Decoding China's regulatory paradigm shift

Understanding the implications of pursuing 'common prosperity'

Aidan Yao,
Senior Economist
Macro Research & Core Investments

Shirley Shen,
Economist
Macro Research & Core Investments

Key points

- A powerful regulatory storm sweeping through many parts of the Chinese economy has left investors baffled at Beijing's intentions behind the far-reaching actions
- We view this as a progressive shift in China's long-term development strategy from 'allowing some to get rich first' – started in the Deng Xiaoping era – to a pursuit of 'common prosperity for all'
- Recent crackdowns – on the property market, big tech monopolies and the after-school tutoring sector – appear rooted in the hope of building a more egalitarian society
- Attempts to reshape China's income structure into an 'olive shape' will require multi-faceted reforms to redistribute income and wealth, bolster social safety nets and create equal opportunities for all
- Beijing's ability to balance 'income creation' with 'income redistribution' will be critical to this success. Managing side effects and containing risks from regulatory changes are also key to achieving long-term sustainability without compromising short-term stability
- This is a delicate manoeuvre and China's successful navigation is by no means guaranteed. Rising financial market volatility lately reflects growing caution among investors, particularly those from offshore

Sweeping regulatory changes in China have caught markets off guard lately and prompted confusion about Beijing's intention behind actions that seemingly contradict its long-term strategy of building a high-tech and knowledge-based society. However, beneath what appear to be uncoordinated actions lies, in our view, a coherent strategy to shift China's long-term economic priority from 'growth first' to 'balancing growth and quality'. At the core of this paradigm shift is the pursuit of 'common prosperity' which marks the next phase of China's social and economic development, supported by regulatory changes that could redefine the relationship between the state and the private sector.

Four types of regulatory moves

The myriad of recent regulatory changes falls into four categories, based on the purposes they try to fulfil:

1. **De-risk the macro system,** which includes the crackdown on the property market – to rein in the house price bubble – and actions against Ant Financial. The latter is seen by the market as a fintech company, but to the regulators, Ant's business falls under classic financial intermediation. Given the size of its balance sheet and exposure to the public, regulation was tightened in line with other systemically important financial institutions, which led to the termination of the company's initial public offering.

2. **Anti-trust and fair competition**, which affected big internet platform companies, such as Alibaba and

Meituan. The fact that China's anti-trust laws are less stringent than those in the US and Europe has led to rapid, and in some cases reckless, expansion of the big tech firms. These companies have been found to, on occasions, abuse their monopoly power and to have competed unfairly with small-and-medium-sized enterprises (SMEs)[1]. Beijing is now catching up on regulating the internet giants.

3. **Data and national security**, which was exemplified by the case of Didi. It was reported[2] that the clampdown on the ride-hailing company was, at least in part, in response to the recent listing rule changes in the US that could force Chinese companies, such as Didi, to hand over sensitive data to local regulators. This was deemed by Beijing as a threat to China's national security, prompting it to tighten data security requirements for tech companies[3].

4. **Social equality and improving demographics,** which relates to policy changes for the after-school tutoring sector. The rapid expansion of the sector – supported by seemingly unbridled capital infusion – had turned education into a source of extraordinary return for capital. This created educational inequality between the rich and poor, an additional financial burden on families[4], and in some instances disincentivised couples from having children.

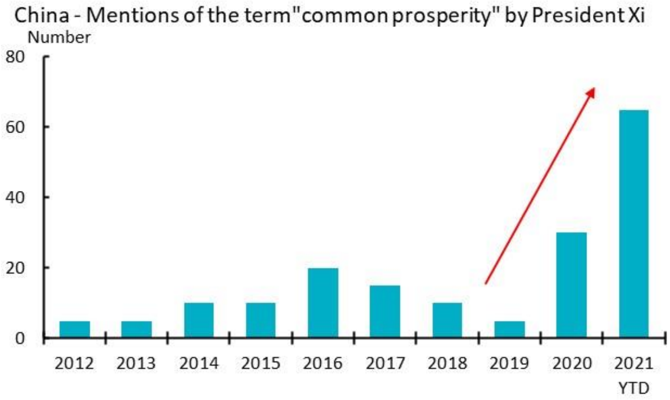
All changes lead to 'common prosperity'

On the surface, the successive regulatory crackdowns on multiple, unrelated sectors seem punitive and perplexing. We think the key to understanding Beijing's intention is by connecting the moves to a major shift in China's long-term development strategy.

In both the 19th Party's Congress and 14th Five Year Plan, "common prosperity" was highlighted as one of the key tenets of the next phase of China's social and economic development. The number of times President Xi Jinping has mentioned the phrase in meetings and speeches has surged since last year (Exhibit 1) after China declared victory in ending extreme poverty. The two – poverty alleviation and the pursuit of common prosperity – are connected, as the former was designed to shrink the base of the income pyramid, which led to a modest drop in China's Gini coefficient (a measure of income inequality) from almost 0.5 a decade ago to around 0.46 in 2020 (Exhibit 2).

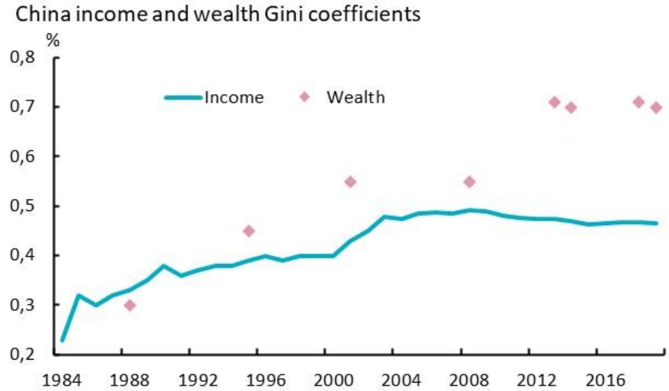
However, the concentration of wealth at the top of the pyramid has worsened over time (Exhibits 2 & 3). The property market, which accounts for over 70% of household wealth in China[5], has been a great driver of this inequality. The monopolistic behaviour of some big tech firms has also, in recent years, limited the flow of resources – profit, credit and manpower – to SMEs that make up the bulk of the economy. Even the education sector, supercharged by capital, has exacerbated the divide between the haves and have-nots in society. Three of four categories of regulatory changes – anti-trust laws, cooling the housing market, and regulating the education sector – can therefore be attributed to removing obstacles of building a more egalitarian society.

Exhibit 1: 'Common prosperity' moves to centre stage



Source: Bloomberg and AXA IM Research, as of September 2021

Exhibit 2: Inequality is high but stops deteriorating



Source: CEIC, China Family Panel Studies, Global Wealth Databook and AXA IM Research, as of September 2021

But unlike poverty alleviation, which aims to lift people out of the lower income echelons, the pursuit of common prosperity is designed to redistribute wealth from the top. The end goal is the same – remoulding China's income and

[1] "China: Alibaba fined $2.8 billion over anti-monopoly violations", News, DW, 10 April 2021

[2] "How the delisting of Chinese firms on American exchanges might play out", The Economist, 14 August 2021

[3] It's imaginable that as 'national security'-related issues escalate going forward, more US-listed Chinese companies may consider coming home to list in Hong Kong or Chinese A-shares.

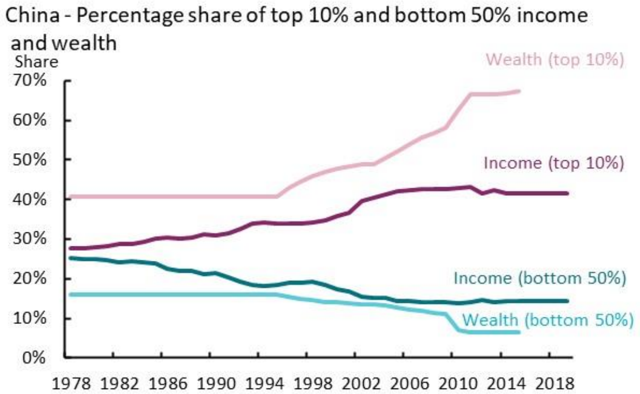
[4] By some estimates, after-school tutoring can cost an average family in some top-tier cities a quarter of their take-home pay

[5] https://www.washingtonpost.com/business/why-china-could-be-serious-about-a-property-tax-now/2021/08/08/36cd3db4-f8a6-11eb-911c-524bc8b68f17_story.html

wealth distribution into an olive-shaped, from pyramid-shaped, structure. To achieve it, we think Beijing needs to adjust policies in three broad areas:

1. **Redistribution of income and wealth** via tax and other incentives. While personal income and corporate tax rates are unlikely to change materially, tax on wealth (e.g. inheritance and capital gain tax) and assets (e.g. property tax) could be introduced to tackle deteriorating wealth inequality. The big tech firms could soon see their tax privileges fade as Beijing tightens the criteria for tax breaks linked to innovation and R&D spending [6]. Recent policy discussions also point to providing incentives for philanthropy as a way to redirect wealth from the super-rich.

Exhibit 3: Wealth inequality worsens more than income

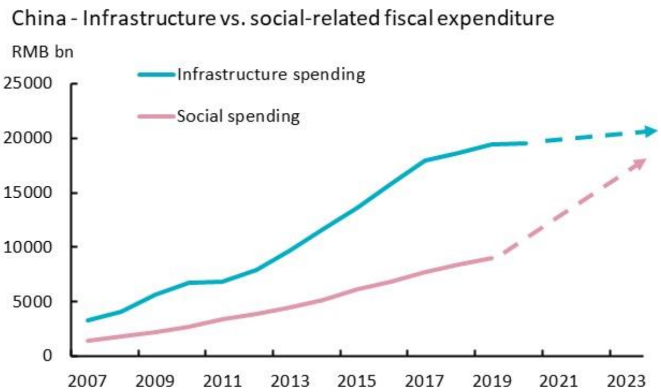


Source: World Inequality Database and AXA IM Research, as of September 2021

2. **Building better social safety nets** by enhancing basic protection. China's total public spending on social security, employment, and healthcare amounts to only 9% of GDP, significantly below the OECD average of 20%[7]. Fiscal spending on social infrastructure has also markedly trailed investment in hard infrastructure as Beijing has prioritized growth over the past decades (Exhibit 4). But as the development focus shifts, the former is expected to grow faster than the latter, particularly as infrastructure investment runs into its own supply bottleneck of high-quality projects. Furthermore, China's hukou system[8] is expected to change to speed up urbanisation that helps to narrow the rural and urban income gap[9].

3. **Enhancing social fairness and equal opportunity** by limiting excess profit for industries that produce goods of social significance. Common prosperity, in our view, is not about equalising income, which reduces incentives for workers and entrepreneurs, but equalising opportunities. In an ideal world, companies of all sizes and people of all backgrounds should be allowed to compete on a level playing field and have the same opportunities for success. The reality is far from ideal, but government regulations (e.g. anti-trust laws) and policies – by enhancing better social welfare – can help to narrow the gap. In that regard, investors should be aware of future regulatory risks for industries that enjoy excess profit, attract significant capital and produce products of social importance[10].

Exhibit 4: Reallocating resources from hard to soft infrastructure



Source: CEIC and AXA IM Research, as of September 2021

Balancing growth and redistribution

As China's development priority shifts from 'growth first' to 'balancing growth and equality', making sure that 'wealth redistribution' does not undermine 'wealth creation' is of paramount importance. As a developing country, with per capita income less than one-fifth that of the US[11], China cannot afford to abandon its growth strategy in pursuit of a full welfare state. Finding an optimal balance between 'dual circulation', which aims at growing the pie, and 'common prosperity' that focuses on sharing the pie, is critical for the success of future development. Furthermore, managing the near-term fallout of multiple structural changes is also key to achieving long-term sustainability without compromising short-term stability.

For near-term growth, the biggest potential disruption is likely come from the crackdown on the property market. As a pillar industry, a hard landing of the market would spell

[6] Ye, J., "China tech crackdown: Beijing's soft touch on tax for Big Tech is set to end as it seeks more focus on science", South China Morning Post (scmp.com), 13 August 2021

[7] National Bureau of Statistics, via CEIC on July 19, 2021

[8] China's household registration system defines residency status and entitlement to social programmes between urban and rural residents

[9] Recent regulatory moves to set a higher minimum wage and benefits for delivery and gig workers can also distribute profits between corporates and low-paid employees.

[10] Beijing has highlighted the need to reduce costs of living in three key areas: housing, education and healthcare. Policy changes have already affected the first two, leaving healthcare vulnerable to similar scrutiny in the future.

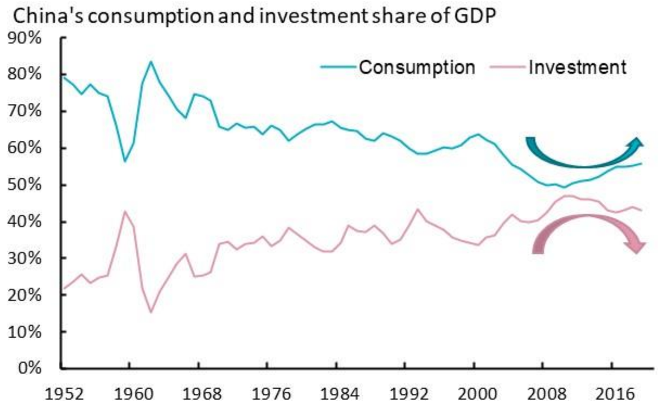
[11] https://statisticstimes.com/economy/united-states-vs-china-economy.php#:~:text=According%20to%20estimates%20by%20World,in%202019%20it%20is%2067%25.&text=The%20Per%20capita%20income%20of,China%20comes%20at%2063rd%20rank.

disaster for the economy. Rather than an abrupt pricking of the bubble, there needs to be a flexible and progressive long-term strategy to distribute wealth linked to the sector[12]. From a policy perspective, even though the worst of policy tightening may be behind – as the economy slows, any material easing is likely still some way off. The sector could remain a drag on economic growth for a period to come.

Over the longer run, the more consequential policy changes are likely those targeted at the big tech firms. Given their role in advancing innovation and attracting global resources – capital and manpower – balancing fair competition and preserving the vitality of these companies will be a delicate task. So far, even though the global trend is for tighter regulation of big tech monopolies, few countries have enacted rule changes that are effective in altering the competitive landscape. China, in this regard, is in uncharted terrain and needs to tread the path carefully. Reforms in this area will likely be a gradual and iterative process.

Finally, at the aggregate level, there is a large swathe of research suggesting that inequality is an impediment to future economic growth[13 14]. A heavily skewed income distribution to the rich, who have a low propensity to consume, tends to constrain consumption in an economy. Similarly, wealth concentration in the hands of a small group of elites will reduce credit access by the mass public – due to their limited possession of eligible collateral, such as property assets – resulting in lower investment and hence potential growth. Reducing inequality could therefore help China lift the consumption share in its economy (Exhibit 5) and spur investment among SMEs. Other changes – aimed at lowering living costs and improving social welfare – could help to halt China's falling birth rate and expediate urbanisation. Importantly, the social and political gains from a more equal and prosperous nation are also key for the stability of the political regime.

Exhibit 5: Lifting consumption to rebalance economy



Source: CEIC and AXA IM Research, as of September 2021

Risks are as large as the gains

The journey to common prosperity is not without risks. As discussed above, achieving fast and equitable growth demands a delicate balance between growth-creation policies and redistribution policies. A poor balance of the two – leading to, for example, over-tightening of regulations – could stifle innovation, and undermine business vitality and productivity growth.

Policy coordination is also key as reshaping income distribution will require multi-faceted reforms. With various departments and local governments eager to heed Beijing's new strategic shift, there is a risk of too many regulations at too fast a pace. A perceived lack of policy coherency is partly to blame for the violent market reaction recently. The last time that poorly coordinated policies wreaked havoc was in 2015/2016 when mismanaged FX reforms, coupled with a deleveraging campaign, prompted hundreds of billions of capital outflows from China. Beijing needs to be mindful of repeating the same mistake.

Finally, a lack of transparency in decision-making and inadequate communication have also exacerbated market volatility. This can undermine business and investor confidence, creating larger-than-necessary side-effects or even sabotaging reforms themselves. The much larger decline of Chinese stocks listed offshore – vis-à-vis those onshore in recent months (Exhibit 6) – suggests that the erosion of confidence has been greater among foreign investors. Without carefully managing their expectations, the misunderstanding of policy intentions could reduce the appetite of foreign (particularly US) investors for Chinese assets, curtailing Beijing's effort on market liberalisation and fuelling further financial decoupling between China and the US.

[12] Property tax was introduced in Chongqing and Shanghai as pilot experiments since 2011. Beijing has also signaled the importance of developing a nationwide rental market.
[13] Deininger, K. and Squire, L., "Economic Growth and Income Inequality: re-examining the Links" IMF, Finance & Development, 1997

[14] Cingano, F., "Trends in Income Inequality and its Impact on Economic Growth", OECD Social, Employment and Migration Working Papers, No. 163, 2014

Exhibit 6: More misunderstanding, more fear

Source: Bloomberg and AXA IM Research, as of September 2021

AXA Investment Managers SA
Tour Majunga – La Défense 9 – 6 place de la Pyramide 92800 Puteaux – France
Registered with the Nanterre Trade and Companies Register under number 393 051 826