Building the Legal and Regulatory Framework

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Of all the requisite components of a market economy in transition and emerging countries, sound legal systems and institutions have been among the slowest to develop. In recognition of this fact, in August 1998, as the Russian financial crisis was unfolding, this author presented a paper at The Aspen Institute Program on the World Economy setting out "Guiding Principles and Core Requirements for a Legal System in a Market Economy."[1] The underlying premise of the "Guiding Principles" is that the awesome complexity and dynamism of a market economy require laws, rules, and norms, based on transparency and openness, that encourage and facilitate economic interchange and at the same time take into account the fact that some degree of governmental intervention in the "free" market is also required, because market participants are human and thus not perfect.

In a market economy, a legal and regulatory framework must support decentralized economic decision-making by market participants based on market prices derived in arm's length interchanges and not based on collusion, corruption, nepotism, or cronyism. The cooperation and confidence that are required for a market economy to operate efficiently and effectively can exist only if a well-developed legal and regulatory framework exists. A market economy is based on the efforts of countless individuals. Yet, for a market economy to operate efficiently

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[1] *Change and Prosperity: The Aspen Institute Program on the World Economy*, 1998 Conference Report 31-39 (Aug. 19-22, 1998); *reprinted* in Chinese *in* Financial Law Forum 1-7 (5/1998). A copy of the Guiding Principles is included as an appendix to this paper.

and effectively, these individual market participants must share a common interest, based on an expectation of fairness and merit-based economic decision-making. Such expectation is grounded in a rule of law that is rooted in a "culture of law"—a culture that supports the rule of law and opposes corruption, and a culture in which the law is enforced by credible and honest authorities in a manner that inspires public confidence in the law and respect for the intentions and the institutions of the law. Rule of law that has at its core concepts of fairness and meritocracy will nurture this culture of law.

This paper will review and analyze the development of the legal and regulatory framework in six emerging or transition countries: Thailand, Indonesia, South Korea, Taiwan, China, and Russia. Fifteen core requirements for a legal system in a market economy are set out in the Guiding Principles. While a comprehensive analysis would focus on each of these core requirements, this paper will focus only on four areas: (i) bankruptcy law, which addresses defaults and restructurings; (ii) the law of security interests ("secured transactions law"), which protects the rights of creditors through pledges of assets from debtors; (iii) the development of the judicial system, which allows contracts to be enforced; and (iv) the development of banking regulation and supervision, which assures the stability and integrity of the financial system through which the market mechanism operates.

These four areas were selected for review and analysis because each is a critical component of the infrastructure that supports the financial system of a market economy, the "central nervous system" through which the market mechanism operates to convert the value judgments of market participants into prices of goods and services and financial instruments. An effective banking system is at the center of the financial system of a market economy. The banking system channels savings to effective uses through the credit decision-making process. Market economies require the money-creating mechanism provided by banks through the extension of credits based on real economic activity, and not that provided by central banks through the inflationary printing of money. Without the money multiplier effect that results from bank lending, economic activity will not grow rapidly. But bank lending must be determined by market forces and not by state planners or cronyism. The four areas of law that will be reviewed and analyzed in this paper provide the foundation for such bank lending.

Experience, education, and technology induce continuous changes in the relative productivity and value of economic inputs, resulting in what the economist Joseph Schumpeter referred to as "creative destruction" in a market economy that continuously reallocates property rights. The four areas of law that are the focus of this paper are essential for such reallocation of property rights. The market mechanism must allow such adjustments and reallocations of economic inputs, which are not painless

to market participants and result in the shifting of property rights among them. In a state-planned economy, the changing value of economic inputs is not reflected in price adjustments determined in the market, and state bureaucrats will be generally resistant to the forces of creative destruction. As a result, over time, state-planned economies will become less and less competitive with market economies.

The paradox of creative destruction is that it results in renewal of the market economy, which has the flexibility and strength to adjust to changes. This renewal is based on innovation, risk-taking, and competition, all of which must be supported and encouraged by the legal and regulatory framework. Western market economies experience incremental creative destruction with a well-developed rule of law. In the transition and emerging economies, wholesale and rapid creative destruction must occur within a poorly developed rule of law. Obviously, this will be a disruptive process. And with a poorly developed rule of law, the process will inevitably result in corruption, which will be stifling to the entrepreneurial efforts of many market participants.

This paper will briefly examine the causes of the financial crises in East Asia and Russia in order to set the backdrop for analysis. It will then survey these four areas of law in the six countries. The legal survey is not intended to be a definitive description of the law in the six countries but rather is intended to provide a legal overview, to serve as a basis for analysis of how the status of the legal and regulatory framework in these six countries affected their economies during the financial crises.

Causes of the Financial Crises

The financial contagion that swept East Asia beginning in the summer of 1997 was the result of economic and institutional factors. The Asian financial crisis was not the direct result of a weak legal and regulatory framework.

The principal economic factors behind the Asian financial crisis were the very high domestic savings relative to the size of the respective economies, combined with a very large inflow of foreign capital. Strong economic growth, low government deficits, high savings, and stable currency exchange rates had encouraged the inflow of foreign direct investment and the buildup of short-term external debt. In 1996, over $160 billion of net private capital flowed into East Asia. Overinvestment resulted in inefficient allocation of capital. The East Asian economies could not provide adequate profitable opportunities at reasonable risk to absorb the domestic and foreign investment funds. This was manifested in a booming stock market and inflated real estate prices, causing speculative bubbles in equity and real estate markets. Further, capital was often allocated at the direction of governments.

At the same time, overvalued currency exchange rates caused a

decline in exports and an increase in imports, resulting in large current account deficits that were financed in large part by short-term external debt. External economic factors also played a significant role. The Japanese recession contributed to the decline in exports, and the depreciation of the Japanese yen against East Asian currencies reduced the competitiveness of Asian goods in the important Japanese market and also decreased the attractiveness of East Asia as a place for Japanese companies to produce goods. East Asian countries ran up large trade deficits in 1996 (South Korea, $23 billion; Thailand, $15 billion; Indonesia, $7.5 billion) and incurred increasing unhedged, short-term indebtedness denominated in foreign currency. In June 1997, South Korea had close to $120 billion of foreign debts and less than $40 billion of foreign exchange reserves; Thailand had about $90 billion of foreign debts and about $30 billion of foreign exchange reserves; and Indonesia had about $115 billion of foreign debts and $20 billion of foreign exchange reserves. By contrast, Taiwan had virtually no foreign debt and about $90 billion of foreign exchange reserves.[2]

The institutional factors behind the Asian financial crisis were fixed currency exchange rate systems—which ultimately collapsed—and weak financial systems with lax supervisory regimes. Downward pressures on currency exchange rates caused foreign creditors to demand payment on their short-term, foreign-currency-denominated loans, which led to further weakness as debtors sold local currency to make such payments. This vicious spiral downward caused the fixed exchange rate systems to collapse. Weak, poorly supervised financial systems allowed systemic mismatching of assets and liabilities and excessive foreign currency and market risks.

These economic and institutional factors contributed to growing financial turbulence. The abandonment of fixed currency exchange rates, the demands for repayment of the high levels of unhedged, short-term external debt, the declining demand for exports, and the weak financial systems transformed such financial turbulence into the Asian financial crisis. The "herd" instinct took over and creditors and investors exited the region, together and at the same time. Little institutional infrastructure was available to contain the crisis, which spiraled out of control.

The financial crisis in Russia that began in August 1998 was caused by entirely different factors than the financial crisis in East Asia. Russia's financial crisis was caused by the collapse of its fiscal system. The infrastructure for tax collection in Russia was woefully inadequate, there were incentives not to pay taxes, and a "culture of nonpayment" had descended from the Soviet days, during which it was accepted conduct to

[2] Ellick Liao, *Financial Reform in Asia*, presentation at 2000 Harvard Asia Business Conference, Harvard Business School (Jan. 28, 2000) (on file with author).

attempt to beat the system. As a result, by the summer of 1998 the Russian government had insufficient resources to run a credible government. In 1999, on a per capita basis, the Russian government spent the equivalent of roughly $1 for every $35 the U.S. government spent.

The collapse of the fiscal system caused the banking system to fail. The assets on the balance sheets of Russian banks consisted predominantly of Russian government securities, and the banks had extensive off-balance-sheet foreign exchange exposure. With the default by the Russian government and the currency devaluation in August 1998, caused by the government's lack of fiscal resources, the banking system immediately, and inevitably, failed. The fiscal crisis brought down the banking system. One great irony is that transactions in the government securities market, which is a very important component of a market economy, caused the failure of the banking system. The failure of the Russian banking system does not reflect a failure of financial system reform efforts in Russia.

It has been recognized that "sound macro-policies were an absolutely necessary, but not remotely sufficient, condition for sustained growth and rising living standards."[3] A developed legal and regulatory framework and a well-supervised and regulated financial system are necessary for sustained growth. While a poorly developed legal and regulatory framework was not the proximate cause of the financial crises in East Asia and Russia, once the crises began, the weakness in legal systems meant that important tools to contain the crises and to work to restore financial stability and confidence were not available. Thus, the magnitude of the financial crises was amplified. The discussion that follows presents evidence of the weaknesses in legal and regulatory frameworks in East Asia and Russia.

THAILAND

Bankruptcy Law

Enacted in 1940, the Thai bankruptcy law was inadequate for the modern economic system that had developed in Thailand.[4] Under the law, no provision existed for the reorganization of insolvent enterprises. Moreover, the law prevented a creditor from recovering funds lent to a debtor if the creditor knew at the time it made the loan that the debtor faced a risk of insolvency.[5] Creditors, therefore, refused to provide funds

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[3] *Change and Prosperity: The Aspen Institute Program on the World Economy*, 1999 Conference Report 4 (Aug. 18-21, 1999).

[4] David T. Gibbons, *Bankruptcy in Thailand*, Com. L. Bull. (1996).

[5] Economist Intelligence Unit [hereinafter "EIU"] Country Analysis (Thailand), *Acquisition of an Existing Firm* 2.2 (Dec. 30, 1999).

to debtors experiencing even temporary shortfalls in liquidity.[6] This made business rehabilitation virtually impossible.[7] The law also expressly prohibited the ranking of creditors in the event of bankruptcy or liquidation.[8]

Liquidation of enterprises was so cumbersome and lengthy that creditors rarely obtained recovery.[9] In theory, a creditor would petition the civil court for a finding of insolvency against a debtor. Upon such a finding, a government-employed receiver (the equivalent of a bankruptcy trustee in the United States) would liquidate the debtor's assets. In practice, however, creditors faced laborious paperwork in identifying assets and filing for liquidation.[10] Further, a petitioning creditor was required (i) to protect the interests of all other creditors that joined the suit and (ii) to pay all court costs as well as the costs of assisting the receiver in disposing of property.[11] In addition, debtors could prolong bankruptcy proceedings for years by obtaining repeated adjournments of court hearings.[12] Some bankruptcy cases in Thailand have continued for more than 20 years.[13] Such difficulties were compounded by the lack of a specialized bankruptcy court[14] and too few receivers.[15] By the time judgment was secured, few, if any, assets of the debtor remained to be recovered. Not surprisingly, creditors rarely utilized the Thai bankruptcy regime.

In 1998, Thailand enacted a new bankruptcy law that addressed many of the flaws of the previous bankruptcy law. The bankruptcy law now permits creditors to force reorganization on insolvent firms.[16] A creditor, a debtor, or a state agency can submit a reorganization plan, and the plan will be implemented upon the approval of a majority of a debtor's creditors.[17] The 1998 law also established a specialized bankruptcy court[18] and removed the provisions of the previous law that had prevented a creditor from recovering funds lent to a debtor if the creditor

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[6] James A. Goodman, *Travels in Thailand: A Report on the Thailand Bankruptcy Project*, Am. Bankr. Inst. J. (1997).

[7] *1998 Investment Climate Statement for Thailand*, Int'l Mkt. Insight Reports A.4 (June 18, 1998).

[8] Nicholas Moller, *How to Protect Lenders on Thai Projects*, 12 Int'l Fin. L. Rev. 5 (1999).

[9] *Thailand: Breaking the Logjam: Pending Reform of Bankruptcy Law*, Int'l Mkt. Insight Reports 1 (March 2, 1998).

[10] *Surviving Bankruptcy*, The Nation (Bangkok) (Oct. 13, 1997).

[11] *Breaking the Logjam, supra* note 9, at 3.

[12] *Surviving Bankruptcy, supra* note 10.

[13] EIU Country Reports (Thailand), *Industry* (Sept. 8, 1997).

[14] Gibbons, *supra* note 4.

[15] *Breaking the Logjam, supra* note 9, at 2.

[16] EIU ViewsWire, *Thailand Economy: Recalcitrant Debtors Tarnish Reform Record* (Dec. 16, 1999).

[17] Moller, *supra* note 8.

[18] *1998 Investment Climate Statement for Thailand, supra* note 7, at A.4.

knew at the time it made the loan that the debtor faced a risk of insolvency.[19]

Secured Transactions Law

While Thai law permits pledges of personal property and mortgages,[20] Thailand has no registration system for the recording of security interests in personal property.[21] Loans cannot be secured by accounts receivable.[22] Thai law does not recognize security interests in property that remains in the debtor's possession.[23] In the absence of a modern secured transactions system, creditors frequently have relied on personal guarantees.

Judicial System

The judiciary in Thailand is well-known for its independence and it has vigorously defended its powers from encroachment by the executive and the legislative branches of government. Together with the civil service, the judiciary is commonly viewed "as the only point of stability in a volatile political system."[24] Judges, who enjoy substantial status in Thai society, undergo a rigorous examination process in order to gain entrance to the judiciary.[25] (This is in marked contrast to the United States, for instance, where judges are appointed or elected to their positions.)

While Thailand's legal system in 1997 was nearing world-class standards for the protection of property and contract rights, enforcement continued to be a problem.[26] And the legal process could be extremely costly and time-consuming (as illustrated by the bankruptcy process). Critics also point to the ability of litigants to affect judgments through extra-judicial means, such as by coercion or bribery outside the courtroom.[27] Thai courts do not recognize judgments of foreign courts (although such judgments are admissible as evidence in Thai legal proceedings).[28]

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[19] EIU Financing Foreign Operations, *Acquisition of an Existing Firm* 2.2 (Dec. 30, 1999).
[20] Moller, *supra* note 8.
[21] Goodman, *supra* note 6.
[22] AP Worldstream (Jan. 20, 1998).
[23] Moller, *supra* note 8.
[24] EIU Investing Licensing & Trading (Thailand), *The Operating Environment* 1.1 (Dec. 1, 1995).
[25] *1998 Investment Climate Statement for Thailand, supra* note 7, at A.7.
[26] *Id.*
[27] *Id.* at A.4.
[28] Moller, *supra* note 8.

Banking Regulation and Supervision

Deregulation in Thailand's financial system in the early 1990s resulted in large inflows of foreign capital into the country. According to the U.S. Treasury Department, Thailand's failure to adequately supervise its banking system in the face of these capital inflows "contributed greatly" to the 1997 financial crisis.[29]

In 1997, rather than addressing issues relating to capital inflows, the Bank of Thailand, the Thai central bank, was attempting to repair its reputation. The Bank of Thailand earlier had been considered the architect of Thailand's financial stability.[30] In 1996, however, its reputation was damaged by revelations that its governor had acquired shares in a struggling finance and securities firm that the Bank of Thailand had been supporting. The ensuing scandal led to the resignations of both the Bank's governor and its deputy governor.[31] As a result, by the time of the 1997 financial crisis, the Bank of Thailand had lost much of the prestige and trust that are so essential for the effective management of the financial system.

During the 1990s, Thailand had gradually deregulated its banking system in an effort to turn Bangkok into a major financial center for Southeast Asia. In 1993, the government launched the Bangkok International Banking Facility (BIBF), which permitted domestic and foreign banks to operate international banking facilities in Thailand. The BIBF program, in particular, contributed to the inflow of foreign capital into Thailand.[32]

Foreign banks were prevented from opening more than three branches in Thailand. Generally, only one of these branches could be located in Bangkok. Each foreign bank's Bank for International Settlements (BIS) capital adequacy ratio and legal lending limit were based on the bank's locally held capital instead of the consolidated capital of the bank. This constrained the activities of foreign banks, which possessed much smaller local capital bases than domestic banks. However, the government began to allow foreign banks to participate more broadly in the banking sector. In late 1996, for example, the BIBFs of several foreign banks were upgraded to full branch status.[33] The 25 percent ceiling on foreign ownership of the shares of a domestic bank was raised in

[29] Thailand: Banking, U.S. Dep't of the Treasury, National Treatment Study 471 (1998) [hereinafter "Thailand National Treatment Study"].

[30] EIU Country Profiles (Thailand), *Economic Infrastructure* (Oct. 10, 1997).

[31] EIU Business Reports, *Banks* (May 27, 1996).

[32] Thailand National Treatment Study, *supra* note 29, at 470-471.

[33] EIU Country Profiles (Thailand), *Economic Infrastructure* (Dec. 24, 1996).

November 1997 to permit foreign investors to hold majority ownership of a domestic bank with the approval of the Ministry of Finance.[34]

No deposit insurance systems existed in Thailand. However, troubled banks received financial and managerial assistance on a case-by-case basis from the Ministry of Finance through the Bank of Thailand's Financial Institution Development Fund.[35]

Since 1997, Thailand has increased its prudential standards for banks by, among other things, requiring increased provisions for nonperforming loans, higher capital levels, and stricter loan classifications.[36] In addition, the government now requires banks to file more comprehensive audits and to file them quarterly instead of annually.[37]

Indonesia

Bankruptcy Law

Indonesia's bankruptcy law, drafted by the Dutch in 1905, remained unchanged in 1997. Remarkably, in the nearly 50 years since the Dutch departed the archipelago, Indonesia had never translated its bankruptcy law from Dutch into the native language.[38] Declarations of bankruptcy were extremely rare in Indonesia.[39] As a consequence of the nonuse of the bankruptcy law, judges and lawyers lacked experience in bankruptcy matters.[40] The courts are highly corrupt in Indonesia. Obtaining a favorable verdict, much less enforcement of such verdict, usually necessitates the use of money or political influence or both. Accordingly, creditors and debtors preferred to settle their disputes outside the legal system. The absence of qualified judges and professional bankruptcy administrators (such as trustees in the United States) reinforced the disposition of parties to refrain from utilizing the bankruptcy procedures.[41]

In 1998, Indonesia established a special commercial court to handle bankruptcies. In addition, the bankruptcy law was amended (in the Indonesian language) to provide for the issuance and enforcement of

[34] Thailand National Treatment Study, *supra* note 29, at 473-474.

[35] *Id.* at 471.

[36] *Id.* at 467; EIU Country Reports (Thailand), *Finance & Banking* (July 1, 1999).

[37] EIU Country Reports (Thailand), *Finance & Banking* (June 1, 1998).

[38] Tim Dodd, *Indonesia Rewrites its Bankruptcy Laws*, Australian Fin. Rev. (April 30, 1999).

[39] According to one Indonesian law firm, as of 1997 almost no declarations of bankruptcy had been pronounced by the courts in Jakarta during the previous 20 years. Stacey Steele, *The New Law on Bankruptcy in Indonesia*, 23 Melbourne U. L. Rev. 144, 146 (1999).

[40] *Id.* at 145-146.

[41] Hafzan Taher and Ludo Mees, *Does Indonesia Need New Bankruptcy Laws?*, Jakarta Post (March 5, 1998).

court decisions within a maximum period of roughly 110 days from filing of a bankruptcy petition.[42] The new procedures permit a court to make a declaration of bankruptcy with respect to a debtor that has two or more creditors and defaults on at least one loan.[43]

Secured Transactions Law

In 1997, Indonesia had no modern secured transactions law. No system existed in Indonesia for the registration of security interests, other than real estate mortgages (known as hypotecs). Security interests were permitted in personal property, but Indonesian law did not recognize security interests in personal property that remained in the debtor's possession. And without a registration system, the utility of such security interests was questionable. In the absence of a modern secured transactions system, creditors frequently relied on personal guarantees.[44]

Indonesia has since enacted legislation, effective in September 1999, that permits—through fiduciary transfers—security interests in personal property that remains in the debtor's possession. In a fiduciary transfer, the debtor transfers title over specified goods to a creditor, but only in trust. Once the debt is paid, title reverts to the original owner. Under the legislation, a fiduciary transfer may be used to secure property other than land, certain buildings, and large ships. Notably, the legislation also calls for registries to be established in each of Indonesia's provincial capitals. While no registries have yet been established, it is expected that the first such registry will be set up soon in Jakarta. However, until a nationwide (and effective) registration system is actually implemented, the utility of security interests in Indonesia will remain questionable.[45]

Judicial System

In Indonesia, judges have been described as "'auctioneers' who hand down verdicts to the highest bidder."[46] The Indonesian courts are not

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[42] *Pay or Liquidate*, The Jakarta Post, July 29, 1998.

[43] EIU Country Reports (Indonesia), *Economic Policy* (June 8, 1998).

[44] Indonesian law also permitted mortgages on aircraft, helicopters and ships of a certain size. *See* Robert Brown and Alan Gutterman, *Asian Economic and Legal Development* 240-241 (1998). *See also* Richard Walsh, *Pacific Rim Collateral Security Laws: What Happens When the Project Goes Wrong*, 4 Stan. J. L. Bus. & Fin. 115, 134 (1999).

[45] Robert Hornick, *Fiduciary Transfer—Indonesia's New Law on Collateral Security*, Int'l Fin. L. Rev. 29 (July 2000).

[46] This is the view of Indonesia's former State Enterprises Minister Laksamana Sukardi. Warren Caragata, *In Favor of Deadbeats*, Asiaweek (March 31, 2000). Shortly after Minister Sukardi made this statement, President Abdurrahman Wahid of Indonesia accused the Minister of being involved in collusion, corruption, and nepotism and removed him from office.

viewed as a viable forum for the resolution of commercial disputes. One commentator has observed: "Indonesian law is so complex and diverse in its sources that it is often impossible to know with certainty what rule applies to a given situation." Moreover, the law as written has "little to do with what actually happens in a dispute, because the courts are so corrupted and politically weak that they rarely oppose the policy of the all-powerful executive and its bureaucracy."[47] This state of affairs is exacerbated by the very low salaries paid to judges, the status of judges as civil servants without tenure, and the lack of judicial experience in commercial matters.[48]

Banking Regulation and Supervision

The unstable banking system that existed in 1997 was the direct result of Indonesia's failure—in the midst of deregulation—to adequately supervise and impose prudential restrictions on the activities of Indonesian banks.[49] In the late 1980s, the government undertook a major deregulation of the state-controlled banking system in order to encourage greater competition and to expand credit.[50] Private sector banks could be established. Increased foreign participation in the banking sector was also permitted. Ten foreign banks, including Chase Manhattan Bank and Citibank, operated branches in Jakarta prior to the government's closure of Indonesia to additional foreign bank activity in 1972. These ten banks were permitted to open branches—offering a full range of banking services—in seven additional major cities. In addition, foreign banks were permitted to form joint ventures with domestic banks.[51]

The banking system expanded rapidly in response to the deregulation measures. Private sector banks quickly gained in importance, although by the end of 1995 the seven state-controlled banks still accounted for about 35 percent of the total deposits and 40 percent of the total loans of the commercial banks.[52] However, largely unrestricted bank lending practices and low minimum capitalization requirements left many of the state-controlled and private sector banks with large portfolios of nonperforming loans and severely undercapitalized.[53]

Belatedly, Bank Indonesia, the Indonesian central bank, attempted to

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[47] Timothy C. Lindsey, *Paradigms, Paradoxes and Possibilities: Towards Understandings of Indonesia's Legal System* in *Asian Laws Through Australian Eyes* 90 (1997).

[48] Dodd, *supra* note 38.

[49] Michael S. Bennett, *Banking Deregulation in Indonesia*, 16 U. Pa. J. Int'l Bus. L. 443, 447-448 (1995).

[50] *Id.* at 460.

[51] Indonesia: Banking, U.S. Dep't of the Treasury, National Treatment Study 286-288 (1998) [hereinafter "Indonesia National Treatment Study"].

[52] EIU Country Profiles (Indonesia), *Economic Infrastructure* (Oct. 18, 1996).

[53] Bennet, *supra* note 49, at 447-448.

strengthen its regulation and supervision of the banking system. It tightened reporting requirements, instituted more frequent on-site inspections, and raised the minimum capital adequacy ratio for commercial banks to 8 percent. However, fearing that the stricter standards would cause widespread bank failures, Bank Indonesia did not enforce the new standards. In the wake of the 1997 financial crisis, audits by international accounting firms revealed that banks had routinely circumvented the legal lending limits and underreported and inadequately provisioned for unsound assets.[54]

In response to the 1997 financial crisis, the government established the Indonesian Bank Restructuring Agency (IBRA) to supervise and restructure the banking sector. In addition, among other things, the government (i) raised the paid-in capital required to establish a new bank (although existing banks were exempted), (ii) instituted bank legal lending limits to control exposure to single groups of borrowers, (iii) increased capital adequacy ratios,[55] and (iv) prohibited banks from investing in equity securities.[56] In February 1998, the government removed restrictions on foreign bank expansion and the opening of branches.[57]

South Korea

Bankruptcy Law

South Korea entered the 1997 financial crisis equipped with a fairly modern bankruptcy law. South Korea's corporate reorganization law, for instance, is based essentially on the Bankruptcy Code of the United States as it existed prior to its revision in 1978. However, until the 1990s, the bankruptcy law was of minimal importance in South Korea because the government usually decided the fate of insolvent companies.[58] The government often forced banks to roll over loans instead of putting distressed firms into bankruptcy.[59] As the government began to lessen its dominant role in the economy, the bankruptcy law gained in importance.[60]

The 1997 financial crisis revealed that South Korea's bankruptcy system was far more effective in protecting—rather than doing away with—inefficient companies. Indeed, rather than suffering from nonuse,

[54] Indonesia National Treatment Study, *supra* note 51, at 286.
[55] EIU Country Reports (Indonesia), *Finance & Banking* (Dec. 4, 1998).
[56] Indonesia National Treatment Study, *supra* note 51, at 285-286.
[57] EIU Country Finance, *Foreign Banks* 1.4 (July 31, 1999).
[58] Mikyung Yun, *A Primer on Korean Bankruptcy Law*, 1999 Am. Bankr. Inst. J. 2.
[59] EIU Financing Operations (South Korea), *Domestic Commercial Banks* 5.2 (March 1, 1997).
[60] Yun, *supra* note 58, at 2.

the bankruptcy system was used too much during the 1990s. The weakness of the bankruptcy system stemmed largely from factors outside the system. South Korea is dominated by large companies, including the huge family-owned conglomerates known as "chaebol," which control 50 percent of the South Korean GDP. A single bankruptcy carries the potential for widespread unemployment in South Korea. Consequently, the government, labor interests, and the South Korean society as a whole were loath to permit such bankruptcies to occur. The prejudice against bankruptcy was reinforced by a business culture that viewed "big liquidations as a national embarrassment."[61] Perhaps most important, the South Korean banks, the main creditors of the conglomerates, were reluctant to force the conglomerates into bankruptcy. Such a course would have required the banks to write off huge amounts of debt.[62] Because several decades of policy lending had already left the banking system in a precarious state, the banks sought to mask the extent of their plight by keeping such debt on their books at face value.[63]

These factors, when combined with a South Korean bankruptcy provision known as "Hwaeui," resulted in abuse of the bankruptcy system. Under Hwaeui, a debtor received court protection in order to reschedule its debt. As practiced in South Korea, however, Hwaeui usually resulted in the indefinite postponement of debt payments. Hwaeui enabled an insolvent firm to defer its existing debts and interest payments and to take out new loans. The original management remained in day-to-day control of the firm and the shareholders' rights and interests remained intact. In addition, a court could not close any company shielded by Hwaeui for 10 years without the agreement of two-thirds of the company's creditors. This usually meant continued "survival" for the company since the creditors, often numbering in the dozens, having their own priorities, could rarely reach agreement. A company, however, could choose Hwaeui only with the acquiescence of its creditors. Creditors typically acquiesced because they preferred Hwaeui to liquidation or restructuring, which would have required them to write down or write off the insolvent company's debt. Hwaeui allowed the banks to keep such debt on their books at face value indefinitely.[64]

South Korea tightened its debt rescheduling laws in 1998. The 1998 reforms provided, among other things, (i) guidelines to judges recommending that debt rescheduling not be allowed for firms with total bank loans of more than 250 billion won and (ii) that debt rescheduling will

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[61] Michael Schuman, *"Never-Never Land": Korea's System Won't Let Biggest Bankrupt Firms Die*, Asian Wall Street Journal (March 10, 1998).

[62] *South Korean Bankruptcy: Death, Where Is Thy Sting*?, The Economist (July 17, 1999).

[63] *Id.*; EIU Country Profiles (South Korea), *Economic Infrastructure* (Oct. 18, 1996).

[64] The Economist, *supra* note 62.

be denied if insolvency resulted from misappropriation of funds by managers.[65]

Secured Transactions Law

South Korea's secured transactions law permits the taking of security interests in real estate, intangible rights (such as intellectual property), inventory, accounts receivable, and, by special acts, aircraft, ships, heavy equipment, and vehicles. Security interests can be taken in property that is in the debtor's possession. Despite the wide variety of permitted security interests, most secured transactions have been collateralized by real estate.[66]

Enforcement of security interests has been effective in South Korea, although it can take up to one year for a creditor to recover collateral. Excepting "extraordinary situations," the government has respected the rights of secured creditors.[67] Despite the regime's relative effectiveness and apparent sophistication, the Asian Development Bank has concluded that security interests were not important in managing risk because much of South Korea's bank lending consisted of policy loans implicitly guaranteed by the government, which obviated the need for collateral.[68]

Judicial System

The judiciary in South Korea is considered to be of "generally good quality." "Contractual agreements are secure," with South Korea's "commercial codes and legal framework comparable to those in developed countries."[69] In 1997, however, observers still discerned corruption and other irregularities in the lower-rank officialdom despite occasional crackdowns.[70]

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[65] Yun, *supra* note 58, at 5.

[66] Katharina Pistor and Philip A. Wellons, *The Role of Law and Legal Institutions in Asian Economic Development* 177, 179 (1998).

[67] In the 1980s, the South Korean government, as part of a restructuring program, prevented creditors from enforcing security interests relating to the shipbuilding, overseas construction, textile, and lumber industries. *Id.* at 178.

[68] *Id.* at 179.

[69] EIU Investing Licensing & Trading (South Korea), *Political Conditions* 1.1 (July 1, 1997).

[70] *Id.* South Korea acted quickly to strengthen its judiciary. In a 1998 report, the EIU noted that corruption in the lower ranks had been dealt with through repeated crackdowns. EIU Investing Licensing & Trading (South Korea), *Political Conditions* 1.1 (July 29, 1998). And in 1999, investor Mark Mobius cited South Korea and Hong Kong as being the most favorable places to invest in Asia due to their established legal systems (and clearer reports to shareholders). *Mobius Raising $500 Million Private Equity Fund for Investment in Asia*, Business Day (Thailand) (Aug. 16, 1999).

Banking Regulation and Supervision

In 1997, nonperforming loans permeated South Korea's banking system. The weak state of the banking system was the result of several decades of policy lending, whereby both state-controlled and private sector banks lent to those industries most favored by the government. As the South Korean economy slowed, these industries, such as shipbuilding, steel, and electronics, could no longer service their debts. South Korean regulators chose to ignore the problem. In 1996, for instance, the amount that banks had to set aside to cover losses was reduced.[71]

In the 1990s, the government took steps to deregulate the banking sector.[72] As part of its liberalization efforts, the government ceased appointing the presidents of the commercial banks, permitted banks to open more branches, lowered reserve requirements, and eased lending guidelines. Nonetheless, many restrictions on the banking sector remained. Despite the removal of most restrictions on interest rates, the interest rates on demand deposits and policy loans continued to be regulated. Other restrictions were maintained in order to moderate the influence of the chaebol. The government prohibited chaebol from controlling any commercial bank or from owning more than 4 percent of the seven largest commercial banks. In addition, the government sought to limit the amount of bank lending to chaebol by requiring national banks, provincial banks, and foreign banks to extend 45 percent, 70 percent, and 25 percent, respectively, of their new loans to small and medium-sized companies.[73] The banks also remained subject to informal government requirements concerning credit allocation, liquidity control, and support for various economic and social policy objectives.[74]

Foreign banks also operated in a highly regulated atmosphere. Foreign banks could not establish subsidiaries.[75] Lending by foreign bank branches was restricted because the government used a foreign bank's local capital in calculating prudential lending limits instead of the worldwide capital of the bank. In addition, foreign banks were subject to a host of other complex rules and regulations.[76] As a result of continued government interference in the commercial banking sector, nonbank financial institutions controlled nearly 75 percent of total loans by late

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[71] EIU ViewsWire (South Korea), *Asia Finance: Fall from Grace* (April 14, 1997).

[72] Korea: Banking, U.S. Dep't of the Treasury, National Treatment Study 364 (1994) [hereinafter "1994 Korea National Treatment Study"].

[73] EIU Financing Foreign Operations (South Korea), *Banks and Other Financial Institutions* 5.0 (March 1, 1997).

[74] 1994 Korea National Treatment Study, *supra* note 72, at 369.

[75] Wholly owned subsidiaries of foreign banks have been permitted since March 1998. Korea: Banking, U.S. Dep't of the Treasury, National Treatment Study 323 (1998) [hereinafter "1998 Korea National Treatment Study"].

[76] 1994 Korea National Treatment Study, *supra* note 72, at 367, 369-371.

1996. These nonbank financial institutions enjoyed greater freedom to manage their assets and liabilities, including charging higher rates on loans.[77]

In the wake of the 1997 financial crisis, South Korea strengthened its prudential regulations by implementing a new asset-quality assessment framework, tighter limitations on loans to single borrowers, a prompt corrective action framework, and improved accounting policies. In addition, regulation of the entire financial system was placed under a newly established Financial Supervisory Commission.[78] Further, the government relaxed foreign exchange regulations, removed restrictions on foreign capital inflows, and permitted foreign banks to participate in mergers and acquisitions of domestic financial institutions.[79]

TAIWAN

Bankruptcy Law

Taiwan's bankruptcy system has been highly effective over the years. In 1996, for example, approximately 25,000 companies went out of business, about 4.7 percent of the total businesses in Taiwan.[80] The regime's effectiveness is explained, at least in part, by the fact that Taiwan's economy consists mainly of small firms. Bankruptcies of small firms can take place without resulting in large-scale unemployment. Thus, it was politically acceptable in Taiwan for insolvent enterprises to be restructured or dissolved.

Secured Transactions Law

Taiwan's secured transaction law is effective and sophisticated, and it utilizes a reliable registration system.[81] The secured transactions law permits the taking of security in personal property that remains in the debtor's possession. However, the law—which borrows heavily from U.S. laws in effect prior to the Uniform Commercial Code—does not recognize the use of inventory and accounts receivable as collateral. In 1995, 65 percent of all loans extended by banks in Taiwan were secured.[82]

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[77] EIU Financing Foreign Operations (South Korea), *Banks and Financial Institutions* 5.0 (March 1, 1997).

[78] 86 Fed. Res. Bull. 4 (April 2000).

[79] 1998 Korea National Treatment Study, *supra* note 75, at 323.

[80] Editorial, *Going for Broke: Korea Steels Itself for Failure*, Far Eastern Economic Review (June 11, 1998).

[81] *1998 Investment Climate Report for Taiwan*, Int'l Mkt. Insight 1, 13 (July 2, 1998).

[82] Pistor and Wellons, *supra* note 66, at 172-175.

Judicial System

Taiwan has a comprehensive legal system that protects property rights and foreign investments, and ensures fair competition.[83] The courts enforce judgments of foreign courts.[84]

Observers, however, have differed in their assessments of Taiwan's judiciary. The U.S. State Department considers the courts to be independent and free from interference by the executive branch.[85] In contrast, the EIU has pointed to the reputation of the judiciary for corruption and cronyism.[86] It believed that this reputation remained warranted in late 1996 despite recent improvements that had resulted in the local judiciary becoming "moderately independent and trying hard to allay concerns about corruption."[87]

By 1997, Taiwan's economic development had led to considerable demand for legal expertise as a result of (i) the legally complex investment projects that accompanied such economic development and (ii) the wave of legislative reforms that followed the end of martial law in 1987. A partner in one of Taiwan's largest law firms stated: "When the economy is good, we have more investment cases; when the economy is bad, we have more litigation cases."[88]

Banking Regulation and Supervision

In 1997, Taiwan's state-controlled and private sector banks operated in a liberalized banking environment marked by strict prudential requirements and oversight. Interest rates were not restricted. Although Taiwan's banking system had been opened to private sector banks in 1988, state-controlled banks continued to dominate the sector. At the end of 1997, 13 state-controlled banks held more than 60 percent of the assets and deposits of all deposit-taking institutions. No law or regulation, however, granted state-controlled banks preferential treatment.[89] Foreign banks could establish an unlimited number of branches anywhere in the country, and such branches were allowed to engage in wide-ranging activities.[90]

In tandem with a liberalized banking environment, Taiwan subjected

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[83] *1998 Investment Climate Report for Taiwan, supra* note 81, at 13.

[84] *Id.* at 14.

[85] *Id.*

[86] EIU Investing Licensing & Trading (Taiwan), *Political Assessment* 1.1 (Dec. 19, 1997).

[87] EIU Investing Licensing & Trading (Taiwan), *Political Assessment* 1.1 (Dec. 1, 1996).

[88] Matt Born, *Keeping Pace with the Tiger*, Asia Law (April 1997).

[89] Taiwan: Banking, U.S. Dep't of the Treasury, National Treatment Study 450-454 (1998) [hereinafter "Taiwan National Treatment Study"].

[90] EIU Financing Foreign Operations (Taiwan), *Foreign Commercial Banks 5.3* (Nov. 1, 1996).

banks to strict prudential requirements. For example, (i) ownership could not exceed 5 percent for each shareholder or 15 percent per shareholder plus relatives and corporate entities under their control, (ii) banks could not offer unsecured loans to bank executives or to shareholders with more than 3 percent ownership, and (iii) banks had to meet the BIS capital adequacy requirement that capital exceed 8 percent of risk-weighted assets.[91] Financial institutions were subject to regular and unannounced examinations. A voluntary deposit insurance system covered 83 percent of domestic banks and 64 percent of foreign banks. The system guaranteed up to the equivalent of approximately US$35,000 (at 1997 exchange rates) per depositor.[92]

China

Bankruptcy Law

China's bankruptcy law applies only to state-owned enterprises (SOEs). Bankruptcy of individuals and private companies is not recognized.[93] The bankruptcy regime is not particularly effective. As of 1995, only slightly more than 2,000 SOEs had filed for bankruptcy[94] despite the fact that a vast number of them were insolvent.[95]

China's bankruptcy law lacks effectiveness for several reasons. First, insolvent SOEs may submit to bankruptcy only with the permission of the relevant government department.[96] Bankruptcy, therefore, is a question not only of economics, but of politics as well. The government makes the final determination as to whether an enterprise may enter into a bankruptcy proceeding. Because the government fears the consequences of widespread unemployment, it is reluctant to permit bankruptcies of SOEs. This reluctance has been heightened by the fact that workers of bankrupt SOEs are threatened not only with the loss of their jobs, but of their entire social security framework. Most SOEs provide China's work force with their housing, pensions, medical care, and schooling. China has established only the rudiments of a social security system with which

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[91] Taiwan National Treatment Study, *supra* note 89, at 452. However, the EIU asserted in 1995 that "[i]ntense competition for business often leads many banks, including foreign banks, to ignore standard international market practices and BIS guidelines." EIU Financing Foreign Operations (Taiwan), *Financial Conditions* 1.3 (Dec. 1, 1995).

[92] Taiwan National Treatment Study, *supra* note 89, at 454.

[93] Ronald Winston Harmer, *Insolvency Law and Reform in the People's Republic of China*, 64 Fordham L. Rev. 2563, 2574 (1996). The law has also been applied in practice by courts to some collectively owned enterprises. Jerome A. Cohen and John E. Lange, *The Chinese Legal System: A Primer for Investors*, 17 N.Y.L. Sch. J. Int'l & Comp. L. 345, 371 (1997).

[94] Steven L. Seebach, *Bankruptcy Behind the Great Wall*, 8 Transnat'l Law. 351, 368 (1995).

[95] EIU ViewsWire (China), *China Investment: EIU Survey Debunks Market Potential Myths* (Nov. 9, 1995).

[96] Cohen and Lange, *supra* note 93, at 371.

to replace that provided by the SOEs.[97] Second, the bankruptcy law's heavy emphasis on liquidation—as opposed to reorganization—can only have increased the government's reluctance to use the law.[98] Third, a local court must also consent to the bankruptcy of an SOE. Here, too, politics plays a major role because of the susceptibility of the courts to local political influence.[99] The local courts are loath to put local industries out of business. Fourth, the large state-owned banks, which are the major creditors of the SOEs, also have opposed SOE bankruptcies. The banks were not willing to write off the huge amount of debt owed to them by insolvent SOEs.[100]

Secured Transactions Law

China's secured transactions system exists—for the most part—only on paper.[101] Pursuant to the Security Law, enacted in 1995, China recognizes mortgages, pledges, and liens.[102] It is unclear under the law whether security interests in bank accounts or floating charges on inventory are also permitted.[103] Prior to the Security Law, secured transaction regulations existed only in several economically progressive provinces, special economic zones, and cities.[104]

The Security Law, however, failed to create a viable secured transactions system in China. Neither the Security Law nor local regulations generally contain provisions for the registration and enforcement of security interests in personal property.[105]

With respect to real property, while the Security Law, like many local regulations, provides for the registration and foreclosure of mortgages in land, enforcement has been largely ineffective.[106] The local courts have been generally unwilling to permit foreclosure against local debtors.[107] And even where creditors have obtained an order of foreclosure from the courts, such orders generally have been enforced only with great difficulty.[108]

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[97] EIU China Hand, *Economy* (Jan. 1, 1999).

[98] Harmer, *supra* note 93, at 2575.

[99] Cohen and Lange, *supra* note 96, at 371.

[100] Harmer, *supra* note 93, at 2579.

[101] Cohen and Lange, *supra* note 96, at 370-371.

[102] Guarantees and deposits are also permitted. A deposit is a 20 percent maximum transfer of cash to secure performance of an obligation. Kevin T.S. Kong, *Prospects for Asset Securitization Within China's Legal Framework: The Two-Tiered Model*, 32 Cornell Int'l L.J. 237, 254 (1998).

[103] EIU China Hand, *Finance* (Feb. 1, 1999).

[104] Todd R. Benson, *Taking Security in China*, 21 Yale J. Int'l L. 183, 197 (1996).

[105] Cohen and Lange, *supra* note 96, at 370-371.

[106] *Id.* This was still the case in 1999. EIU China Hand, *Finance* (Feb. 1, 1999).

[107] Benson, *supra* note 104, at 216; Cohen and Lange, *supra* note 96, at 371.

[108] Benson, *supra* note 104, at 215, 227 n.204.

Judicial System

No independent judiciary exists in China. The judiciary is a functional arm of the political bureaucracy and subject to heavy influence from the Communist Party. Every court has a committee of senior judges, including party members, that can reverse verdicts. In addition, the courts are subject to local political influence. As a result, the courts not only make decisions based on political factors, but engage in localism whereby the local party is favored over litigants from outside the region. Judgments from other parts of the country are difficult to enforce.[109]

Those with the most political or economic influence have the best "guanxi," or personal connections, as well. Guanxi, rather than the rule of law, determines the outcome of many Chinese court proceedings. It has been observed that victory goes to the side with the most powerful people supporting it and not to the side with the most compelling legal argument.[110]

In addition, the laws themselves lack transparency. Rules are subject to repeal without notice, and many internal regulations (directives given by the government to its officials) are not easily accessible to the public.[111] The legal system also lacks adequate numbers of judges and lawyers experienced in commercial law.[112] China has had a modern commercial law only since the ascendency of Deng Xiaoping in 1978. It has been observed that this has been much too short a "period of time to develop the web of rules, customs, practices, institutions, habits, and attitudes that make up a legal system."[113]

It is noteworthy, however, that in 1995 at least one commentator had already discerned increasing independence in the Chinese judiciary and argued that politically mandated reversals of court decisions were becoming rare. The Chinese leadership, most of whom know firsthand the consequences of lawlessness from the decade-long nightmare of the Cultural Revolution, want to see an independent judiciary develop.[114]

Banking Regulation and Supervision

While no modern commercial banking system existed in China in 1997, the Chinese government had taken steps in that direction. In 1994, the government converted four "specialized" state-owned banks (the "Big Four") that had dominated the domestic banking system into

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[109] Kong, *supra* note 102, at 249-250.
[110] Benson, *supra* note 104, at 217-218.
[111] *Id.* at 191.
[112] Kong, *supra* note 102, at 264.
[113] Cohen and Lange, *supra* note 96, at 348.
[114] Marcus W. Brauchli, *Beijing Eases Up: China's Economic Changes Spur Legal-System Reform*, Wall St. J. (June 21, 1995).

"commercial" banks by assigning their duties for making so-called "policy loans" to three newly established "policy" banks.[115] The policy banks do not accept deposits. As part of their conversion, the Big Four banks were given a measure of autonomy in making decisions to extend credit.[116] And in 1995, the People's Bank of China (PBOC) received legal authority to function as China's central bank.[117] Also, the system was opened to private sector banks.

Despite such reforms, however, the system remained under heavy government control. All interest rates on deposits and loans were set by the PBOC.[118] Government regulations impeded the development of new products.[119] Moreover, the banking system remained inextricably linked to the SOEs. The SOEs continued to receive an overwhelming percentage of the loans extended by banks.[120] And the government controlled overall bank lending through a credit plan.[121] Favored sectors of the economy were given preferential lending rates in the form of policy loans. The Big Four state-owned banks continued to dominate the banking sector, with about 70 percent of the banking system's assets as of year-end 1997.[122] The Big Four banks—despite their conversion into commercial banks—continued to participate in directed lending to SOEs and national projects, and they purchased bonds issued by the policy banks.[123] Aggregate lending volume had to comply with the government's development policies,[124] and a large percentage of their policy loans were not transferred to the policy banks.[125] In addition, official policies discouraged state-owned banks from providing private sector enterprises with credit in proportion to their increasing weight in the economy.[126] Lending

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[115] China: Banking, U.S. Dep't of the Treasury, National Treatment Study (1998) [hereinafter "China National Treatment Study"]; John L. Walker, *Financial Reform in China*, presentation at 2000 Harvard Asia Business Conference, Harvard Business School (Jan. 28, 2000) (on file with author).

[116] Moody's Investors Service, *Banking System Outlook (China)* 13 (1999) [hereinafter "Moody's"].

[117] *Id.* at 14.

[118] China National Treatment Study, *supra* note 115, at 181.

[119] Moody's, *supra* note 116, at 10.

[120] At year-end 1998, for instance, about 90 percent of all bank loans were made to SOEs according to the PBOC. Moody's, *supra* note 116, at 11.

[121] The credit plan was eliminated in January 1998. China National Treatment Study, *supra* note 115, at 177.

[122] *Id.* at 178.

[123] Moody's, *supra* note 116, at 13.

[124] *Id.*

[125] China National Treatment Study, *supra* note 115, at 179.

[126] *Id.* at 178.

decisions of state-owned banks remained subject to the heavy influence of provincial governments.[127]

Foreign banking activities were highly restricted. Among other things, foreign banks were limited in where they could be located[128] and prevented from conducting business in local currency (except in the Pudong district of Shanghai).[129] A foreign bank could not accept deposits from a Chinese enterprise unless the enterprise had received a loan from the bank. In addition, foreign banks could not make foreign currency loans to Chinese enterprises without the approval of both the PBOC and the State Administration of Foreign Exchange.

Despite supervisory guidelines requiring all banks to achieve international capital standards,[130] prudential regulation remained lax. International standards were not used in the classification of nonperforming loans—only the overdue portion of a loan, rather than the entire loan, was classified as nonperforming. Also, no regulation required depositors to put their real names on their bank accounts. Anyone could open a savings account under any name, without any identification being required. This aided individuals in concealing money obtained through bribery, corruption, or the taking of assets from SOEs.[131]

Since 1997, China has undertaken further reforms of the banking sector. In 1998, the provincial branches of the PBOC were reorganized from 31 into nine regional centers, modeled somewhat after the Federal Reserve System in the United States, to enhance the PBOC's regulatory authority and to counter interference from the provincial governments.[132] Also, the government injected the equivalent of roughly $33 billion of new capital into the Big Four banks, closed several particularly weak financial institutions, and established government-owned asset management companies to handle nonperforming loans made by the banks prior to 1996.[133]

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[127] Moody's, *supra* note 116, at 14. Prior to 1997, the management of a Chinese bank's branch reported in a dual manner both to the bank's head office and to the provincial government. Since 1997, branch management reports only to the bank's head office. *Id.*

[128] At year-end 1997, foreign banks could operate only in 23 cities and in Hainan Province. *China: Overseas Financial Business Encouraged*, Beijing Review (Nov. 24, 1997).

[129] By year-end 1997, nine foreign banks, including Citibank, had received approval to engage in renminbi business in Pudong. Loans denominated in renminbi, however, may not exceed 35 percent of a bank's total renminbi deposits. China National Treatment Study, *supra* note 115, at 183.

[130] China National Treatment Study, *supra* note 115, at 184.

[131] Erik Eckholm, *China to End Bank Secrecy in Effort Against Corruption*, N.Y. Times (Jan. 21, 2000). The PBOC has recently announced a "real-name system" for bank deposits. *Id.*

[132] Moody's, *supra* note 116, at 14.

[133] *Id.* at 13, 14, 18.

Russia

Bankruptcy Law

When the August 1998 financial crisis arrived, Russia's bankruptcy law—its second since 1993—had been in place for less than six months.[134] The law was considered one of Eastern Europe's strictest.[135] Unlike its predecessor, the new law applied to nearly all corporate forms and covered for the first time personal bankruptcies as well. Under the law, an entity qualifies for bankruptcy if it is unable to pay its debts, including tax obligations to the government, for a period of three months. This is a much stricter and more effective definition than that of the previous law, under which bankruptcy occurred when an entity's liabilities exceeded its assets. This balance sheet definition allowed many insolvent firms to escape bankruptcy as a result of the difficulty of determining the value of assets in Russia, as well as the use of Soviet accounting methods.[136] Also, the new law requires an insolvent company's executive body to apply for a declaration of insolvency within one month of the emergence of the insolvent condition. If the executive body fails to do so, its members face potential personal liability for all obligations arising after an application should have been filed.[137]

The new law's restructuring provisions permit companies to continue operations while enjoying some protection from creditors. But unlike the previous law—under which cases could linger in court for years—the 1998 law requires the debtor, its creditors, and the court to act within a definite time frame.[138] The law provides for an observation period of three to five months prior to a formal declaration of bankruptcy. During this period, the court appoints an interim manager, convenes a creditors' meeting, and assesses the financial status of the debtor. The management of the debtor remains in control unless removed by the court for cause, such as hindering the interim manager. If bankruptcy is approved, the entire management has to be dismissed and replaced with external managers selected by the creditors. External management can last for no more than one and one-half years. If such management fails, or if the enterprise is deemed unsuitable for reorganization, the court can order liquidation.[139]

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[134] The law took effect on March 1, 1998. Robert Wood and Brian Zimbler, *Russia: New Bankruptcy Law*, Int'l Fin. L. Rev. (1998).

[135] EIU ViewsWire (Russia), *Russia Finance: Bankruptcy Petitions Soar* (April 26, 1999).

[136] Geoffrey York, *Russia Launches Bankruptcy Reform*, The Globe and Mail (March 6, 1998).

[137] Britt Shaw, *New Law Resolves Issues of Bankruptcy*, Int'l Fin. L. Rev. (1998).

[138] *Id.*

[139] Craig A. Hart, *Undoing Privatization? Russian Bankruptcy Law and Privatization*, 14 Bankr. Dev. J. 311, 314-318 (1998).

The law, however, contains flaws. First, it generally exempts from its coverage "town-forming enterprises"—companies with more than 5,000 employees or whose employees and family members constitute one-half or more of a town's population. Such enterprises can be externally managed for up to 10 years, but cannot be liquidated.[140] Therefore, the largest and most inefficient companies in Russia are relatively untouched by the law. Second, the law requires preliminary hearings to be held in the debtor's home city. This creates the potential for court bias in favor of local debtors.[141] Other flaws, however, are systemic and not the fault of the bankruptcy law. For example, although the law introduced the position of court-appointed receivers, the number of properly trained receivers remains insufficient to handle bankruptcies.[142] Also, the government itself often is opposed to the bankruptcy of an enterprise because the large Russian enterprises provide housing, schools, clinics, and other social services to employees. One commentator has stated that "[w]hen an entire country is insolvent implementing a bankruptcy law is a delicate business."[143]

Secured Transactions Law

Russia's secured transactions law, based on the 1992 Law of Pledge and the 1995 Civil Code, recognizes a broad range of security interests. Collateral, for instance, can be taken in inventory and after-acquired property, and the law permits debtors to remain in possession of secured property.[144] However, no registration system exists for personal property. Personal property is automatically perfected against subsequent creditors upon execution of a valid security agreement. In lieu of a filing system, the law obligates the debtor to inform each subsequent secured creditor about existing security interests in the relevant collateral.[145] Failure to make such disclosure results in liability of the debtor for any loss suffered by the creditor. This approach requires creditors to depend almost solely on the assurance of the debtor. Creditors are not likely to be impressed by such recourse to the debtor, since the purpose of a secured transactions law is to enable the creditor to recover on the property without having to pursue the debtor.

The law does provide for a unified registration system for real

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[140] *Russia's New Bankruptcy Law Workable But Flawed*, 26 Bankr. Ct. Dec. 7 (1998).

[141] EIU ViewsWire (Russia), *supra* note 135.

[142] Moreover, these receivers were observed in 1999 to be "notorious [for] fraud or collusion with debtors." *Id.*

[143] *Id.*

[144] Jason J. Kilborn, *Securing Russia's Future: A Plea for Reform in Russian Secured Transactions Law*, 95 Mich. L. Rev. 255, 259-260 (1996).

[145] Brandon Bennett, *Secured Financing in Russia: Risks, Legal Incentives, and Policy Concerns*, 77 Tex. L. Rev. 1443, 1452, 1455-1456 (1999).

property, but it was not until February 1998 that Russia passed legislation establishing a national registry.[146] The effectiveness of this registration system remains to be seen.

Judicial System

Russians and non-Russians alike have a low opinion of Russia's legal system. One Western mutual fund manager complained in 1995: "Don't even think about getting justice in a Russian court."[147] Russians view the courts, along with other state institutions, with broad distrust and disrespect. During the Soviet era the courts engaged in "telephone justice," making rulings based on the telephone instructions of Communist officials.[148] In the post-Soviet era, judges became susceptible to bribery and coercion. It did not escape public notice that in court the more powerful and influential party tended to prevail regardless of legal merit.[149]

Low salaries have left judges open to bribery. While judges are among the highest-paid officials in the Russian government—receiving the equivalent of roughly $550 a month in 1997—their compensation is meager compared to that of workers in the private sector.[150] And with the exception of the Russian Supreme Court, the courts lack independent budgets.[151] As a result, judges in the regional and local courts, in particular, are subjected to political pressure by local political officials who control their salaries and access to housing.[152] In addition, judges have been subjected to physical coercion by organized crime groups.[153]

Most commercial litigation is handled by commercial courts, known as arbitrazh courts.[154] Unfortunately, most arbitrazh judges are holdovers from the Soviet era and lack training in the legal principles of a market-oriented system. Observers have also complained that arbitrazh judges routinely issue inaccurate and carelessly drafted opinions.[155]

Since 1997, Russia has permitted the enforcement of foreign arbitration awards, even if no reciprocal treaty exists between Russia and the

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[146] *Id.* at 1456-1458.

[147] Glenn P. Hendrix, *Business Litigation and Arbitration in Russia*, 31 Int'l Law. 1075 (1998).

[148] *Id.*

[149] Karen Halverson, *Resolving Economic Disputes in Russia's Market Economy*, 18 Mich. J. Int'l L. 59, 101-102 (1997).

[150] Hendrix, *supra* note 147, at 1090.

[151] Scott P. Boylan, *The Status of Judicial Reform in Russia*, 13 Am. U. Int'l L. Rev. 1327, 1334 (1998).

[152] *1998 Investment Climate Statement for Russia*, Int'l Mkt. Insight (July 10, 1998); Halverson, *supra* note 149, at 102.

[153] Halverson, *supra* note 149, at 102.

[154] Hendrix, *supra* note 147, at 1086.

[155] Halverson, *supra* note 149, at 104.

country in which the order was issued.[156] But enforcement of court decisions, including foreign arbitration awards, remains a major problem in Russia.[157] According to the Ministry of Justice, in 1995 only 50 percent of court rulings involving the recovery of money were implemented. To remedy this, Russia created a marshals service, which became operational in 1998. The marshals were vested with broad powers to compel compliance with court rulings.[158] However, as of 1998, the service was not fully staffed and had yet to prove its effectiveness.[159]

Banking Regulation and Supervision

In 1998, the diverse and fast-growing activities of Russia's banks were not sufficiently regulated or supervised. Use of international accounting standards was infrequent and the banks were undercapitalized.[160] The assets on the balance sheets of Russian banks consisted predominantly of Russian government securities, and the banks had extensive off-balance-sheet foreign exchange exposure.

In the late 1980s, Russia decentralized its financial sector and permitted the establishment of private banks. The Central Bank of Russia (CBR) was created and the state bank of the Soviet Union, Gosbank, was dismantled.[161] The reforms led to an explosion of private sector banks in Russia. The number of licensed banks reached a high of approximately 2,500 in 1995 and then declined to approximately 1,600 by July 1998. Despite the large number of banks, banking activity was concentrated in the 200 largest banks. Many of these large banks were linked together with industrial firms, forming financial–industrial groups. Other banks, so-called "pocket" banks, were entirely controlled by and dedicated to serving a single enterprise. Despite the rapid expansion of private sector banks, Sberbank, the state-owned savings bank, remained the largest bank and dominated the market, accounting for more than one-fourth of all banking assets. Because no deposit insurance system existed in Russia, the vast majority of retail deposits were held by Sberbank owing to the implied government guarantee of its deposits, as well as its extensive national branch and agency network.[162]

Banks were allowed to engage in widespread activities including

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[156] *1998 Investment Climate Statement for Russia, supra* note 152.

[157] The general courts, not the arbitrazh courts, are responsible for enforcement of foreign arbitration awards. Hendrix, *supra* note 147, at 1086.

[158] Hendrix, *supra* note 147, at 1099.

[159] *1998 Investment Climate Statement for Russia, supra* note 152; Hendrix, *supra* note 147, at 1099.

[160] Russia: Banking, U.S. Dep't of the Treasury, National Treatment Study 394 (1998) [hereinafter "Russia National Treatment Study"].

[161] EIU Country Profiles (Russia), *Economic Infrastructure* (June 24, 1997).

[162] Russia National Treatment Study, *supra* note 160, at 394, 395.

making investments in securities, interbank lending, foreign exchange, futures operations, export financing, custody services, the issuance of debt instruments, and investment banking activities. Foreign banks were generally free to engage in any banking activities. However, policy decisions of the CBR permit foreign banks to operate only through subsidiaries instead of branches and impose higher capital requirements on foreign banks. Since 1996, foreign banks have been permitted to establish full-service subsidiaries that provide retail and commercial banking services to Russian clients. Seventy-five percent of the employees of such a subsidiary must be Russian citizens and 50 percent of its management board must be Russian citizens. Further, foreign banks may not own more than 12 percent of the total paid-in capital of all banks in Russia. Permission of the CBR is required for nonresidents to own more than 1 percent of the shares of a domestic bank.[163]

In response to the expansion of private sector banks in Russia, in July 1995 the CBR was given stronger supervisory powers. These new powers included the ability to revoke the licenses of banks that reported incorrect data, performed operations for which they had not been licensed, and evidenced an unsatisfactory financial position. However, the CBR could not shut down the operations of unlicensed banks. Thus, even though by July 1998 the CBR had revoked 927 licenses, only 439 of those institutions had been liquidated.[164] Intense liquidity problems led to rapid consolidation in the banking industry after August 1998.[165]

The CBR also strengthened its supervision and regulation of the banking sector by the following actions: (i) forming a special unit, OPERU-2, to oversee the activities of the 14 largest institutions; (ii) gradually raising capital adequacy ratios; (iii) moving toward the establishment of international accounting standards through the introduction of a new Chart of Accounts early in 1998; (iv) tightening licensing procedures; (v) requiring banks to establish internal controls; and (vi) adopting provisioning requirements for nonperforming loans.[166]

In response to the events of August 1998, the CBR raised minimum capital adequacy ratios for banks effective January 2001. Reporting standards were strengthened as well.[167] In order to restructure the banking sector, the government created the Agency for Restructuring Lending Institutions (ARCO).[168]

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[163] *Id.* at 393, 398-399.

[164] *Id.* at 395. The CBR's power to close banks was strengthened in the wake of the financial crisis with the passage in 1999 of bank insolvency legislation. EIU Country Finance, *Domestic Banks* 1.3 (April 30, 2000).

[165] Russia National Treatment Study, *supra* note 160, at 395.

[166] *Id.* at 397.

[167] *Id.*

[168] EIU Country Finance, *Bank Regulators* 1.2 (April 30, 2000).

Analysis of the Situation

As stated above, poorly developed legal and regulatory frameworks were not the proximate cause of the financial crises in East Asia and Russia. But once the crises began, weak legal and regulatory frameworks made it impossible to contain the problem and to work to restore financial stability and confidence. The magnitude of the crises was amplified as a result. And it is entirely possible that in a well-regulated and well-supervised financial system, the systemic mismatching of maturities and the foreign currency and market risks that occurred in East Asian countries might have been avoided.

In comparing the legal and regulatory frameworks of Thailand, Indonesia, and South Korea, it appears that Indonesia has the weakest legal and regulatory framework of the three countries and that South Korea has the strongest. This ranking mirrors the depth of the financial crisis, and the level of recovery from the crisis, in these three countries. While each of the three countries is currently experiencing positive growth rates, Indonesia's economy was the most affected by the Asian financial crisis and has recovered the least. This is reflected in the current long-term bond ratings by Moody's Investors Service for the three countries: South Korea, Baa2; Thailand, Ba1 (under review for possible upgrade); and Indonesia, B3. Similarly, the ratings of long-term bank deposits by Moody's are as follows: South Korea, Baa3; Thailand, B1 (under review for possible upgrade); and Indonesia, Caa1. By comparison, Taiwan, which has the most developed legal and regulatory framework in East Asia, suffered the least from the Asian financial crisis. Taiwan's current long-term bond rating by Moody's is Aa3.

Inappropriate sequencing of financial deregulation and liberalization, and the lack of prudential supervision of the financial system, were important factors contributing to the Asian financial crisis. In order to implement financial deregulation and liberalization, stability and the proper sequencing of the steps for deregulation and liberalization are required. Unfettered international capital mobility is not the best system for all countries. The issue is one of proper sequencing. Capital markets need supervisory and regulatory structures in place *before* broad-based financial deregulation and liberalization are introduced. While sound fiscal and monetary policies and the avoidance of large current account imbalances are necessary for the development of market economies, such macro policies need to be accompanied by bankruptcy and secured transactions regimes, and competent and maturing judicial and bank regulatory and supervisory regimes.

Over the past decade many lessons have been learned in the transition and emerging economies. Perhaps the most important is that the development of market economies in these countries will be long-term processes involving many steps. Another important lesson is that

the sequencing of these steps is critically important. Far more attention needs to be paid to such proper sequencing. Broad financial liberalization should not occur without the existence of a developing legal and regulatory framework that contains, at a minimum, bankruptcy laws, secured transactions laws, a functioning judicial system, and effective banking regulation and supervision. While such important components of a legal system do not have to be fully developed in order to begin financial deregulation and liberalization, the foundation for such a legal system with these components as cornerstones needs to be in place as such deregulation and liberalization are introduced. Just as it is easier to build a dam before the water is flowing, it is easier to put in place the necessary legal and regulatory framework before the financial system is broadly deregulated and liberalized. Financial crises will still occur even with the existence of a well-developed legal system—witness the U.S. savings and loan crisis—but a developing and maturing legal system can reduce the likelihood of a financial crisis, can help prevent a correction in the market from becoming a systemic financial crisis, and can help contain a spreading financial crisis and so work to quickly rebuild confidence in the financial system, which is necessary for a market economy to function effectively and efficiently.

China's legal and regulatory framework is the least developed of the six countries that are the focus of this paper. Yet China did not suffer the full consequences of the Asian financial crisis. The Chinese economy, while slowing down during the crisis, continued to grow throughout the crisis and the Chinese renminbi was not devalued. China's current long-term bond rating by Moody's is A3. China's experience during the Asian financial crisis reflects the fact that China's financial system has not been deregulated and liberalized as much as the other East Asian countries that suffered the full blow of the financial crisis. Political and other considerations may be behind the fact that China's financial system has not been opened up as much as in other East Asian countries. But the Chinese leadership now has the opportunity to follow a better and more orderly sequencing of financial deregulation and liberalization steps than has been followed in other transition and emerging economies.

Both Russia and China have set their sights on the same end point—a market-oriented economy. Never before in history have transitions been undertaken on the scale and scope being undertaken in Russia and China. However, the two countries are approaching the transition from a state-planned to a market-oriented economy from very different paths. The Chinese approach is top down, whereas the Russian approach is bottom up. This author believes that China might well have followed Russia's bottom-up approach—with its apparent chaos accompanying broad financial deregulation and liberalization—if the Chinese leaders had not themselves directly experienced the chaos of the Cultural Revolution.

Given the high priority that the Chinese leadership has given to economic reform, combined with the government's high level of financial resources, including foreign exchange reserves, and the high degree of state control over the economy and the financial system, a systemic financial crisis should not be expected in China in the foreseeable future. But the Chinese leadership must use this period to put in place the broad infrastructure that is necessary for financial stability. It is vitally important that the legal and regulatory framework be significantly strengthened in China as quickly as possible.

It is the view of this author that the bankruptcy and secured transaction laws of Russia are sufficiently well developed. Russia also has satisfactory commercial banking laws, central banking laws, and bank insolvency laws. While each of these laws can certainly be improved, Russia's statutory framework for its financial system is sufficiently well developed. The Russian financial regulatory authorities, particularly within the Central Bank of Russia, have gained much sophistication since 1992. While in recent years the Central Bank of Russia as an institution has lost much of the credibility and confidence that it was building during the earlier years of the transition, a cadre of personnel remain in the Central Bank of Russia who well understand the techniques and tools for effective banking regulation and supervision.

The problem for Russia is one of implementation. Russia needs to build a common and collective interest among its citizens and to develop a culture of law. It is this author's belief that no country has greater economic potential than Russia. A comparison of Russia and Japan is illustrative. Russia has 20 million more people than Japan and has 45 times the land mass of Japan. Russia has more than one-half of the world's natural resources; Japan has very limited natural resources. Yet Russia's GDP is only one-fifth the GDP of Japan. The global economy would be significantly stronger if Russia's economy could meet its full potential. The new Putin government has an historic opportunity to exercise the political will that is required to implement the rule of law and strengthen the culture of law in Russia that are essential for economic growth and financial stability.

Conclusion

A market economy requires stability and confidence to operate effectively and efficiently. The confidence that is necessary to support the financial system of a market economy requires a well-developed legal and regulatory framework. A vibrant market economy requires financial intermediation through the channeling of savings to creditworthy borrowers in order to allow the entrepreneurial efforts of market participants to develop more fully and rapidly. The word "credit" is derived from French and Latin words that mean "to believe." The legal and regulatory

framework discussed in this paper is critical in establishing the basis for such belief. A financial sector that makes creditworthy loans is an essential component of a market economy. The making of creditworthy loans requires bankruptcy laws, secured transaction laws, the ability to enforce contracts in courts, and banking regulation and supervision.

While the Asian and Russian financial crises have receded, they have triggered the recognition of the need for better infrastructure. Among the most important infrastructure components of a market economy is a legal and regulatory framework that is developing and maturing in a manner that fosters and supports financial stability. Certain important steps to build such infrastructures have been taken, but they must continue.

Appendix: Guiding Principles and Core Requirements for a Legal System in a Market Economy*

John L. Walker

The foundation of a market economy and its underlying legal system is generally based on the premise that the public good results from individual decisions in the market which allocate limited economic resources under the constraints of supply and demand. In direct contrast, the foundation of a centrally planned, command economy is generally based on the premise that the individual good results from decisions by public authorities which allocate limited economic resources according to such authorities' perception of the public good.

The legal systems of a market economy and a centrally planned, command economy contain certain common elements, for example, the need for criminal laws and their fair and predictable application by the police and the courts. The awesome complexity and dynamism of a market economy, however, require laws, rules, and norms, based on transparency and openness, that encourage and facilitate economic interchange and that at the same time take into account the fact that, because market participants are human and thus not perfect, some degree of governmental intervention in the "free" market is also required.

During the 1990s, market participants have examined on a more comprehensive basis than before the institutional infrastructure required by market economies. Such infrastructure, which developed in the market economies as such economies themselves developed, had been taken for granted. It has been recognized that the "hardware" of a market economy includes (i) a stable medium of exchange, which requires competent monetary authorities, (ii) creditworthy financial institutions,

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and (iii) an efficient payments system. The "software" of a market economy includes the rule of law that recognizes and protects well-defined private property rights (with respect to real, personal, and intellectual property) and basic human rights.

The importance of the "culture of banking" has been recognized in transition market contexts. Similarly, it is essential that the rule of law be accompanied by, and indeed be rooted in, the culture of law: a culture that supports the rule of law and opposes corruption, and a culture in which the law is enforced by credible and honest authorities in a manner that inspires public confidence in the law and respect for the intentions of the law. The rule of law based on the principle of "equal justice under law" will nurture the culture of law. Without such a culture, a market economy cannot function effectively.

Economic globalization is intensifying the focus by policymakers and market participants on the rule of law. The rule of law in a society must reflect the unique culture, history, and demographics of its people. While certain universal values and precepts may underlie the rule of law, rule-of-law reform cannot be imposed on a society and the will to reform must come from within the society. The imposition by outside forces of any value or precept as being universal will only result in resentment.

The rule of law must recognize and protect the rights of all market participants. Such rights enable the value judgments of market participants to be converted through the legally protected market mechanism into prices of goods and services and financial instruments. For the market mechanism to work effectively, the rule of law must include laws, rules, and norms that encourage and facilitate the provision of timely and accurate information to the public to allow market price adjustments. Market-determined prices, which effectively facilitate the clearing of markets, substitute for the decisions of public authorities in a centrally planned, command economy. It is the market mechanism "hardware," supported by the rule of law "software," that converts the changing values of market participants into market signals (that is, prices) that direct economic activity. Without this "software," the "hardware" will not work; the market mechanism will not function and governmental intervention in the economy will lack necessary accountability and will likely be arbitrary and unfair.

The financial system of a market economy is the "central nervous system" through which the market mechanism operates. The infrastructure of the financial system must be supported by a comprehensive legal and regulatory framework that provides for a stable medium of exchange, creditworthy financial institutions, fair and honest capital markets, and efficient payments, clearance, and settlement systems.

Experience, education, and technology induce continuous changes in the relative productivity and value of economic inputs, resulting in what the economist Joseph Schumpeter referred to as "creative destruction."

The market mechanism must allow such adjustments and reallocations of inputs to occur, which are not painless to market participants and which result in the shifting of property rights among market participants. The paradox of creative destruction is that it results in renewal of the market economy, which has the flexibility and strength to adjust to changes. This renewal of the market economy is based on innovation, risk-taking, and competition, all of which must be supported and encouraged by the rule of law. Too heavy a hand of law and governmental regulation will stifle innovation; too light a hand will allow infringement of private property rights. The cooperation and confidence that are required for a market economy to operate can only exist if the rule of law exists.

Globalized market forces, with their unforgiving nature and remarkable speed, can no longer be controlled over the long term by governments. This has put enormous pressure on governmental and economic structures in certain countries. Corrupt, authoritarian governments cannot adjust to the demands of the global marketplace. Market economies require governments that are law-abiding and fully accountable under the rule of law. The period when authoritarian systems created stability and thus promoted economic growth has been brought to an end by globalized market forces. Systems that promote order over freedom will not succeed over the long term. The rule of law that balances the fundamental human desires for both freedom and order is required.

It should be recognized, however, that the transition to such a balanced rule of law must be a gradual process in certain countries because of their culture, history, and demographics. Otherwise, the chaos that could result from abrupt change that threatens the existing political order could be too destabilizing and thus harmful to the development of a market economy. Nevertheless, over the longer term, the rule of law is the natural antidote to chaos. While the sacrifices that are inherent in the transition to market economies from centrally planned, command economies might lead some to seek authoritarian discipline during the transition, the transition will not be successful over the long term without the involvement, trust, and consensus of the people. Visionary and inspiring leadership is important to the transition process, but such leadership if unconstrained by the rule of law will almost certainly prove in the end to be myopic if not despotic. The transition to a market economy from a centrally planned, command economy may have disappointing results during the early years, and after public enthusiasm has dissipated much will depend on the acceptability, resilience, and vitality of the rule of law. Law is a political and not an economic concept, but economic reform should be grounded in legal reform and thus political reform should accompany economic reform. The principles guiding political reform must be based on the rule of law.

A market economy is by definition a system with checks and balances. The rule of law in a market economy, which balances freedom

and order, must also have checks and balances built into it. A centrally planned, command economy does not have checks and balances built into economic interactions or its governmental structure. Good government, subject to checks and balances for necessary accountability, is a core institutional requirement for a market economy.

If emerging market and transition economies want to participate in the global marketplace, they will have to adopt rule-of-law reform with the necessary corporate governance system that provides scrutiny of corporate behavior. A comprehensive legal and regulatory framework must support their developing financial systems. The rule-of-law reform must foster meritocracy and not favoritism. It must support decentralized economic decision-making based on market prices derived in arm's-length interchanges and not based on cronyism and corruption. It must require transparency and accountability of the market participants and governmental authorities.

Based on the above discussion, set out below are guiding principles for a legal system in a market economy, followed by core requirements for such a legal system.

Guiding Principles for a Legal System in a Market Economy

1. The legal system should be based on the premise that the public good results from individual decisions in the market, which allocate limited economic resources under the constraints of supply and demand.

2. The rule of law should recognize and protect well-defined private property rights (with respect to real, personal, and intellectual property) and basic human rights.

3. The rule of law should balance the fundamental human desires for both freedom and order.

4. Laws, rules, and norms, based on transparency and openness, should encourage and facilitate economic interchange.

5. The rule of law should take into account that some degree of governmental intervention in the "free" market is required. Too heavy a hand of law and governmental regulation will stifle innovation; too light a hand will allow infringement of private property rights. Governmental intervention in the market requires checks and balances for necessary accountability and to prevent arbitrary and unfair actions. The government should be law-abiding and fully accountable under the rule of law.

6. The culture of law that supports the rule of law and opposes corruption should be nurtured in the society. The law should be enforced in a manner that inspires public confidence in the law and respect for the intentions of the law.

7. The rule of law should reflect the unique culture, history, and

demographics of a society. The will for rule-of-law reform should come from within the society.

8. The rule of law should foster meritocracy and support decentralized economic decision-making based on market prices derived in arm's-length interchanges and not based on cronyism and corruption. The market mechanism through which value judgments of market participants are converted into prices of goods and services and financial instruments should be supported by the rule of law. Laws, rules, and norms should encourage and facilitate the provision of timely and accurate information to the public to allow market price adjustments.

9. The financial system in a market economy should be supported by a comprehensive legal and regulatory framework that provides for a stable medium of exchange, creditworthy financial institutions, fair and honest capital markets, and efficient payments, clearance, and settlement systems.

10. The rule of law should support the shifting of property rights among market participants that results from the "creative destruction" inherent in market economies. The rule of law should support and encourage innovation, risk-taking, and competition and lead to cooperation and confidence.

Core Requirements for a Legal System in a Market Economy

1. Laws that clearly define and protect private property rights (with respect to real, personal, and intellectual property) are required.

2. Laws that clearly define and protect basic human rights are required.

3. Administrative laws are required that prevent arbitrary and unfair actions by governmental authorities.

4. Corporate laws that set corporate governance standards and protect shareholders' rights are required. The roles, rights, and responsibilities of directors, managers, and shareholders must be legally defined.

5. Contract laws are required that protect the rights and enforce the obligations of counterparties, including lenders and borrowers. A collateral law that protects the rights of lenders through obtaining a pledge of assets, including real property (mortgages), is required.

6. Laws that provide protection against fraud and unfair and deceptive trade practices are required.

7. A competent, ethical, politically independent judiciary is required. Such a judiciary must be supported by a sufficient number of lawyers with appropriate legal training and by credible and honest law enforcement authorities.

8. A bankruptcy statute is required to address defaults and restructurings.

9. Governmental regulation and supervision, which form a part of the rule of law, must support an environment in which counterparties can effectively assess the risks of transactions.

10. The burden of managing risk in the financial system should not lie with private institutions alone. A central banking law is required that establishes a politically independent but accountable central bank that is mandated with the responsibility to maintain price stability and to act as the "lender of last resort."

11. Laws and regulations are required that create a comprehensive legal framework for financial institutions. The laws should address the powers of such institutions, the minimum safety and soundness standards that they must meet, and their regulation and supervision on a consolidated basis. Such laws must allow supervisors to set prudential rules and regulations to control risks (including those covering capital adequacy, loan loss reserves, asset concentrations, liquidity, risk management, and internal controls), provide for the enforcement of such laws, rules, and regulations, and address the resolution of problems in financial institutions, including insolvencies.

12. Laws that provide for a transparent, fair, and effective legal and regulatory environment for capital markets are required, including laws to protect investors and regulate the issuance of securities, broker-dealers, and stock exchanges, and laws that provide for financial transparency through adequate disclosure, accounting, and auditing. Laws and regulations governing collective investment vehicles (for example, investment companies) are an important component of capital market regulation.

13. Laws and regulations are required that govern the noncash payments system and the clearance and settlement systems for securities transactions, including depository and custodian facilities for securities.

14. Antitrust laws are required to prevent concentration of power and collusive price setting. Such laws and their enforcement must seek to foster competition and innovation.

15. Tax laws are required that are clear, fair, and predictable and that provide the government with sufficient financial resources to meet its obligations and to provide a minimum social safety net.