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Behind Beijing's Big Tech Crackdown

President Xi Jinping's administration's earth-shattering crackdown on Chinese 'tech stars' is both shocking and unprecedented.

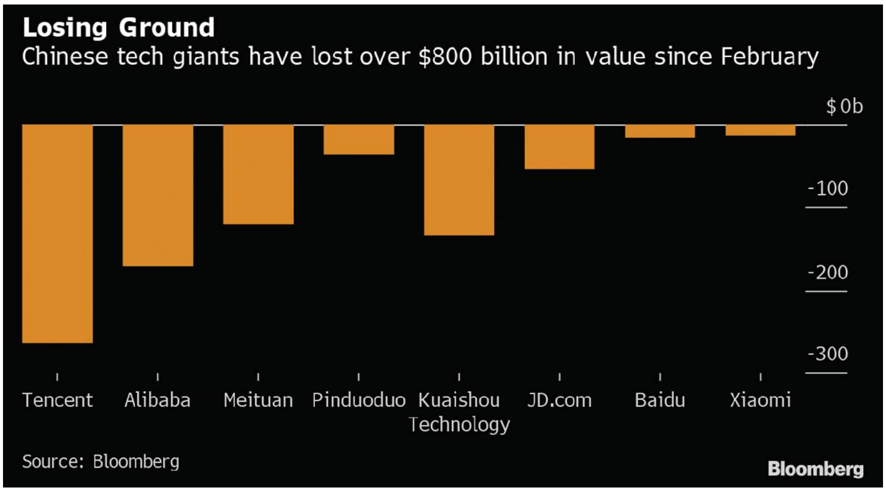
> One plausible reason (of the crackdown) is that in recent years, some rapidly-rising tech stars like Jack Ma of Alibaba and Pony Ma of Tencent Holdings seem to be getting too big for their boots.

A "Big Tech Crackdown" is currently underway in China that has caught both the local businesses as well as international investors off guard and has sent shock waves across the financial markets globally. In a shocking development that began to unfold late last year, the authorities halted Ant Group's $37 bn IPO in both Shanghai and Hong Kong. This was followed by a more rampaging clampdown across the entire $4 tn Chinese technology sector. Casualties include who's who of Chinese "tech stars", from Tencent (internet conglomerate) to Meituan (food delivery), Pinduoduo (e-commerce), and Didi (ride-hailing app) to Full Truck Alliance (freight logistics app), Kanzhun (recruitment), New Oriental Education and TAL Education (online private-tutoring), coming close on the heels of the crackdown on cryptocurrencies. A massive sell-off that followed has sent shivers down China's tech market. According to *Bloomberg*, Chinese tech giants had lost a colossus $831 bn in market capitalization between February and July 7. And there does not appear to be an end in sight!

A recent edition of *The Economist* (dated August 14) warned that President Xi Jinping's assault on tech will change China's trajectory and is likely to prove self-defeating: "China's tech revolution has … helped transform its long-run economic prospects at home, by allowing it to leap beyond manufacturing into new fields such as digital healthcare and Artificial Intelligence (AI). As well as propelling China's prosperity, a dazzling tech industry could also be the foundation for a challenge to American supremacy". A number of international experts have expressed concerns over the events that have unfolded in last several months, which seem to be undoing years of gains made by Chinese tech entrepreneurs. Stephen S Roach, a faculty member at Yale University and former chairman of Morgan Stanley Asia, lamented in *Project Syndicate* on July 27 about the apparent stifling of China's "animal spirits" by such a massive crackdown. He rued, "The Chinese government has taken dead aim at its dynamic technology sector, the engine of consumption-led economic rebalancing. The authorities' recent actions are symptomatic of a deeper problem: the state's battle to control the energy of animal spirits could sap the confidence of households and businesses".

Confusing signals?

Some pundits point out that up to now, China's manufacturing high-tech icons, such as Huawei and ZTE, appear to have been spared, for now. Does this mean that the crackdown is a signal to shift the whole tech sector towards self-sufficiency in high-end semiconductor



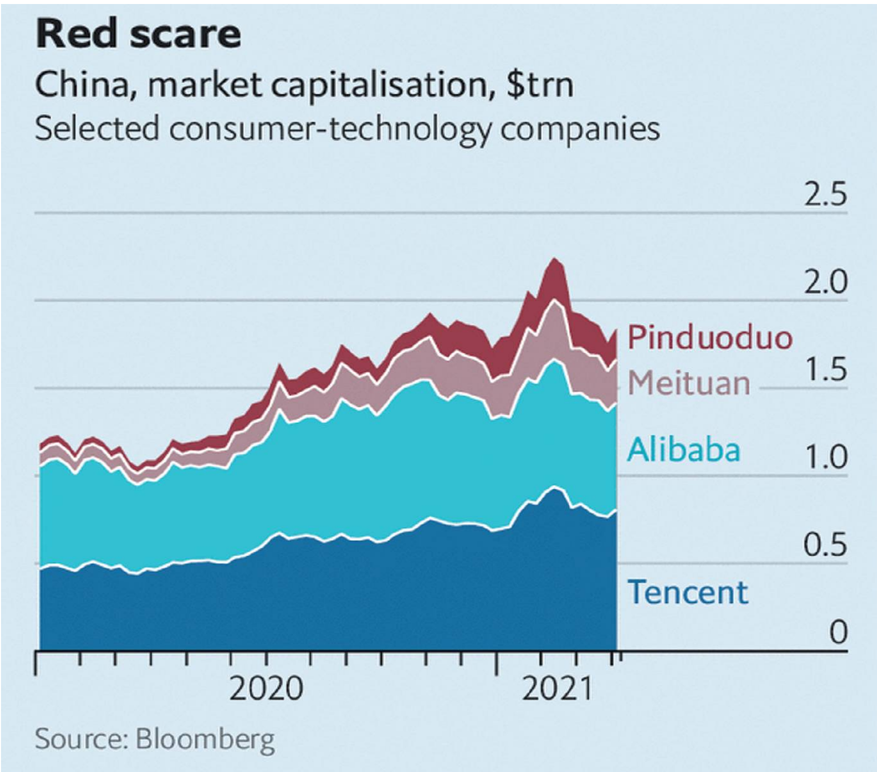
microchips, which is China's tech Achilles Heel? This line of thinking is preposterous, to say the least. Closing down Didi's ride-hailing apps, for example, will not turn them into ASML (Dutch proprietor of the world's most advanced microchip lithographic machines) or TSMC (Taiwan Semiconductor Manufacturing Company, the world's dominant semi-conductor producer).

Nor can this be a signal of Beijing's wish to downplay the importance of tech-driven consumer businesses. As Beijing's "Dual Circular Economy" strategy (a combination of "internal circulation", i.e., domestic cycle of production, distribution, and consumption, as well as "external circulation": read exports) suggests domestic consumption is critical to rebalance China's over-dependence on manufacturing and exports.

Too big for their boots?

One plausible reason is that in recent years, some rapidly-rising tech stars like Jack Ma of Alibaba and Pony Ma of Tencent Holdings seem to be getting too big for their boots. Alibaba's IPO on New York Stock Exchange in September 2014 raised $25 bn, by far the largest IPO in world history, giving the company a market valuation of $231 bn. It was ranked 23rd among the world's largest public company on the *'Forbes Global 2000'* list for the year 2021. In January 2018, Alibaba had become the second Asian company, after compatriot Tencent, to reach the $500 bn valuation landmark. Alibaba had the sixth-highest global brand valuation in 2020. The conglomerate is today one of the world's largest retailing and e-commerce companies, hosting the world's largest B2B (Alibaba.com), C2C (Taobao), and B2C (Tmall) marketplaces. It has also been expanding into media industry, where its revenues have risen in triple percentage points year after year. Three years ago, it set a new 'Singles Day' sales (the world's biggest online and offline shopping day festival) record, after notching up GMV (Gross Merchandise Value) of nearly $31 bn in 24 hours. In 2020, Alibaba was rated as the fifth-largest artificial intelligence company. It is also one of the biggest venture capital firms, and one of the biggest investment corporations in the world.

Another domestic tech major, Tencent, based in Shenzhen, is the world's largest video game vendor. But it also has several other interests: it is among the largest social media, venture capital, and investment corporations globally. Its services include social networks, music, web portals, e-commerce, mobile games, internet services, payment systems, smartphones, and multiplayer online games. Offerings in China include the instant messengers Tencent QQ and WeChat, and one of the largest web portals, QQ.com. Besides, it also owns the majority of China's music services (Tencent Music), with more than 700 million active users and 120 million paying subscribers. Tencent surpassed a market value of $500 bn in 2018, becoming the first Asian technology company to cross this valuation-mark. It has since emerged as the most valuable publicly-traded company in



The Economist

China's Big Tech Crackdown: The Timeline

On the surface, China's "tech crackdown" is exactly that: a clash between government power—wielded by the Chinese Communist Party (CCP)—and what many call the "tech sector." The reality is more complicated. Though there may be some method to the madness, the agencies involved are diverse, the sectors targeted are wide-ranging, and so, too, are the justifications.

SupChina published a guide to the tech crackdown on August 2, 2021. This timeline accompanies that guide.

The timeline of regulatory events and other developments can be filtered by Agency, Sector, or Official Justification. Those three categories have the following components:

Sector

- Fintech
- E-Commerce
- Education
- Ride-hailing
- Social media and user-generated video
- Music, literature, and other IPR
- Gaming
- E-Cigarettes
- Insurance

Agency or Government Department

Politburo: The highest policy-making body of the Communist Party of China, made up of 25 officials and led by President Xi Jinping.

State Council: China's highest governing body, or Cabinet.

SAMR: The State Administration of Market Regulation, the department in charge of antitrust cases along with intellectual property, food safety, equipment safety, etc.

CAC: The Cyberspace Administration of China, the central internet regulator in charge of data security and censorship, was founded in 2014.

CSRC: The China Security Regulatory Commission, a government ministry of the State Council, China's highest administrative body, and the main regulator of the securities industry in China.

PBOC: The People's Bank of China, China's central bank responsible for monetary policy and financial regulation.

MIIT: The Ministry of Industry and Information Technology, the agency responsible for regulating the postal service, internet, wireless, broadcasting, communications, and software industry.

MOE: The Ministry of Education, which regulates all aspects of the educational system.

SAPPRFT: The State Administration of Press, Publication, Radio, Film, and Television, which, along with the State Administration of Radio, Film, and Television (SARFT) and the General Administration of Press and Publications (GAPP) are an alphabet soup of agencies that still have some say over news agencies, publishers, and broadcasters.

CBIRC: The China Banking and Insurance Regulatory Commission.

Official Justification

- Data security
- Antitrust
- Financial risk
- Marketing deception
- Workers' rights
- Content regulation
- Burden on children

Courtesy: supchina.com

China, and among the world's top technology companies by market value. The tech behemoth has been credited as one of the world's most innovative companies by the Boston Consulting Group. It has stakes in over 600 companies and began focusing on tech start-ups in Asia in 2017, letting its portfolio start-ups operate autonomously. The problem (in the eyes regulators) is that the rapid rise of a variety of tech giants and "unicorns" has been outpacing the capacity and tech-savvy of Beijing's lawmakers, who have become increasingly wary of their ability to elude normal banking and other regulatory rules, cannibalize related markets, gobble up smaller rivals, stifle competition, and exert an outsize social influence, not always benign, on the preferences, behavior, and upbringing of a whole generation of tech-savvy youngsters. These worries were exacerbated when Jack Ma was seen as openly mocking Beijing's ability to catch up with his business model. In November 2020, Ant Financial had to halt its planned Shanghai and Hong Kong listings less than 48 hours before it was due to go public, following a last-minute summon of Jack Ma to meet with Beijing's financial regulators.

But then, at the end of the day, regulating a bank is not the same as regulating a fast-moving, evolving tech financial sector. After the 2008 global financial crisis, the specter of a Chinese one rearing its head can be real frightening in the country of a 1.4 billion plus people. Similarly, some of the worries are reminiscent of the United States' early antitrust laws vigorously enforced by President Roosevelt against monopolistic behemoths like the Standard Oil Company.

Even the education sector feels the heat

To understand the crackdown on the education sector, one has to appreciate the pervasive, over-arching, importance of the National Higher Education Entrance Exam (*Gao Kao*) to the lives of tens of millions of China's pre-university kids. This competitive annual nationwide examination determines who is qualified to enter university, and more importantly, who would have any chance of admission to an elite university. To the hearts and minds of secondary students (many a single-child) and their parents and grandparents, the *Gao Kao* dictates life-long prospects. Many parents scrape to hire private tuition to give their only child a head start. This has spawned a plethora of private tuition businesses across the country, some better run than others.

This phenomenon increasingly widens the sense of social inequality in a country that already has one of the highest Gini Coefficients in the world. A Gini Coefficient of zero represents perfect equality and a Coefficient of One

Source: FTSE Russell; April 1 2021. Rebased to 100 as of end 2008. Past performance is no guarantee of future results. Please see end for important legal disclosures).

denotes perfect inequality. China's Gini coefficient is around 0.47, compared to the US at around 0.41. In a socialist country like China, inequality above 0.40 is potentially destabilizing. What is more, the cost of private tuition is beginning to break the back of the camel already burdened with myriad unsubsidized expenses of raising a child.

Even after the "One Child Policy" has been abandoned, many youngsters are deterred from starting a family, worsening the nation's aging demographics and chances of realizing the China Dream of becoming "a strong, democratic, civilized, harmonious, and modern socialist country" by 2049, the centenary of the founding of the People's Republic of China.

Another education dimension is the reliance on Western textbooks on learning the English language. Much of the textual references and ideological context is at variance with China as a socialist country. At a time of intensified ideological rivalry with the US, a preference for using local teaching material and context is understandable.

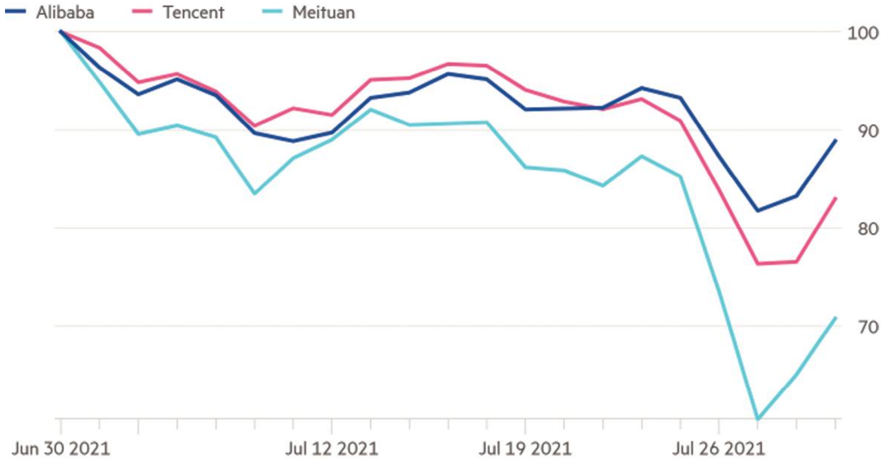
More rules and regulations for "people-based governance"

Putting the above clampdown measures in a holistic context, an "Outline of Implementation of Building China's Law-based Governance 2021-25" was issued by the State Council on August 11 is instructive.

Cutting through Party jargon and reading between the lines, it is clear that President Xi wants to install a robust, results-oriented, law-based system of "people-based governance" to ensure better lives for the people in realizing the China Dream of national renaissance. Vital imperatives include the resolution of social, economic, technological, financial, and other challenges to the Party's legitimacy, socioeconomic and security safeguards for the people,

China tech stocks bounce after regulators hold call

Hong Kong share price (indexed to 100)



Source: Bloomberg
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social justice, government responsiveness, fair competition, education quality, as well as technology, data, financial and national security.

As reported in the *South China Morning Post* of August 13, President Xi declared in a major speech on July 1 that a solid foundation has been laid to continue the Party's governance for another 100 years. The CPP has now established a "systematic and comprehensive" system, fusing the Party and the State, that is unique in the world. This is intended to leave a legacy of a formalized decision-making system to prepare the party for the long run. This approach departs from the previous practice of reaching major decisions in small-circle meetings, such as those held annually in Beidaihe, an exclusive summer resort for Beijing's leaders.

Source: QUICK-FactSet

Implications for China's trajectory

Admittedly, Beijing's sudden earth-shattering crackdown on China's vibrant tech sector has caught many investors and ordinary citizens by surprise. It also raises many alarm bells, calling into question the predictability of the nation's system and practice. But this is precisely the reason why President Xi saw fit to put the Party's more predictable long-term governance system on an even keel.

Is Beijing's tech crackdown self-defeating as *The Economist* claims? Or are China's "animal spirits" being sacrificed, as Stephen Roach fears? As pointed out in my think-piece, "China's Slow Growth: What Does It Mean for the World?", which was published in *The Global ANALYST*'s April 2021 issue, China's economy has been driving towards innovation and indigenous technology, enhanced productivity, competitive high-end manufacturing, greater household income, less reliance on low-end exports and property investments, and a robust pivot towards domestic consumption.

The following national dynamics remain intact:

"China's innovative capacity is supported by a massive reservoir of human capital. More than 8-9 million university students graduate every year, more than the numbers of the US and India combined. The number of tertiary students surged six-fold from 7.4 million in 2000 to nearly 45 million in 2018. The tertiary enrollment rate has reached 50%. More than 40% of China's graduates are in Science, Technology, Engineering, and Mathematics (STEM). China is second only to the US in the number of scientific journal publications, while its leading universities are climbing up in global rankings."

"While adopting a lower profile, the "Made in China 2025" strategy remains very much alive to boost productivity and competitiveness of manufacturing, now 38% of China's GDP. The strategy is to hone leading expertise in 10 key high-tech sectors: New information technology, numerical control tools, aerospace equipment, high-tech ships, railway equipment, energy-saving, new materials, medical devices, agricultural machinery, and power equipment. China plans to invest $1.4 tn through PPPs in 5th generation 5G networks, Cloud Computing, AI software, autonomous vehicles, automated factories, and the Internet of Things (IoT)."

What the future holds?

Beijing is not so foolhardy as wanting to kill the goose that lays the golden egg. China's nimble business leaders Post-reform and Opening Up are no strangers to sudden bouts of rule tightening and relaxation. A period of adjustment and adaptation is inevitable in response to Beijing's new pointers. But to claim that this will change China's long-term trajectory for worse could be an exaggeration! ■

Reference # 20M-2021-09-11-01