A new rubric? China's new model for dealing with income inequality and data

Mo Ji, Chief China Economist

Leia Ma, Multi Asset Analyst

Crystal Cui, Credit Analyst

Claire Xiao, Credit Analyst

A recent wave of new regulations in China focusing on a number of sectors caught many investors off guard. Some commentators have declared that China's uncertainty premium, the return investors require to compensate for extra risk of unexpected policy action, has risen significantly in the last few months. However, we believe that while the new regulations aimed at increasing data security and tackling inequality will cause some serious short-term disruptions, they have the potential to bolster China's long-term growth prospects.

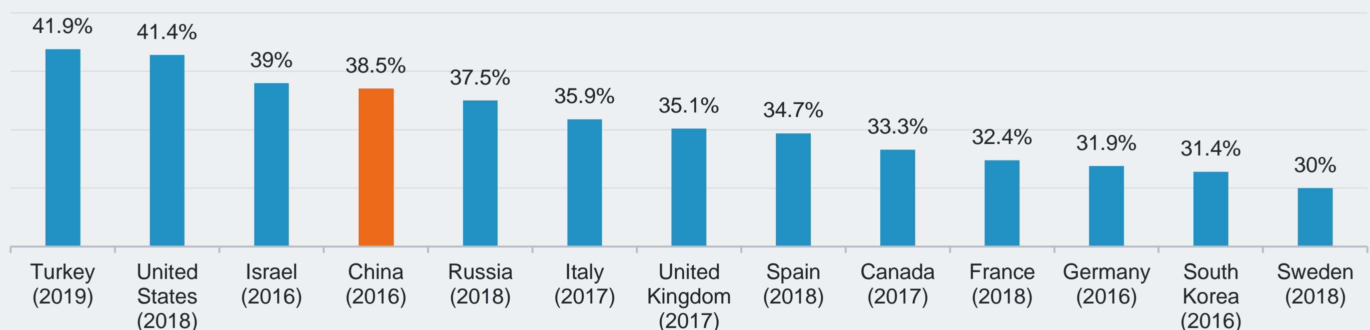
Income inequality and data security take centre stage in China

From a structural perspective, China is facing two acute issues – income inequality and data security. In its first stage of reform, China adopted the model of "crossing the rivers by feeling the stones" - taking a pragmatic approach when tackling growth and development problems - as it embarked upon creating a Socialist Market Economy with Chinese Characteristics. After four decades, China is now in the middle of that river, where lessons that can be learnt from western countries are sparse, especially concerning income inequality and data security. The recent changes in regulation confirm China is intent on tackling income inequality and addressing data security issues. As a result, global investors are watching keenly to see how this "new China model" manifests, how successful it is, the long-term implications for investing, and the extent to which other countries adopt it.

China develops a new model to tackle rising income inequality

Inequality in China has increased over the last few decades. The Gini coefficient, a measure of inequality, has increased in China from 30% in 1987, roughly the same as Sweden, to 39% in 2016, nearly as high as the US (higher values indicate greater inequality).

Chart 1: China's income inequality has risen in recent years



Latest available Gini (income inequality) coefficient, where higher figures = more inequality. Source: World Bank, 2021.

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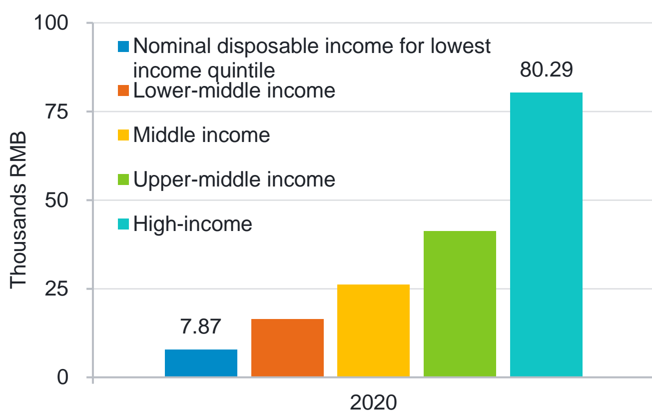
The causes of income inequality vary significantly between countries. In China, the government has identified “three mountains” – property, education and healthcare– that it believes to be the key to reversing the trend. And in order to tackle these three mountains, the government has re-used the concept of “common prosperity”, giving itself new tools to reduce income inequality even if it causes macro and financial sector pain.

We believe that the recent actions of the Chinese government give bureaucrats and regulators greater powers to fight income inequality far more proactively. The 18 August speech by President Xi on common prosperity including redistribution, social welfare, taxes, charity and inclusive education, used an old theme but with new content and, as is increasingly becoming clear, serious intent. The target date to achieve this common prosperity is 2050, a full thirty years in the future. We expect the Chinese government will be gradual and pragmatic as it has been in the last four decades of reform despite a somewhat disruptive start to the profound shift.

Investors might be experiencing short term pains at present, however the reforms should drive long term gains. New regulations covering the education, healthcare and property sectors should increase disposable household income, which will in turn lead to increased spending on consumption and services and thereby rebalance the economy in that direction. However, what is becoming increasingly true is that the three mountains may become tougher to invest in for profit as they will form the planks of the common prosperity paradigm.

Chart 2: China’s richest quintile earn ten times more than its poorest



Source: Source: China National Bureau of Statistics

Why these “three mountains”?

The three mountains account for the vast majority of disposable income spend in China. Estimates vary, but housing can account for 70% of spend, compared to an average of 21% for the OECD. And when added to education and healthcare, the three can represent as much as 90% of disposable income usage in China. This is stifling consumption in other areas, even as China is attempting to transform into a consumption and services led economy.

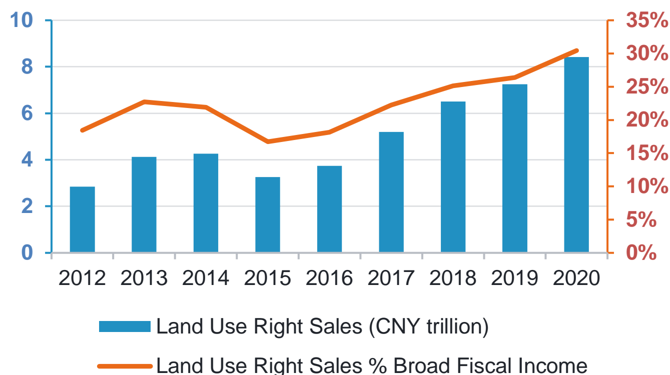
Mountain One - Education: The recent regulatory crackdown that effectively banned for-profit tutoring in core subjects and stipulated tutoring can only take place on school days hurt private education companies. However, the wider short-term economic impact remains limited given the education sector only represents 4% of GDP. In the long-term, policy makers hope the new rules will result in more time for students and parents at weekend and during school holidays and cut the costs of out of school education and thereby increase in disposable income. However it is as yet unclear how effective it will prove, as students will have to lengthen their weekdays to allow for lessons at night and engage in more extra curricula activities over the weekend, which may not necessarily have the desired effects.

Mountain Two - Healthcare: Chinese policy makers have made it clear they intend to lower medical costs. China has made progress in providing basic medical insurance to cover all types of illness. However, procurement fees for medicine are still high due to patents and import taxes. The government is making lowering the cost of medicine a priority, but there is still a long way to go to lower the cost of healthcare overall.

Mountain Three - Property: Of the three mountains that the government has identified as standing in the way of common prosperity, the property sector is undoubtedly the largest. Regulators have repeatedly emphasised the need to develop long-term mechanisms to bring property prices under control in order to fundamentally shift the population’s mindset away from thinking that speculation on property is a one-way bet, and in so doing make the Chinese economy less dependent on the sector.

Here the ongoing case of Evergrande is a pertinent one. Property restrictions and financing constraints have pushed the largest and most indebted property developer to the brink of collapse. These policy-induced actions highlight a much greater tolerance for macro and financial pain by the authorities given the risk of contagion, and to our minds illustrates suggest the importance being placed on reforming the third mountain to achieve the common prosperity outcome.

Chart 3: Local government revenue is increasingly dependent on land sales tax



Source: Wind.

On the fiscal policy front, authorities see property taxes as the best way to drive change. At the moment, property in China is only taxed when ownership changes hands. However, replacing this with an annual tax based on the value of property is favoured as a long-term solution. In order to implement this, progress is being made to compile an official register of all property holdings. Driven by the goal of common prosperity, a tax on property is likely to be adopted sooner rather than later and long-term benefits should include:

- **More sustainable local government funding**: Land sales have been an important funding source for local governments in China. Taxing property ownership instead would lead to tax revenues that are more stable than land sales and less dependent on high housing prices, thus removing the implicit incentive for local governments to keep prices high. Despite regulators' efforts to control government debt, the default risk of local governments has risen in recent years. In the long term, property tax reform should lead to more sustainable local government income and reduced credit risk.
- **A better chance for manufacturing to thrive**: Property has been the best performing asset class in China over the past 20 years and therefore now accounts for a large proportion of retail investment that is squeezing out manufacturing to some extent. The goal of switching the engine of economic growth from speculation to more productive and greener investment is a tough but necessary one. In the long term, if return on investment falls in the real estate sector and there are policy incentives encouraging innovation, investors should be more willing to put their capital into manufacturing, which should in turn lead to increases in productivity.

Demand-led growth might be the correct approach

Global investors have witnessed Chinese policy makers' efforts to transform the Chinese economy from export-led growth to consumption- and services-led growth. While there has been some progress, there is still long way to go for consumption and services to rise from the 50% of Chinese GDP today to reach 70% or 80% as in developed countries. However, in our minds, demand-led growth may be a better fit for China. The reason is that demand includes both consumption and investment, and China at this stage of development still needs investment. The only question left is how to encourage investment in a better or greener way than before.

The intensifying US-China data war is driving China's approach to data security

US-China relations are now more dynamic than ever and at a new stage defined by three "C"s - confrontation, collaboration and competition. A range of new regulations introduced by the Chinese authorities over the last few months that target the tech sector has brought data security to the forefront of the tech war and indicated the importance of tech and data regulations in China's new model.

Internet companies have enjoyed nearly two decades of unfettered growth. Like any infrastructure provider, builders of digital infrastructure may need some degree of natural monopoly in their early stages to recover initial investments and earn reasonable returns. But it's long past that stage and the negative effects from their outsized power now overshadow any efficiency gains.

The recent regulatory changes have clearly spooked the capital markets. But a look around the globe would suggest that China is not the only one seeking to redress its historic lack of oversight of the tech sector. The US, Europe and a few other countries are either debating or enacting tighter regulations on issues such as data privacy, algorithm ranking, and anti-competitive behaviours.

For China, slowing domestic growth and ongoing geopolitical tensions give even more reason to contain excessive profit-seeking behaviours that could be detrimental to consumer welfare and stifle innovation. China and many other countries must now grapple with the age-old problem of striking the correct balance between regulatory oversight and commercial incentive, something that could take some policy trial and error to

figure out. However, the speed and aggressiveness of the recent regulatory changes were a surprise. The West must also confront similar issues in due course, but governments there are taking a slower, softer approach for now. But the lack of warning given in China has led to investors pricing in an uncertainty risk premium, which we think is likely to last for some time especially in those areas most likely to be hit with additional policy shifts.

China's capital markets are still investable

The primary question on global investors' minds right now is whether China's capital markets are still investable. As we have seen, if the Chinese government is successful in boosting disposable income by reducing consumer spending on the three mountains of the property, education and healthcare sectors and reforming the tech sector to improve data security, then lower inequality and higher innovation is a plausible outcome. And given that the regulatory crackdowns did not cause large capital outflows or big fluctuations in the RMB, we believe that China's capital markets remain investable over the long-term. Additionally, we continue to think that China's government bonds and currency will outperform over the long-term, though we are closely watching the property sector for any signs of contagion risk.

In our view, the success of the "New China Model" will largely depend on how well policy is designed - better consideration of sequencing, implementation and communication will be the fundamental factor for determining the success of this historical attempted transformation of the Chinese economy. While this transition will take years, if the policies are well designed, both now and in the future, we believe the Chinese economy will continue to be an engine of growth and healthy asset return in the years to come. For now, however, uncertainty remains high as the new china model takes shape.

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