FOR WHOLESALE INVESTORS ONLY – 15 September 2021

Chi on China

REGULATORY TIGHTENING EXPLAINED: A STRATEGIC POLICY SHIFT AND THE OUTLOOK FOR CHINA'S PRIVATE SECTOR

Only the wisest and stupidest of men never change.

Confucius

SUMMARY

- China's regulatory tightening since 2H20 is, arguably, a tactical shift of its "dual circulation" policy reflecting the strategy of senior leaders to tackle intensifying domestic and geopolitical challenges, in particular Sino-US competition.
- Regulatory reform is part of this strategy, which now favours the development of "hard tech" over "soft tech" to resolve the domestic problems of wealth inequality, asset speculation and declining fertility. The resultant re-industrialisation could boost China's long-term GDP growth.
- To achieve "common prosperity", China wants to increase the private sector's contribution. High value-added manufacturing and innovation driven by the small and medium-sized enterprises (SMEs) are to serve as the engines for raising China's productivity.

While the flurry of regulatory tightening measures that China has implemented since 2H20 may seem uncoordinated and chaotic to some players, they actually follow the central theme of China's "dual circulation" strategic pivot to counter external exigencies and the shift in global demand[1]. The aim is to strengthen the domestic sector and reduce reliance on the external sector to sustain domestic growth and investment in the face of long-term strategic competition with the US. The policy focuses on:

1) Industrial upgrading by emphasising high-value manufacturing,
2) Technological self-sufficiency by substituting imports,
3) Consumption upgrading by making income growth and distribution more even and re-directing Chinese outbound tourist spending back to China.

[1] See "*Chi on China: China's "Dual Circulation" Strategic Pivot to Counter External Exigencies and Global Demand Shift*", 16 September 2020.

A CHANGE IN THE REFORM TACTICS

The economic recovery from the Covid-19 shock has given China's leadership an opportunity to tackle its structural problems by tightening regulatory oversight, which favours "hard tech" development over "soft tech" expansion[2]. This marks a shift in Beijing's structural reform tactics. A main theme of reform since 2013 had been raising the share of tertiary output of GDP and reducing that of the secondary sector as a way to rebalance to shift from investment-led to consumption-driven growth.

This has no longer been the case since 2020 when the 14th Five Year Plan dropped the efforts to boost the tertiary sector's growth. Beijing now wants to increase high-value manufacturing to support the development of technology and renewable energy. This change marks a strategic policy shift under the dual circulation framework in response to the changing domestic and international environment.

The changes include intensified Sino-US competition. US national security hawks have successfully hampered corporate China's expansion through embargos and supply restrictions. The damage on Chinese tech firms, notably Huawei and ZTE, shows that even China's most successful firms are vulnerable to the new US foreign policy[3]. Their supply chains are too dependent on the US and its allies as China lacks the production of key hardware and technology components.

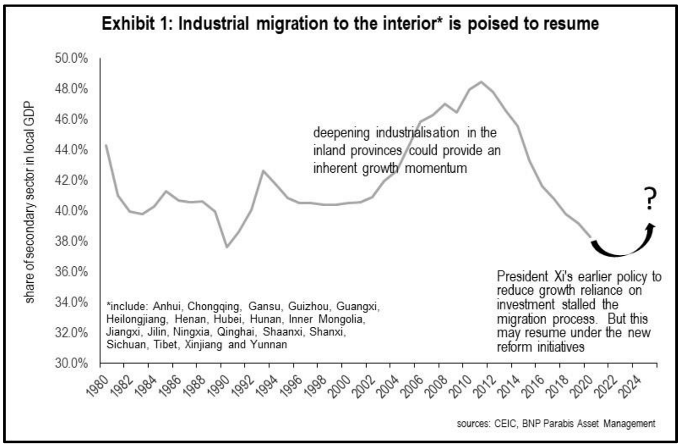
This vulnerability drives the import substitution effort under China's dual circulation policy and the recent regulatory reform to favour high-value manufacturing and hard tech production over traditional manufacturing and soft tech investments. Soft tech, in Beijing's eyes, has attracted too much investment, but it only serves consumption and the sectors that have little long-term strategic values.

MANUFACTURING IS BACK

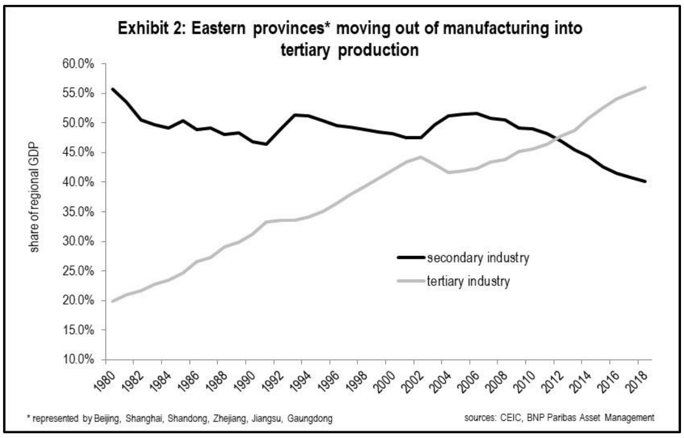
The manufacturing sector has regained policy favour. This has positive implications for long-term growth. As we have long argued, China's domestic sector started a slow structural rebalancing process in 2005 with lower costs and improving infrastructure driving industrialisation to poor inland provinces[4] (Exhibit 1).

[2] Hard tech refers to the production of hardware and components that caters for the country's strategic and high-tech development. Soft tech refers to the e-commerce development that caters for non-strategic consumption demand.
[3] US foreign policy towards China has changed from constructive engagement, as pursued by the administrations before Donald Trump, to strategic competition since Trump. For example, see "*Strategic Asia 2020: U.S. – China Competition For Global Influence*", Edited by Ashley J. Tellis, Alison Szalwinski and Michael Willis, The National Bureau of Asian Research, Seattle, Washington D.C. 2019 https://carnegieendowment.org/files/SA_20_Tellis.pdf
[4] See "*Chi on China: Structural Rebalancing – Part II, the Domestic Sector*", 16 July 2013, and "*Chi on China" Mega Trends of China (6): Evolution of China's Growth Model*", 6 April 2018.

Note: All tables are as at September 2021, unless otherwise stated



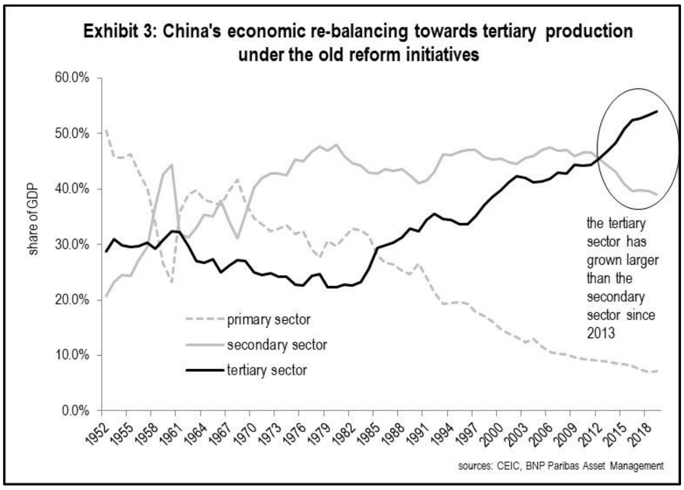
This resulted in a regional division of labour, with the costly eastern region moving from manufacturing to high value-added services industries (Exhibit 2) and cheaper inland regions picking up low value-added manufacturing. The industrial migration process was expected to generate inherent growth momentum that, in our view, could keep China's GDP growth at an annual average of 6.0% for much longer than the market expected[5].



However, the process has reversed since 2013 (see Exhibit 1) when the then reform policy focused on shifting the economic growth drivers from investment and manufacturing to services and consumption. This led to a rise in the GDP share of the tertiary sector at the expense of the secondary sector (Exhibit 3). Overall GDP growth also slowed, reflecting Beijing's policy goals at the time to lower the growth rate but lift quality of growth.

Under the current approach, industrial migration to the interior provinces is likely to resume, with high-value-added industries dominating the trend. This will revive the momentum of GDP growth and raise China's productivity in the longer-term.

[5] See references in footnote 2, and "*Chi on China: Progress on China's Structural Rebalancing and Reverse Migration"*, 8 November 2017.



THE ROLE OF THE PRIVATE SECTOR

Beijing attaches great importance in developing cutting-edge technologies and reducing the dependence of supply chain on external sources. It sees innovation as a way to achieve common prosperity, with digitalisation as the solution to improve economic efficiency and people's access to modern services. While it wants state-owned enterprises to do the heavy lifting for technology investment, it wants the SMEs and the private sector to drive innovative changes and fund the development of hard tech.

In this context, China has announced the setting-up of a new stock exchange in Beijing offering SMEs a low-cost financing channel with simple listing procedures[6]. This is a step towards developing onshore capital markets to reallocate capital to the real economy. It will also go a long way to facilitating the common prosperity goal by redistributing wealth to the SMEs and privately owned businesses away from the state sector and conglomerates. The new exchange can be seen as a policy signal that private businesses would be encouraged if they help achieve the country's strategic goals.

So the regulatory crackdowns are not meant to rein in the private sector. Rather, they aim at aligning the private sector's interest with Beijing's strategic targets. Those deviating from the public goals will risk being sidelined and penalised. This incentive strategy underscores our long-held argument that China's economic reforms were based on the strategic use of markets under state guidance and not on using market forces to drive change[7].

THE DOMESTIC AGENDA

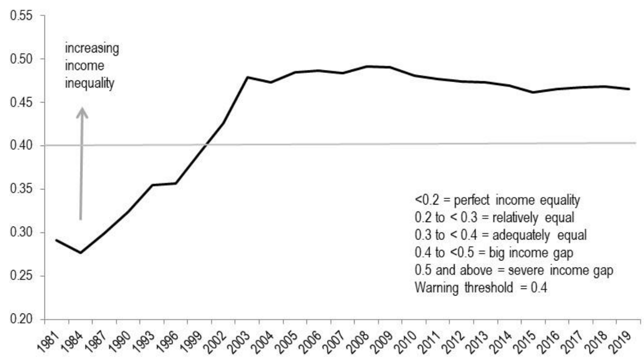
Further underscoring this argument is China's concern over the media influencing public opinion and government policy, risking potential abuse by serving vested interest, distorting public policy and creating systemic instability. To minimise these risks, the cybersecurity regulator moved to take board seats in some of China's social media platforms in August 2021[8].

Reducing wealth inequality is now a top policy priority. President Xi sees income and social inequality as the sources of many problems that could threaten long-term development. Indeed, China's Gini coefficient, a measure of income

[6] "*China's Xi Jinping Says It Will Set Up a Stock Exchange in Beijing for SMEs*", CNBC, September 2, 2021 https://www.cnbc.com/2021/09/03/xi-jinping-says-china-to-set-up-beijing-stock-exchange-for-smes.html
[7] See "*Chi on China" Mega Trends of China (6): Evolution of China's Growth Model*", 6 April 2018.
[8] "Beijing Owns Stakes in ByteDance, Weibo Domestic Entities", Asiafinancial, August 17, 2021 https://www.asiafinancial.com/beijing-owns-stakes-in-bytedance-weibo-domestic-entities-records-show

inequality, has risen sharply since economic reform started in 1978, and there is no sign of it declining (Exhibit 4). This underscores the need for structural measures to correct the distortions. Indeed, the common prosperity policy aims at raising labour compensation as a share of GDP to help address inequality.

Exhibit 4: China's Gini coefficient* suggests high income inequality



* World Bank calculations before 2003

sources: World Bank, CEIC, BNP Paribas Aset Management

Many Chinese private businesses, especially the internet companies, started out when laws and regulations were inadequate. Supervisory loopholes have allowed them to prosper. These companies have now come under scrutiny. In response, many large companies have announced plans to donate to the society.

However, it is unlikely that by just giving away money, the good old days of lax supervision and regulatory forbearance will return. The regulatory regime has tightened. It will not be reversed and execution will be tough, as Beijing is determined to reduce inequality by redistributing income and to create high-value jobs by boosting innovation and technological advancement.

IMPLICATIONS ON CONSUMPTION

Common prosperity policies that boost job and income growth should be positive for consumption. Building a better social safety net, which is a key plank of the policy, should help reduce household savings and increase consumer confidence. Since the poor have a higher marginal propensity to consume than the rich do, the impact of distributing income more equally on consumption should be significant.

Public policies should shift support to the mass and mid-value consumption sectors from the high-end luxury sector. However, distributing wealth more evenly to the SMEs and the private sector should augment aggregate income growth, allowing it to continue to drive the growth of the luxury goods sector[9] even without policy endorsement.

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[9] See "*Chi on China: Mega Trends of China (1) – Domestic Demand for Financial Assets*", 5 August 2015.

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