COMMENTS

THE SILVER LINING IN THE RED GIANT: CHINA'S RESIDENTIAL MORTGAGE LAWS PROMOTE TEMPERANCE AMONG THE SURGING MIDDLE CLASS

"For China's emerging middle class, this is an age of aspiration—but also a time of anxiety. Opportunities have multiplied, but each one brings pressure to take part and not lose out, and every acquisition seems to come ready-wrapped in disappointment that it isn't something newer and better. An apartment that was renovated a few years ago looks dated; a mobile phone without a video camera and color screen is an embarrassment. Classes in colloquial English are fashionable among Shanghai schoolchildren, but everything costs money."[1]

I. INTRODUCTION

The nascent Chinese middle class bypassed the "Great Recession"[2] despite China's global infrastructure investments suffering dire consequences.[3] Wall Street's toxic tranches stacked atop one another in collateralized debt obligations seemingly comprised the most epidemic and obscure entity in financial history. Media outlets reported China's second largest commercial bank held over nine billion dollars in U.S. subprime mortgage-backed secur-

1. Leslie T. Chang, *Gilded Age, Gilded Cage: China's Sudden Prosperity Brings Undreamed-of Freedoms and New Anxieties*, NAT'L GEOGRAPHIC, May 2008, http://ngm.nationalgeographic.com/2008/05/china/middle-class/leslie-chang-text.

2. Referring to the recent economic downturn as the "Great Recession" was partially motivated by a *Wall Street Journal* article. *See* David Wessel, *A Big, Bad . . . 'Great' Recession?*, WALL ST. J., Apr. 8, 2010, at A2.

3. *See Chinese Bank Has $9 Billion in Subprime-Backed Securities*, N.Y. TIMES, Aug. 24, 2007, at C7.

ities,[4] yet China's gross domestic product surged as usual by 8.7% in 2009.[5] Members of the middle class marched on, renovating the apartment and following the latest trends.

Astronomical growth in unstable times begs the question: what corners do the Chinese cut to obtain such extraordinary results? U.S. Treasury Secretary Timothy Geithner frequently chides the Chinese Politburo for undervaluing the yuan in an effort to offer more beneficial financing to nations importing Chinese products.[6] Secretary Geithner, however, need hark back only five years to discover a conclusive finding that China's actions failed to reach the threshold of currency manipulation.[7] While Secretary Geithner's argument merits further investigation, the Treasury should seek alternative rationales for China's extensive growth in the last two years.

How did the Chinese government beat the system? The international community frequently criticizes China for failure to codify human rights guarantees,[8] blatant disregard of intellectual property rights,[9] and dangerous poisons in its exports.[10] Its governmental structure, however, guided it through arguably the most turbulent financial period in eighty years.

This comment examines the rise of China's middle class and proactive governance to protect its economy from a housing bubble during the global downturn. An analysis of recently enacted Chinese labor and corporate laws demonstrates how the government facilitated the rise of the middle class. The comment discusses the ramifications of strict domestic residential mortgage regulations and how China's tempered investment structure se-

4. *Id.*

5. *China's GDP Grows 8.7% in 2009*, GOV.CN (Jan. 21, 2010), http://www.gov.cn/english/2010-01/21/content_1516261.htm.

6. *See, e.g.*, Jackie Calmes, *Geithner Hints at Harder Line on China Trade*, N.Y. TIMES, Jan. 23, 2009, at A1.

7. U.S. GOV'T ACCOUNTABILITY OFFICE GAO-05-351, INTERNATIONAL TRADE: TREASURY ASSESSMENTS HAVE NOT FOUND CURRENCY MANIPULATION, BUT CONCERNS ABOUT EXCHANGE RATES CONTINUE 15 (2005).

8. *See, e.g.*, Comm. on the Elimination of Racial Discrimination, Rep. on its 75th Sess., Aug. 3–28, 2009, U.N. DOC. CERD IC/CHINICO 190-13 (Sept. 15, 2009) [hereinafter Committee Report].

9. *See, e.g.*, Ted C. Fishman, *How to Stop Intellectual Property Theft in China*, June 1, 2006, at 98.

10. *See, e.g.*, Rick Weiss, *Tainted Chinese Imports Common*, WASH. POST, May 20, 2007, at A1.

cured its domestic housing market. Part II of this comment examines China's investment and consumption patterns compared to domestic growth. Part III discusses how the surging middle class grew to seek investment opportunities in the real estate market and abroad. Part IV analyzes China's efforts to tame growing interest in the domestic housing market. Part V assesses the shortcomings in U.S. mortgage laws before 2008 and efforts to remedy such oversights, and concludes that China's anticipatory legislating and restrictive investment structure shielded it from depression.

II. CROSSING THE RIVER BY FEELING THE STONES: EXPANSION, INVESTMENT, AND CONSUMPTION THE RIGHT WAY

The concept of crossing the river by feeling the stones summarizes China's growth initiative. The notion implies a country's rapid pursuit of a variety of investments, while simultaneously isolating itself in unstable markets and only emerging when it feels certain one minor miscue will not result in demise.[11] These isolationist policies often create strife between China and its economic and diplomatic partners;[12] however, such initiatives have immunized China from suffering alongside those partners.

China's reluctance to expand its housing market,[13] permit foreign investment in its infrastructure,[14] and create investment programs for its citizens to invest in overseas initiatives seemingly paid dividends.[15] Review of the Chinese financial firms' balance sheets likely would yield nothing pertaining to subprime mortgages, collateralized debt obligations, and mortgage-backed securities, outside the substantial investments made in Wall Street firms. Still hesitant to open its real estate investment doors to outsiders after the subprime mortgage crisis, China understand-

11. *See* Wang Ming, *Chinese Investing Overseas Gets Easier*, WALL ST. J., Jan. 11, 2011, at A9; Satya J. Gabriel, *Economic Liberalization in Post-Mao China: Crossing the River by Feeling for Stones*, SATYA GABRIEL'S ONLINE PAPERS: CHINA ESSAY SERIES (Oct. 1998), http://www.mtholyoke.edu/courses/sgabriel/economics/china-essays/7.html.

12. *See, e.g.*, Thom Shanker, *Rumsfeld Warns Young Chinese on Isolationism*, N.Y. TIMES, Oct. 19, 2005, at A8.

13. *See, e.g.*, Gregory M. Stein, *Mortgage Law in China: Comparing Theory and Practice,* 72 MO. L. REV. 1315, 1345 (2007).

14. *See* Steven M. Dickinson & Daniel P. Harris, *Dickinson and Harris on Foreign Investment in China*, 2008 EMERGING ISSUES 1197 (Nov. 29, 2007 (LEXIS)).

15. *See* Keith Bradsher, *China Relaxes a Barrier, Letting Citizens Invest in the Hong Kong Stock Market*, N.Y. TIMES, Aug. 21, 2007, at C4.

ably has idiosyncratic mortgage policies excluding low income earners.[16]

Residential mortgage law in China ostensibly assumes three tiers: fervent protection from the lower class, gradual pacification of the wealthy, and establishment of a niche for the rapidly growing middle class.[17] Rampant economic, technological, and population growth requires a forward-thinking government to conform laws to technological innovation and an inversely vigilant government to recognize the hardships of its growing middle and lower classes. China's labor, real estate, and foreign investment measures in the previous four years promoted housing expansion and domestic consumption in a manner protecting the country from financial turmoil. By cautiously moving forward and not bending to populist sentiment, China brought about unparalleled economic success.

A. *Promoting Individual Growth from Lower to Middle Class Citizenry with Revolutionary Labor Laws*

The Chinese economy begins and ends with the laborer. Millions of migrant workers travel to urban centers each season in search of temporary work.[18] The economic downturn cost laborers several million job opportunities, and contract rights under obsolete and draconian Chinese labor laws failed to protect them.[19] Difficulties in guaranteeing workers' rights still arise despite updated labor laws; however, the measures now provide practical remedies for employees.[20]

Merely enacting groundbreaking legislation does not automatically elevate a nation rife with labor atrocities to a human rights champion.[21] The Politburo, however, promulgated an employee

16. *See* Stein, *supra* note 13, at 1340 & n.63.

17. *See id.*; Chang, *supra* note 1; Ming, *supra* note 11.

18. *China's Economy: A Great Migration into the Unknown*, ECONOMIST, Jan. 31, 2009, at 32.

19. *See id.*

20. *See, e.g.*, Labor Contract Law (promulgated by the Standing Comm. Nat'l People's Cong., June 29, 2007, effective Jan. 1, 2008), art. 14 (China) http://www.fdi.gov.cn/pub/FDI_EN/Laws/GeneralLawsandRegulations/BasicLaws/P020070831601380007924.pdf (last visited Apr. 15, 2011) [hereinafter PRC Labor Contract Law].

21. *See, e.g.*, Christine M. Bulger, *Fighting Gender Discrimination in the Chinese Workplace*, 20 B.C. THIRD WORLD L.J. 345, 346–48 (2000).

friendly labor and employment law in 2008.[22] The measure contains several provisions which may propel low wage factory workers to economic self-reliance and enhanced socioeconomic status. The first phase of the law brings China into conformity with the West in three ways: (1) it applies to all employers, (2) it requires written labor contracts, and (3) it imposes significant penalties on employers for failure to comply.[23] The second phase resoundingly demonstrates China's intention to ensure employees receive adequate treatment: employees can claim double salary for months worked without a contract for up to twelve months salary.[24] This rule is "absolutely going to be applied to 'informal' employment relationships common to so many . . . businesses doing business in China."[25]

The legislation also substantially mitigates the detrimental impact of term contracts and probationary periods, which were "previously popular ways to skirt China's existing labor law regime."[26] The new law eschews the tradition of employing workers under various short-term contracts to circumvent for cause termination, limiting the number of term contracts into which the employer may enter with the employee to two.[27] Under the subsequent open-term contract, "the [competent] employee is employed until he or she chooses to terminate the contract or reaches retirement age. The employer can only terminate the employment contract by discharge of the employee for breach."[28] This provision will specifically benefit the migrant worker. The employer retains the right to enter into two term contracts; as such, the migrant worker may not see the benefits of the legislation until the third season in which he returns to the city.[29]

The measure implies that once the employee enters into a third contract, he will enjoy indefinite employment, subject only to

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22. *See generally* PRC Labor Contract Law, *supra* note 20.

23. *See id*. at art. 2, 10.

24. *See id*. at art. 82.

25. Steven M. Dickinson & Daniel P. Harris, *Dickinson and Harris on China's New Labor Law*, 2008 EMERGING ISSUES 1369 (Dec. 6, 2007 (LEXIS)).

26. *Id*.

27. *See* PRC Labor Contract Law, *supra* note 20, at art. 14; Dickinson & Harris, *supra* note 25.

28. *See* Dickinson & Harris, *supra* note 25.

29. *See* PRC Labor Contract Law, *supra* note 20, at art. 14; Jovita T. Wang, *Article 14 of China's New Labor Contract Law: Using Open-Term Contracts to Appropriately Balance Worker Protection and Employer Flexibility*, 18 PAC. RIM L. & POL'Y J. 433, 441–42 (2009).

termination for incompetence and other codified reasons.[30] Guaranteed income ostensibly reduces apprehension and fosters willingness to invest, thereby increasing domestic consumption. Initial reports indicate that the measure tightens the labor market and actually increases wages and minimizes turnover rates.[31]

The employment contract jeopardizes employers' most prized asset: income. Threats to solvency likely will increase compliance. Enterprises failing to implement the legislation face administrative fines, awards of double wages, and liability for actual damages.[32] Employees, furthermore, may almost always successfully sue:

> [V]irtually every violation of the law gives the employee the right to sue the employer for penalties and damages in the local employment arbitration bureau or in the local courts. . . . [T]he private right of action on this [law] all but guarantees plenty of enforcement through litigation. The new law has been actively publicized, and employees are well informed about their rights under the new law. . . . This is a change from the past when employees were not allowed to file claims against companies.[33]

Employers face substantial ramifications for straying from these innovative provisions, and employees stand to reap what previously would have been considered a financial windfall upon unlawful derogation from this labor contract law.

The difficulty remains in the practical application of antibusiness legislation in a nation driven primarily by commerce and lacking firmly rooted rule of law principles. In early 2009, the CLSA China Purchasing Managers Index reported that China's manufacturing sector contracted for the fifth consecutive month in December.[34] Coupled with such difficulties, "[p]ressures from the labor law may encourage factories to close [during the downturn] rather than pay what they owe to workers under the law."[35]

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30. *See* PRC Labor Contract Law, *supra* note 20, at art. 39; Wang, *supra* note 29, at 443.

31. Jonathan Adams, *Chinese Union: New Labor Regulations Designed to Protect China's Workers Are Already Having an Impact, According to an American-Based Watchdog*, NEWSWEEK, Feb. 14, 2008, http://www.newsweek.com/2008/02/13/chinese-union.html.

32. *See* PRC Labor Contract Law, *supra* note 20, at arts. 80, 81, 82, 83, 84, 85; Dickinson & Harris, *supra* note 25.

33. *See* Dickinson & Harris, *supra* note 25.

34. Sky Canaves, *Factory Closures Strain China's Labor Law*, WALL ST. J., Jan. 17, 2009, at A6.

35. *Id.*

If the expected revaluation of the yuan lessens formal appeal of Chinese exports, "then local officials and mainland companies may collude to ignore laws and ensure that labor costs stay low."[36] Mainland companies face sharply increasing mediation and arbitration requests from hundreds of thousands of employees, and those who engage in the process "encounter severe obstacles."[37]

Conversely, and perhaps most importantly, workers now have specific forums of remedy to seek redress for grievances. Only time will tell whether the judiciary remains independent enough to enforce the legislation and whether employers will accept the fines rather than seek legal advice, but these laws will become particularly crucial as the lower class ascends to more affluent socioeconomic status and pursues investment opportunities, particularly overseas.

B. *Patience is a Virtue in a Global Market*

England's transfer of sovereignty of Hong Kong to China in 1997 corresponded with the rapid ascendancy of a relatively wealthy Chinese middle class.[38] When China reclaimed dominion over its economically prosperous territory, it did so under the condition that Hong Kong and China operate under the "One County, Two Systems" style of governance.[39] Hong Kong would remain Asia's financial hub,[40] while accepting military patronage and foreign diplomacy oversight from the mainland.[41] The new sovereign thus waited patiently, neglecting any attempt to capitalize on Hong

36. Edward Wong, *As China Aids Labor, Unrest Is Still Rising*, N.Y. TIMES, June 21, 2010, at A1.

37. Stanley Lubman, *Chinese Workers' Rising Rights—Consciousness,* WALL ST. J. BLOG (Oct. 20, 2010, 7:11 PM, http://blogs.wsj.com/chinarealtime/2010/10/20/chinese-workers-rising-rights-consciousness/.

38. Tai-lok Lui, *How a Fragmented Business-Government Alliance Has Helped Change Hong Kong's Political Order*, H.K.J., SUMMER 2008, http://www.hkjournal.org/PDF/2008_summer/5.pdf.

39. *See Background Note: Hong Kong*, U.S. DEP'T OF STATE (Aug. 3, 2010), http://www.state.gov/r/pa/ei/bgn/2747.htm; *see also One Country; Two Systems*, CHINA.ORG.CN, http://www.china.org.cn/english/feaures/china/203730.htm (last visited Apr. 15, 2011) (discussing the "one country, two systems" form of government).

40. *See Background Note, Hong Kong*, *supra* note 39.

41. *See* XIANGGANG JIBEN FA art. 13, 14 (H.K.), *available at* http://www.basiclaw.gov.hk/en/basiclawtext/chapter_2.html; *Background Note: Hong Kong*, *supra* note 39.

Kong's recently exploded property bubble that so many exploited.[42]

In 2007, a few months before "subprime" became a dirty word, China's National Development and Reform Commission issued a revised Catalog for the Guidance of Foreign Invested Enterprises, which "provide[d] the basic guidance for foreign investment within China."[43] It divided investments into "encouraged," "restricted," and "prohibited" categories.[44] "The new policy discourages or prohibits foreign investment in businesses solely devoted to export (a 180 degree reversal of prior policy)."[45] The 2007 amendments also prohibit investment in home development and real estate operations.[46] The amendments to restrict investment in home development and real estate operations exemplify Chinese foresight, substantiating the Trade and Economic Cooperation Bureau decision to prohibit individuals from investing in overseas housing markets and foreign investors from plaguing China's development industry.

Four years later, flush with over one trillion dollars of American debt[47] and incurring an onslaught of international provocation about its lack of stimulus policies,[48] China finally opened its individual citizens' doors to the international market.[49] The Chinese government initiated its first step toward facilitating individual foreign investment when it permitted individuals in the city of Wenzhou to invest directly overseas.[50] The government sought to reduce controls on its currency,[51] whereby it could pla-

42. *See, e.g.*, Alex Frew McMillan, *A Village Getaway from Busy Hong Kong*, N.Y. TIMES, Apr. 15, 2010, http://www.nytimes.com/2010/04/16/greathomesanddestinations/16iht-revillage.html.

43. Dickinson & Harris, *supra* note 25; *Catalogue for the Guidance of Foreign Investment Industries*, CHINADAILY.COM.CN (Apr. 20, 2006, 9:30 AM), http://www.chinadaily.com.cn/bizchina/2006-04/20/content_572219.htm (translating the Catalogue for the Guidance of Foreign Investment Industries).

44. Dickinson & Harris, *supra* note 25.

45. *Id.*

46. *Id.*

47. *See Major Foreign Holders of Treasury Securities*, U.S. DEP'T OF THE TREASURY (Feb. 28, 2011), http://www.treasury.gov/resource-center/data-chart-center/tic/documents/mfh.txt.

48. *See, e.g.*, U.S. DEP'T OF THE TREASURY, OFFICE OF INT'L AFFAIRS, REPORT TO CONGRESS ON INTERNATIONAL ECONOMIC AND EXCHANGE RATE POLICIES 12–16 (2011).

49. *See* Ming, *supra* note 11.

50. *See id.*

51. *See id.*

cate international concern over currency manipulation and analyze the success and failure rates of its citizens' investments. The Foreign Trade and Economic Cooperation Bureau, the Politburo's guardian of the experiment, determined that no single project could receive more than three million dollars annually from the community, and that the community as a whole may invest no more than $200 million annually.[52] The Chinese are gradually starting to venture into the field of individual foreign investment, but this should not dissuade capitalist systems from closely observing the investors' pursuits and success rates.

Beijing's decision to place its currency in flux throughout Hong Kong and U.S. markets (Hong Kong and China have different currencies) indicates a second initiative: to acquiesce to investors. China "launched trading in its currency in the [United States] for the first time [in January 2011], an explicit endorsement by Beijing of the fast-growing market in the yuan and a significant step in the country's plan to foster global trading in its currency."[53] Daily trading is currently at $400 million (in yuan).[54] Trading currency in the United States should increase the value of the yuan, and it likely is no coincidence that China considered opening its individual investors to foreign markets at the same time.

Permitting gradual ascendance up the investment ladder and timid introduction of the yuan into foreign markets seems both prudent and calculating. China understands the risks associated with permitting unbridled investment in farcical entities and employed an intelligent, albeit spartan, method by which to monitor individual investment. Cautiously facilitating the introduction of private investors into foreign markets allows the Chinese to simultaneously appease international concerns over intentional currency devaluation while scrutinizing the markets in which its citizens invest.

Revaluation of the yuan "will simply result in a shift of manufacturing among emerging markets, leaving the [United States] with a somewhat smaller trade deficit, higher prices for imported goods and higher interest rates, but not necessarily higher levels

52. *See id.*
53. Lingling Wei, *China Shows Its Growing Might—New Move to Make Yuan a Global Currency*, WALL ST. J., Jan. 12, 2011, at A1.
54. *See id.*

of employment."[55] If interest rates increase, further outcry from the G-20 may arise in a continued effort to replace the dollar as the global standard. The twenty regional economic hegemons "supported a general allocation of the [International Monetary Fund's Special Drawing Rights equivalent to $250 billion to boost global liquidity [and] urged urgent ratification of the Fourth Amendment to the International Monetary Fund Charter, first proposed in 1997, which seeks to make the allocation of SDRs more equitable."[56] The organization took the first step toward slighting the dollar; the yuan, consequently, may demonstrate its strength on the world stage while the dollar falls. This process began with the advent of a Chinese middle class, however, before the world endured the ramifications of granting adjustable-rate mortgages to subprime borrowers.

III. THE REAL ESTATE MARKET AND THE MIDDLE CLASS: 100 MILLION HOMES FOR EVERYONE?

The emerging middle class stormed into the new decade 100 million members strong,[57] saddled with the notion that their life station entitles them to home ownership.[58] An amalgamation of revisions in land ownership laws, foreign investment policy, and mortgage regulations that created the middle class now drives up property values in urban centers across China. But China has subsequently tempered the housing market in a timely fashion. Savings accounts of Chinese individuals are plummeting,[59] and personal housing mortgages, while not spiraling, indicate that the

55. Zhiwu Chen, *Renminbi Revaluation Won't Trigger a Shopping Spree*, YALEGLOBAL ONLINE MAG. (May 12, 2010), http://yaleglobal.yale.edu/content/renminbi-revaluation-wont-trigger-shopping-spree.

56. *IMF Resources and the G-20 Summit*, INT'L MONETARY FUND (Feb. 11, 2010), http://www.imf.org/external/np/exr/faq/sdrfaqs.htm.

57. *See* CTR. FOR INFO. POLICY LEADERSHIP, HUNTON & WILLIAMS LLP, CHINA PRIVACY GOVERNANCE (2007), http://www.hunton.com/files/tbl_s47Details%5CFileUpload265%5C 1944%5CChina_Privacy_Two-Pager.pdf.

58. *See* Josef Jelinek, *British Chamber Eye Interviews with Tom Docteroff, CEO of JWT Greater China*, CHAMBER EYE: MAG. OF THE BRIT. CHAMBER OF COM. GUANGDANG, Spring/Summer 2010, at 17, 18, *available at* http://www.britchamgd.com/userfiles/file/Chamber%20Summer%202010-Leisure%20&%20Entertainment(WEB).pdf.

59. *See Chapter 2: China Towards 2020: Growth Performance and Sustainability*, ORGANISATION FOR ECON. CO-OPERATION & DEV., http://www.oecd.org/document/45/0,3746,en_33873108_39418537_45666733_1_1_1_1,00.html (last visited Apr. 15, 2011) (surveying Chinese domestic savings accounts from 1994–2007).

government must rein in excessive loans.[60] The Chinese find themselves comfortably situated, however, because of their historical tendency to gradually cede control back to the market after heavy regulation.[61] China's standard corporate structure, as discussed below, helped guide low income earners to new socioeconomic levels, and its unique mortgage and land laws motivated investment in infrastructure while limiting exposure to dire financial risk.

A. *History of Incorporating in China and the Emergence of Medium and Small-Scale ("M&S") Enterprises*

Foreign investment legislation "did not exist until China made a policy shift to open its markets in the late 1970s. . . . The legislation thus has turned from a system of 'two standards for domestic and foreign investment' to a single-standard system."[62] This single standard system fostered foreign corporate growth within China.[63] The two basic types of corporations in China are the limited liability corporation ("LLC") and the joint stock limited company ("JSC").[64]

The National People's Congress ("NPC"), one of three branches of the Chinese government, passed the M&S Enterprises Promotion Law to "regulate[ ] financial and business support, technological innovation, market expansion, social services, and other im-

60. *See generally Report: China's Banks Suspend Property Loans*, CHINA BRIEFING (Nov. 15, 2010), http://www.china-briefing.com/news/2010/11/15/chinas-banks-suspend-property-loans.html.

61. *Compare* General Principles of the Civil Law (promulgated by the Standing Comm. Nat'l People's Cong., Apr. 12, 1986, effective Jan. 1, 1987), art. 73 (China), http://www.fdi.gov.cn/pub/FDI_EN/Laws/GeneralLawsandRegulations/BasicLaws/P020060620320966257030.pdf [hereinafter Civil Law] (stating that "[s]tate property shall be owned by the whole people" and that "[s]tate property is sacred and inviolable"), *with* Law on the Administration of Urban Real Estate (promulgated by the Standing Comm. Nat'l People's Cong., July 5, 1994, effective Jan. 1, 1995), art. 7 (China) http://www.npc.gov.cn/englishnpc/Law/2007-12/12/content_1383755.htm [hereinafter Law of Urban Real Estate] (granting individuals the right to use state-owned land).

62. 2 GAO LINGYUN & JIA XILING, SERIES ON CONTEMPORARY CHINESE LAW: CHINESE BUSINESS LAW 17 (Charles Wellford ed., 2008).

63. *See, e.g.*, Pascal Lamy, Dir.-Gen., World Trade Org., Message to the Fourth Beijing International Forum on WTO and China (2005) and the Sixth Beijing Chaoyang International Business Festival (Sept. 15, 2005), *available at* http://www.wto.org/english/news_e/sppl_e/sppl01_e.htm.

64. *See* Companies Law (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 27, 2005, effective Jan. 1, 2006), art. 2 (China), http://www.npc.gov/en/englishpc/law/2007-12/13/content_1384124.htm [hereinafter Companies Law].

portant aspects of the development of the M&S enterprises."[65] The NPC effectively mandated that the federal government must, with minimal restriction, cultivate market expansion through financial support.[66] This policy cogently demonstrates (1) why China infuriates countries by breaching trade and subsidy agreements, and (2) how the middle class emerged from the Great Recession largely unscathed.

B. *China's Violations of Subsidy and Trade Agreements*

China, unlike the United States, is not a party to the Organisation for Economic Cooperation and Development ("OECD").[67] The OECD requires its members to consult with it on substantial export deals to ensure governments are not unfairly subsidizing private ventures, thus skewing "a level playing field."[68] China may subsidize its operations without repercussion because it is not an OECD member, and it is "winning deals in part because [it is] not playing by the rules."[69] China's bids for export contracts, in short, likely succeed because the NPC subsidizes its own market or offers unmatchable funding options to developing third-world countries needing its exports. Chinese companies upon which the government relies for consistent revenue streams, therefore, suffered substantially less than the United States, Japan, and the European Union during the height of the recession,[70] permitting employment levels to stagnate or decline.[71]

OECD parties have sought creative methods by which to counter Chinese initiatives. The United States Export-Import Bank, for example, responded in kind by matching China's cheaper prices for the first time *ever* on a locomotive deal with Pakistan, and

65. LINGYUN & XILING, *supra* note 62, at 16.

66. *See id.* at 16–17.

67. *Members and Partners*, ORG. FOR ECON. CO-OPERATION & DEV., http://www.oecd.org/pages/0,3417,en_36734052_36761800_1_1_1_1_1,000.html (last visited Apr. 15, 2011).

68. *See, e.g.*, Sudeep Reddy, *U.S. Export Financing Challenges China*, WALL ST. J., Jan. 12, 2010, at A11.

69. *Id.*

70. Press Release, World Trade Org., Trade to Expand by 9.5% in 2010 After a Dismal 2009, WTO Reports 5 (Mar. 26, 2010), *available at* http://www.wto.org/english/news_e/pres10_e/pr598_e.htm.

71. *See, e.g.*, *China's Unemployment Rate Falls to 4.1% in Sept*, CHINA DAILY (Oct. 22, 2010), http://www.chinadaily.com.cn/china/2010-10/22/content_11445691.htm.

received OECD approval.[72] Intergovernmental organizations now recognize the necessity of interpreting their rule structures leniently when nonmembers gain economic advantages over members merely because of a state's membership in the organization.

C. *Too Small to Fail: How Small Business Subsidies Promote a Growing Middle Class*

Establishing M&S enterprises requires that capital contributions from incorporators must meet statutory minimums,[73] a risky first step for individuals lacking substantial disposable liquidity. The State Council, however, rewards the risk by providing a structural safety net through

> regulating M&S enterprises and formulating a thorough development plan. To create a development fund, the M&S Enterprises Promotion Law requires the central government to establish a separate budget item for M&S enterprises. The law also provides that the government consider first procuring goods and services from M&S enterprises in formulating its central plan. Other measures include local government's financial support and a credit guarantee system. State policy also encourages M&S enterprises to utilize foreign capital, as well as advanced technology and management experiences from foreign countries by establishing foreign-Chinese equity or contractual joint ventures. Qualified M&S enterprises also are encouraged to invest abroad and participate in international trade.[74]

The logical conclusion to derive from codification of such benefits is that the Chinese government refuses to permit small and medium-sized businesses to fail. This special treatment inoculates them from downturns. The law seems to provide a regimented process through which M&S enterprises may succeed, or through which the government may make the enterprises succeed.[75] Data does not exist articulating the number of employees currently working for M&S enterprises, but the Politburo deemed it substantial enough to merit extremely invasive regulation. This

72. Reddy, *supra* note 68.

73. Companies Law, *supra* note 64, at arts. 23, 77 (requiring the statutory minimum amount of capital for the incorporation of a "company with limited liability" and a "company limited by shares").

74. LINGYUN & XILING, *supra* note 62, at 17; *see* Law on Promotion of Small and Medium-Sized Enterprises (promulgated by the Standing Comm. Nat'l People's Cong., June 29, 2002, effective Jan. 1, 2003), arts. 4, 10–13, 17, 27, 34, 36 (China), http://www.gov.cn/english/laws/2005-10/08/content_75040.htm [hereinafter Law on M&S Enterprises].

75. *See* Law on M&S Enterprises, *supra* note 74; LINGYUN & XILING, *supra* note 62.

example of unadulterated government intervention in the private sector demonstrates another reason why the middle class has rarely foundered, comparatively, from 2008 until the present.

Protection of small business and egregious subsidization of exports are two factors that created the mass-personal financial growth spawning the middle class. As the middle class grew in wealth and number, a reasonable assumption would be that an increase in domestic consumption and home purchasing followed. However, "Chinese consumption as a percentage of [gross domestic product] has actually declined in the past decade, from 46 percent in 2000 to 36 percent in 2009."[76] China can sustain rapid growth "only by increasing investment well beyond what is economically useful" to the country, "unless domestic consumption expands dramatically."[77] Some reports rank China "as one of the world's biggest savers, at a national rate of 38 percent of [gross domestic product]."[78] Recently, new studies revealed that savings accounts among Chinese households plummeted by approximately 30 percent between 1994 and 2007.[79] The issue becomes locating the money if a middle class citizen with discretionary spending ability saves 38 percent of his gross domestic product,[80] domestic consumption falls by 10 percent throughout a decade,[81] and individual overseas investment only recently became available.[82] One answer is the housing market.

D. *A History of Land Ownership and Personal Residential Mortgages in China*

The principles of Communism dictate that the land belongs to the people.[83] A 1988 amendment to the Chinese Constitution reads, however, "The right to the use of land may be transferred

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76. Owen Matthews & Alexandra A. Seno, *How Asia's Binge Shoppers Will Help the West*, NEWSWEEK, Dec. 30, 2010, http://www.newsweek.com/2010/12/30/ how-asia-s-binge-shoppers-will-help-the-west.html.

77. *Id.*

78. *Id.*

79. *See Chapter 2: China Towards 2020: Growth Performance and Sustainability*, *supra* note 59.

80. *See* Matthews & Seno, *supra* note 76.

81. *See id.*

82. *See* Ming, *supra* note 11.

83. Civil Law, *supra* note 61, at art. 73 (stating that "[s]tate property shall be owned by the whole people" and that "[s]tate property is sacred and inviolable").

in accordance with the law."[84] This provision does not allow private land ownership[85] but does allow the government to grant land use rights for a specified term.[86] Such a structure permits the government to requisition lands without providing fair market value for the property. China contemporarily enforces this land provision by

> "plugging" local markets into a large scale financial infrastructure of investment resources from outside the country and integrating it with locally emerging networks. Network access, strategic use of leasing mechanisms, and the willingness to deal in property-like assets proved sufficient for real estate development without a need for an official legal classification of "property." We can understand this idea of property-like assets when we think of important assets that are valued and exchanged in the United States even if they are not necessarily classified as property per se. Examples of such property-like assets include trademarks, goodwill, licenses, contract rights, and rights in lawsuits.[87]

The timing of the 1988 amendment ironically corresponds with the introduction of the first residential mortgage loan programs offered in China.[88]

"The first residential mortgage loan in China was issued by the China Construction Bank (CCB) in 1986."[89] In 1997, the "total outstanding mortgage balance in China was only around . . . 22 billion [yuan]."[90] "[T]he outstanding balance of residential mortgages reached 1.7 trillion [yuan], approximately . . . 207 billion [U.S. dollars]" in 2005.[91] "The current residential mortgage market in China is dominated by four major lenders—[the] Industrial and Commercial Bank of China (ICBC), [the] China Construction Bank (CCB), [the] Bank of China, and [the] Agricultural Bank of China."[92] "They account for more than 90 [percent] of the total

84. XIANFA art. 10 (2004) (China).

85. Ming, *supra* note 11.

86. Law of Urban Real Estate, *supra* note 61, at art. 7.

87. Robin Paul Malloy, *Real Estate Transactions and Entrepreneurship: Transforming Value Through Exchange*, 43 IND. L. REV. 1105, 1110–11 (2010).

88. *See* Yongheng Deng et al., *An Early Assessment of Residential Mortgage Performance in China*, 31 J. REAL EST. FIN. & ECON. 117, 117 (2005).

89. *Id.*

90. *Id.*

91. Yongheng Deng & Peng Liu, *Mortgage Prepayment and Default Behavior with Embedded Forward Contract Risks in China's Housing Market*, 38 J. REAL EST. FIN. & ECON. 214, 214–15 (2009) (citation omitted).

92. Deng et al., *supra* note 88, at 119.

outstanding mortgage balance,"[93] and all banks follow the same lending rules so as to avoid confusion among lenders and borrowers.[94] All loans are adjustable-rate mortgages,[95] which means that the interest rates may be changed periodically throughout the term of the loan.[96]

Depository institutions' role in issuing the majority of adjustable-rate mortgages differs from our regime, where government-sponsored entities such as Fannie Mae play a substantial role in the U.S. mortgage market.[97] Domestic safeguards shielded China from the same tailspin as the United States. For example, "[t]he loan amount [of a mortgage may] not exceed 80 percent of the appraisal value or the purchase price of the house, whichever is smaller, and payment to income ratio should not exceed 70 [percent]."[98] These provisions effectually require the borrower to either make a 20 percent down payment on the loan or pay 20 percent on the purchase price of the real estate up front, establishing a firm equity base.

China manifests its guiding principles for personal residential mortgages in a rule that requires lower income borrowers to prepay a substantial portion of the loan as a down payment, as "loans that are eventually prepaid have higher equity to market value ratio than the rest of the loans in the pool."[99] This practice "suggest[s] that borrowers with less liquidity constrain [sic] in China are likely to payoff [sic] their mortgage earlier."[100] Empirical analysis suggests, however, that .03% of low-income mortgage recipients defaulted on loan repayments between 1999 and 2002.[101] This practice alone may reveal the most pivotal difference between U.S. and Chinese mortgage policies that could have spared the United States from recession.

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93. Deng & Liu, *supra* note 91, at 217.
94. *Id.*
95. Deng, Zheng & Ling, *supra* note 88, at 122.
96. *See* FED. RES. BD., CONSUMER HANDBOOK ON ADJUSTABLE RATE MORTGAGES 1 (2009), *available at* http://www.federalreserve.gov/pubs/arms/armsbrochure.pdf.
97. *See About Us*, FANNIE MAE, http://www.fanniemae.com/kb/index?page=home&c=aboutus (last visited Apr. 15, 2011).
98. Deng, Zheng & Ling, *supra* note 88, at 119.
99. *Id.* at 125.
100. *Id.*
101. *Id.* at 126.

Default risk in residential mortgage lending in China, while more likely if not prepaid, is "quite low."[102] "For all groups, the default risk is less than one percent."[103] Approximately "69 percent of borrowers are from . . . high income households."[104] "[M]edian income households are the most reluctant to prepay."[105] The middle class thus finds itself bolstered by the wealthy, who possess the requisite capital to repay the loans, and the lower class, from which Chinese banks also require a down payment on a substantial portion of the loan.[106] Providing loans primarily to the wealthy yields the intended result of an adjustable-rate mortgage: procure more income by elevating rates as the market fluctuates. Delinquency results in higher interest percentages, which the wealthy can afford. Banks simply neglect to consider low income earners when gauging a potential rate increase because they already have a substantial down payment.[107]

Lastly, the culture simply refuses to borrow. "According to a survey reported by Beijing City Survey Organization, more than 75 percent of Beijing residents are aware of the availability of personal loans, but less than 10 percent of them have ever applied for loans."[108] Rigorous procedures govern the process by which banks provide personal residential mortgages, and specific emphasis on upfront down payments has drastically mitigated default among subprime borrowers.

E. *The SAFE Act: Perhaps Too Little, Certainly Too Late*[109]

The origin of the housing crisis in the United States began not simply with overzealous homeowners who quickly found themselves underwater, but also with the loan originator. Banks suffered publicity nightmares for investing in packaged subprime

102. *Id.* at 125.
103. *Id.*
104. *Id.*
105. *Id.*
106. Stein, *supra* note 13, at 1339–40.
107. *Id.*
108. Deng et al., *supra* note 88, at 120.
109. Mr. Kyle Fondren, Business Development Manager and Registered Mortgage Originator at CapCenter, deserves special praise and recognition for his invaluable contributions to the domestic analysis section of this article. Mr. Fondren's expertise and diligent stewardship of this complex industry should serve as a beacon to policymakers and fellow originators alike.

loans,[110] but the loan originator also bears liability. A loan originator, as statutorily defined, "offers or negotiates terms of a residential mortgage loan for compensation or gain."[111] Home purchasers who relied on the advice of an underqualified and financially motivated loan originator quickly found themselves facing monthly financial hardships and negative equity. The "rate of default was highest when the mortgages were sold by [a] loan originator [or mortgage broker] to financial firms unaffiliated with the loan originator."[112] Loan originators sold the home purchasers on "creative" mortgage options to help them buy the "American Dream," then turned around and sold the mortgage, as well as the risk, to financial institutions. Analysts agree that "securitization adversely affects the incentives of lenders to screen their borrowers. . . . It simply reflects the classic moral hazard problem that arises once loan originators do not bear the cost of default by their borrowers."[113] Loan originators, consequently, could contract with subprime candidates at minimal risk.

Until 2008, no uniform federal law standardized threshold competency requirements for loan originators. The Secure and Fair Enforcement for Mortgage Licensing Act of 2008 ("SAFE Act"), one of the seminal laws enacted at the height of the downturn, provides safeguards to ensure intelligent and equitable lending practices and simplify complex mortgage agreements.

The SAFE Act establishes several benchmarks for anyone issuing a residential mortgage, including licensure requirements mandating that "an applicant has never had a loan originator license revoked in any governmental jurisdiction"[114] and has not been convicted of a crime involving fraud, dishonesty, a breach of trust, or money laundering.[115] Further protection mandates that every applicant pass a written test[116] with numerous specifications that solidify a foundational knowledge of safe lending prac-

110. *See, e.g.*, David Evans & Jody Shenn, *AIG Subprime Debt May Cost $2.3 Billion, Analysts Say*, BLOOMBERG (Aug. 1, 2007, 5:44 PM), http://www.bloomberg.com/apps/news?pidnewsarchive&sid=aGuw9h.w2Ksc&refer=home.

111. 12 U.S.C. § 5102(3)(A)(i)(I)–(II) (Supp. III 2009).

112. John C. Coffee, Jr. & Hillary A. Sale, *Redesigning the SEC: Does the Treasury Have a Better Idea?*, 95 VA. L. REV. 707, 732 (2009).

113. *Id.* at 733.

114. § 5104(b)(1).

115. *Id.* § 5104(b)(2)(B).

116. *Id.* § 5104(b)(5).

tices.[117] The statute also obliges state-licensed loan originators to complete annual continuing education requirements in federal law and regulations, ethics, and lending standards.[118]

Comparatively, China limited its exposure to mortgage vulnerability by effectively excluding subprime candidates without sufficient capital to provide substantial down payments. Prior to the 2008 enactment of the SAFE Act, inconsistent state laws determined the standards by which loan originators could guarantee loans on personal residences,[119] and one state even neglected to enact such provisions.[120] The SAFE Act established the first mandatory national standard by which loan originators must gain accreditation. In principle, the SAFE Act pursues the same fundamental objective as China's residential mortgage laws: prevent inevitable default. Congress simply reacted, while the NPC understood the complexity of the industry and initiated the restriction.

IV. EFFORTS TO TAME THE FRENZY

Beijing justifiably finds itself increasingly concerned with the housing market despite various measures in place to prevent a growing bubble.[121] Housing reflects status, and the middle class frequently craves tangible recognition of their newly acquired wealth.[122] "[T]he residential real estate market has not been able to keep up with the demand for units in which to invest. This scarcity of desirable vacant land has contributed to the sharp spike in prices for urban residential units."[123] Those enthused by

117. *Id*. § 5104(d)(1)–(3).

118. *Id*. § 5105(b)(1).

119. *See generally* FED. RESERVE BANK OF MINNEAPOLIS, Report No. 2007-2, FEDERAL RESERVE BANK OF MINNEAPOLIS COMMUNITY AFFAIRS REPORT: A COMPILATION OF STATE MORTGAGE BROKER LAWS AND REGULATIONS, 1996–2007 (2007), *available at* http://www.minneapolisfed.org/publications_papers/capapers/mortgagebrokerregs/mortgagebrokerregulations_report.pdf (summarizing the basic licensing and registration policies for the fifty states and the District of Columbia pertaining to mortgage brokering).

120. *Id*. at 5, 16.

121. *See, e.g.*, Edward Wong, *Beijing Looks to Tighten Policy to Cool Economy*, N.Y. TIMES, Dec. 4, 2010, at B3.

122. *See* Friederike Fleischer, "*To Choose a House Means to Choose a Lifestyle*." *The Consumption of Housing and Class-Structuration in Urban China*, 19 CITY & SOC'Y 287, 301 (2007); Chang, *supra* note 1; Chengri Ding & Gerrit Knaap, *Urban Land Policy Reform in China*, LAND LINES, Apr. 2003, at 2.

123. Gregory M. Stein, *Private and Public Construction in Modern China*, 12 SAN DIEGO INT'L L.J. 5, 23 (2010).

the bustling housing market experienced "a first-hand lesson in the laws of supply and demand, and prices for urban residential units have continued to rise rapidly."[124] The demand for housing appears endless, and raises the question: how much would the average citizen be willing to pay?

Despite fierce oversight, China nevertheless fell prey to the starving demand for housing at any cost and surpassed its self-imposed limitations on lending to individuals seeking personal residential mortgage loans.[125] "Shanghai's new personal housing mortgage loans hit 33.81 billion yuan in the first quarter, up 31.13 billion yuan year-on-year, according to the Shanghai head-quarter of the People's Bank of China. . . . That is [eleven] times more than in the first quarter of 2009."[126] China has nonetheless displayed restraint and prudence to its benefit, rather than acquiescing to populist sentiment.

The state imposes higher interest rates on residential mortgage loans whenever the housing market spikes. "Interest rates generally have climbed during the past several years, from 4.12% (with government workers entitled to a reduced rate of 3.58%) to 5.27%, then to 5.51%, and then to 6.12%, before settling at the 2007 rate of 6.93%."[127] Such a measure likely deters the middle class demographic and some wealthier investors from seeking the loan. This makes sense because housing prices will rise, banks will seek to adjust the interest rate on the mortgage or convince a subprime borrower to leverage the equity on the property and take out a second mortgage, and the nearly impoverished borrower will inevitably default. China's exclusionary policy wisely maintains the integrity of the mortgage process as an exclusive offering made only to those with sufficient liquidity.

The four major mortgage providers, furthermore, also pursue initiatives to dissuade the low income, or subprime, borrowers from requesting loans. The four banks are state owned,[128] and when the government anticipates a rush on the housing market,

124. *Id.*

125. *See Chinese Banks Lent 1.2t Yuan in Jan: Report*, CHINA BUS. NEWS (Jan. 26, 2011), http://cnbusinessnews.com/chinese-banks-lent-1-2t-yuan-in-jan-report/.

126. Hu Yang, *Shanghai Personal Mortgage Loans Way Up*, CHINA DAILY (Apr. 14, 2010, 5:39 PM), http://www.chinadaily.com.cn/bizchina/2010-04/14/content_9730403.htm.

127. Stein, *supra* note 13, at 1340 n.62.

128. Deng & Liu, *supra* note 91, at 217.

the banks increase the minimum down payment from 20 percent to 30 percent, with some banks charging even more.[129] These provisions would effectively diminish the number of low-income and middle-class earners who seek mortgages, while strengthening the banking industry and the mortgage market because the majority of loans are made to wealthy investors.

The Politburo, exclusive from its influence with the banking system, also promulgates its own initiatives when the housing market grows too popular. It most recently restricted urban families by limiting a family living in the city to purchase only one residential property per household.[130] "These are the first regulations to be adopted restricting a [Chinese] national's ability to own residential property since China . . . return[ed] to private home ownership more than 10 years ago."[131] The government has also imposed several new taxes and raised rates on some existing taxes that affect the real estate market.[132] For example, investors incur a

> new 1.5% transfer tax. Additional taxes apply to larger apartments, which are defined as those that exceed a baseline of 120 square meters (about 1,270 square feet) by more than 20%. In addition, the government implemented a new 5.5% tax on gains if an owner sells property within one year of purchasing it.[133]

These recent changes demonstrate the government's inclination to restrain the market.

V. CONCLUSION

The Chinese government weathered one of the darkest storms in financial history, growing nearly 9 percent in the process.[134] The international community offers various reasons for China's growth, many involving unethical or illegal practices violating human rights,[135] intellectual property rules,[136] and currency de-

129. *See* Stein, *supra* note 13, at 1336–37.

130. Paul McKenzie et al., *Measures to Cool Chinese Property Market Target Both Foreign and Local Purchasers,* MORRISONFOERSTER CLIENT ALERT (Jan. 6, 2011), http://www.mofo.com/files/Uploads/Images/110105-New-Measures-Cool-Chinese-Property.pdf.

131. *Id.*

132. Stein, *supra* note 13, at 1340.

133. *Id.* at n.63.

134. *China's GDP grows 8.7% in 2009*, *supra* note 5.

135. *See generally* Committee Report, *supra* note 8 (discussing concerns with China's potential human rights violations and recommending solutions).

valuation.[137] The United States and other members of the World Trade Organization should continue to encourage China to fulfill its treaty obligations and respect customary international law. It would be imprudent, however, to disregard the success China has enjoyed as a result of its real estate investment policy simply because China competes against the United States for global hegemony. The Chinese culture's propensity for cautious optimism and attempted reform has proved, if nothing else, economically successful in staggering proportions.

China navigated the crisis by acknowledging the need for forward-thinking labor law to increase the individual wealth of its populace, provide employees stability in the workplace, and enhance the level of confidence among a burgeoning middle class to pursue home ownership and newly emerging investment opportunities. The test of time will determine whether localities disregard the federal government's decree, or whether workers have a genuinely effective bill working for them.

Simplistic real estate investment and mortgage regulations continue to temper a vibrant middle class in its materialist quests. Requiring low-income earners to provide capital up front before receiving loans insures against default and drastically reduces the number of defaulters. The Chinese banking system primarily relies on the wealthy citizenry to profit from the standard adjustable-rate mortgage, particularly in instances of delinquency. Shielding lower income earners from default and benefitting from property investment and consequent residential mortgage loans permits banks to extend such loans to the rising middle class.

The mortgage industry likely will refine its policies toward middle class borrowers throughout the next five years to more accurately reflect its level of default compared to timely repayments. The government's adaptation to this new demographic makes the mortgage industry more vulnerable to exploitation. The banks' ability to mitigate overzealous property and housing

136. *See generally* Tania Branigan, *Good for the Goose, Good for Propaganda: China Steals* Top Gun *Clip*, GUARDIAN (U.K.), Jan. 28, 2011, at 26, *available at* http://www.guardian.co.uk/world/2011/jan/28/china-tv-news-top-gun (discussing the potential use of a movie clip in place of actual video by the Chinese air force).

137. *See, e.g.*, Calmes, *supra* note 6.

Investment, however, protects the integrity of the mortgage system from potential mass default and excessive loans.

China's increasing reliance on exports and decrease in domestic consumption over the previous several years should alarm officials in Beijing. The Politburo should continue to cultivate its middle class through consistent wage increases, enforcement of employment provisions, maintenance of its mortgage market, and tentative, gradual forays into individual investment markets overseas. Perhaps the capitalist investor should pay homage to Chinese wisdom: seek examples of temperance from China's mortgage policies when entering unstable markets.

Clayton D. LaForge *

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