Myths vs Realities – Part II

Examining China Through The Top Headlines of 2023

MORGAN CREEK
CAPITAL MANAGEMENT

Introduction

China's rapid industrialization, unprecedented in human history in terms of scale and pace, has come at a significant cost. First, China's renaissance destabilized the incumbent world system, triggering its current geopolitical contest with the advanced nations. Second, its rise was established on the old model of debt-fueled infrastructure investing, which has begun to reach its limits: China's marginal efficiency of debt has now halved from what it was in the 1990s[1]. This means China's economic transition to a more sustainable and innovative model must inevitably translate to slower growth.

Lastly, its economic ascent has resulted in sweeping changes to its citizenry. An HBR article[2] captures this phenomenon vividly by visualizing the life story of a hypothetical 65-year-old Chinese woman:

> "Born in 1955, she experienced…the Great famine… by the 1980s, she was in the first generation to go back to university…in the 1990s, she became a 30 something entrepreneur in one of the new Special Economic Zones…[buying] a flat – the first time anyone in her [family] had owned property…by 2008 she was making the most of the rise in disposable incomes by buying new consumer goods that her parents could have dreamt about…by 2020 she was intent on seeing her seven-year-old grandson and infant granddaughter (a second child had only recently become legal) do well."

This is not surprising: the Industrial Revolution has exponentially elevated man's material well-being in every nation that has embarked on it, in the process transforming its social fabric. However, in predecessor Western nations the process was more gradual and measured in centuries (as opposed to the decades in China). This meant authorities in China had to undertake significantly more rapid and greater regulatory adjustments simply to keep pace with the country's evolving economic conditions and social values. The shorter regulatory cycles, coupled with greater regulatory volatility unsettled many foreign observers and investors who concluded that:

- 40 years after reform and opening, China is now regressing politically
- China's regulatory framework is a blackbox.

In this second installment of our whitepaper on macroeconomic issues on China, we will attempt to address these concerns.

Government & Regulation

Chinese politics and regulations have confounded many foreign observers, who tend to measure its progress (or lack thereof) against their own contemporary yardsticks and extrapolate recent policy data points without necessarily taking into consideration the history and broader context. This tends to result in deep and continued misunderstanding of the Chinese authorities' actions and goals.

Two points of particular concern to investors which we will attempt to explain adopting a local perspective are: (i) that China's political system is regressing and (ii) its policy-making is erratic and unpredictable.

Headline 1: 40 Years After Opening Up, China Is Moving Backwards

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[1] Source: Property shakeout Beijing's tool to fight fiefdoms; https://asiatimes.com; Aug. 18th, 2023
[2] Source: Rana Mitter. Elsbeth Johnson (2021). Understanding China

The past few years has witnessed the gradual consolidation of authority under President Xi, who is now viewed as the strongest Chinese leader since Chairman Mao. There is worry around the overconcentration of power in an individual and a potential reversion of China to the Communist ideology of its past.

The logic of this narrative is as follows:

- Mao was an autocratic leader who wanted absolute control over every aspect of China, including the economy which he managed disastrously top-down
- Deng was a reformer and his contribution to China was simply unleashing and allowing market forces free reign over the economy
- Xi's actions of consolidating power mirrors that of Mao, and does not bode well for the future economic growth prospects for China

Notwithstanding the factual errors in the above narrative, we believe the argument is flawed:

First, China under Mao, even after considering the calamity that was the Great Leap Forward and the Cultural Revolution, witnessed tremendous progress in the standard of living of its citizenry with life span almost doubling and infant mortality and illiteracy both declining more than 75%. It is not well appreciated, but China's progress actually began exceeding India's in the period under Mao despite starting off much poorer[3].

Second, China learned from the spectacular failure[4] of economic shock therapy policies adopted by Russia in the 1990s, when it decided to remove all protectionist measures overnight to rapidly transition to a free-market economy. China instead adopted an incremental, experimental approach to shift to its current mixed economy structure. Market liberalization undoubtedly played an instrumental part unleashing the Chinese entrepreneur; however, the role the state played should not be overlooked. Among other things, it set the fences allowing new Chinese businesses time to grow before opening the market to large MNC[5] competition; it also consolidated public resources to invest in the physical, digital and financial infrastructure necessary to turbocharge Chinese enterprises.

Lastly and most importantly, political systems are never static. To survive, they must always evolve to:

- Remain relevant to society as countries advance and transition over time; and
- Prevent corruption by an "elite" class. This can seem inevitable in any system administered by people, who tend to be motivated by self-interest.

As a result, history has shown time and again that political systems oscillate between centralization and decentralization. Decentralization allows for markets to efficiently allocate resources at the outset. Left unchecked however, free markets can eventually give way to monopolies and/or oligopolies as industries inevitably consolidate and corporate interest begins to capture the system via methods like lobbying. At that point, paradoxically, some centralization of state authority can be necessary to compel a system reset. Yet if centralization of power is left unchecked over time, that could also mutate into the corruption it was trying to prevent.

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[3] India was at par with China in many areas during the period before Mao took over, with an average lifespan of 34 years old, infant mortality of 16.4% and illiteracy of 81.7% in 1950, but India fell behind significantly overtime. By 1980, India's average lifespan increased to only 48 years (15 years behind China's); its infant mortality fell incrementally to 11.5% (double China's); and illiteracy remained high at 56.4% (thrice of China's). Source: Census 2011: Literacy Rate and Sex Ratio in India Since 1901 to 2011; https://www.jagranjosh.com; Oct.17th, 2016

[4] Source: Shock therapy (economics); https://en.wikipedia.org

[5] Multinational Corporation

The US vs. China political milestones

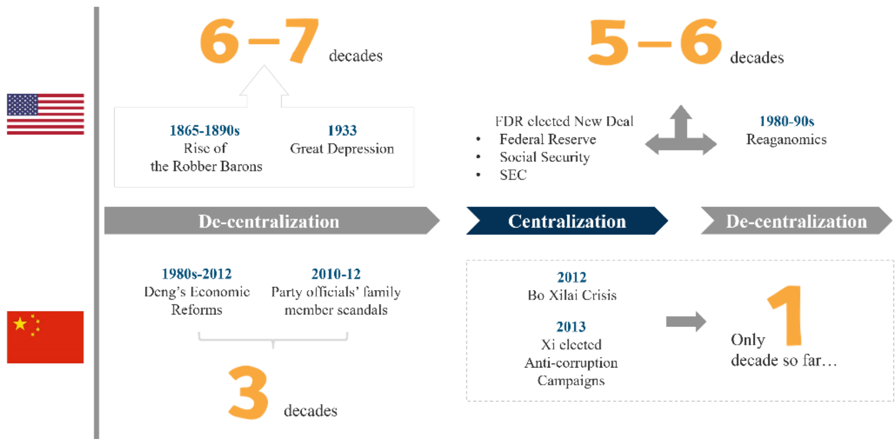

Figure 9: (An attempt at a) Comparison between US and China

An example of this cycle playing out in a completely different system to China was the US a century ago. The Roaring Twenties marked the climax of a decentralized era defined by rapid economic growth (but also massive wealth inequality and significant social discontent). This disequilibrium eventually pushed the economy into a Great Depression, handing President Roosevelt the mandate to begin centralization, which he promptly did by enlarging government and creating institutions like the SEC, FDIC and Social Security[6]. Political centralization reached its peak under President Reagan five decades later, who then exercised his authority to begin the process of decentralization[7], closing out the cycle and subsequently propelling the US into one of its longest bull markets.

The Chinese situation has many parallels with that period of US "robber baron" history which featured high levels of social inequality. When Xi came into power in 2013, the party elites and their families were embroiled in numerous scandals:

- The son of a provincial level deputy police chief was involved in a drunk hit-and-run case[8] injuring and killing two pedestrians in 2010. He drove off the scene, shouting, "Go ahead and sue me if you dare. My father is Li Gang".
- In 2011, Wenzhou officials were accused of trying to cover up a fatal high-speed train collision[9] that killed 40 people. Officials were accused of burying and taking apart train compartments to destroy evidence[10].
- The son of a high-ranking government official died crashing his Ferrari[11] in 2012. He and his two female passengers were discovered unclothed in the car. His father was later investigated and discovered to have received bribes and stolen state secrets.

Public fury at the blatant corruption of elites and their relatives was at an all-time high. Weak central authority meant the top leaders in the central government were unable to rein in their subordinates, who were unabashedly fighting to line their own pockets. No major decisions could be made given infighting.

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[6] Source: New Deal; https://www.britannica.com
[7] Source: Trends in centralized control of the executive branch; https://pubmed.ncbi.nlm.nih.gov; Jun. 11th, 1990
[8] Source: Li Gang's son faces trial over fatal accident; http://www.china.org.cn; Dec. 23rd, 2010
[9] Source: China bullet train crash 'caused by design flaws'; https://www.bbc.com; Dec. 28th, 2011
[10] Source: In China Train Crash; Buried Evidence?; https://forbes.com; Jul 25th, 2011
[11] Source: Son of Chinese politician died after engaging in 'sex games' with two women while driving at high speed in his Ferrari; https://www.independent.co.uk; Sep. 7th, 2012

In fact, many analysts anticipated given the prevailing trend that President Xi would be a “weak leader… hampered by factional struggles”[12].

The future going concern of the party was at stake. President Hu, Xi’s predecessor, broke with tradition and handed over all positions – including the important chairmanship of the central military commission – to Xi simultaneously giving him full authority to centralize authority once more to clean house. Xi promptly punished more than 4 million cadres (of which nearly 500 are senior officials[13]) since his ascension.

This ongoing campaign appears to have restored national trust in the government, with public polls showing a sharp increase in trust level from 76% in 2016 to 89% in 2022[14]. Simultaneously, inequality[15] has also been under control as illustrated in the chart below.

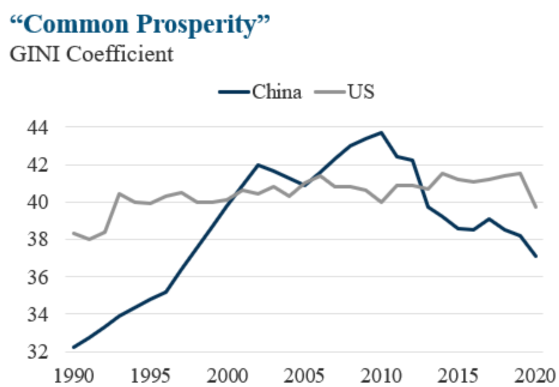

Figure 10: Xi Administration has made significant effort in reducing inequality[16]

China appears yet early in its current cycle of centralization. A potentially comparable period of centralization in the US – from Roosevelt through Regan lasted almost six decades; Xi has been currently in power “only” for one.

Headline 2: China’s policy and regulations are made in a blackbox

The Chinese authorities have been very prolific the past few years updating their regulatory framework: the internet sector was subject to anti-monopoly and data security laws, the education sector hit with “double reduction” policy, and the property sector restricted with the “three red lines” policy, etc. The breadth and pace of the regulations alarmed many foreign investors, sparking the beginning of a wave of capital outflow.

We believe the chances for a similar seismic regulatory shock in the future to be greatly diminished, for a few reasons.

First, we believe the breakneck pace of China’s industrial advancement will slow as the technological gap with its advanced peers closes. China can no longer rely on the “low hanging fruit” of importing or replicating existing technologies from abroad and must conduct its own R&D to upgrade its economy which

[12] Source: Xi To Be 'Weak' President; https://www.rfa.org; Nov 12th, 2012
[13] Source: China’s Anti-Corruption Campaign: Tigers, Flies, and Everything in Between; https://thediplomat.com; May. 12th, 2022
[14] Source: Level of trust in government in China from 2016 to 2022; https://www.statista.com
[15] Measured by GINI, which is the proportion of income that is unevenly distributed compared to the total income, where 0 stands for perfect equality while 1 indicates maximum inequality.
[16] Source: Time once again to make superhero of China economy; https://asiatimes.com; Dec. 27th, 2023

will necessitate more time. Given policy tends to lag industrial developments, this follows that the pace of future regulations will also slow in tandem.

Second, Chinese regulators have become more sophisticated and proactive in policy setting. The internet sector in China developed for over a decade with minimal regulations, facilitating the rise of Alibaba and Tencent at the expense of smaller competitors. The authorities were slow to respond until these giants had completely dominated their markets. By that point, severe actions had to be undertaken to return the ecosystem to an acceptable equilibrium, which understandably alarmed investors who had expected continued monopolistic-level cash flows from the industry incumbents. Learning from its past, China has attempted to anticipate new technologies: it was among the first countries to embrace and regulate cryptocurrencies[17] and the first to put in place a law specifically addressing generative AI[18]. Where only a few years ago China drafted its anti-monopoly and data privacy laws on the back of an EU blueprint, it is today at the forefront of cutting-edge technology policymaking. This new incremental regulatory approach to disruptive technologies is likely to reduce policy volatility going forward for investors.

Lastly, the government continues to improve their communication with investors. China has a system it utilizes to pass laws. All laws must go through either the National People's Congress and/or its Standing Committee. Before that, the various ministries must review (and revise) draft laws *at least thrice*, with every iteration soliciting public feedback before the law is deliberated upon and passed by the bodies mentioned above. The potential timeframe for this process in the most extreme scenario could be months (i.e. the Data Security Law took 11 months to pass) instead of years for the Western equivalent, which is something that rattles investors unused to such fast regulatory changes. The authorities have recognized the importance of striking a balance. Recently, an overzealous gaming regulator was dismissed for proposing severe video gaming restrictions that led to significant volatility of gaming companies' stocks[19], in this case favoring investors and signaling the end to their regulatory overhaul of the sector.

Conclusion

China's approach to progress has always been to "cross the river by feeling the stones", and this sometimes necessitates taking one step back to advance later. Long time observers agree that at this stage of his career, President Xi is concerned primarily with molding his legacy, which is invariably tied to the continued prosperity of the Party. In turn, the Party's primary goal is to remain in power, and it can only achieve that via social stability and improving the livelihoods of its citizenry.

There are two ways to make profits. An easy way is when businesses extract economic rent because of a privileged position (potentially unsustainable in the long run). The other way is to create/add value to society. China has demonstrated that it is inadvisable to invest in the former but has welcomed investors to the latter.

Businesses could start out in one camp but evolve to the other as industry dynamics change. As an example, internet platforms early in their lifecycle brought enormous benefits to society – convenience and transparent pricing for consumers, new economy jobs for workers, and new channels for distribution for producers. However, as the industry consolidated later in the cycle, platforms began boosting their profits in unsustainable ways – edtech firms engaged in predatory marketing practices to enroll anxious students[20],

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[17] Source: China Creates Its Own Digital Currency, a First for Major Economy; https://www.wsj.com; Apr. 5th, 2021
[18] Source: The future of AI policy in China; https://www.eastasiaforum.org; Sep. 27th, 2023
[19] Source: Exclusive: China removes official after video games rules spark turmoil; https://www.reuters.com; Jan. 3rd, 2024
[20] Source: As China cracks down on online education, it wrecks IPO prospects; https://www.aljazeera.com; May. 31st, 2021

ecommerce companies rammed one-sided contracts to mom-and-pop suppliers[21] and food delivery companies put significant pressure on drivers compelling them to disregard traffic safety[22]. All these resulted in mass public outrage, threatening social stability, and ultimately forcing regulators to intervene.

It is important for investors to recognize the long-term motivations of management and the sustainability of business models they back. Being on the ground to understand the externalities a business exerts on society and having the local insights into potential reactions is crucial.

China has experienced significant regulatory reforms over the past few years, taking technology investors by surprise. However, we believe the pace and scale of regulatory changes will slow as the authorities become more sophisticated and learn to better: (i) communicate their policies and intentions, (ii) balance managing social externalities with investors' interests and (iii) anticipate technology trends, regulating incrementally.

We believe this shifting landscape has generated many opportunities for discerning investors to capture. We will cover in a separate whitepaper how to leverage China's scale and competitive advantages to identify sectors and entrepreneurs to invest in for the long term.

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For further information on Morgan Creek's activities in the region, including our newsletters, research whitepapers, webinars and/or product offerings, please contact us at asiateam@morgancreekcap.com.

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[21] Source: What is 'forced exclusivity'? And why did it get Alibaba fined $2.8 billion?; https://technode.com; Apr. 15th, 2021
[22] Source: Driven to death? China food-delivery services criticised for pressuring drivers; https://www.campaignasia.com; Sep. 10th, 2020
[23] Data as of March 2023

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