Allison Nathan: This is Exchanges at Goldman Sachs and I'm Allison Nathan, a Senior Strategist in Goldman Sachs Research and Creator and Editor of the firm's Top of Mind report. In this episode we're focusing on the recent regulatory tightening cycle in China and President Xi Jinping's new Common Prosperity agenda to promote more sustainable and equitable growth. We touched on this topic in a recent episode, but the situation has continued to evolve with regulations targeting specific sectors, now wiping out more than a trillion and a half dollars of market cap from Chinese equities since their recent peak in mid February. Here we focus on what these ongoing regulatory and policy shifts, as well as potential future actions, might
mean for the Chinese economy, its markets and beyond.

We first turn to a number of China watchers to better understand the motivations behind the government's actions and whether they mark a meaningful shift in the relationship between the government and the private sector in China. Fred Hu, Founder, Chairman, and CEO of Primavera Capital, and David Li, who is an economics professor at Tsinghua University, see the latest wave of regulations as largely consistent with the government's goal of achieving sustainable and socially responsible growth. And they argue that the government is targeting certain behaviors and industry practices, especially in the tech sector, that work against these goals, rather than the private sector itself. And that this is not unlike actions that Europe, the US, and other major economies are taking to address the disruptive effects of digital innovation. Here's Li.

David Li: If you put the current regulatory changes into a larger context than just the previous five, three, two years, then you will see a big picture, a clear big picture that is President Xi Jinping since coming to power in 2012
has been saying that China will seek quality growth rather than rapid growth. By quality growth he actually meant three things. Number one, he wants economic growth to be based on innovation, rather than consumption of resources and all intensifying investment. Second, he wants growth to be inclusive for the society or equitable for the whole society. And third, he wants the growth to be environmentally sustainable. So, these are the three long-term goals: innovation based, socially equitable, and environmentally sustainable or low-carbon growth. That's his consistent odyssey. And he has been gradually pushing for this policies. And recent changes, including the changes in regulating internet platforms and investment in the education sector are actually reflections of this trend. It's not a surprise if you put it into a larger context, in short.

**Allison Nathan:** And here's Fred Hu on the motivations behind the tech sector tightening in particular.

**Fred Hu:** I understand why China has stepped up efforts to regulate the tech sector. And it shouldn't be entirely surprising to the market, right? China has one of the world's largest and the most successful tech sectors.
And indeed, you know, people often compare China's tech industry to that in the US in terms of size and scale and reach. So, unquestionably, the tech sector, especially the rise of the so-called platform companies or the big tech has had tremendous impact on the economy, society, and the daily lives of, you know, in China, it's hundreds of millions of ordinary citizens.

I would say most of the impact is positive, you know, strong, both to business efficiency activity and offering consumers connectivity, convenience, choices, value, and unprecedented access to information, as well as to products and services anywhere at any time. So, the tech sector has played a massively beneficial impact, you know, indispensable role throughout the pandemic. And has proven to be crucial in maintaining a degree of normalcy of ordinary citizens' daily life and in making the economy more resilient.

Nevertheless, the ubiquity and the growing role of tech companies has clearly also caused a variety of concerns in China as elsewhere. The three most common concerns are big tech's possible abuse of market power, data security,
and consumer privacy. So, the European Union has been, by far, the most effective in scrutinizing the tech sector. And has taken on quite aggressively big tech's market power and violations of privacy.

China and the US, by contrast, have been relatively hands off, that is until recently in the case of China, you know, when Beijing has started to impose sweeping and tight regulations across the board. And the Biden administration has stepped up efforts as well. So, if viewed from global lenses, China's regulatory intentions and goals are strikingly similar. The only difference, or the glaring one, is that China has taken a far strong, and some would argue, a more heavy-handed approach to regulation and enforcement.

**Allison Nathan:** But George Magnus, Associate at the China Center at Oxford University and Jude Blanchette, who is a China secular at the Center for Strategic and International Studies see these regulatory actions as mostly motivated by the government's desire for power and control, and as an extension of a pattern of the Chinese state reasserting its dominance over the private sector
since President Xi came to power in 2012. And they suspect strong political motivations behind these shifts in the run-up to the 20th National Party Congress of the Chinese Communist Party in the fall of next year where President Xi is widely expected to break with decades of tradition and stay in power for a third term.

Here's Magnus.

**George Magnus:** I don't think this is business as usual. It's true that actually over the last 20, 25 years, China's use of law and of regulation have increased very significantly. And to the point where in, you know, certainly before Xi Jinping came to power, it was quite common for people to say that, you know, China had really made a kind of significant break with its previous proclivity to have government by dictate and by degree. So that there was more certainty for business and so on as a consequence of these developments.

The problem is now under Xi Jinping's era, or in his era, the use of law and regulation also has another purpose, which is basically to try to underscore the buttressing of
the power of the Communist Party, which has been Xi Jinping's principal priority, along with an attempt to enlarge the borders of the state even at the expense of China's private sector, with a strategy, basically, to produce a new China model. I think this is what Xi Jinping's, almost personal, agenda is, is to create a new model. And also, to put the socialism back into the phrase of, you know, socialism with Chinese characteristics. I mean, a lot of people have kind of taken that as rhetoric and, you know, they're not really socialists, you know? It's a capitalist state. But actually, we'll see what happens in the next year or two. But it certainly feels and looks as though this is more statist and, you know, party-controlling initiatives that we're seeing here than we have seen in the last few years. But certainly, it's a discreet break from the China we knew over the last 20 and 30 years.

**Allison Nathan:** What in particular makes you feel like this is more about power and expanding the state?

**George Magnus:** Well, I think it's a question of kind of joining the dots, as they say. So, if you took a snapshot of,
at any time over the last few years, really, well, let's say after 2013, in 2013, the end of the year, there was the third plenum of the 18th Congress that basically came out with this huge program of economic reform and bureaucratic change and people were kind of falling over themselves saying, "Well, you see, Xi Jinping is a closet reformer. He's just waiting for the opportunity. And this is the opportunity to reenergize reform." But in fact, as we know really since then, nothing of that nature has really happened. And in fact, reform as we kind of expected it and knew it, has pretty much kind of ground to a halt.

So, if you took a snapshot of, let's say, you know, the cancellation of the Ant Financial IPO, or of the investigation into Didi after the IPO more recently in New York, or the meeting of the Central Committee for Financial and Economic Affairs where the phrase "common prosperity" was elevated by Xi Jinping, if you look at all of these things in isolation, they kind of all look very orderly and, you know, yeah, you could understand this, and it fits into a pattern and a scheme. But actually, I think you have to stand back a little bit and look at it in the big picture and see, really, a continuum in which this drive that Xi Jinping
has tried to inject into China to revitalize this kind of Leninist idea of the purity of the party, that the party leads all. You know, as he said himself, you know, north, south, east, and west, in other words, in all realms of economic and social and political life, the party is in the vanguard of leadership. And people need to get on that train.

So, the introduction of Xi Jinping's thought into primary schools, secondary schools, and universities. The exhortation that there's now coming out since last year of private sector executives should be, quote, "taught," unquote, the significance of government policy and government priorities. And that they need to take steps to show that they're following the party line. I mean, there's a big picture here which is really about the supremacy and the controlling influence of the president within the party.

**Allison Nathan:** But if look around the world, at Europe in particular, but also the US, you know, there has been this momentum towards scrutiny over some sectors, technology in particular, regulatory tightening in many ways on many levels. So, how is this different from what we're really seeing in other places? Or is it not?
Fred Hu: How is it different? I think that we're going through our own so-called tech lash, right, which is this backlash against all-powerful tech companies and, you know, we don't know what they're doing with their data. And you know, how do we exercise control over that? We go through the same kind of motions in a way, though, trying to figure out how we're going to do this.

But what's different about China is that it's highly politicized and it's all about what serves the interest of the ruling party. I think we might argue that Democrats and Republicans in the United States or, you know, Conservatives and Labor Party politicians in the UK also have vested interests, of course, in pursuing regulatory initiatives of a different kind. But we do this, really, in the knowledge that at the end of the day it is all subject to a legal system in which you do have, supposedly, we believe, neutral contract enforcement and the government can get its nose bloodied if it kind of steps out of line. Obviously, in China this does not happen.

Allison Nathan: And here's Jude Blanchette.
Why do you think Chinese policy makers have chosen to implement these measures now and with so much urgency?

**Jude Blanchette:** I think there's a proximate reason and an ultimate reason. The proximate reason, which I think gets to the heart of the "why right now" is we have just official entered what we could call 20th Party Congress season. Next year at the 20th Party Congress, sometime in the late fall, Xi Jinping will take a third term as the General Secretary. And while that feels like it's a very long time away, planning and action around a Party Congress usually starts about 12 to 14 months before, which is precisely where we are now. And, indeed, the recently announced sixth plenum, which will take place this November, it's worth nothing that a plenary session of the Central Committee, especially the sixth one, is usually dedicated in part to actual formal planning of the 20th Party Congress.

So, what's happening right now, I think, is Xi Jinping is pushing for and beginning to create some momentum
behind policy making that will sustain, really, over the next year.

The ultimate reason why, even if you take out the political calendar, I think there's an agreement that if we pull the thread on any given regulatory action, whether that's on data security, whether that's on overseas listings, whether that's cracking down on some of these sectors like education where the party feels like there's too much profit and profit incentive driving industry growth, you know, all of these have their own individual rationales to them. And I think all of these are intuitable.

But at its core, I think what's going on is there has always been a lag between where a sector or a technology, how far it's able to get ahead of the regulatory apparatus, and when regulators finally realize there's a problem and start to crack down. And that time lag has always been structural in nature. It is the case that technological development in almost any country gets ahead of where the regulators understanding the technology is. But I think this was becoming almost existential for the Communist Party. You had these areas around platform economy and these
private companies hoovering up massive amounts of data that, I think, COVID-19 showed the Communist Party that these private companies just had far too much data. So, they wanted to fully and finally break the back of that time lag. And so, I think what that means moving forward is you're going to see a much more proactive regulatory posture rather than one that's always on its heels and is racing to catch up.

And just a final note, you know, it was the case that really for a lot of these, especially the tech platforms, there really wasn't much regulation around them. And that had created this perspective that this was kind of a Wild West. And as we think about the Communist Party's view of technology and governance, I think that was just an untenable situation. And so, they've moved aggressively to crack down. And I suspect that's the going to be the posture moving forward.

**Allison Nathan:** And so, we are hearing narratives about the Communist Party, this is all about power, it's about targeting the private sector, reestablishing the supremacy of the State over the private sector. Does any of that
Jude Blanchette: We could have had that conversation about the party reasserting control over the private sector six months ago, a year ago, 18 months ago, 24 months ago. That has been a secular trend, especially in the second term of Xi Jinping starting in 2017 that we've been in this prolonged period of the party asserting dominance over the private sector. And this has happened in the reassertion of the role of party cells in companies. This has been installing the Communist Party in corporate governance structures within private firms. This has been about passing the Intelligence Law, which mandated that private sector companies must participate in any national security investigation. So, in a sense, this is not a new trend that we're seeing here by any stretch of the imagination. And I think it's important that we don't see this as a sudden lurch towards nationalization or party authority, because to do so would be to ignore the trend that's been occurring since 2016 or 2017.

You could argue that this is an amplification of that trend. But anyone thinking that the party just suddenly
discovered that the private sector had levels of autonomy that it was uncomfortable with hasn't been paying attention for much of the last several years.

One thing I should note though. There has been some speculation that the party has just become more robustly socialist and is moving to fundamentally rectify capitalism. And I think that's a misreading of this. As we saw with Xi Jinping's announcement that they're going to create a new stock exchange in Beijing, the party is trying to strike a balance between ensuring that the party has sufficient levels of oversight and control over market mechanisms, while also ensuring that China is able to maintain a sufficiently robust, albeit constrained capital technology and talent market. They're not looking to move away from markets wholesale. What Xi Jinping is trying to do is ensure that markets are leveraged to drive strategic outcomes that redound to the Communist Party and the national goals that China has. So, I think in the construct of the party wants and needs markets, it just wants to make sure that markets serve national interests.

**Allison Nathan:** But even if that is the case, the question
is whether these shifts will ultimately harm innovation and the longer-term growth trajectory of the country. David Li is not particularly concerned, but Magnus is. Here's Li.

Are you concerned that we'll see less innovation as this regulation comes down on key industries?

**David Li:** I am concerned in the short run because this does send waves of shocks among investors. Because the way is very abrupt. It is very sudden. Very impolite to understate. So I am concerned in the short run that there will be a shortage of investment in many sectors in the Chinese economy.

However, in the slightly longer future, in one or two years, I am not concerned. Why? Because the Chinese economy has three things working for innovation. Number one, still China has a huge market. A huge market, for good or for bad. The US policy under President Trump, which to some extent is still ongoing in restricting exports, high tech exports to China, actually pushes the Chinese demand for domestic high technology parts, high technology goods. That's the first thing. A big market.
The second thing is China still has a huge amount of capital. China's liquidity, measured by cash plus bank deposits, is two times as large as the Chinese GDP. US is about after so many runs of QEs is about 100 percent. China it's 200 percent. And the Chinese economy is two thirds of the US economy. So, overall, China has much more liquidity ready for investment.

The third thing, which I think is most important, is this, China has 8 million college graduates each year. Out of these 8 million college graduates, how many percentages actually have majored in pure engineering? Not sciences, not physics, not mathematics, but pure engineering? 40 percent. 40 percent of Chinese college graduates of 8 million have majored in, each year after year, okay, majored in engineering. So, 3.2 million. How large is 3.2 million college graduates in engineering? That's larger than the US, the graduates of engineering, plus Europe, plus India, plus Japan. It's a huge number. And also coming from Tsinghua University, which traditionally was an engineering school, I can vouch that the average quality of Chinese training of engineers in college is very good. Maybe
too good because they're very practical.

The Chinese college education is very brutal. You know? They don't teach them Homer. They don't teach them philosophy. Don't teach them literature. From day one in most colleges, they just teach them engineering. They're too technical. For good or for bad these kids coming from college can jump into companies and start designing things. Whereas US engineering graduates are wonderful. They're very well trained. But early on they have to get more training after graduation.

So, these are the three things making me still optimistic after a short period of time about the future of China's investment in technology.

**Allison Nathan:** And here's Magnus.

**George Magnus:** You've got a number of different examples where the government or the state is intervening in the operational management of companies, whether it's by threat or by dictate or by punishing the chief executives or by training session. Party officials in party committees
have to be present in any company that's got more than three party members. So, all of this adds up to a different sort of modus operandi for private firms from the one in which we've come to grow to expect and see in years gone by.

So, the question I pose, really, is what does this do for their innovative capacity? We often kind of conflate invention, like science and tech stuff that we can use, and we can see, with innovation, which is basically a business decision about organization and management and marketing and branding and commercialization and profitability and so on. And if you introduce more and more government regulation and more and more government restriction on what companies are allowed to do, what does that say about the potential for private firms to be in pole position of China as they have been for the last two or three decades? My hunch, you know, really is that this is leading China, because of the importance of the politics to the Communist Party in China down an economic path they wouldn't normally or otherwise have chosen to go. So, I think it's going to add to the structural economic headwinds that we already know about in China. And it will reduce, I think,
China's trend growth. And it'll complicate or delay the realization of the holy grail that everybody's looking for, which is more productivity because that's how we grow in the future.

The big problem, apart from, you know, debt and demographics, is China is, like many countries, has reached a kind of a productivity hiatus. It needs to basically do a reset, which basically requires reform. But actually, that reform isn't really on the agenda. And I think this political intervention, regulatory and political intervention, is going to set that back quite significantly.

**Allison Nathan:** And of course, the key question is whether China is still investable amid all of these regulatory and policy shifts. Again, David Li and Fred Hu are discretionarily optimistic. Here's Li on where he thinks opportunity for investment still lies.

**David Li:** There are areas which the government under Xi Jinping would guard tightly. There are social and political media areas, culture areas [PH] in which the government worries that its authority, its control, its
influence will be compromised by external investors. I think outside these areas, all investments will be welcome.

In the past few years, look at Jack Ma. They have been venturing into many, many media companies. Many, many media companies. This people may not know. It's got about 29 provincial level media companies. It's got the *South China Morning Post*. This kind of investment sends alerts to the government. So, in other words, if I were 30 years younger, if I were trying to do business in China, I will concentrate on technology. I would not bother media. I would not bother the mathematics teaching of young kids trying to let them outcompete their other schoolmates. I would do my own business. I would try to be a hero in my own area. I wouldn't try to make comments on areas like politics or international relations. So, in a way, I think this is a new era of China. For the lack of better words, professionalism. Business is business. Politics is politics. Don't mix them.

And this is also true for many officials under investigation. They got involved in business. They got corrupt. This is not just consistent, right? And that's the culture. That's the
new era.

**Allison Nathan:** And here's Fred Hu on why he's optimistic about investment in China tech despite the near-term uncertainty and what he looks for in deciding whether a company is a good investment.

**Fred Hu:** There are clearly some legitimate concerns in the short term because there's a lack of communication, lack of clarity of the government or the goal, when is enough is enough? So, a host of short-term uncertainties. So, I do understand why some investors may be frightened.

But I believe very strongly that Chinese tech will weather the current rough storms. Most of the Chinese tech companies will be able to adjust and adapt. Therefore, you know, continue to achieve very strong growth all the while bringing their business model and practices in better compliance with the tighter regulatory environment. I think it would be a mistake to ignore the opportunities in China tech.

**Allison Nathan:** Should investors be more optimistic about
the hard tech sectors versus the soft tech sectors?

**Fred Hu:** Clearly, the current regulations affect the consumer internet sector most. But fintech, e-commerce, from social media to gaming, from food delivery to ride sharing, and last but not least, EdTech. So by and large all of these businesses are consumer facing and store a massive amounts of data on their platforms. So, these types of companies are impacted most by the current regulatory actions.

So, I do agree that it will be hard tech, notably semiconductors, you know, industrial automation, robotics, et cetera, you know, have been completely spared from the rest of the tech crackdown altogether. I would also add MedTech, including medical devices and pharmaceuticals, is also left unscathed or untouched. More importantly, cleantech, everything from renewable energy, you know, electrical vehicles to batteries, continues to receive strong government support. So, there are vast spaces in the broad tech sector that are largely unaffected by what's going on of the last few months. And continue to thrive in a largely benign regulatory environment. So,
definitely, if someone is thinking about the regulatory risk, these are areas almost safe havens.

But I would also say, even consumer internet, there are still a lot of opportunities. Tightening of regulations unties monopolies, data protection, you know, consumer privacy protection. You know, those are going to happen regardless in China and elsewhere. It doesn't mean it's the end of tech investment opportunities in that. Far from it. In China and the US are the two largest consumer internet or consumer tech economies or digital economies, e-commerce and fintech and digital health, entertainment and social media. I think they'll still continue. There you have to make some adjustments, some pivoting how you run your business or interface with the users. But I do think the companies in these sectors will continue to succeed, you know, if they are very thoughtful trying to really make some necessary changes. So, there are still a lot of growth opportunities out there. And so, therefore, investors should not ignore consumer internet, despite, clearly, some of the more significant regulatory uncertainties, certainly in the short term.
**Allison Nathan:** So, as an investor, how do you discern which companies in that sector are still great investment growth opportunities and ones that aren't going to be able to pivot as easily and do as well under the new regulations?

**Fred Hu:** Yeah. Well, at the risk of oversimplification, I would say three things we could be paying close attention to, namely, the underlying technology, the better the technology, the more interesting the company as an investment targets. And B, the business model. So, given technology, you know, let's say AI, different companies develop different business models to tackle the opportunities so they can capture more market share. And the third, I would say it's really leadership and talent. So, that includes the culture and also, frankly, in terms of, you know, compliance culture. So, as they get bigger, more successful, if they have the right leadership, forward-looking, broad-minded leadership, they will recognize the increasing scrutiny they're going to be get. And the disproportional increased responsibilities on their shoulders to make sure tech remains a force for good.

So, technology, business model, and the leadership
qualities, those three things I would be most focused on right now or over the mid to long term.

**Allison Nathan:** But George Magnus and Jude Blanchette advise investors to tread cautiously. Here's Magnus.

**George Magnus:** If you look at any company or any sector or index that's dropped 40 to 50 percent in the space of six months, a bell goes off and it says, value. But I do think this is something that people need to think about, actually, very carefully because China is not your run of the mill investment universe for reasons that we've been talking about, which is intervention of politics in the extreme. But also because the transparency of companies is not the way that we normally expect.

I think the balance between the risk and the opportunity is shifting here towards what risk am I taking? And what don't I know? Rather than what do I know. So, my hunch is, it's not to say that you can't make money in the Chinese market, or you can't find companies that will be able to deliver good returns. But I think it's a much riskier and a much more dangerous market than what it was six months
ago. I don't think this is a momentary event where something has happened that's made the government react and then in six months time it'll revert, and it'll all be forgotten. This is pretty serious stuff. And, you know, it's pretty serious stuff politically, which is a pointer, I think, to the way things will continue to evolve for the foreseeable future. And I think that should put us on edge, really. So, caution would be the right watchword, I think.

Allison Nathan: And here’s Blanchette.

Jude Blanchette: I think it’s a brute reality that increasingly Xi Jinping is calling the shots in relative isolation, especially compared to the level of collective decision making we had ten or so years ago. There are still extraordinarily impressive individuals at the top of the regulatory bodies. That's undeniable. But increasingly, these are political decisions that are being made that the regulatory bodies are having to respond to, rather than consultative regulatory decisions that are the outcome of more robust group decision making.

And so, I think we have to start recognizing that this type
of surge campaign, uncoordinated, sudden shock decision making is going to be a regular feature now, and especially after the 20th Party Congress, for investors who've been able to sideline politics up till now. I think that's an untenable position moving forward because a lot of these decisions are, at root, political in nature. Which means that the regulatory system in China, as much as investors will be caught off guard or in a position of having to respond to political decisions lobbed over the wall by Xi Jinping, and that's not going to go away anytime soon. Indeed, it's going to get worse as his level of authority and control over the political apparatus continues to strengthen, as it appears likely to do, especially after the 20th Party Congress.

Next year's 20th Party Congress is not like a normal party congress. One of two things is going to happen. Xi Jinping is either going to take a third term as General Secretary. And if that's the case, that's momentous. That is a fundamental break with four decades of thinking within the party about the need to move away from centralized power so that way the party avoids some of the catastrophes of the Mao era. Or, otherwise, Xi Jinping won't take a third term as General Secretary. Which will be equally as
important because one year out, we have no idea who a possible successor would be. And so, we're all going to be scratching our heads when we see who this is.

But my point is this is not a normal party congress. Xi Jinping is no longer the type of ruler he was in 2016 where he was still having to establish and solidify his own power base. He is now the dominant, uncontested leader of an increasingly autocratic political system. And expecting that political system is just going to operate like it did ten years ago, I think, is an outdated approach here. We're seeing the world's second largest economy with an increasingly sophisticated, complex, and at the same time unpredictable sort of economic and regulatory apparatus moving forward under a political system which is becoming increasingly autocratic. And we've not seen anything like this, really, ever.

**Allison Nathan:** As the regulatory and policy environment in China continues to evolve, we'll be closely watching the implication for China's economy, its markets, and beyond. I'll leave it there for now.
If you enjoyed this show, we hope you subscribe on Apple Podcast and leave a rating or comment. I'm Allison Nathan. Thanks for listening to Exchanges at Goldman Sachs. And I'll see you next time.

This transcript should not be copied, distributed, published or reproduced, in whole or in part, or disclosed by any recipient to any other person. The information contained in this transcript does not constitute a recommendation from any Goldman Sachs entity to the recipient. Neither Goldman Sachs nor any of its affiliates makes any representation or warranty, express or implied, as to the accuracy or completeness of the statements or any information contained in this transcript and any liability therefore (including in respect of direct, indirect or consequential loss or damage) is expressly disclaimed. The views expressed in this transcript are not necessarily those of Goldman Sachs, and Goldman Sachs is not providing any financial, economic, legal, accounting or tax advice or recommendations in this transcript. In addition, the receipt of this transcript by any recipient is not to be taken as constituting the giving of investment advice by Goldman Sachs to that recipient, nor to constitute such person a client of any Goldman Sachs entity.
This transcript is provided in conjunction with the associated video/audio content for convenience. The content of this transcript may differ from the associated video/audio, please consult the original content as the definitive source. Goldman Sachs is not responsible for any errors in the transcript.