thailand into a globally competitive financial center of Asia.

⁴¹⁷ The concepts of “full branch” and “subsidiary” were totally novel to Thailand at the time. The Financial Institutions Business Act of 2008 defers authorities to prescribe regulations and supervise branches and subsidiaries of foreign banks, during FSMP phrase 1, to the Bank of Thailand. A full branch is allowed to operate under the same scope as Thai commercial banks but with only one branch and had to maintain assets amounting to no less than at 3 billion in Thai baht. On the other hand, the central bank permits up to 4 branches for a foreign subsidiary which is required to maintain assets in excess of 4 billion baht in Thai jurisdiction. See the Financial Sector Master Plan (2006), at 22. In 2011 during the FSMP Phrase 2, the central bank revised its rule and allowed a licensed foreign subsidiary to have up to 20 branches in the country. Nevertheless there was no parallel upgrade for the foreign branch category.

⁴¹⁸ The conversion from an IBF license to a commercial banking license as well as the application for a full branch and foreign subsidiary was subject to a three-part merger guideline found in the Notifications of the Ministry of Finance Re: Rules, Procedures, and Conditions for Establishing Commercial Banks, Retail Banks, Subsidiaries, and Full Branches of January 30, 2004.

⁴¹⁹ The Financial Sector Master Plan (2006), at 26.

Restructuring IBFs under the post-crisis legislative reform



c. The subsequent phrases of the FSMP and the current ongoing global financial volatility (2008-2015)

While this period of time can be characterized by growing confidence in the strengthen of the Thai financial system, the overall regulatory approach of the central bank was still very much consistent with the cautious principles of the preceding stage and arguably put greater emphasis on containing the effects of global financial volatility.

In term of the financial institution regulatory regime, the Financial Institutions Business Act (FIBA) since its promulgation in 2008 has been the most important legal tool empowering the Bank of Thailand to continue its tight grip on the sector. The central bank controls the number of subsidiaries and branches of foreign banks through its selective licensing policy. In prevention of foreign takeover of domestic financial institutions, Thai nationals must make up at least 75 per cent of equity ownership and the total number of directors, except when deemed appropriate by the central bank on a case by case basis.⁴²⁰ These protective mechanisms were designed to afford time to Thai banks to gain competitive footing in anticipation of the ASEAN Economic Community. At the end of 2011, there were only 15 foreign branches and 1 subsidiary authorized to do business in Thailand.⁴²¹

Even though the barrier to entry has been relax in recent years, it is argued that this has been achieved through careful design rather than under the pressure of market forces. Phrase 2 of FSMP commencing in 2010 and lasting for 4 years geared the regulatory direction towards balancing between the need to create a competitive banking sector that can withstand the ongoing global

⁴²⁰ Para 1, S. 16, FIBA.

⁴²¹ 'Thailand Allows Foreign Banks to Convert to Subsidiaries' <<http://www.iflr.com/Article/2969988/Thailand-allows-foreign-banks-to-convert-to-subsiidiaries.html>> accessed 16 February 2016.

volatility and the protection of the public against perilous banking activities.⁴²² On the one hand, the Ministry of Finance, in agreement with the Bank of Thailand, started permitting foreign takeover of domestic banks, beginning with bridge banks the government nationalized in the aftermath of the AFC.⁴²³ Despite its plan to allow for further consolidation to increase the sector's economies of scale⁴²⁴, the central bank still adopts caution and proceed to approve merger applications only when the existing customers, borrowers, and other domestic stakeholders would reap benefits.⁴²⁵ In preparation for this new era of the banking sector liberalization, FIBA grants the Bank of Thailand a set of enhanced supervisory powers, chief among which was the power to assume control of financial institution when it deems urgently necessary to protect public interest.⁴²⁶

⁴²² The Financial Sector Master Plan Phrase 2, Bank of Thailand News No. 54/2552 <https://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=2&cad=rja&uact=8&ved=0ahUKEwiArIrizP3KAhUJk4MKHYJPCQoQFggmMAE&url=https%3A%2F%2Fwww.bot.or.th%2FThai%2FPressAndSpeeches%2FPress%2FNews2552%2Fn5452e.pdf&usg=AFQjCNGO2Aatb_6uNzgN5c9zaVcWTiFrVA> accessed on February 16, 2016.

⁴²³ The Malaysian CIMB Group's takeover of BankThai Bank in 2009 and the Chinese multinational banking company ICBC's buyout of ACL Bank in 2010.

⁴²⁴ The Financial Sector Master Plan Phrase 2. Also there have been numerous calls and expectations for consolidation either through horizontal merger or foreign acquisition. See Suttinee Yuvejwattana and Anuchit Nguyen, 'Thai Bank CEO Sees Competition Spurring Mergers: Southeast Asia' (*Bloomberg.com*) <<http://www.bloomberg.com/news/articles/2012-06-24/thai-bank-ceo-sees-competition-spurring-mergers-southeast-asia>> accessed 12 February 2016.

⁴²⁵ The only approved acquisition so far is the takeover of the country's fifth largest lender Bank of Ayudhya (BAY) by Japan's Mitsubishi UFJ. The merger, by share purchase from private shareholders, was completed at the end of the year making the first acquisition of a domestic bank that was not under the financial rehabilitation program. Japan is the largest direct investor in Thailand contributing around 30-40 per cent of FDI each year from 2001-2012. The takeover will, it is hoped, strengthen BAY's domestic portfolio, support cross-border trade especially with Japanese counterparts, and helps the bank expand to other markets in Asia. See John Fernquest, 'Foreign Banks: Larger Role in Thailand' (<http://www.bangkokpost.com>) <<http://www.bangkokpost.com/learning/learning-from-news/359379/foreign-banks-larger-role-in-thailand>> accessed 17 February 2016.

⁴²⁶ Section 90(2), FIBA.

In all, the Thai government in the past 15 years has set as its utmost priority containing systemic vulnerabilities that infested the Thai financial sector prior to the AFC, specifically with the root-and-branch reform of financial institution licensing regime and the controlled and selective admission of foreign financial institutions into the domestic market. Primarily because of the elimination of tax and regulatory incentives of the IBFs and the largely floated value of the Thai currency, Thai banks found no reason to resume their aggressive and risky practice of raising funds in the volatile international capital market. Instead, they have since refocused onto consolidating their presence and increasing revenue channels in the domestic market. As a result, Thailand managed well to parry the full brunt of the Global Financial Crisis in the late 2000s and is now well placed to face its new challenge of financial integration alongside its South East Asian neighbors. The next section of the article explores the aforementioned ASEAN-wide project before the following part turn to investigate the potential effects on Thailand's financial standing and its long term sustainability of its financial system.

4. The ASEAN Banking Integration Framework (ABIF)

ABIF for the most parts is far less ambitious in its nature and scope than one might generally think of a regional banking union. At present, it might be somewhat a misnomer to even describe the initiative a regional integration project due to its bilateral, as opposed to multilateral, approach and flexibility afforded to the member states by the Framework Agreement. This fragmented approach is nevertheless adopted based on conscious desire of ASEAN nations and thus reflects the institutional underpinning and the overriding principle upon which ASEAN was established. Therefore, it could be argued that the understanding of such process as well as rights and responsibilities bestowed upon the member states is crucial to appraising the potential impacts of ABIF on the Thai banking sector and consequently the entire financial system.

a. Internalizing ABIF: from the ASEAN policy to domestic law

Since its establishment, ASEAN has always been operated under an intergovernmental, consensus-based model which provides a platform for economic and social development cooperation.⁴²⁷ To this end, some commentators have gone as far as arguing that under the current setting ASEAN's economic integration objectives are being achieved through discussion, consultation, and consensus which to a large extent relies on personal connection as opposed to through the Western style formal legalistic institutional framework.⁴²⁸ Yet they also argued further that a regional economic community thrives on confidence and predictability offered by a rule-based, formalistic framework, as opposed to the so-called ASEAN Way.⁴²⁹ In the area of financial and banking integration at least, evidence suggests a strategic shift towards the former. The ASEAN Economic Community (AEC) is a rule-based regional framework in which the participating member states are obligated to adopt the freedom principles enshrined in the master agreement as well as all accompanying instruments issued by the ASEAN Secretariat. On the intergovernmental level, the legitimacy of ASEAN rule-making process flows directly from the specific provisions in the ASEAN Charter, the highest constituent document of the Association. The Charter designates as the ASEAN Summit attended by the heads of government of each member state as the general agenda setting body and the ASEAN Sectorial Ministerial Bodies to elaborate the political

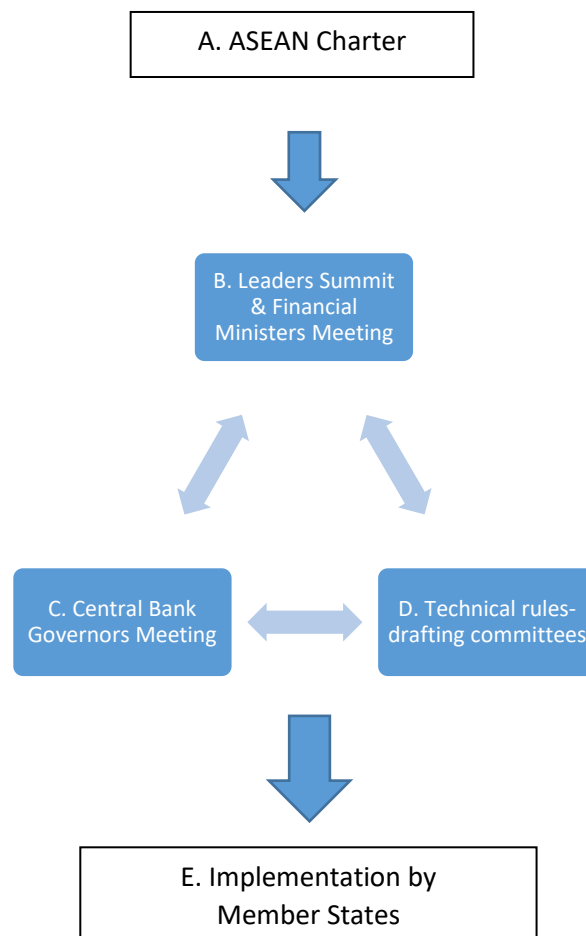
⁴²⁷ See the ASEAN Declaration (Bangkok, 1967), the Declaration of ASEAN Concord I and II (Bali 1976 and 2003), the ASEAN Economic Community Blueprints 2015 and 2025. See also Article 20 of the ASEAN Charter which states that "as a basic principle, decision-making in ASEAN shall be based on consultation and consensus."

⁴²⁸ Paul Davidson, 'The ASEAN Way and the Role of Law in ASEAN Economic Cooperation' (2004) 8 Singapore Year Book of International Law 165.

⁴²⁹ H.E. Rodolfo C. Severino Jr., ASEAN Secretary-General, "Reforms and Integration in East Asia Could Strengthen Regional Stability" (August 14, 1999), quoted in *ibid*.

agreements made during the Summit under their respective purview.⁴³⁰ Article 10(2) of the Charter also specifies further that each ASEAN Sectoral Ministerial Body may institute supporting subsidiary bodies to undertake the technical tasks of policy or guideline formulation. Once drafted, it must first be endorsed by the ASEAN Sectoral Ministerial Body and if necessary christened by the Leaders' Summit.

Legitimacy and policy-making mechanism of ABIF



⁴³⁰ Articles 8 and 10, the ASEAN Charter.

With regard to ABIF, the framework was first adopted by the ASEAN Central Bank Governors Meeting (ACGM) and endorsed by the ASEAN Finance Minister Meeting (AFMM) in 2011 as part of the effort to codify and develop the commitments to create an economic union supported by a liberalized pan-ASEAN financial market.⁴³¹ As depicted in the box above, the legitimacy of the process flows from (A) the Charter to (D) the committee of banking and legal experts. This is followed by the process of adoption and endorsement. The aforementioned expert committee proposes its draft of the texts for approval to the supervising political bodies with specific mandate of financial and banking integration (B). Various sets of standards and guidelines, for instance the ASEAN Disclosure Standards, Corporate Governance Scorecard and the ASEAN Collective Investment Schemes Handbook, have been prepared by the ASEAN Capital Market Forum, while the ASEAN Framework Agreement on Services and its various Protocols for implementation were drafted by the Working Committee on Financial Services Liberalization (WC-FSL). The framework agreement on banking integration thus is another important piece promulgated according to the ASEAN legislative procedure and added to the AEC rulebook.

The next step of the analysis is to determine the status of ASEAN instruments and agreements in the member states' domestic context. There is no mentioning in the ASEAN Charter of the ASEAN agencies' capacity to create regionally binding instruments.⁴³² The contemporary literature on international financial law would point out to the soft-law compliance mechanism such as

⁴³¹ The commitment was immortalized during the ASEAN Summit in 2003 when the ASEAN leaders signed and published the Bali Concord II creating a binding promise to work together toward the ASEAN Economic Community. The goal has since been further refined through various accompanying documents such as the AEC Blueprint 2015 adopted in 2007, and with regard to financial integration, the Road Map for Monetary and Financial Integration in ASEAN as well as the ASEAN Financial Integration Framework in 2011.

⁴³² The decisions of the Leaders Summit only amount to "policy" (Article 7(2)(a)) while the documents produced by technical supporting entities and endorsed by AFMM are considered as "reports and recommendations" (Article 10(1)(d)).

reputation, market disciplines and institutional disciplines⁴³³, yet none of these is expected to work effectively in the ASEAN context. The Association operates on a consensus-based platform with a weak institutional structure, negating any chances of instigating either formal or even informal disciplinary measures such as name and shame, economic sanctions, or withdrawal of financial and technical assistance. Moreover, the reputational and market-based punishment would further alienate the violating member state and in turn jeopardize future progress of the fledging regional community.

Mindful of these preexisting conditions and challenges, the ASEAN nations have chosen to play to their advantage relying on the core strengths of the ASEAN Community principles – flexibility policy implementation and consensus-based decision-making process – as a way to get around the potential compliance problem. Firstly, all member states are afforded time and freedom to implement the ABIF incrementally by their own accord. In 2011, when the ASEAN Central Bank Governors Meeting (ACGM) adopted the ASEAN Financial Integration Framework Agreement (AFIF) in order provide top-level guidance for the regionalization and integration initiatives. The Framework specifically states that the AEC aspires to a semi-integrated financial market by 2020. In other words, each member state defines its own initial conditions as well as the timeline of integration at their own volition. Effectively the system purposefully allows for fragmentation of financial integration in which some members may be able to join the common market sooner than those that decide to hold out for whatever reason.

This strategy ensures compliance among participating member states for two primary reasons. The fact that each individual ASEAN government is left to tailor the terms of the integration hopefully

⁴³³ See for instance Brummer (n 234). at 138-156.

means that it is less likely to overpromise certain undertakings that may turn out to be economically, legally, and politically infeasible. The ASEAN Framework Agreement on Services (AFAS), under which the banking integration initiatives fall, also has a procedure in place to facilitate the transposition of intergovernmental commitments into domestic laws. AFAS dictates that the technical and high-level negotiations conclude with all ASEAN finance ministers undersigning a series of protocols detailing the schedule of specific commitments for each individual member state.⁴³⁴ The protocol dictates that the member states must carry out their respective internal procedure to enforce the protocol and the commitments contained therein within 90 days from the date of the signing.⁴³⁵ Under the governance principles of ABIF approved by central bank governors, ASEAN member states have agreed to be extraordinarily patient with the pace of integration and liberalization such that the 2015 Protocol which authorizes the implementation of ASEAN banking integration exempts the member states from Article X of the AFAS which sets a minimum three-year requirement for modification or withdrawal of Schedules of Specific Commitments. In other words, two member states will be allowed to conclude negotiations at their own pace if they so wish.⁴³⁶

In order to ensure the aforementioned flexibility, ABIF is advanced on a bilateral basis as a pair of member states enters into their own negotiation based on the principles of mutual recognition and reciprocity.⁴³⁷ This is extremely crucial in the ASEAN context of a financially diverse cohort of

⁴³⁴ See for instance the Annexes to the Protocol to Implement the Sixth Package of Commitment on Financial Services under the ASEAN Framework Agreement on Services, March 20, 2015.

⁴³⁵ Para 6 of the Protocol to Implement the Sixth Package.

⁴³⁶ Para 5 of the Protocol to Implement the Sixth Package.

⁴³⁷ Article V(2) of the AFAS.

countries for which uniform standards or rules are believed to be counterproductive and appealing only to the lowest common denominator. Additionally, ASEAN as a bloc still lacks necessary resources to effectively monitor, and enforce its rules upon member states.⁴³⁸ By contrast, the bilateral strategy is less time and resource consuming in a consensus-based approach preferred by the ASEAN member states. It appears more politically palatable to the voting public since the national governments retain their autonomy over their own legislative and regulatory process. Furthermore, it allows for national regulatory policies to change over time without the need to amend the outstanding bilateral agreement so long as the prospective changes are compatible therewith. As a consequence, the member states should expect less oppositions from their own domestic banking sector and the general public than they might otherwise have faced with an implementation of a uniform harmonization program.

b. The Qualified ASEAN Banks (QABs) Scheme

At the heart of the ABIF which comes into force along with the AEC on December 31, 2015, is the Qualified ASEAN Banks Scheme or QABs. The number of QABs is considered as a measure of success of the ASEAN banking integration.⁴³⁹ A QAB license can be issued by the ASEAN host country's banking regulator after an applying financial institution passes certain pre-determined requirements set by both the bilateral agreement and the domestic regulatory rulebook. The QABs Scheme has been designed to achieve the main objectives of the ABIF – to provide

⁴³⁸ Pierre-Hugues Verdier, 'Transnational Regulatory Networks and Their Limits' (2009) 34 Yale J. Int'l L. 113. at 134-137.

⁴³⁹ This of course has been a contentious issue since AFAS, under which ABIF posits, allows for other variables as measures of banking integration such as cross-border bank flows, consumption abroad, the movement of bank professionals, to name but a few. See Joko Siswanto and others, 'Debate over ASEAN Banking Integration' (Jakarta Post, 4 June 2012) <<http://www.thejakartapost.com/news/2012/06/04/debate-over-asean-banking-integration.html>> accessed 20 February 2016.

market access and operational flexibilities in ASEAN member states for qualified banking institutions.⁴⁴⁰ Supplementary to the QAB regime, the home-host regulatory and supervisory cooperation arrangements are established between two negotiating member states in order to maintain the effective surveillance and supervision of QABs.⁴⁴¹ The QAB guideline has been endorsed by ASEAN Finance Ministers in March 2015 and will provide the framework for any two ASEAN countries to enter into reciprocal bilateral agreements to allow their respective QABs to operate across the borders without being subject to additional regulatory burdens of the host country.⁴⁴²

To that end, the framework addresses the prerequisites of banking integration for both private banks and national regulators in turn. With regard to the former, a QAB must be an *indigenous ASEAN bank*, meaning it shall (1) be incorporated in one of the ASEAN member states, (2) do business in ASEAN countries, and (3) be under ownership of ASEAN citizens.⁴⁴³ The QAB eligibility criteria requires further that the bank must demonstrate strong and resilient financial foundation by being adherent to the prevailing international prudential standards.⁴⁴⁴ It is expected

⁴⁴⁰ Para 9, Joint Statement of 1st ASEAN Finance Ministers' and Central Bank Governors' Meeting (AFMGM), Kuala Lumpur, Malaysia, March 21, 2015.

⁴⁴¹ On top of the bilateral surveillance and supervisory cooperation, ASEAN+3 Macroeconomic Research Office (AMRO) mandated under the Chiang Mai Initiative Multilateralization provides the on-going monitoring of the entire East Asian region for signs of possible systemic vulnerabilities that could threaten safety and soundness of the region's financial systems. More on the role of AMRO and CMIM in Section 5 below.

⁴⁴² This guideline has not yet been available to the public. The 1st AFMGM concluded by releasing the Protocol to Implement the Sixth Package of Commitments on Finance Services under the ASEAN Framework Agreement (AFAS) on Services with its annexes specifying specific steps that would be undertaken by each individual member states to fulfill their respective obligations under AFAS. The Meeting also released a Joint Statement which announces the conclusion of ABIF and merely provides a brief account of what ABIF entails. Most of the information regarding ABIF was therefore gathered from secondary sources currently available.

⁴⁴³ Joint statement by Bank Indonesia (BI) and Indonesia's Financial Service Authority (OJK) "Indonesia Agrees to Support ASEAN Banking Integration."

⁴⁴⁴ *Ibid.*

that the exact details of the minimum thresholds such as the capital adequacy requirements may be further negotiated on the bilateral basis.⁴⁴⁵ On the other hand, the framework prescribes two governing principles to which the ASEAN member states must adhere. Firstly, ASEAN leaders agreed to adopt **the three dimensional framework of equality** as a prerequisite condition for the AFIF including the ABIF.⁴⁴⁶

1. Equal access. There shall be no barrier to entry for all banks that obtain the QAB status from their respective home regulatory authorities based on the minimum qualifications set in ABIF and the bilateral agreement. There are five key areas of regulation that must be considered during the bilateral negotiation round: (1) capital adequacy requirements, (2) consolidation requirements and authority for consolidated supervision, (3) restrictions on large exposure, and (4) accounting and transparency requirements.⁴⁴⁷ Depending on the readiness of each pair of negotiating member states, the ABIF envisages the liberalization of cross-border wholesale banking activities subject to the same licensing regime as locally incorporated wholesale banks in the host country. The liberalization of wholesale banking activities could potentially have regulatory implications to another ASEAN financial services integration initiative, namely the ASEAN Collective Investment Scheme (CIS) Framework, since a large number of CIS are administered by banks. Asian Development Bank (ADB) foresees the minimum qualifications set by the ABIF and upcoming bilateral

⁴⁴⁵ In the past, some member states accused the others of using prudential regulation as a barrier to entry measure. For instance, the Indonesian authorities have accused their Malaysian counterpart of using the minimum initial capitalization requirement (of at least 300 million in Malaysian currency Ringgit) as a protective tool preventing Indonesian banks of operating in Malaysia.

⁴⁴⁶ The Road to ASEAN Financial Integration: A Combined Study on Assessing the Financial Landscape and Formulating Milestones for Monetary and Financial Integration in ASEAN. 2013 Asian Development Bank, at 10-12.

⁴⁴⁷ Ibid. at 11

agreements will provide incremental if not uniform benchmarks for regulatory harmonization in the banking industry which in turn accelerate the full integration of banking markets in the region.⁴⁴⁸

2. Equal treatment. The host regulators shall monitor the activities of both QABs and domestic banks based solely on the intended purposes of such activities, and potential risks to which the host country's financial sector may be exposed. In addition to the inherent risk associated with different banking practices, the host country authority may assess each individual bank, both domestic banks and QABs, for their capacity to manage such risks. In other words, the equal treatment principle advocates the risk-based approach to financial regulation.
3. Equal environment. ADB advocates that while the QABs scheme should be for now utilized as an indirect banking integration strategy due to various preexisting constraints inherent in the ASEAN banking sectors, in the long run the region will benefit from a uniform regulatory environment. ADB further prescribes a two-part approach to the equal environment principles. Firstly, it identified four main areas to streamline potential regulatory and supervisory conflicts between the home and host country authorities: (1) banking accounting standards and disclosure, (2) restrictions on internal transfer of asset and liability in bank group for the purpose of regulatory arbitrage, (3) coordination on prompt corrective action, and (4) risk management regulations.⁴⁴⁹ These matters, the Bank further advised, should be brought on the agenda of the ASEAN leaders for pan-regional regulatory harmonization, rather than being left to the bilateral negotiation under ABIF.

⁴⁴⁸ Ibid. at 11.

⁴⁴⁹ Ibid. at 11.

Secondly, complete banking integration depends on the more advanced member states and other stakeholders to provide assistance and cooperation to the member states with a less developed banking industry. In this intervening period however, the latter should be allowed to opt out of the program until such time that they have put in place necessary infrastructure to support the consequences of banking integration.

The second important concept governing ABIF is **the reciprocity principle** which is derived from the well-established international law doctrine.⁴⁵⁰ It was incorporated into the ABIF at the conclusion of the ASEAN Central Bank Governors Meeting (ACGM) in 2014 and endorsed by the joint meeting between ASEAN finance ministers and central bank governors in March 2015.⁴⁵¹ Although the Joint Declaration of ASEAN Finance Ministers and Central Bank Governors states merely that any two ASEAN countries may enter into a *reciprocal bilateral agreement* to regionalize their banking sectors, further details regarding what the reciprocity principle under the ABIF might entail emerged during the negotiation between the representatives from the central banks of Indonesia, Malaysia, and Singapore in late 2014 in the running up to the adoption of ABIF.⁴⁵² In gist, reciprocity refers specifically to *a balance in the number of QABs allowed to operate in ASEAN members*. For instance, if the Bank of Thailand allows two Malaysian banks into its banking sector, the Malaysian regulatory counterpart must reciprocate and admit at least

⁴⁵⁰ See Simma Bruno, *Reciprocity*, in Rudiger Wolfrum (ed), *The Max Planck Encyclopedia of Public International Law* (Second Edition, Oxford University Press 2013) <<https://global.oup.com/academic/product/the-max-planck-encyclopedia-of-public-international-law-9780199689651>> accessed 20 February 2016.

⁴⁵¹ Para 5, Joint Statement of the 1st AFMGM.

⁴⁵² Editorial, 'Reciprocity in ASEAN Banking' *Jakarta Post* (8 December 2014) <<http://www.thejakartapost.com/news/2014/12/08/editorial-reciprocity-asean-banking.html>> accessed 20 February 2016; 'Reciprocal Expansion of Indonesian Banks in Malaysia' <<http://www.globalindonesianvoices.com/23979/reciprocal-expansion-of-indonesian-banks-in-malaysia/>> accessed 19 February 2016.

two qualified Thai banks. This governing principle was borne out of frustration that a few ASEAN member states seem to have “gold-plated” their requirements which became impossible for smaller foreign banks to obtain a local banking license.⁴⁵³ Lastly, the ABIF also allows banks from the ASEAN member states which have already been in operation in other ASEAN countries to automatically qualify as QABs in respective of those particular countries. In other words, once the ABIF comes into full effect in 2020, all ASEAN banks that have been operating in more than one ASEAN markets outside their respective own home countries will automatically acquire the status of QABs *regardless of* the absence of the home-host reciprocal bilateral agreement.⁴⁵⁴

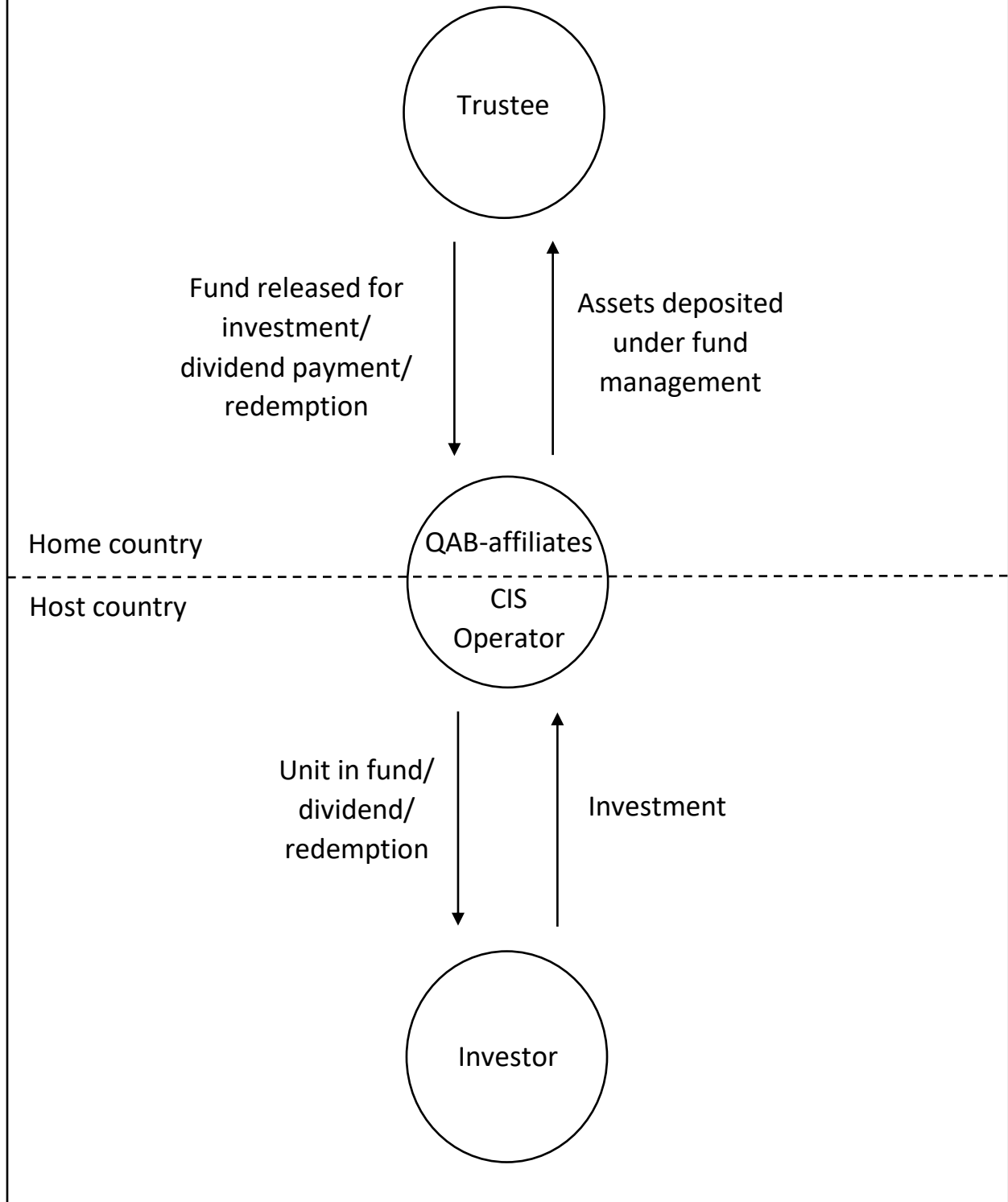
c. ASEAN Capital Markets Harmonization: ASEAN banks and Collective Investment Scheme (CIS)

The ASEAN Collective Investment Scheme Framework is an initiative undertaken by the ASEAN Capital Market Forum (ACMF) as part of the regional capital market integration plan endorsed by the ASEAN Finance Ministers Meeting in 2009. The framework requires participating capital market regulators to internalize the CIS Framework according their respective legal and regulatory procedure and allows qualified operators to market and offer financial products such as shares in funds or investment schemes and vehicles under their management directly to both retail and sophisticated investors in the host countries, of which currently only Malaysia, Thailand, and Singapore are participating.

⁴⁵³ At present, the Malaysian central bank, Bank Negara Malaysia (BNM), imposes a minimum initial capitalization of 300 million Malaysian Ringgit for foreign banks to operate a full-branch service in Malaysia. Such requirement has been labelled during the ABIF negotiation as protectionist by the Indonesian contingents. See Grace D Amianti, ‘Agreement to Give Indonesian Banks Leeway in Malaysia’ *The Jakarta Post* (9 February 2016) <<http://www.thejakartapost.com/news/2016/02/09/agreement-give-indonesian-banks-leeway-malaysia.html>> accessed 20 February 2016.

⁴⁵⁴ Editorial (n 453).

A stylized depiction of ASEAN CIS after ABIF



While this initiative is technically not part of the ABIF, it could potentially expand the scope of banking activities under the ABIF significantly. In essence, ASEAN banks may play at least three roles in this new fledgling regional regime. First, an ASEAN bank could potentially incorporate a separate company to operate as a CIS operator subject to licensing and registration requirements in the ASEAN constituent documents including the Standards of Qualifying CIS (SQC)⁴⁵⁵ as well as all applicable laws of the home jurisdiction. As the law stands currently, the CIS manager is required establish a local affiliated entity in the host country and obtain necessary local license to run such business and in order to take advantage of the ASEAN CIS Passport and to offer CIS in other ASEAN markets.⁴⁵⁶ As soon as the ABIF comes into force in 2020 or whenever the relevant reciprocal bilateral agreement under such framework takes effect, all CIS operators which are also qualified as QABs may set up local full-service branches in the host jurisdiction and be regulated as if they were locally incorporated banks with minimal or no entry requirements. Lastly, a QAB may also act as a CIS trustee or supervisor subject to both the ASEAN harmonized rules and any applicable additional local laws and regulations including the requirement of independence between the trustee or fund supervisor and the CIS operator as well as the applicable rules on custody of fund assets.⁴⁵⁷

⁴⁵⁵ Memorandum of Understanding on Streamlined Authorization Framework for Cross-Border Public Offers of ASEAN Collective Investment Scheme, October 1, 2013, available at <http://www.theacmf.org/ACMF/upload/standards_of_qualifying_cis.pdf> accessed February 20, 2016.

⁴⁵⁶ SQC prohibits cross-border offering of a qualifying CIS, see Section 8.1, the Standards of Qualifying CIS. For instance, a Singapore-qualified CIS operator may decide to establish a brokerage firm, a bank, or management company to market and sell CIS in Thailand as long as it has obtained necessary license to operate such business from the relevant Thai regulatory authorities. See the Handbook for CIS Operators of ASAEAN CISs, August 25, 2014, at 19, available at <http://www.theacmf.org/ACMF/upload/asean_cis_handbook.pdf>, accessed on February 20, 2016.

⁴⁵⁷ Sections 2 and 3, the Standards of Qualifying CIS.

Specifically with regard to the offer of ASEAN CIS in Thailand as a host jurisdiction, while Foreign ASEAN CIS is exempted from the provisions of public offering for sale of securities under the Securities and Exchange Act of 1992, it could still not be offered to the Thai public without preparing the ASEAN CIS fact sheet in accordance with the Notification of the Office of the securities and Exchange Commission (SEC) and receiving an explicit approval from by the SEC.

5. ABIF and Potential Impacts on the Thai Financial System

While the last section explores the ASEAN (quasi) rule making process of the ABIF, this part investigates how these ambitious banking integration initiatives could potentially alter the current infrastructure of the Thai domestic banking sector including the local regulatory framework in Thailand. As demonstrated above, the Thai government has since the 1997 Crisis developed a cautious approach to the banking and financial sector reforms preferring the consolidation of financial autonomy over unfettered financial expansion. In addition, the Bank of Thailand has accumulated one of the world's largest reserve holdings⁴⁵⁸, as well as encouraged Thai banks to raise funds internally, as opposed to excessively relying on the volatile international capital market.⁴⁵⁹ On the other hand, the primary premise of ASEAN economic integration is that there are huge potential upsides to be gained from market regionalization from both demand and supply elements of the ASEAN economy. Even though the ASEAN leaders are certainly mindful of the downside risks of future crises and have thus tried to instigate *ex ante* safety measures, existing

⁴⁵⁸ Thailand has the second largest holdings of foreign exchange reserves in South East Asia (after Singapore) and 13th largest in the world, while the GDP is ranked 2nd in ASEAN (behind Indonesia) and 29th in the world in 2014. Sources: IMF and World Bank.

⁴⁵⁹ The cautious and sensible approach to financial advancement in Thailand was echoed by the new central bank governor, Dr. Veerathai Santiprabhob, in December 2015 when he spoke of the need to balance the priorities between implementing the upcoming ASEAN financial integration initiatives and maintaining safety and soundness of the financial system. See 'Veerathai Santiprabhob: Monetary Policy and Financial Sector Development Policy of the Bank of Thailand' (29 December 2015) <<http://www.bis.org/review/r151229a.htm>> accessed 9 February 2016.

institutional constraints both within ASEAN itself and in the international financial community currently render these preemptive arrangements less effectively and thus theoretically could expose systemic vulnerability in the ABIF paradigm. This section explores this claim in three areas closely associated with the ASEAN banking integration: (1) regulation and supervision of QABs, (2) potential systemic risks in the ASEAN capital markets, and (3) the effectiveness of the regional crisis resolution mechanism.

a. *Delineation of QAB authorities between home and host regulators*

Unlike the Indonesian and Malaysian authorities which have already begun their bilateral negotiation, the Bank of Thailand has so far exercised restraint over the QAB regime. The current policy is geared towards supporting Thai businesses overseas by facilitating the Thai banking expansion in the ASEAN markets with significant Thai corporate presence. This trade and investment oriented approach reflects the long-standing principle in the Financial Sector Master Plan Phase I and II (2004-2014). As a consequence, the following analysis has to be based primarily on the existing Thai banking laws and regulations complemented by ASEAN formal documents including press release materials and high ranking official interviews.

The delineation of authorities between home and host country regulators under ABIF raises an important concern of systemically important nature. As observed by LTF-inspired researches on various financial market developments around the world⁴⁶⁰, both construction and destruction of financial market can be instigated by small alterations in the existing infrastructural landscape creating loopholes for market opportunists to arbitrage.⁴⁶¹ In the hypothetical context of Thailand

⁴⁶⁰ For instance, the global foreign exchange market, see Harvey (n 9). For the development of OTC derivative sector, see Awrey (n 21). And for the sovereign debt market, Gelper and Gulati (n 403).

⁴⁶¹ Pistor, 'A Legal Theory of Finance' (n 18).

under the QAB framework, the Ministry of Finance and the Bank of Thailand face the delineation challenges in three stages which are grouped under the two following headings.

i. Regulation of the entry point to the domestic banking sector

The most crucial aspect of the ABIF is to provide freedom of entry, on a reciprocal basis, to QABs to establish either full function branches or locally incorporated subsidiaries in the host jurisdiction. Currently, the Thai government uses the regulation of foreign bank entry as a way to control foreign dominance in the banking sector in order to both afford local institutions to sufficiently enhance their competitiveness and prevent its financial system from becoming over-reliance on foreign banks. Under the statutory powers in the Financial Institutions Business Act of 2008 (FIBA), the Finance Minister with recommendation from the central bank governor may refuse admission or award a license to any applying foreign bank.⁴⁶² In addition to demonstrating the business strategy and the safety and soundness of the head office, the foreign bank is required under s.32 of FIBA to maintain a minimum regulatory capital ratio of 8.5 percent of total risk-weighted assets.⁴⁶³ The Bank of Thailand stated in the preamble of the Notification⁴⁶⁴ that this entry as well as ongoing prudential requirement is especially necessary for foreign bank branches

⁴⁶² Ss.10 and 13, FIBA.

⁴⁶³ The Bank of Thailand's Notification No. 14/2555 Re Components of Capital of Branches of Foreign Commercial Banks, dated November 27, 2008. The Notification prescribes many forms of government- or government agency- issued instruments, however the vast majority of foreign banks have chosen to maintain their minimal capital requirement in form of central bank bonds and usually at the level significantly higher than the regulatory threshold. See for instance, the Bank of America Bangkok Branch maintained around 15.38 per cent (updated June 30, 2013) while JP Morgan Chase Bank Bangkok disclose 18.38 per cent in its mid-2014 disclosure. Sources: Pillar Three of Basel II disclosure documents, <http://corp.bankofamerica.com/documents/10157/218572/semi_annual_disclosure_june_30__2014.pdf> and <https://www.jpmorgan.com/cm/BlobServer/thailand_baselIII_PillarIII_31Dec14.pdf?blobkey=id&blobwhere=1320694379087&blobheader=application/pdf&blobheadername1=Cache-Control&blobheadervalue1=private&blobcol=urldata&blobtable=MungoBlobs>, accessed February 22, 2016.

⁴⁶⁴ A form of secondary legislation issued by Thai sectoral regulators and required an enabling primary legislation which in this case is FIBA.

which were not incorporated under the Public Limited Company Act and thus are not subject to the minimum registered capital contained therein.⁴⁶⁵ Furthermore, the Bank of Thailand views the capital charge for foreign branch as a guarantee or bond since it has no jurisdiction over the affairs of the entire bank group.⁴⁶⁶

With regard to the entry regulation of locally incorporated foreign subsidiaries, the Bank of Thailand seeks the power under s.16 of FIBA to regulate the ownership of domestically incorporated banks.⁴⁶⁷ As a general matter, licensed commercial banks in Thailand must be at least 75 per cent owned by Thai nationals, the threshold which can be further relaxed to 51 per cent.⁴⁶⁸ However the section empowered the central bank to approve foreign takeovers of Thai banks which are deemed to be in the interest of the country. For a long time, the Bank has relied on this broad exception to manage the legacy bridge banks the government nationalized in the aftermath of the AFC. In 2013, the ownership limit was lifted to allow Japanese Mitsubishi UFJ to purchase a majority stake in the fifth largest bank, BAY.⁴⁶⁹ This deal, while historic in its size and nature, does not represent a shift in the regulatory attitude of the Thai central bank who continues to use the power under s.16 to manage foreign presence in its banking sector.

⁴⁶⁵ The Bank of Thailand's Notification No. 14/2555

⁴⁶⁶ Ibid.

⁴⁶⁷ In addition, the Bank of Thailand prescribes a set of prerequisites, found in Ministry of Finance's Notification Re Principles, Procedures, and Conditions of Applying for License to Operate A Foreign Commercial Bank's Subsidiary, November 15, 2011. The applying foreign bank must demonstrate a track record of strong financial and management history. Furthermore, once approved, the subsidiary is required to have registered paid up capital of at least 10 billion baht.

⁴⁶⁸ Para 2 s. 16, FIBA

⁴⁶⁹ This was approved by the Bank of Thailand according to the s.72 procedure of FIBA.

With the ABIF in place, it is expected that the barriers to entry will be significantly lowered if not dropped. The initial capital surcharge may be a subject of contention on the ground of reciprocity especially if Thai banks have already been permitted into the negotiating member state's jurisdiction which has more business friendly entry requirements.⁴⁷⁰ On the other hand, it could be argued that the current entry threshold is reasonable and sound, aligning well with the internationally accepted standards notably the capital adequacy requirements under the Basel II Accord (and soon the Basel III), although the foreign bank branch applicants would be expected to demonstrate their capacity to set aside capital reserves at a significantly higher level than the prescribed bottom line. The s.16 ownership limitation on the other hand would likely be superseded by the bilateral agreement under the ABIF. Liberalization of access to the market for foreign-owned ASEAN banks is the cornerstone of the ASEAN economic integration project. In order to regain some control over the entry requirement regime, the Thai negotiators must press their counterparts on putting in place the eligibility criteria of QAB that are at least as comparable to if not better than the existing regime in Thailand.

Another noteworthy market entry issue concerns the so-called ASEAN-ization of non-ASEAN banks. A fragmented national banking regulatory landscape could potentially incentivize banks from other regions to forum-shop for the most cost-effective ASEAN jurisdiction to enter by acquiring a relatively small local institution and then expand to other fast growing neighboring economies through acquiring the QAB status. While it is true that ASEAN countries including Thailand have hosted a number of systemically important global banks for a long time, their national regulators are able to limit their exposure to external risks through various institutional

⁴⁷⁰ This precise issue is currently brought up to the debate by the Indonesian central bank who is protesting Malaysia's onerous capital maintenance threshold for foreign banks. Their QAB agreement negotiation is ongoing and expected to be the first bilateral agreement signed under ABIF. See Amianti (n 454).

and market controls which would no longer be legal, should all the regionalization programs under the AEC come into force.⁴⁷¹ In absence of a transregional financial authority, it may still be wise if the ASEAN countries are still allowed to insist upon the capital adequacy requirement appropriate to the perceived risks the financial system takes on. Furthermore, supervisory and surveillance cooperation between the collegiate of ASEAN regulators and the regulators of major financial markets needs to be formalized.⁴⁷²

ii. Ongoing surveillance and ex-post management of troubled QABs

Once a QAB gains access to the host jurisdiction, it is then subject to various ongoing regulatory compliance obligations, three areas of which are worthy of discussion. No significant change in current continuing regulation and compliance is expected in the first area, while there is a real concern regarding potential systemic risks from the other two. With regard to prudential regulation, all locally incorporated QABs must comply with prudential requirements under Ss. 29-31 of FIBA just like their native Thai bank counterparts while all foreign bank branches fall under the s.32 jurisdiction as articulated above. The QAB framework as currently planned does not interfere with the home-host regulatory authority allocation of responsibilities, therefore the Thai authorities are

⁴⁷¹ In 2013, the Minister of Finance ordered a drafting of a new regulation which would discourage the short-term capital inflows and require foreign investors to hedge certain Thai baht-denominated investment. It is uncertain whether such restrictive measures would be legally feasible under the capital account liberalization framework under AFIF in 2010. See James Hookway And Nopparat Chaichalearmmongkol, 'Thailand Wrestles With Currency Woes' *Wall Street Journal* (28 May 2013) <<http://www.wsj.com/articles/SB10001424127887323855804578510501300025748>> accessed 22 February 2016.

⁴⁷² At present, Indonesia is the only ASEAN member state with a permanent membership (while ASEAN as an organization receives "permanent guest invitation" and is usually represented by the summit chair and the general secretary with no ASEAN central bank representation) in the G-20 forum which since the Global Financial Crisis of 2008-9 has taken the leading role in coordinating the new global financial standards on prudential regulation among other important areas.

likely to continue assuming the principal role in prudential regulations and ongoing disclosure requirements for both foreign branches and subsidiaries.⁴⁷³

Nevertheless, since QABs may finance their operation by taking deposits from the public and then invest in a relatively wide range of financial assets, the systemic risk implications arising from these activities should be addressed. From the depositor protection point of view, it is still debatable whether the home or host authorities should be primarily obligated to provide the minimum deposit guarantee scheme in the host country in case of a QAB failure. According to the Thai law, foreign bank branches as well as foreign bank subsidiaries, which fall under the broad definition of financial institution⁴⁷⁴, are legally compelled to contribute to the pre-funded deposit protection pool at a variable premium rate set annually by the Deposit Protection Agency.⁴⁷⁵ Therefore, their customers' deposits should theoretically be covered just as the depositors of native Thai banks are.⁴⁷⁶ Yet as we have seen many times in past crises, the crisis-hit government inevitably ended up extend the coverage, often on an unlimited basis, in order to preempt further bank runs and reinstall market confidence that it possesses sufficient backstopping resources to stand behind the financial system. This is a real issue of systemic concern for Thailand regardless

⁴⁷³ Foreign subsidiaries as well as native Thai banks must comply with the s.67 obligation of FIBA while foreign bank branches are subject to a separate regime in s.68.

⁴⁷⁴ The definition of financial institution found in Ss. 3 of Deposit Protection Agency Act of 2008 (DPAA) defers in part to the definition of commercial bank, finance company, and credit foncier company under FIBA. Under S.4 of FIBA, commercial bank is defined as all public limited company licensed to undertake commercial banking business and shall include a retail bank, a foreign commercial bank's subsidiary and a foreign commercial bank's branch licensed to undertake commercial banking business.

⁴⁷⁵ Ss 49, DPAA.

⁴⁷⁶ The deposit guarantee claim procedure may only take place after the revocation of the failed bank's license and the announcement of the claim period by DPA, after which the eligible deposits have 30 days to file their claims for up to 1 million baht (approx. US\$28,500). This maximum limit shall cover the aggregate sum (deposits plus accrued interest denominated in Thai baht) of all accounts under the name of the claimant. Ss. 52 and 53, DPAA.

of the available foreign reserves, since Thailand and other countries in the region are limited by hard budget constraint. In other words, they are still subject to the same hierarchical structure of global finance and must rely on currencies issued by other states to satisfy their external liabilities. In the face of hard budget constraint, the conundrum could then arise as to whether the government should prioritize native banks over subsidiaries or branches of foreign banks. Furthermore, the deposit guarantee scheme in this nature, while perfectly sensible from the domestic public interest point of view, can be construed as prioritizing home depositors over host ASEAN depositors of home country's QAB operating and failing in its neighboring ASEAN member states. In absence of a coordinated ASEAN-wide deposit guarantee mechanism, one can foresee a crisis situation arising within the ABIF in which two member states argue over whose depositors should be bailed out first. In fact, this issue could be even more complicated under the context of the somewhat convoluted ASEAN adjudication mechanism⁴⁷⁷ which is not a permanent court and has no body of past judgements and supporting doctrines required to strike the right balance between financial stability and consumer protection.

The flipside of the deposit taking business is the bank investment operation. Virtually all banking crises in the history are rooted in the failure to prevent profiteering investment enterprise from compromising the bank's ability to honor on-demand liabilities – in other words the failure of “double ownership” of modern banking.⁴⁷⁸ Due to its fragmentation of regulatory oversight of

⁴⁷⁷ The ASEAN Charter compels the disputing parties to first find an amiable solution through mediation. Otherwise, it mandates the 2004 Protocol for Enhanced Dispute Settlement Mechanism (EDSM) to appoint an ad hoc panel and appellate review body to adjudicate the conflict.

⁴⁷⁸ What the economists call “maturity mismatch” is in essence the conflict of quasi ownership of deposits by depositors (memorialized in the form of contractual IOU but with a special ability to withdraw at par value on demand) and by bank (represented by its possession and ability to reuse the sum for profit almost at will, bar regulatory intervention). See Kim, ‘Money Is Rights in Rem’ (n 120).

banks' investing activities the QAB regime could lead to this problem. Despite the early stage of negotiation, the framework seemingly leaves the discretion to regulate QABs' investment activities to the host regulators.⁴⁷⁹ This situation theoretically allows for an opportunistic QAB to raise money in a cash-rich ASEAN member state before investing it through various subsidiaries incorporated in other member states that attract foreign capital in exchange for high return on investment. As an illustration, the Bank of Thailand through a series of Notifications gradually permit its regulated banks to engage in non-traditional financial transactions primarily in order to hedge against changing market conditions but also increasingly for profit maximization.⁴⁸⁰ In addition, the Thai Securities and Exchange Commission is considering a proposal to allow mutual funds including ASEAN CIS to hedge more than 100 per cent of the value of securities or assets in order to generate more income.⁴⁸¹ It is therefore not difficult to extrapolate a situation in which a number of QAB-sponsored CIS invest in the highly volatile and sophisticated financial products, thus creating such condition that put the entire ASEAN financial system at risk.

Ultimately, the issue goes back to the original question posed at the beginning of the article, namely what kind of financial market the ASEAN Community aspires to cultivate? If the plan is to have the ASEAN financial framework that supports intra trade and investment-related endeavors, then the ASEAN leaders may be well advised to design the regional architecture that reflects that objective, for instance by instituting blanket bans curtailing certain risky activities which could

⁴⁷⁹ This conclusion can be inferred from the governing principle of mutual recognition enshrined in ABIF.

⁴⁸⁰ For instance, the Notifications No. 08/2551 Re Permission for Financial Institutions to Engage in Securitization (2008), No. 09/2551 Re Permission for Commercial Banks to Engage in Collateralized Debt Obligations, and No. 15/2015 Re Permission for Commercial Banks to Engage in Structured Products.

⁴⁸¹ 'Thai OTC Derivatives Market Set To Open Up To Accredited Investors' <<http://asiaetrading.com/thai-otc-derivatives-market-set-to-open-up-to-accredited-investors/>> accessed 20 February 2016.

potentially put the entire region in jeopardy. On the other hand, if the goal of the Community is also to develop a globally competitive financial sector rivalling other world financial centers in term of market size, depth and innovation, this development path requires a different kind of fail-safe mechanisms which should be designed specifically to safeguard the public interest in the event that the system will crash at some point in the future. There are already proposals available for consideration based on comparable experiences of regional banking unions in other parts of the world, notably the British Vickers Report's ring-fencing proposal of retail banking against more risk-tolerant wholesale banking sector. Furthermore, the ABIF should also go further than its current plan to harmonize pre-emptive regulatory tools such as prompt corrective action (PCA)⁴⁸², but rather institute a regional collegiate system of national regulators that is mandated to issue PCA and other measures as it sees fit to prevent a potential collapse of the ASEAN financial system.⁴⁸³ Fortunately, except for the market access provisions ABIF still affords the member states ample room for further cooperation on enhancing the necessary safeguarding measures both at the multilateral level and through bilateral negotiation.

⁴⁸² Asian Development Bank, *The Road to ASEAN Financial Integration* (Asian Development Bank 2013) <<http://www.adb.org/publications/road-asean-financial-integration>> accessed 23 February 2016. at 11.

⁴⁸³ ASEAN can take inspiration from the now institutionalized Vienna Initiative II, a collegiate of Eastern European central banks, representatives of major banking institutions in the region, and relevant international financial institutions such as the IMF, the ECB, and the EBRD. It provides a unique public-private sector forum aimed to monitor banking and financial development in the region as well as resolve systemic banking failure. See a detailed discussion on the success of the initiative during the Global Financial Crisis of 2008-9 in Pistor, 'Governing Interdependent Financial Systems' (n 15); Ralph De Haas and others, 'Taming the Herd? Foreign Banks, the Vienna Initiative and Crisis Transmission' [2014] *Journal of Financial Intermediation* <http://trafficlight.bitdefender.com/info?url=http%3A//www.sciencedirect.com/science/article/pii/S104295731400031X&language=en_US> accessed 14 May 2015.

b. Chiang Mai Initiative Multilateralization: the new regional fail-safe emergency facility

If a country opts to have a regionalized financial system, expect an interconnected financial crisis. This should be Thailand's number one reminder as it embarks upon implementing its obligations under the ABIF. By realizing a regional banking union, ASEAN member states will have raised a possibility of "regionally systemically important banks (R-SIBs)".⁴⁸⁴ During a financial crisis, the international capital market could become reluctant to continue lending to R-SIBs due to the uncertainty over their true financial conditions and immediate macroeconomic outlooks of their home ASEAN nations. With borrowing rates skyrocketing in order to absorb the sharp spike in counterparty risk, R-SIBs may be unable to sustain the cost of borrowing. While their respective home ASEAN countries could provide local currency to their banks, their ability to supply foreign currency though will be limited by the amount of international reserves they hold. This case of foreign currency funding of certain interconnected banks could easily turn into the balance of payments difficulties affecting the entire regional economy. In addition to its depleted foreign reserves, Thailand's only available option during the 1997 Crisis was the IMF-led financial assistance which was in hindsight found to be counterproductive.⁴⁸⁵ Currently, Thailand along with its ASEAN allies can also count on the Chiang Mai Initiative Multilateralization (CMIM), a pool of post-funded swap arrangements linking up the ASEAN region with its major trading and investment partners in East Asia, namely China, Japan, and South Korea. Using the LTF analytical framework, this section attempts to answer two questions; firstly, whether the country is now in a

⁴⁸⁴ Currently, Thailand has a subsidiary of a Bucket-2 globally systemically important bank (G-SIBs) in Bank of Ayudhaya which was taken over by Mitsubishi UFJ Financial Group.

⁴⁸⁵ The IMF conceded the flaws in its financing framework and initiated a reform in September 2008. See Hagan (n 372). at 58.

better, more resilient position to cope with future balance of payments crises under this new regional arrangement; and secondly, whether the presence of CMIM reduces the need for reserve accumulation.

An important aspect of global finance as observed by LTF is that it is inherently hierarchical.⁴⁸⁶ In other words, the countries or institutions that populate the apex of the global financial architecture have the authorities to affect the rules in the international market⁴⁸⁷ and crucially for the present purpose have the resources to extend financial support to others, including setting terms and conditions of such support, without being legally obliged to do so.⁴⁸⁸ Despite the Chinese Renminbi's growing prominence in international trade⁴⁸⁹, the US dollar remains the final means of settlement and thus the foundation of the international financial system.⁴⁹⁰ Due to the US dollar overwhelming supremacy, the foreign exchange market can be seen in term of the price of US dollar while all other currencies are considered promises to pay in US dollars.⁴⁹¹ As a consequence,

⁴⁸⁶ Pistor, 'A Legal Theory of Finance' (n 18).

⁴⁸⁷ The influence come from two sources. Firstly, the apex countries' domestic legislative and regulatory changes directly affect global financial institutions as well as globalized sectors of financial market (for instance, the foreign exchange market) under its jurisdiction. Secondly, it can leverage its financial and political pressure on the international financial policy-making fora.

⁴⁸⁸ Pistor, 'A Legal Theory of Finance' (n 18). at 323.

⁴⁸⁹ Cindy Li, 'Banking on China through Currency Swap Agreements' (*Federal Reserve Bank of San Francisco*) <<http://www.frbsf.org/banking/programs/asia-program/pacific-exchange-blog/banking-on-china-renminbi-currency-swap-agreements/>> accessed 24 February 2016; 'China, UK Enlarge, Extend Bilateral Currency Swap Deal' (*Reuters UK*) <<http://uk.reuters.com/article/uk-china-britain-renminbi-idUKKCN0SF0Q920151021>> accessed 24 February 2016; 'News Release - People's Bank of China Swap Line | Bank of England' <<http://www.bankofengland.co.uk/publications/Pages/news/2015/078.aspx>> accessed 24 February 2016; 'Central Bank Currency Swaps' <http://www.cfr.org/currency_swaps/> accessed 24 February 2016.

⁴⁹⁰ In 2013, 87 percent of trading volume involved US Dollar at least as one leg of the trade, up from 84.9 percent in 2010, while Renminbi accounted for 2.2 percent, up from a mere 0.9 percent during the same period. See 'Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity in 2013' (8 December 2013) <<http://www.bis.org/publ/rpfx13.htm>> accessed 24 February 2016.

⁴⁹¹ DeRosa (n 221). at 4; Mehrling, 'Essential Hybridity' (n 403). at 361.

it can be argued that an effective crisis resolution arrangement is the one that afford Thailand access to as much US dollar reserves it needs to stand in as the dealer of last resort in order to support its currency, at the price point that the private dealer system is unwilling or unable to do so. Unsurprisingly, the international financial architecture and its future reform, for better or for worse, continue to serve and reflect the US dollar dominance.

The first and the most self-reliant measure is for Thailand to build up its own foreign reserves which as of December 2015 stands at US\$ 157 billion⁴⁹² – an extremely healthy level compared to the pre-Asian crisis benchmark of \$US 40 billion. The advantage of hoarding reserves is the Bank of Thailand has an absolute legal authority as a trustee of the country’s reserves to maneuver the fund as it sees fit.⁴⁹³ Nevertheless, there is a limit to how much FX risk the central bank can tolerate as the dealer of last resort, such limit is termed the survival constraint or hard budget constraint.⁴⁹⁴ In this sense, the Bank of Thailand’s intervention to stabilize the balance of payments difficulties is no different to a system of private dealer of last resort except for the size of US dollar reserves held by the central bank vis-à-vis the domestic private banking sector.

Alternatively, Thailand may choose to expand its reserves constraint through exercising its rights and obligations under the IMF Framework Agreement by requesting one of the two available lending instruments. From the LTF point of view, neither the IMF’s financial assistance program nor the new Flexible Credit Line⁴⁹⁵ is desirable due to the conditions attached to the lending

⁴⁹² Source: Bank of Thailand, available at <<http://www.bot.or.th/English/Statistics/Standard/SDDS/Pages/Template.aspx>> accessed on February 24, 2016.

⁴⁹³ Ss. 23-24, 26-30, Currency Act of 1958.

⁴⁹⁴ Hyman P Minsky, ‘Central Banking and Money Market Changes’ (1957) 71 *The Quarterly Journal of Economics* 171.

⁴⁹⁵ FCL is a standby precautionary arrangement made available in order to reassure the market of the sound financial footing of the requesting member state who is temporarily facing collateral effects of external factors outside its

agreement or standby credit line, which simply reaffirms Thailand's peripheral position in the hierarchy of finance. Firstly, the availability of funds is made subject entirely to the discretion of the IMF upon reviewing the letter of intent. Secondly, the actual release of committed resources is contingent on the requesting member state meeting each step specified in the conditionality attached. And even if Thailand can satisfy the eligibility requirements, the funding cannot be disbursed in full but rather in tranches upon the IMF's review confirming compliance with performance criteria. At that point, the interplay between power and legal arrangement stripes financial autonomy out of the requesting member state and reduces it to a mere contractual debtor who must abide by the borrowing terms of its powerful creditor.

CMIM was established against the backdrop of these shortcomings of the international crisis management framework and also as an attempt by ASEAN member states and their strategic East Asian partners (collectively the ASEAN+3 group) to provide additional safety net mechanisms for the region. The multilateral arrangement offers two borrowing facilities designed for two different crisis situations. For the crisis preemption purpose, a contracting party may request the CMIM Precautionary Line (CMIM-PL) which mirrors the IMF's Flexible Credit Line in its design. In other words, it helps the requesting country stem the spillover effects from financial turbulence which occurs in other markets and causes disruptions such as bank failure, temporary closure of the international credit market, or simply investors' flights to safe assets in advanced markets. The Annex to the Joint Statement of the 15th ASEAN+3 Finance Ministers and Central Bank Governors in 2012 lists five broad qualification criteria which will be assessed on an *ex ante* basis (i.e. during

control. FCL is thus made without any strict amount limit but only because it is not expected to be triggered in the first place. See Hagan (n 372). at 60-61.

the peace times) as well as used as ex post conditionality.⁴⁹⁶ If however the requesting nation is encountering a serious balance of payments difficulty, the arrangement offers the CMIM Stability Facility (CMIM-SF) which may be quickly dispensed without attracting the ex-ante eligibility assessment or the commitment fee in the same way CMIM-PL does.⁴⁹⁷ The drawing limits for both facilities are identical in the amount and fixed as multiplies to individual parties' committed financial contribution. There can be no simultaneous drawing from CMIM-SF and CMIM-PL, however a request of additional support in case that any CMIM-PL recipient country ends up facing with a crisis will be determined on a case by case basis.

If CMIM were to replace or at least reduce the need of reserves accumulation by individual central banks, it needs to provide an equally flexible access to a pool of US currency of an equivalent or greater size on a timely manner. Likewise, in order to present itself to the member states as a viable alternative to the IMF lending instruments, CMIM has to address the latter's aforementioned shortcomings. It is argued that the arrangement does have the potential to eventually become an effective regional safety net mechanism, however in its current setup its usefulness will be somewhat limited. Most obviously, both CMIM-SF and CMIM-PL are still operationally attached to the respective IMF facilities as only up to 30 percent of the maximum swap amount may be activated without being subject to the IMF's financial assistance program and flexible credit line as the case may be. Effectively, this means that a requesting country faces a two-step approval process: first, the CMIM decision making body, and if more than 30 percent of the swap amount is drawn, the IMF's. The involvement of the IMF still represents the biggest hurdle in creating a

⁴⁹⁶ These criteria, external position and market access, fiscal policy, monetary policy, financial sector soundness and supervision, and data adequacy, are designed to ensure that the requesting member state is in fact on a sound financial footing, and thus qualified for CMIM-PL.

⁴⁹⁷ The commitment fee was set at 0.15 percent in the hope to reduce unnecessary requests that may not warrant the

regional financial supporting arrangement which affords the member states access to funding without harsh conditionality and thereby preserving their financial autonomy.⁴⁹⁸

CMIM Contributions, Drawing Limits, and Voting Power

| | Share of financial contribution (%) | Maximum swap amount (Billion US\$) | Total voting power (%) |
|-----------------------------|-------------------------------------|------------------------------------|------------------------|
| Japan | 32 | 38.40 | 28.41 |
| China (including Hong Kong) | 32 | 38.40 | 28.41 |
| South Korea | 16 | 38.40 | 14.77 |
| ASEAN Bloc | 20 | 126.20 | 28.41 |

Source: AMRO website (www.amro-asia.org/).

Straight from the appearance through to its DNA, CMIM is very much an ASEAN creation. The arrangement as well as its operational guideline were endorsed by ASEAN+3 Finance Ministers, representatives of the 13 participating countries. Without a firm international law footing, CMIM is at best governed by contractual relationship based on political commitments, peer pressure, and

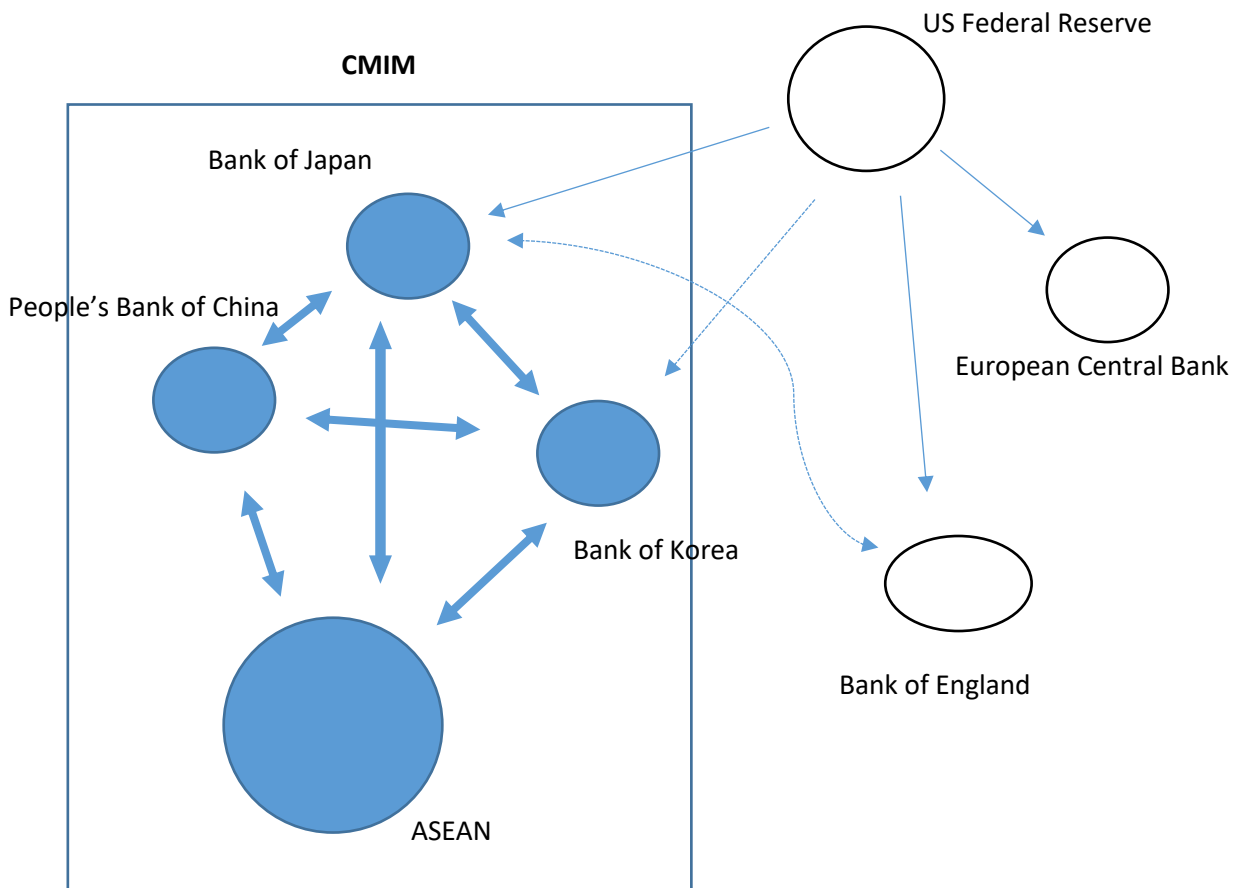
⁴⁹⁸ The IMF linkage has been justified on the ground that the ASEAN+3 Macroeconomic Research Office (AMRO), the supporting research and surveillance agency, is still a work in progress with the limited operational capacity and resources. In order to convincingly argue for further delinkage from the IMF lending framework, AMRO must demonstrate the ability to operate as an independent surveillance authority. As of now, its institutional agreement is still in its finalized draft awaiting the member state's ratification. See Kaewkamol Pitakdumrongkit, 'Where to Now for the Chiang Mai Initiative Multilateralisation?' <<http://www.eastasiaforum.org/2015/08/28/where-to-now-for-the-chiang-mai-initiative-multilateralisation/>> accessed 24 February 2016.

fear of retaliation. The flexible governing framework though could be the key for the ASEAN as a bloc which is more likely to seek emergency swap facilities than their East Asian counterparts. Any swap request notice requires an approval from the Executive Level Decision Making Body (ELDMB)⁴⁹⁹ and such decision must be reached within 2 weeks of submission. Considering the total voting right from the table above, no individual participating country may dominate the voting procedure especially when a two-third majority is required to approve the borrowing application. Crucially, neither the potential lenders (China, Korea, and Japan) nor the likely borrowing group (the ASEAN cohort) can block a collective decision on their own. This setup therefore offers a much stronger bargaining power to Thailand, provided that it acts in consort with fellow ASEAN members and votes as a bloc, than the IMF's decision making process which is monopolized by

⁴⁹⁹ ELDMB is populated by the Deputy-level representatives of the ASEAN+3 Finance Ministries and Central Banks and the Hong Kong Monetary Authority.

its Executive Board in which ASEAN is represented by less than 3.87 percent of the total voting power.

Figure 1: Stylized depiction of the network of US dollar swap lines



Last but not least, CMIM allows ASEAN member states to be indirectly connected with the global emergency central bank swap lines through the dollar liquidity facilities the US Federal Reserves (the Fed) can authorize according to its power under s.14 of the US Federal Reserves Act. It should be noted that Thailand and a few other ASEAN countries made unsuccessful attempts to the Fed

establish emergency dollar swap lines during the Global Financial Crisis.⁵⁰⁰ On the other hand, Bank of Japan and Bank of Korea had had standby swap lines allowing them to obtain the dollars during the time of crisis without being exposed to extreme currency risk.⁵⁰¹ The US Federal Reserves unlike all other central banks is able to produce dollar reserves as its own liability and therefore is not held hostage by the reserves constraint. Even though it is unlikely that the Fed would reactivate its swap lines to either Korea or Japan except when the global systemic viability is being threatened, the indirect linkage should bolster market confidence in the ASEAN monetary supporting device. Furthermore, the region is able to benefit from the increasingly prominence of the Renminbi bilateral swap agreements to which many ASEAN member states are counterparties including Thailand. While at present, the Renminbi swap lines were primarily designed to facilitate international trade between China and its trading partners, it could one day provide an additional monetary support for the entire region.

6. Conclusion

The AFC has long lasting influence in shaping Thailand's financial development agenda. Cognizant of the potentially disastrous consequences of the unfettered internationalization policy, the Thai government, led by Bank of Thailand and the Ministry of Finance, embarked upon 15 years of systemic overhaul and reorientation of the fundamental objective of its financial system to support the recovering productive sectors of the economy. As a result, the banking sector was consolidated and streamlined while the legacy entities from the bygone era notably the offshore banking facilities were demoted and eventually invalidated. Through correcting various incentives

⁵⁰⁰ Setser (n 10).

⁵⁰¹ The US Dollar swap line is essentially a repo transaction in which the exchange rate is fixed at the prevailing market rate at the time of the first leg of transaction, thereby eliminating the risk from adverse exchange rate movement.

to reduce appetite for foreign-denominated funding, Bank of Thailand has finally gained the autonomy over its banking sector which is now largely domestically financed. In addition, any remaining foreign exposure the Thai financial system may still have is fully covered by the country's extremely healthy international reserves. Despite its successful navigation through rough patches of water in the aftermath of the Global Financial Crisis, the central bank has also refused to allow an influx of external investment in the domestic banking sector having chosen to approve only a handful of foreign bank ownership whose strategies are in alignment with the general development direction. While the country is currently facing political and economic uncertainty, it could be said that its banking sector has never been in a better shape in a long time.

Yet, as the country together with its fellow ASEAN member states embarks upon the economic and financial integration program under the framework of the AEC, Thailand's banking sector is facing with a new challenge. The centerpiece initiative of the ABIF, QAB, allows for a new class of ASEAN banks to operate in Thailand under the principles of reciprocity and mutual recognition. Even though the framework requires a threshold of important banking regulation and supervision be harmonized and the progress be made on a bilateral basis, the fragmented nature of the project could cause loopholes and attract regulatory arbitrage in the previously closely regulated sector. The article points out to various crucial areas of banking integration that should be ironed out on the multilateral level rather than left to any pairs of ASEAN member states to negotiate between themselves. At present, ABIF is currently a work in progress as the additional details emerge when the member states enter into the bilateral agreement among themselves. Among other things, it is imperative we have more information on the following systemically important issues: the home-host coordination over minimum deposit guarantee coverage, a regional collegiate system of prompt corrective action in place of the central bank's regulatory authority to vet and approve

foreign bank operation in its domestic market, and cross-border regulation of financial activities permitted by banks and their affiliates. Above all, ABIF does not provide a framework for resolution of failed QAB which is especially significant in the region which does not have a good track record of successful corporate bankruptcy regime catered for the interconnected and complex nature of financial institutions. Furthermore, if Thailand were to compromise its financial autonomy in the interest of the regional community, it should make sure to have the costs of potential downsides, notably of crises, mutualized and shared by the community. CMIM represents a step towards that direction regardless of its current limitations.

Even though the ASEAN member states are in explicit agreement to continue with the present incremental approach to financial and banking integration, this cannot be the ultimate roadmap to achieve a fully functioned economic community. A semi-integrated banking union based on a network of bilateral agreements in order to accommodate the different degrees of financial maturity is bound to leave an uneven and potted foundation. For instance, it may incentivize the cross-border capital movement to flow into the member states with the most cost effective regulatory compliance framework. Furthermore, the more advanced member states will continue to strengthen their own safety net mechanisms to squarely raise to the new challenges posed by its commitment to ABIF. As their economies become more deeply connected, ASEAN nations will have to consider a more institutionalized strategy to advance their cause. Yet, the overarching principle of integration should remain the same; namely, mutualization of potential upside gains must be equally mirrored by equitable sharing of potential downside risk.

Epilogue - Finance in an Uncertain Time

1. Looking Back to the AFC: Lessons Learned

We have had to endure a number of financial disturbances in the past 30 years in almost all four corners of the world. The repeated pattern suggests that financial crises should be considered part of the construction of financial system, as opposed to exceptions to an otherwise smooth functioning of the system. This doctoral dissertation takes a small piece from this colorful period of the world's financial history to study as the subject matter of the analysis. It proposes a reinterpretation of the Thai experience of the AFC. The widespread institutional collapses and the floating of the Thai baht were widely considered to be the epicenter of that financial catastrophe, which subsequently reverberated across the developing economic regions and arguably beyond. The reconceptualization of the Crisis in turn calls for a re-evaluation of the entire post-crisis reform initiatives.

The main thesis of the dissertation asserts that the AFC was caused by the mutually reinforced dynamics between publically promulgated rules and private contractual arrangements both at the national and international levels, working in tandem to exacerbate financial instability which was eventually morphed into a financial crisis by the strict application of *ex ante* legally binding obligations installed throughout the financial system by both public agents and private entities.

This proposition asserts an alternative interpretation of the AFC in contrast with the conventional narrative which emphasizes the triumvirate of 1) inefficient government-directed development policies, 2) market failure caused by corruption and crony capitalism, and 3) inadequate infrastructural standards. To reiterate, the dissertation does not question the prevalence of these issues in the Asia Pacific region, particularly in Thailand. Rather, it invites the readers to look

beyond the political economic factors and consider the institutional changes made in to the Thai financial system over the pre-crisis period. At the least, an institutional assessment provides a supplementary account of the AFC, complementary to the mainstream views. As explored in Chapters 1 and 2, the mainstream claims do not provide a comprehensive picture of the reality at the time. For instance, while corruption remained undoubtedly rife in that part of the world, there was strong evidence pointing to the fact that the situation was improving in the early 1990s. In addition, the mere fact that the cross-border liberalization measures came too soon explains neither the type of capital inflow nor the intensity vis-à-vis the situations in the neighboring countries. At best, the LTF reinterpretation of the AFC could potentially offer a new conceptual foundation of finance as a social system constructed in law. In other words, the financial system expands and contracts according to the pre-existing legally binding rules.

To this end, the dissertation proposes a new analytical framework and develops the LTF explanation of the AFC based on the building blocks of LTF. Effectively, it gives a roadmap or a blueprint to start our investigation of the phenomenon. Without repeating ourselves, there are four main takeaways of note from the new LTF-based narrative of the Asian Crisis.

The institutional autopsy of Thai financial institutions and global capital surpluses suggests to us that financial instability is an accumulative process⁵⁰² as opposed to a short-term trend or a shock to the system.⁵⁰³ It is impossible to give a comprehensive account of the dominant presence of banks and finance companies in 1994-5 without understanding the legislative interventions in the

⁵⁰² Minsky, 'The Financial Instability Hypothesis' (n 70).

⁵⁰³ Frederic S Mishkin, 'Global Financial Instability: Framework, Events, Issues' (1999) 13 *The Journal of Economic Perspectives* 3. Mishkin defines financial instability as problems of asymmetric information, particularly moral hazard and adverse selection. at 4-5.

1970s which effectively provided a legal justification for the non-bank financial industry. With the LTF perspective, the analysis focuses on the regulatory scaffolding of the financial liberalization program. This approach helps explain the exact arrangement of the special conduit, the so-called BIBF, which allowed the most destabilizing type of capital inflows to finance the activities of banks and finance companies. Only after we get a good grip on the institutional background can we then proceed to examine the mechanism of the Crisis.

Secondly, while it is true that the ultimate objective of a private participant in the financial market is to reap profit, the analysis of the financial cycle is more complicated than that. Before even considering profit maximization, the financial actor needs manage the balance sheet of cash inflows and outflows so that he can maintain his going-concern status. There is no denying that profit or revenue maximization is an important consideration in that. After all, it helps raise the standard of living as well as motivates hard work and self-development.⁵⁰⁴ If we consider again the situation of Thai banks and finance companies in the period immediately prior to the AFC, they no longer operated with a goal to reap as much revenue or profit as possible. Rather, they relied on refinancing just to be able to meet the withdrawal demands of the depositors and the repayment obligations owed to foreign creditors. The cash flow management becomes even more crucial in the contemporary credit-based financial system. Each and every creditor-debtor relationship is concluded in legal instruments and enforced by courts of law. With very few exceptions, the consequences of non-payment are severe and strictly observed.

Next, the hierarchical structure is everywhere in a contemporary financial system. Additionally, its operating rules determine priority, order, and seniority of products and entities that may be

⁵⁰⁴ Amartya Sen and others, 'Capitalism beyond the Crisis' (2009) 56 *The New York Review of Books* 26. at 6-7.

encountering a crisis situation. LTF starts by observing the fact that the global financial framework is US dollar-centric. The relative power in relation to the creation and management of the US dollar decides the elasticity of law. A vast majority of currency exchange transactions have US dollar in one leg of the transactions. Parties often commit themselves to pay and settle their financial transactions in US dollar, even though neither of them has a connection with the US. A case in point in relation to our story is that most Thai foreign liabilities during the Crisis were denominated in US dollar, yet the biggest lenders to Thai financial institutions were Japanese banks. The dollar-centric arrangement has serious ramifications for the crisis resolution management. The account of the negotiation process presented in Chapter 4 informs us that the US controlled the outcomes of the discussion regarding both the rescue package and reform initiatives, even though the US administration did not send a significant contingent of representatives to the meeting. The same outcome can be expected from a regional financial hierarchy in which a major regional currency, such as Japanese yen, is considered a safe currency during the time of crisis. The investors would take flight against Thai baht in favor of Japanese yen but only so far as the Japanese systemic viability remains unaffected. In the case of the AFC, the Crisis was regarded as having so serious global implications that the US, as the country at the top of the hierarchy, felt the need to intervene.

Lastly, while it is unlikely that the next crisis will repeat exactly what happened in the 1990s, the manner in which financial instability will have built up and the mechanism of the unraveling will be more or less consistent with the past pattern.⁵⁰⁵ To this end, the LTF account of the AFC can still be relevant to current financial developments in Thailand and South East Asia's regional

⁵⁰⁵ Kindleberger and Aliber (n 2). at 288-290.

integration project. First of all, the potential for fragmentation between national and regional regulatory frameworks could create exposure to arbitraging activities by opportunistic financial actors. The lessons from the financial development history of Thailand told in Chapters 2 and 3 tells us that arbitrage is a primary factor contributing to financial instability. Another important consideration for sustainable integrated regional financial markets is to maintain an effective transnational safety valve mechanism. The ASEAN members have made a remarkable stride toward achieving this goal with the CMIM. However, any future changes to the arrangement must take into account the realities of the hierarchy of global finance. The IMF linkage is an important roadblock which resigns the members of the CMIM to the periphery of the system. In addition, they should make sure to strengthen monetary cooperation with the US Federal Reserve. During the recent crisis, South Korea received the emergency swaps line with the Fed, while many requests from other central banks in the region were turned down.

2. Legal Theory of Finance: Rediscovering the Role of Law in Finance

An important insight of the analytical framework developed from the building blocks of LTF is the central role that law plays in finance. Prior to LTF, the law and economic literature focused its debate on how, if at all, certain laws and regulations could enhance efficiency or distort the otherwise orderly function of the market.⁵⁰⁶ Law serves a different purpose in finance from the one envisaged by LTF. The growing LTF literature sets out to challenge this conceptualization of the relationship between law and finance.⁵⁰⁷ This dissertation would like to make a small

⁵⁰⁶ 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.

⁵⁰⁷ For instance, Harvey (n 398); Dan Awrey, 'Complexity, Innovation and the Regulation of Modern Financial Markets' (2012) 2 *Harvard Business Law Review* 235; Gelper and Gulati (n 403).

contribution to this body of scholarly work by providing another instance of the dynamics between law and finance at work by demonstrating the causes and mechanisms of the AFC.

Nevertheless, law is an encompassing term. The assertion that finance is a legally constructed system requires not only the conceptual foundation, but also factual demonstration. This dissertation offers such an in-depth factual demonstration pinpointing a number of significant public and private rules in play.

Conceptually, LTF highlights the interplay between public laws and private financial instruments, or the so-called essential hybridity of financial markets. Pistor expounded this fundamental concept in the following way. “[Finance] is based on money as the legal tender, relies on the legal enforceability of private/private commitments and in the last instance depends on backstopping by a sovereign.”⁵⁰⁸ These private commitments are vindicated and enforced according to the legal rulebook and by legal institutions, particular courts of law.⁵⁰⁹ Furthermore, she asserted that “the central role of law in financial contracting is reflected in the fact that every financial intermediary wanting to issue a new financial instrument employs lawyers to ensure that it is compliant with relevant laws and regulation.”⁵¹⁰ To put it differently, LTF’s primary contribution is the revelation that the contemporary financial system we live in today does not and cannot exist as a purely private construct, operated independently from the law and its institutions. Conceptually, LTF posits further that a sophisticated, scalable, and predictable financial market cannot spontaneously arise through private arrangements alone. Law has got to play an integral role. To achieve

⁵⁰⁸ Pistor, ‘A Legal Theory of Finance’ (n 18). at 323.

⁵⁰⁹ *ibid.*

⁵¹⁰ *ibid.*

predictability and trustworthiness, law “lends authority to public and private financial instruments or means of pay; delegates power to different regulators; vindicates financial products rooted in private contracts.”⁵¹¹ To make it scalable, “credible contractual commitments that are enforceable in a court of law without prior investigation into the creditworthiness of the borrower, originator, or intermediary”.⁵¹²

The story of the AFC is littered with assertions, illustrations and examples of these roles that law played in organizing the Thai financial system. On the international level, the early 1990s witnessed the near universal adoption of the prudential standard, the Basel Accords, from the capital-surplus economies in Japan, South Korea, and Taiwan to the borrowing countries, notably Thailand. Chapter 3 demonstrates that this early period of regulatory harmonization in the Asia Pacific region coincided with the dramatic increase in international capital flows primarily from East Asia to South East Asia. Arguably one contributing factor of this phenomenon was the fact that the said harmonization together with other standard contractual terms employed by transactional lawyers working in the Asian capital market greatly enhanced the predictability and fungibility of cross-border financial instruments. Focusing on events in the Thai domestic setting, Chapter 2 explores at length the crucial importance of certain contractual clauses, particularly the jurisdiction, maturity, and default clauses, in triggering the initial disruption in the Thai capital market. At the peak of the euphoria, too many Thai banks and finance companies leveraged themselves heavily on foreign debts to remain cash flow positive without paying sufficient attention to the downside risk of rigid contractual obligations enforced during extremely unfavorable market conditions. Last but certainly not least, LTF observed further that regardless

⁵¹¹ Katharina Pistor, ‘Law in Finance’ (2013) 41 *Journal of Comparative Economics* 311.

⁵¹² *ibid.*

of how well the private stakeholders work together to keep the system running during the good times, finance can only be ultimately backstopped by the public entity at the apex of the hierarchy. Chapter 4 elucidates the complex international hierarchical structure of which Thailand has become a part after the government implemented a set of liberalization measures. After running into the crisis in 1997, the Thai government lost its financial sovereign and instead was beholden to the collegiate of foreign governments, and international financial institutions for financial assistance.

Beyond these fundamental insights on the predictability, scalability, and survivability properties that law and its institutions provide to the constitutive components of finance, the LTF framework invites us to examine more closely the relationship between public law and regulation on the one hand and market developments and innovations on the other hand. Awrey observed that there are three key different incentives that drive financial intermediaries to innovate.⁵¹³ First, there is genuine demand from the marketplace. Second, they innovate in order to maintain their monopolistic power in the absence of the traditional intellectual property protection scheme, which is otherwise available to products in other sectors of the economy. Third and most pertinently, financial intermediaries innovate in order to mitigate the impact of regulatory requirements. The greater the degree of flexibility in the interpretation and gaps between rules, the more “creative” they can be with regulatory compliance. New market practices and products developed out of these interactive dynamics present a new source of systemic vulnerability. The fast-paced nature of the highly competitive financial market means that these new instruments may very well be hastily pushed to the market without proper due regard for and understanding of all the associated risks.

⁵¹³ Awrey (n 508). at 263.

Worse still, regulators have an even weaker understanding of the complicated financial innovations and products and are restricted to playing a catch-up game with savvy market professionals and experts. As a result, they will be poorly equipped to come up with the necessary legal, operational, and risk-management infrastructure to withstand consequential financial shocks. Arguably, this analytical framework supplements the narrative explored above by providing a context for the remaining aspects of the AFC.

In the context of the domestic financial development, Chapter 2 explains the institutional background of the financial system dominated by two types of financial intermediaries: traditional commercial banks, and smaller but risk-tolerant finance companies. The period between the late 1960s and 1970s saw a series of legislative and regulatory interventions put in place initially to supplement the underperforming banking sector during the time of rapid industrialization in which a consistently high level of capital investment into the productive sectors of the economy was indispensable. Beginning with the Finance, Securities and Credit Foncier Act of 1979 and subsequent supplementary regulations which offered a set of unique legal and regulatory incentives, finance companies emerged as a significant driving force in the Thai domestic market within a short ensuing decade. As explicitly argued in this chapter, the intense competition between Thai banks and finance companies became a source of systemic vulnerability in the Thai financial system.

Towards the end of the 1980s, financial intermediaries started to exhaust their existing domestic funding pool and thus actively sought extra sources of finance as well as new business opportunities. Chapter 3 shows that prior to the 1990s, the regulatory framework heavily restricted the range of activities in which they could be involved. By 1987, they successfully lobbied the Ministry of Finance so that the country was set on a mission to develop the Thai financial system

into the regional financial center rivalling the more advanced markets in the Asia-Pacific region. The major regulatory intervention which came into force in 1992 was the Bangkok International Banking Facility (BIBF). BIBF, which itself was a regulatory construct, did more than just validate and enforce the transactions concluded under its jurisdiction. While the BIBF-licensed financial institutions complied with the prescribed regulatory requirements, they did so not to avoid compliant costs but specifically to exploit the extraordinary regulatory and tax benefits which made the BIBF extremely popular for certain types of foreign capital, particularly short-term debt transactions. In other words, the BIBF was acting far beyond its role as gatekeeper of cross-border financial transactions. Its peculiar regulatory framework became the foundation for qualified financial institutions to essentially create a new market by reaping incentives and advantages offered through the special conduit which were not available in the onshore jurisdiction.

Finally, Chapter 5 shows that systemic vulnerability can emerge through fault lines in the regional financial regulatory framework created under the auspices of the Association of South East Asian Nations, better known as ASEAN. This new layer of compliance will undoubtedly prompt a new wave of financial innovations in order to arbitrage the additional regulatory complications. With limited information regarding the future direction of this regional development, Chapter 5 offers an educated conjecture about the potential pitfalls in the scheme, using the LTF analytical framework. Among the current initiatives in place, the ASEAN banking integration framework appears most highly susceptible due to its fragmented nature, which conveniently tees up international financial intermediaries to seize arbitrage opportunities. After the full implementation, the same analytical tool may be used to identify with more precision the inherent systemic vulnerabilities.

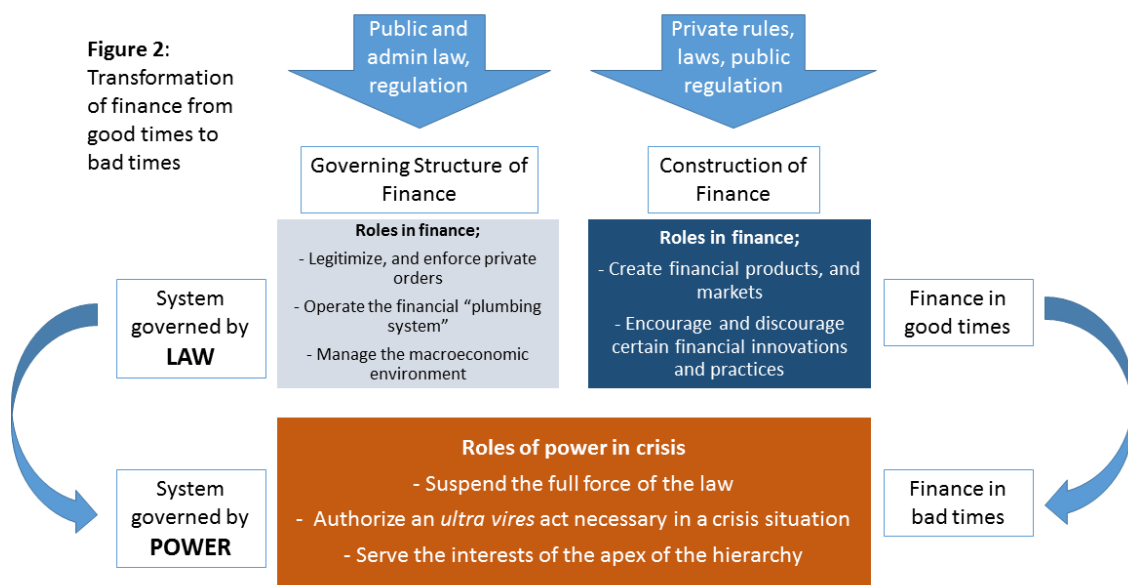
Although the interplay between law and regulation on one hand and regulatory arbitrage and resulting innovative changes on the other hand has not been highlighted, in the original formulation of LTF, in the similar forceful fashion as the contributions of law in enabling the predictability and scalability of a contemporary financial system, the conceptual reach of the LTF building blocks is far-reaching enough to provide the analytical framework for the relationship between public rules and private innovations above. Indeed, Pistor herself recognized the potentially destabilizing effect of regulatory arbitrage: "... to the extent that financial instruments are designed to weaken regulatory costs, it effectively sanctions regulatory arbitrage and the erosion of formal law."⁵¹⁴ To put it differently, the prevalence of regulatory arbitrage as a springboard for financial innovation is evidence that the financial system is not only rule-bound but also inherently a hybrid construct requiring both public and private inputs.

This is precisely what sets LTF apart from the mainstream law and finance literature. The latter views the role of law as an efficiency-gaining "add-on" to the already fully functional system of finance. More significantly, this school of thought sought to connect political instability with weak property rights protection afforded to individuals. To put it differently, as a conceptual framework it is completely oblivious to the legal codes engineered into every single financial instrument from the most simple IOU to the sophisticated cross-border collateralized debt contract. In order to provide a sharp departure point from this extremely popular narrative, LTF calls into question the obvious weakest link in the mainstream theory.

To this end, one can make a conceptual distinction between the term regulatory arbitrage in the LTF model and that very same term when it is referred to in the mainstream law and finance. The

⁵¹⁴ Pistor, 'A Legal Theory of Finance' (n 18). at 324.

latter considers arbitraging activities from the efficiency perspective They can either increase or decrease price and allocative efficiencies. Some arbitraging behaviors are considered to be in the public interest since they speed up the release of previously private material information to the public and thus reduce the gap between the bid-ask spread. Yet, they do not significantly alter the integral construction of the financial system. In other words, these activities can be regarded as a trading strategy, which has an effect in narrowing the gap between an asking price and an offer for the same financial asset. By contrast, LTF explains the mechanisms and institutions which are used by the market actors to arbitrage the governing structure of financial system in order to gain comparative advantage over competitors. It is a prime example of multidirectional linkages connecting important stakeholders in the system, namely, public agencies, private entities, and international financial institutions. An introduction of new, more onerous financial regulation



encourages (or sometimes forces) legal innovations, which in turn can give rise to a new financial instrument, practice, or even a whole new market sector.

To this end, we may be able to summarize an LTF stylized model of the contemporary financial system as depicted above. Absent any large-scale financial difficulties, a financial system can maintain its ordinary operation because law together with its institutions and apparatuses provides at least four infrastructural qualities to finance; namely by, 1) maintaining predictability in the financial system; 2) providing the toolkit necessary to enable the system to scale from a localized relationally based arrangement to a complex, arms-length, cross-border financial market; 3) protecting, in the time of crisis, the system's viability by an effective backstopping mechanism; and 4) setting the stage for the dynamic interactions between public and private stakeholders, which become the evolutionary force of contemporary finance.

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