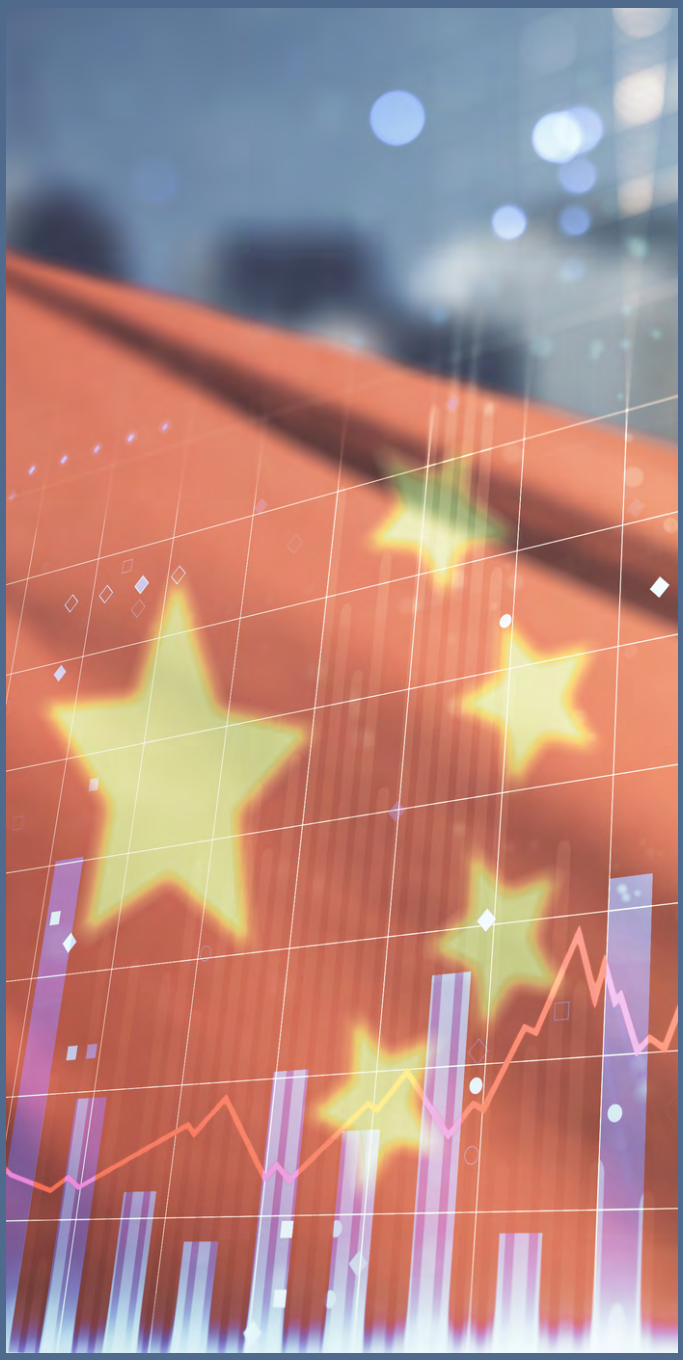

JS | HELD

PERSPECTIVES

Navigating China's Recent Regulatory Reforms

Our perspectives feature the viewpoints of our subject matter experts on current topics and emerging trends.

INTRODUCTION

In recent months, Chinese financial industry and cybersecurity regulators have "cracked down" on overseas IPOs, enforced antitrust policies against lauded national champions, including Tencent and Alibaba, and banned for-profit private tutoring and online gaming, with a focus on minors. These efforts have led to confusion and anxiety among foreign investors, producing headlines such as "Is it time to avoid investing in China?" and "Goldman clients are asking if China's stocks are 'uninvestable" Also, highly leveraged Chinese developer Evergrande is teetering on the brink of collapse, while other indebted Chinese developers are having difficulties making loan or interest payments, leading to speculation around "China's Lehman moment." For long-time China watchers, these developments are not entirely surprising, but rather constitute predictable responses to long standing issues within China's economy and society.

WHAT IS TAKING PLACE

The economic model that has served China well for decades, characterized by suppression of domestic consumption, high levels of investment, and export-led manufacturing, is no longer considered optimum at this stage of the country's development.

Under the old model, Chinese central government planners chose pre-determined annual GDP targets in the interest of growing the total size of the Chinese economy and realizing specific developmental milestones, as part of "five-year plans." Essentially the central government attempts to set GDP growth targets and earmarks specific investment subsidies to bolster certain industries, based on the data available to central government planners. Provincial and local governments then attempt to meet or exceed those targets, and local and provincial-level officials are measured on their performance along these metrics. Local governments have funded their operations and local development in two key ways, firstly by selling land to real estate developers or other firms and, secondly, by setting up local government financing vehicles (LGFVs). These LGFVs act as investment companies that sell a form of municipal bonds to finance real estate, infrastructure, manufacturing, or heavy industry in the region. Local governments then repay the LGVFs from the proceeds of local investments they have made.

This old model of investment has led to high levels of debt in the Chinese economy as well as overcapacity, creating a drag on investment, not to mention excess levels of pollution, wasted natural resources, and other social issues.

Chinese central government planners are acutely aware of the limitations of this model and are now trying to balance difficult trade-offs to create an environment conducive to sustainable long-term growth. Some of the most significant challenges include: (1) preventing the country from falling into a "middle-income trap", by reforming the country's regulatory institutions and redirecting investment to areas that its leadership believes will help China ascend the value chain and become a mature economy; (2) phasing out carbon-intensive production and moving towards a carbon-neutral economy; (3) addressing the problems of an ageing workforce; (4) tackling high levels of inequality among Chinese citizens and related discontent; and (5) facing an increasingly confrontational geopolitical climate.

WHY IS THIS HAPPENING NOW

In many ways, China is experiencing growing pains typical of an emerging economy that has relied on a combination of state capitalism and high debt, to finance its transition from a poor country to a middle-income country. This model has provided above-average growth rates and materially improved the lives of a sizeable portion of the country, all while turning China into an export powerhouse with impressive infrastructure. However, these efforts have also generated widespread economic, social, and environmental problems that cannot be resolved without concerted, determined, and top-down policy measures.

PROBLEMS WITH THE "OLD MODEL"

Under the old economic model, local governments relied disproportionately on supporting investments in real estate, infrastructure, and heavy industry to meet their GDP targets, as "growth" in these areas is significantly easier to organize than capital-intensive industries such as precision manufacturing.

At lower levels of economic development, investments in factories; housing estates; and roads, railways and other physical infrastructure all generate immediate benefits, providing jobs, housing and services to workers and firms. However, the marginal utility of each such investment decreases with time.

As China's economy has grown in complexity and sophistication, it has become increasingly difficult and expensive for local governments and state-owned enterprises (SOEs) to foster productive investments and meet the headline GDP growth rate, as it is easier to transition from a low to moderate level of development that a moderate to high level of development. This is why mature economies grow at rates of between one and three percent per year, rather than the impressive "catch-up growth" rates possible in developing economies.

Moreover, roads, railways, bridges, and underutilized real estate not only consume resources, energy and generate pollution while under construction, but also cost money to maintain. Without sufficient demand to justify their construction, road and railway networks become a drain on the operating companies that need to be written off somewhere in the economy, by a local or provincial government, or by the majority state-owned financial system. Under the old model of growth, the country has seen a real estate asset bubble and high levels of debt, reaching an estimated 290% of GDP in the third quarter of 2020 according to data from the Bank of International Settlements.

Equally worrying for central planners is the risk of off-balance sheet liabilities. The exact size of these liabilities is unclear, but economists at Goldman Sachs recently estimated that total debt of LGFVs rose to around RMB 53 trillion (USD 8.2 trillion), by the end of 2020, a figure equivalent to 52% of Chinese GDP. This off-balance sheet activity has been made possible by a lack of oversight, the limitations and incentives of the Chinese financial system, and wrongdoing on the part of some local government officials. Accordingly, the cost of servicing high levels of debt will either squeeze out funding for productive investments, or interest rates will have to drop to reduce the burden on borrowers.

"GENTLY" DEFLATING THE REAL ESTATE BUBBLE

The recent case of Evergrande and the ensuing market contagion speaks to the emergence of China's housing bubble in recent years. This has taken place as Chinese households, which have few investment options, have poured their savings into real estate investments in the belief that housing prices can only go up. Many Chinese now "own" two or more apartments that remain under construction, and which have been purchased with high levels of debt. Chinese regulators have long hoped to gradually deflate the property market bubble in their quest to reduce overall leverage in the Chinese economy but need to do so without threatening the hard-earned savings of ordinary Chinese families and causing social instability — one of the central government's biggest fears.

Previous leaders have chosen to "kick the can down the road", rather than dealing with the problem head-on, but the current generation of leadership has shown greater courage in tackling long standing interconnected issues related to the old model. Policymakers are now seeking to maintain a balancing act by curbing wasteful real estate investment without producing excess strain on the broader financial system or generating significant social unrest. This may undermine investor sentiment in the short term, but this factor is generally understood in China as an inevitable price that must be paid.

IDEOLOGICAL FACTORS

There are also ideological factors underpinning recent policy moves in China. The Communist Party of China has arrived at the 40-year mark of reform and opening up, which began in 1978. China believes that it has achieved its goal of eradicating abject poverty and creating high levels of material wealth in the economy as a whole. Nevertheless, for China's socialist transformation to be realized, the Chinese Communist Party now seeks to build a modern socialist country that is prosperous, strong, democratic, culturally advanced, harmonious and beautiful". To achieve this, China's leadership has begun emphasizing themes such as "common prosperity", by which is meant a prosperity shared by all rather than a small number of people profiting enormously at the expense of

the masses; and the protection of the interests of laborers, consumers, and small-to-medium enterprises ("SMEs").

THE "GERMAN MODEL"

Some commentators have suggested that state media discourse is promoting a so-called "German model" of development after losing enthusiasm for an American model. The Chinese leadership's understanding of the American model, which provided the main inspiration for the last generation of leaders, is characterized by a market-driven economy with relatively limited government intervention, and greater attention given to the needs of capitalists than the needs of workers and ordinary households. Given the various problems in the economy and observation of problems in the United States since the Global Financial Crisis, the Chinese leadership now believes the American model is also characterized by concentration of power among a few large corporations and major institutional investors, a significant social and financial gap between the rich and the poor, and exploitation of consumers and workers.

In contrast, the "German model" is seen to be one in which the government actively intervenes to ensure sustainable development of SMEs, relatively strong governance standards for large corporations, space for high-value manufacturing, and adequate protections for workers and consumers to prevent the pernicious effects when markets and capital are allowed to operate in an unrestricted manner.

MADE IN CHINA 2025

One document that demonstrates the Chinese leadership's preference for the German model is the Made in China 2025 ("MiC 2025") plan, published in 2015. This document was loosely modelled on Germany's "Industrie 4.0" high-tech strategy, which aims to promote the computerization of German manufacturing. The Chinese version of Industry 4.0, MiC2025, outlines ten industries that the Chinese government has identified as industries of the future, as well as specific goals and market shares that it hopes to achieve by 2025.

Given the exceptionally ambitious targets for global market share under MiC 2025 and Chinese industrial subsidies, there was considerable pushback against the policy internationally, especially from the United States. The Chinese government has since downplayed the significance of the targets in public. However, the Chinese central government is still committed to achieving high-end manufacturing and stated that it will not allow manufacturing to fall as a share of GDP. This, in turn, means that China's leadership is now paying less attention to growing the services sector. The recent focus on workers' rights is an outgrowth of this, as is the discussion of nurturing a culture of "craftsmanship" of the kind seen in Germany.

GEOPOLITICS

Chinese relations with the United States have been exceptionally strained in recent years. While the MiC 2025 strategy is one component of this, there are a broader set of factors undermining that relationship. During the Trump administration, the US government introduced heavy tariffs on Chinese imports, implemented sanctions targeting Chinese enterprises and individuals, and ordered the closure of the Houston consulate, to name just a few actions.

Actions by the US and its allies have alerted the Chinese leadership to prepare for being cut off from Western supply chains, supplies of energy resources, or even food supplies. This has led to a greater emphasis on achieving technological independence in critical industries seen as necessary for future growth.

Meanwhile, many in China saw the United States' repeated failure in addressing domestic problems, such as wealth disparity, social and political divisions, gun violence, healthcare, as well as the withdrawal from Afghanistan, as signs of significant structural issues within the American model of development. All of this has reinforced Beijing's confidence and willingness to forge its own path of growth and development.

RECENT REGULATORY REFORM

Meanwhile, Chinese leaders also recognize that the same economic model that led to impressive growth in the country had produced widespread fraud, corruption, wasted investment, and environmental degradation. It also allowed massive inequality at the individual level, the growth of an enormous real estate bubble, and a small number of firms to generate vertically and — more problematically — horizontally integrated monopolies.

In the case of technology giants such as Alibaba and Tencent, China's tech "unicorns" have collected massive troves of data on Chinese consumers and relied on big data, AI, and algorithms to attempt to control what individual Chinese consumers choose to buy. There is widespread popular resentment among ordinary Chinese people about these issues. The Chinese government also worries about the potential for this data to be abused by the companies themselves, or by foreign governments.

One other problem weighing on government policy planners is the country's looming demographic challenges. In 2015, the Chinese central government abandoned the one-child policy in place since 1982 and allowed couples in urban areas to have a second child. This was increased to a three-child policy in 2021. To date, there are no signs that these policies have resulted in a baby boom. The Chinese leadership is therefore seeking to address the factors that are preventing family formation and prevent couples from having more children.

Current Chinese regulatory reforms are multi-pronged to address these collective problems from a variety of angles, with the most visible ones being:

1. Reducing systemic financial risks — In addition to the reforms targeting the real estate sector, Chinese regulators are forcing Alibaba's fintech arm, Ant Group, to restructure, with the view to separating the linkage between the market-dominant payment platform Alipay with its other businesses. The restructuring, which is be overseen by China's central bank, will transform Ant into a separate financial holding firm. This move aims to differentiate between financial and non-financial firms in an effort to prevent the growth of new off-balance sheet risks. The linkage between Alipay and Ant's other businesses was also viewed as problematic by regulators due to the massive trove of consumer data that was being amassed regarding user activity across platforms and could be used to offer financial services such as loans and investment products. There is also an important symbolism with this move, as it demonstrates that the largest companies also have to play by the same rules.

2. Anti-trust behaviour – A separate crackdown on anti-competitive behaviour is being led by the State Administration for Market Supervision ("SAMR"), the agency which regulates all market participants. This includes traditional anti-trust regulation, such as fines for illegal M&A that the SAMR is very experienced at enforcing. In the future, it will likely expand to include technology-driven anti-competitive behaviour such as differential pricing and the regulation of algorithms more generally (the latter also involving the China's internet watchdog). SAMR has considerable experience with traditional investigations into anti-competitive behaviour such as irregular M&A activity and improper pricing. For example:

   a. Improper pricing – In early March 2021, SAMR fined five Chinese group-buying platforms a maximum penalty of RMB 1.5 million for improper price competition practices, focusing on the use of subsidies. Firms that received the fines included group-buy platforms backed by Didi, Pinduoduo, Meituan and Alibaba.

   b. Abuse of market position – SAMR imposed a USD 2.75 billion fine on Alibaba in April 2021 for its alleged forcing of vendors to use its platform exclusively. SAMR also listed additional prohibited behaviours that firms may not engage in August 2021. These include producing misleading publicity and information about competitors, the use of "excessive pop-up windows", amongst other matters.

   c. M&A irregularities – SAMR had imposed 22 fines on several of China's major technology firms — including Alibaba, Tencent and Didi — over irregularities related to M&A deals completed over the past decade.

3. Data and network security – The Cyberspace Administration of China (CAC) has been reviewing mobile applications for years and taking them offline for non-compliance. It has recently become more powerful and will likely continue to remain so, having been empowered by several important recent legislations:

   a. The 2017 Cyber Security Law – This law relates to how data is acquired and stored. This was the primary law used to justify intervention in the case of DiDi's overseas IPO listing.

   b. The Data Security Law – This law came into effect on 1 September 2021 and focuses on the regulation of data from a national security perspective.

   c. The Personal Information Protection Law – This set of laws is broadly analogous to the European General Data Protection Regulation (GDPR), though recent announcements suggest that it will also regulate other types of activity, such as the use of algorithms. If implemented as outlined, this set of regulations would place China at the forefront of personal data protection and regulation globally. The Personal Information Protection Law is set to come into effect on 1 November 2021.

4. Crackdown on the "disorderly expansion of capital" – Finally, Chinese regulatory authorities have intervened in a number of areas of the economy that may at first glance appear unrelated, but which are seen by the Chinese leadership as having a negative effect on society, legal and regulatory compliance and/or growth. These areas have been described as "disorderly expansion of capital" in several policy documents and in state media. Some recent examples include the education sector, which state media has long criticized for being heavily profit driven and burdening ordinary Chinese households, disrupting the broader education and growth goals of the country, and companies seeking to list overseas due to a desire to avoid complying with domestic regulations. This category also relates at times to business practices believed to exploit workers, such as delivery personnel. Many of the areas targeted by this set of regulations have grown rapidly and enormously throughout the past two decades and were relatively underregulated, at least as compared with their counterparts in other countries.

From the perspective of the *laissez-faire* economic tradition in countries such as the US and UK, these measures may be either perplexing or counterproductive. However, from the perspective of the Chinese leadership and much of the populace, such interventions are overdue, and a bitter medicine required to realize sustainable economic goals.

HOW INVESTORS SHOULD RE-THINK CHINA

For international investors considering an investment or additional investment in China, it is important to keep in mind certain factors specific to the Chinese business environment:

1. Despite recent decades of spectacular growth and high-profile technological accomplishments, China remains a developing country with many issues hindering that development. Confusing and contradictory regulations set by different regulatory fiefdoms and regulatory experiments are par for the course, as a sustainable regulatory framework with (more or less) fair rules for all market participants is in the process of being realized. While this process will involve trial and error, pushback, and discrepancies between theory and implementation, China's leadership has the advantage of acting without the need to develop a political consensus and can take a more reflective and long term view towards systemic issues since Beijing is not constrained by partisan struggles.

2. As in the case of many emerging and frontier markets, reliable information is more difficult, and in some cases impossible, to come by. This difficulty is further compounded in the case of China, where Western sources are often inclined to focus predominantly on negatives and Chinese sources are inclined to focus on the positive. Understanding where to access information, and the nuance of information, is mission critical for any investor in China.

3. China is — to a degree that is unique — a "strong state" market environment, where the direction set

by the central government does have a significant bearing on the types of projects in which private firms choose to invest in. Chinese firms are accustomed to carefully monitoring the details of five-year plans and adjusting their investments accordingly. To remain competitive in the Chinese market, investors must also keep abreast of state-led industry trends and be aware of areas likely to fall afoul of regulators due to security, political or social concerns. As has been demonstrated in recent months, going forward, data security and semiconductor independence are to remain as significant matters for the Chinese leadership – in the same way that they will be for the leaders of many Western nations.

CONCLUSION

Doing business in China is very different from doing business in investors' home markets, and it is imperative that would-be investors understand clearly up-to-date market dynamics. J.S. Held can assist an investor considering an investment in China by providing them with a full understanding of the potential regulatory issues, market segment risks, or the company in which they are investing. Ultimately, not all investors will find the market environment in China to their liking, but for those who see an opportunity, an informed decision should only be made on the basis of reliable, unbiased, and timely information.

ACKNOWLEDGMENTS

We would like to thank Ben Yeung and Scott McKay for providing insight and expertise that greatly assisted this research.

Ben Yeung, PhD, is a Managing Director in J.S. Held's Global Investigations practice. Based in Hong Kong, Ben gathers timely and insightful information for clients in support of business and investment decision-making. He has managed a large number of business intelligence projects, including in-depth reputational due diligence, corporate and fraud investigations, asset searching, corruption and bribery issues, and other fact-finding studies for major financial institutions, global law firms and multinational corporations.

Contact Ben Yeung at byeung@jsheld.com or + 852 2297 2255.

Scott McKay is a Senior Consultant in J.S. Held's Global Investigations practice. He provides clients with expertise in business intelligence, fraud and corruption investigations, investigative due diligence, and investigative research. He brings prior experience as a credit rating analyst and researcher, focusing on credit risk in China's property and financial sectors as well as risks in less-developed markets.

Contect Scott McKay smckay@jsheld.com or + 852 6072 8576.

For more information, please contact:

In Hong Kong – Ben Yeung, byeung@jsheld.com
In Singapore – Jeremy Tan, jtan@jsheld.com
In Japan – Ben Fouracre, bfouracre@jsheld.com
In India – Abhijit Yadav, ayadav@jsheld.com

REFERENCES

1. The "Spirit" of the 5th Plenum 五中全会精神, Pekingnology, 25 February 2021

2. This idea was first introduced in 2011 and 2012 and produced a set of Industry 4.0 implementation recommendations to the German federal government. For reference, the German plan calls for customization of products, highly flexible mass production, and automation.

3. China extends crackdown on Jack Ma's empire with enforced revamp of Ant Group, Reuters, 12 April 2021

4. Beijing drafts rules to rein in the algorithms used by Big Tech to push videos and popular apps in widespread crackdown, SCMP, 27 August 2021

5. China steps up antitrust campaign with new draft rules targeting internet companies, SupChina, 17 August 2021; China Targets Mobile Pop-Ups in Latest Tech Crackdown, Bloomberg