S&P Global Ratings

# What Last Year's China Policy Surprises Mean For The Future

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This is a cross-divisional thought-leadership report issued by S&P Global with contributions by S&P Global Ratings, S&P Global (China) Ratings, and S&P Global Market Intelligence. Each are separate, individual divisions of S&P Global/SPGI. This report does not constitute a rating action, neither was it discussed by a rating committee.

## Key Takeaways

- China's growing focus on aging demographics and uneven wealth and income distributions is likely behind its recent wave of policy directives and regulations.
- Privately owned enterprises, especially those operating in property, healthcare, private education, and even traditional "old-economy" sectors, such as low-end manufacturing, will face policy and regulatory headwinds.
- China may rely on selected large state-owned enterprises (SOEs) to champion social policies and raising taxes to fund burgeoning social welfare spending.
- High-tech industries, particularly technology hardware, automation, and artificial intelligence, will benefit from growing subsidies, favorable tax rates, capital injections and investments from SOEs, and protective policies.

China's increasing focus on demographics and uneven income distribution is pushing a broad range of regulatory changes across education, housing, labor, and social welfare. S&P Global believes regulatory risks will stay elevated for corporates in related industries for years to come. These issues are long term in nature, and COVID-19 has exacerbated their effects and brought them into sharper focus for policymakers.

Related regulatory measures taken last year surprised investors and drove volatility across markets. The government's most recent statements suggest a desire to avoid such knock-on effects and lessen the economic burden in the current environment. But such policies and their associated risks could remain for the next decade. Ad hoc actions will be codified into formal regulations for stronger and more consistent enforcement. These and future actions will remain driven by underlying forces that have pushed aging demographics and equitable income and wealth distribution to the top of Chinese policymakers' priority list.


**CORPORATE CREDIT ANALYST**

**Clifford Kurz**
Hong Kong
+ 852 2533 3534
clifford.kurz@spglobal.com

**FINANCIAL INSTITUTIONS CREDIT ANALYST**

**Harry Hu**
Hong Kong
+ 852 2533 3571
harry.hu@spglobal.com

**ASIA-PACIFIC ECONOMIST**

**Vishrut Rana**
Singapore
+ 65 6216 1008
vishrut.rana@spglobal.com

**SOVEREIGN CREDIT ANALYST**

**Rain Yin**
Singapore
+ 65 6239 6342
rain.yin@spglobal.com

**CONTRIBUTORS**

**Dan Li**
S&P Global (China) Ratings

**Aries Poon**
S&P Global Market Intelligence

**RESEARCH ASSISTANTS**

Boyang Gao
Sam Lee

Table 1

## Recent Directives And Regulatory Moves Point To Greater Policy Risk

| Category | Date | Policy or event | Details and implications |
|---|---|---|---|
| Housing | Aug-20 | "Three Red Lines." | – This directive reined in property speculation by directing financial regulators to outline leverage ratio restrictions on real estate developers, among others. |
| Internet regulation | Nov-20 | Ant Group IPO suspended. | – Increased regulatory scrutiny of tech platforms. |
| Internet regulation | Nov-20 | "Seeking Opinion On Anti-Monopoly Guidance For Platform Economy Industries." | – SAMR announces guidelines to root out monopolistic practices among tech platforms. |
| Housing / basic services | Apr-21 | "Key Tasks For New-type Urbanization and Urban-Rural Integrated Development in 2021." | – Improve integration of agricultural migrants into cities.<br>– Provide subsidized training and increase vocational training programs.<br>– Expand enrollment of vocational colleges.<br>– Relax restrictions on urban settlement for lower tier cities. |
| Population | Jun-21 | "Promoting The Long-Term Balanced Development Of The Population." | – Balanced population growth and aging demographics are China's top priorities.<br>– Relaxes household restrictions to three children from two.<br>– Eliminates fines for additional childbirth. |
| Housing | Jul-21 | "Opinions On Accelerating Construction Of Affordable Housing." | – Solve housing problems in big cities.<br>– Support housing for younger populace and new urban citizens.<br>– Construction of social houses supported by government and market mechanisms. |
| Housing | Jul-21 | "Continued Regulations To Restore Order To The Real Estate Industry." | – Reduce speculation in real estate industry.<br>– Stabilize housing prices and rent.<br>– Enhance people's sense of achievement, happiness, and security. |
| Labor protection | Jul-21 | "Opinions On Safeguarding Labor Rights For New Employment Forms." | – Better protect the rights and interests of workers engaged in new forms of employment (i.e. gig workers).<br>– Boost flexible employment, create jobs, and increase income.<br>– Enterprises must ensure prompt payment of salaries and provide safety and insurance protections. |
| Education | Jul-21 | "Opinions On Further Reducing Burden For Students In Compulsory Education." | – Reduce academic burden.<br>– Improve education quality.<br>– Balanced academic learnings.<br>– Restrict for-profit after-school tutoring. |
| Internet regulation | Aug-21 | National Press and Publication Administration suspends new online game approvals. | – Online game approvals were suspended until April 2022. |
| Basic services | Oct-21 | "14th Five-Year Plan To Actively Address Population Aging And Implementation Plan For Nursery Construction." | – Implement the "14th Five-Year Plan" to actively respond to population aging and nursery construction.<br>– Expand infrastructure and services for nurseries and elderly care.<br>– Support various non-academic education for children and renovate public facilities to support the healthy development of children. |
| Basic services | Nov-21 | "Work Plan For Comprehensive Improvement Of County Hospitals." | – Shift high-quality medical resources from provincial cities to county areas.<br>– Raise the scale and capacity of county hospitals.<br>– By 2025, at least 1,000 county hospitals to reach the level of medical service capacity of tertiary hospitals. |
| Basic services | Feb-22 | "Notice Of Development And Planning Of The Elderly Service System." | – Set up development goals on elderly care in the next five years.<br>– Performance indicators include number of beds and social workers for elderly service. |

SAMR--State Administration for Market Regulation. Source: Announcements from various Chinese ministries and regulators. S&P Global Ratings.

## Why Now?

China's policies are rapidly evolving as the country focuses on two major challenges: achieving a more balanced society in terms of growth and income; and slowing the aging trend in the population. Though these concerns may not be entirely new, the government is increasingly concentrating on such issues.

In a policy address published on Oct. 15, 2021 titled "Solidly Promoting Common Prosperity," President Xi Jinping suggested that in some countries, income inequality has torn the social fabric, leading to political polarization and rampant populism. The fix in China is to promote more balanced growth. This involves increased transfer payments and support to less-developed regions, reform of monopolistic industries, better basic services, promoting education for citizens (particularly vocational training), solving the housing problem for society, and adjusting taxes to better balance incomes across China, among other initiatives[1].

Moreover, China's population growth is decelerating. According to the Population Development Studies Center at the Renmin University of China, the 2021 census report suggests that China's population could stop growing in 2022, five years earlier than many previous estimates had indicated[2]. This is despite the steady relaxation of the previous long-standing one-child policy, starting in 2007.

Once again, the government's solutions for such issues are to reduce housing costs for families with young children, balance the burden of education on households--such as strictly regulating off-campus tutoring, and increasing investments in education infrastructure and services.

Thus, the reinforcing spiral of slowing growth and accelerated aging and the government's concern around a balanced society is, in our view, informing many of the recent "surprise" policy moves. It likely played a role on the closure of for-profit tutoring and test-prep centers, reining in property sector leverage and supply of mortgages, and possibly even the crackdown on China's internet sector. The tightening of regulations around social media and online games are in line with the broader goal of reducing the burden on households (i.e., reducing kids' time spent on "less productive" games and social media platforms).

Policy initiatives to improve wealth and income distribution are likely in their early innings. We expect further reforms that prioritize residents' livelihoods, such as more equitable distribution of essential welfare services and taxation. While the benefits are clear, balancing this against economic growth and financial risk is the real challenge ahead. As an example, a crash in the property market is not an outcome that policymakers are seeking. A year or so into the property related policy crackdown, efforts are already underway to stabilize market sentiments (see "China's Property Downcycle Won't End With Policy Easing," published on RatingsDirect on April 6, 2022).

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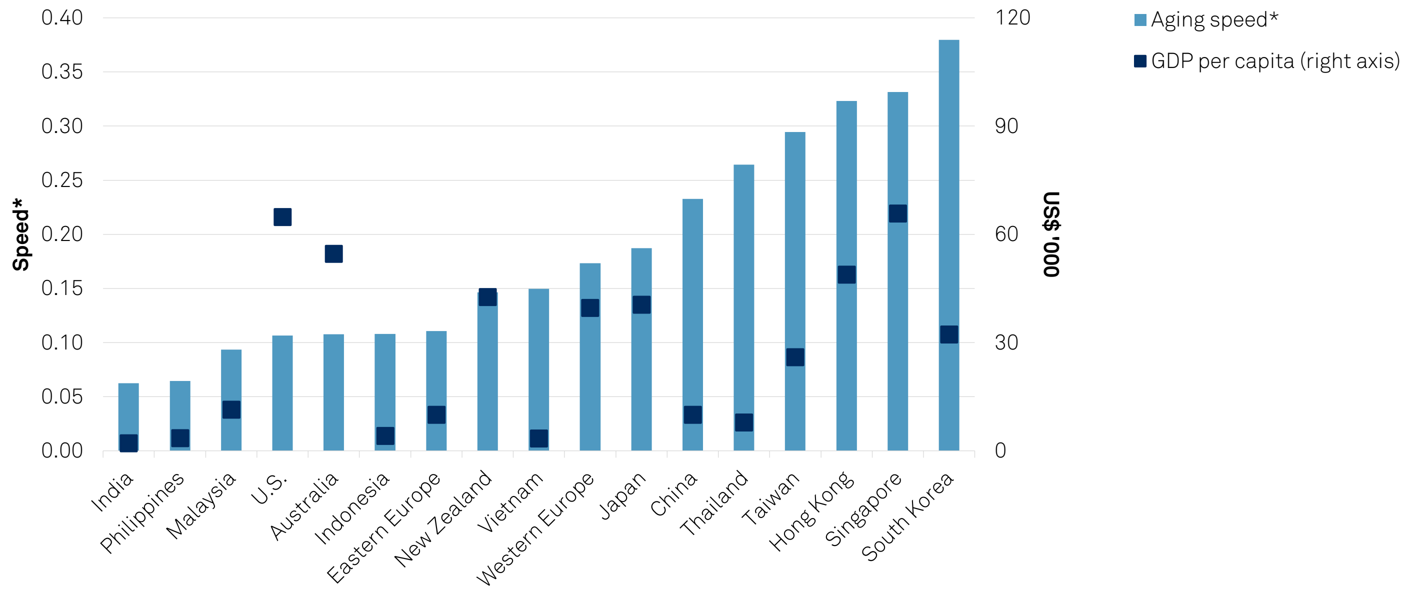
[1] http://www.qstheory.cn/dukan/qs/2021-10/15/c_1127959365.htm

[2] http://pdsc.ruc.edu.cn/jdjx/2cbfcb1c4fe84c43bd520cf477731976.htm or https://www.chinanews.com.cn/sh/2022/01-17/9654035.shtml

Chart 1

**China Population Is Aging At Rates Similar To Some Developed Economies**

Aging speed versus GDP per capita

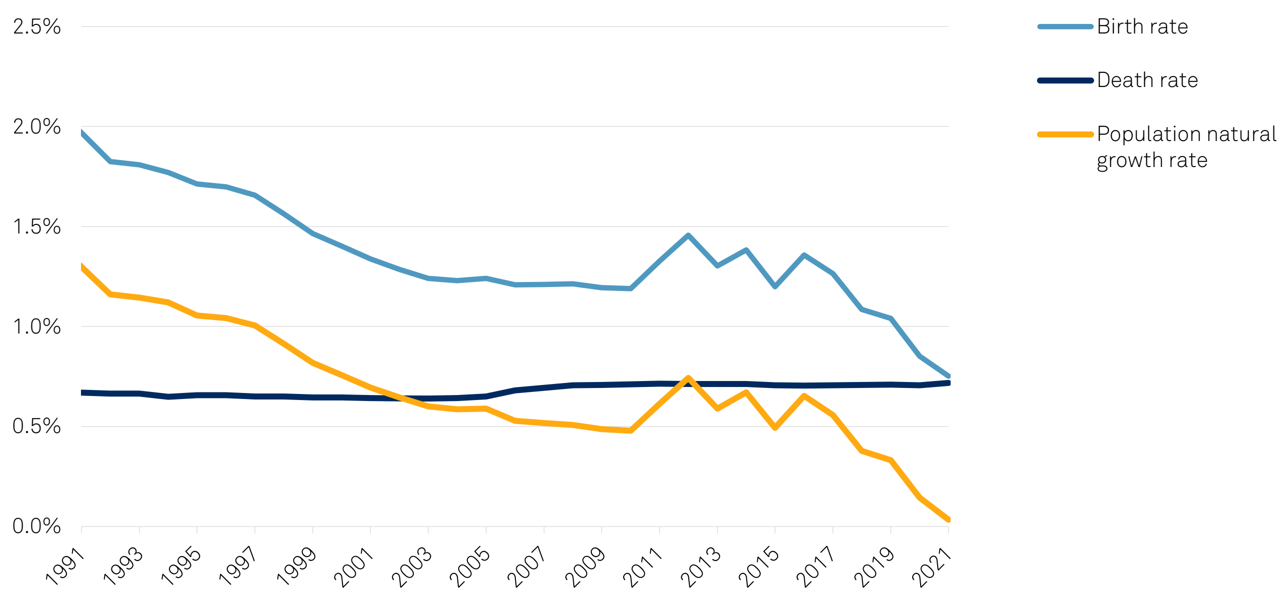



*Aging speed refers to the expected increase in old age dependency over the next 20 years. Data as of 2019. Old age dependency is calculated as the number of citizens over age 65 per 100 working-age people. Eurozone GDP per capita used as approximate GDP per capita for western Europe. Source: U.N. World Population Prospects, Oxford Economics, and S&P Global Economics.

Chart 2

**China's Population Growth Is Turning Negative For The First Time**

Population growth rate--birth rate vs. death rate




Source: National Bureau of Statistics.

## Housing: Building Social Housing While Tearing Down "Speculation"

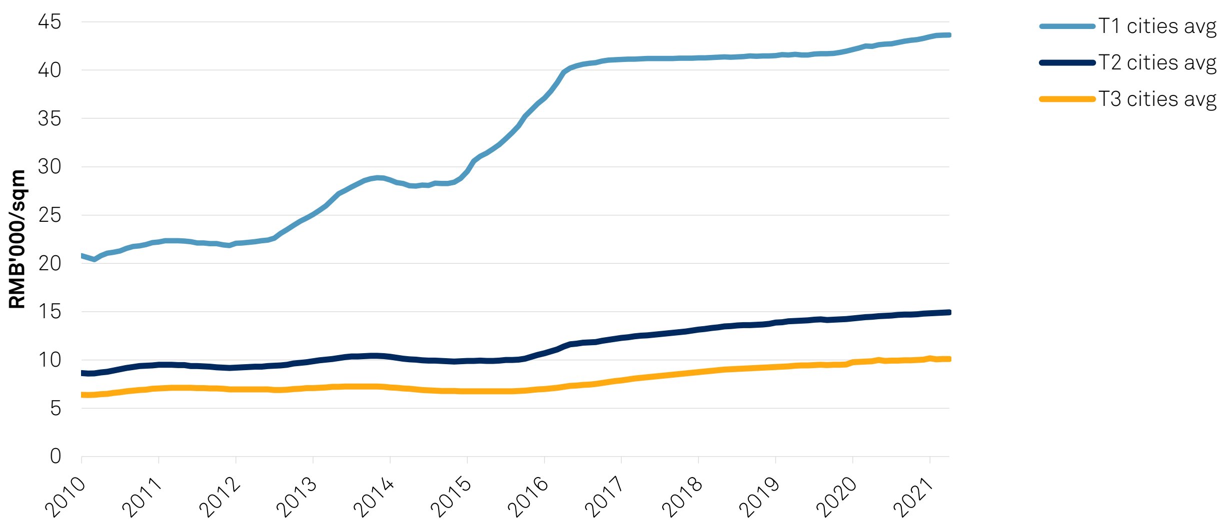
Housing is a prime example of an area that drives and exacerbates tensions from uneven wealth distribution. Housing affordability has become a more urgent objective as highlighted in both President Xi's "common prosperity" policy address and the policy to "Promote The Long-Term Balanced Development Of The Population." The result will be more social housing and less tolerance for speculative excesses in the commercial market. The State Council made these points clear in its "Opinion On Accelerating The Development Of Affordable Rental Housing" released in July 2021, stating that "housing must not be used for speculation" and referring to the negative effects of multi-decade housing appreciation by saying the government must "solve housing issues for the younger population."

Rising housing prices, particularly in the urban cities, create a dilemma for the government. The widening gap of house prices in higher-tier cities versus lower-tier cities increases the wealth disparity between urban and rural populations.

Chart 3

### Widening Gap Of Housing Prices In Higher-Tier Cities

Average housing price per square meter by city tiers



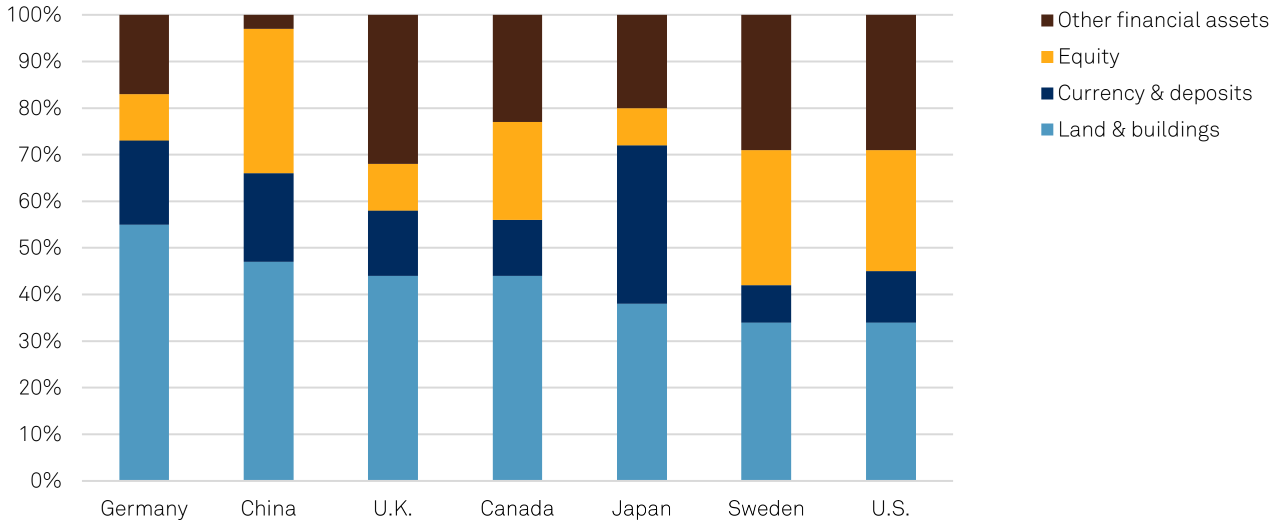

T1--Tier-one cities, like Beijing, Shanghai, etc. T2--Tier-two. the next largest cities. T3--Tier three. RMB--Chinese renminbi. avg--Average. Source: National Bureau of Statistics.

On social housing, the government has set an ambitious plan to build 2.4 million social-housing units in 2022, more than double the 940,000 units built in 2021. The goal is to construct eight to nine million new units within its 14th five-year plan, which ends in 2025. At the same time, with much of household wealth in China tied to property, the government must balance policy by preventing a sharp drop in housing prices, which would be counterproductive to consumption and likely aggravate social tensions.

Chart 4

## Nearly 50% Of China's Household Wealth Is Tied To Real Estate

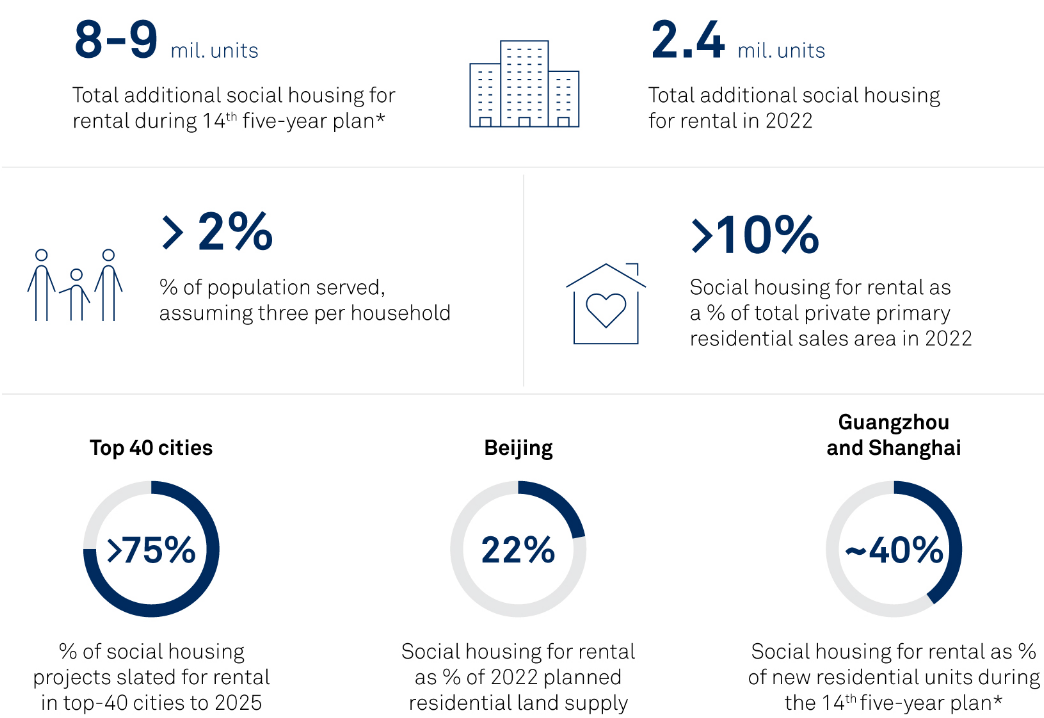
Household wealth by asset class




Source: CEIC; Federal Reserve Board; various nations' statistics offices; OECD; World Bank; McKinsey Global Institute analysis.

Chart 5

## Social Housing Is Taking A Larger Slice Of The Residential Property Market




*Spanning 2021-2025. mil.--Million. Source: S&P Global Ratings, government work reports.

## Shifting Resources From Cities To Villages For Basic Services

Economic and population growth will increasingly shift away from first- and second-tier cities toward lower-tier cities. In recent years, migration trends have already started to localize somewhat--with rural denizens moving to their province's biggest city, for example, rather than to the richer east coast. This is supported by increased connectivity via a greater network of transport and communications infrastructure and the relaxation of restrictions on urban settlement for lower-tier cities[3].

Corporates with larger operational footprints in surrounding cities and villages are likely beneficiaries of this trend. At the same time, building out the infrastructure for basic services in lower-tier cities and rural townships will require additional fiscal resources, and could add to the financial burden of local governments and its SOEs.

Still, the rich eastern seaboard will continue to be much richer, which means fiscal transfers from the richer provinces will continue. This will help alleviate less adequate basic services in lower-tier cities and rural villages.

As one example of execution on this issue, the national medical security plan in September 2021 cuts medical bills and seeks to improve the medical security of rural areas. The government is also shifting high-quality medical resources toward counties, from provincial cities[4]. And to relieve the burden of rising educational costs and improve educational outcomes for the broader population, the government will increasingly promote and invest in vocational schools[3].

[3] http://www.gov.cn/zhengce/zhengceku/2021-04/13/content_5599332.htm
[4] http://www.gov.cn/zhengce/zhengceku/2021-06/25/content_5620868.htm

## SOEs To Lead By Example

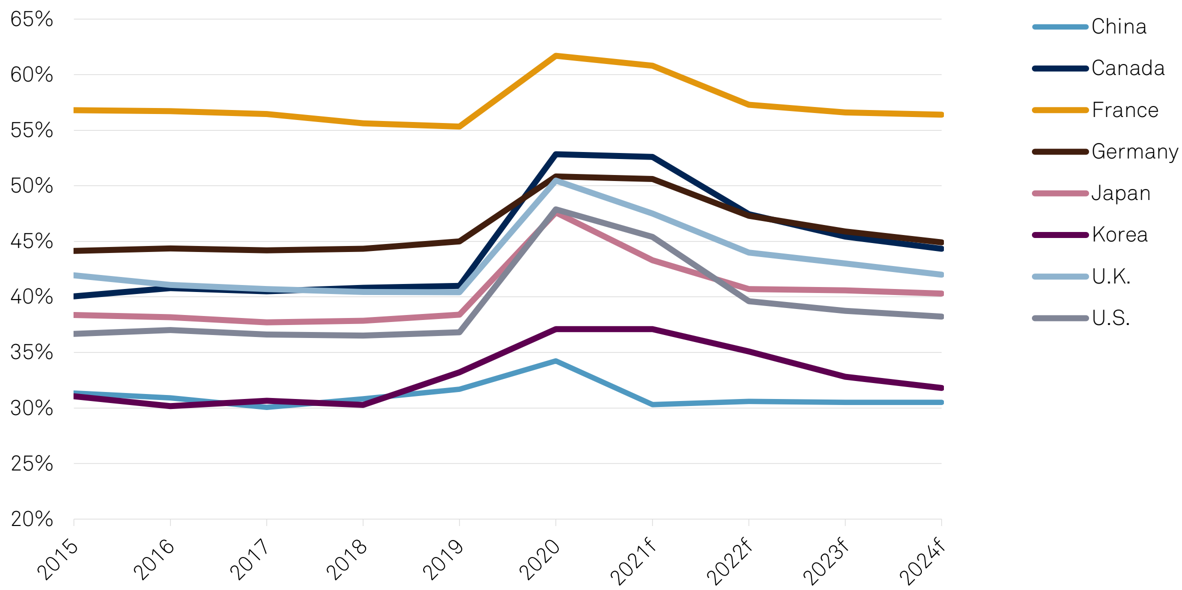
Large corporations could be increasingly tasked with taking a lead on social welfare spending. This is particularly true for SOEs, which are expected to exemplify socially responsible behavior. Large privately owned enterprises (POEs) could also experience higher costs and expenditures as a result.

Social welfare is an important tool to attain "common prosperity" and an area where government spending is still low as a proportion of GDP relative to other developed countries. China's growing elderly population will significantly increase the need for more spending in the areas of medical insurance and pension, especially as most households have only one child to support their aging parents. In our view, social welfare spending in China is set to expand dramatically over the next decade.

Chart 6

**China's Government Spending Has Room To Shift Higher**

General government expenditures/GDP




f--Forecast. Source: S&P Global Ratings.

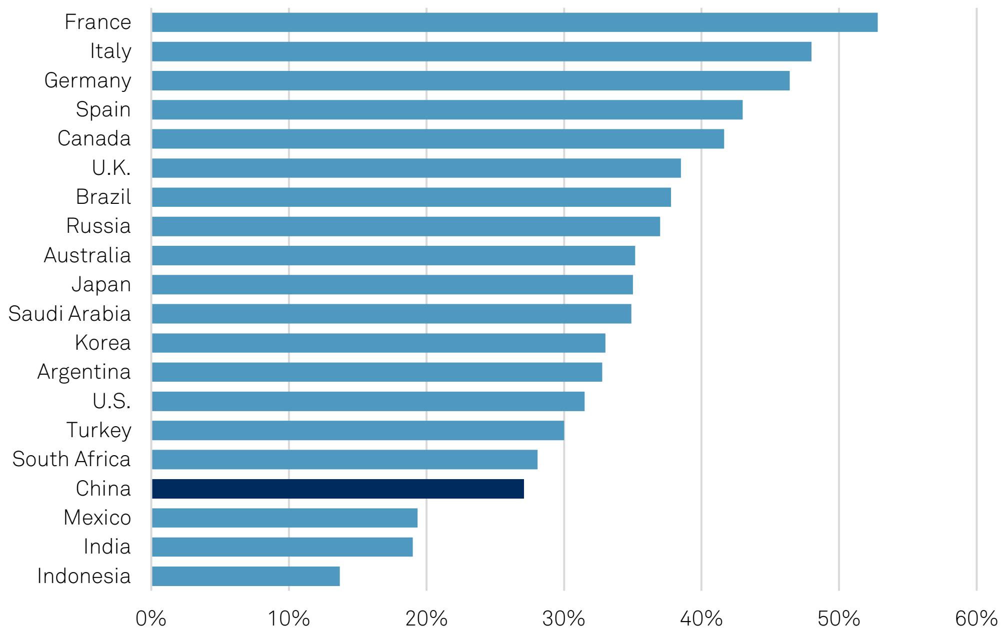
To fund burgeoning social welfare spending and social policies, China may rely on taxes and its large SOEs to fund the gap. Expanding tax revenues may not be easy as the country's tax rate is already among the highest in the world. China's total tax rate on enterprises ranked among the top 10% according to the World Bank, while its income tax rate on its highest earners is also among the highest. Despite the high rates, tax revenues still have room to grow.

Although China's highest marginal income tax rate is relatively steep, most high earners pay relatively little in taxes, given low taxation on capital gains and dividends, which account for a substantial portion of their income. Additionally, increasing enforcement of compliance to tax policies on the wealthy, including those overseas, could be another source of tax income. For corporates, preferential taxes for certain corporates may be eliminated or tax rates may increase, such as what has happened recently for certain Chinese internet companies. Finally, land resources from SOEs could constitute another fiscal resource.

Chart 7

**Room For China To Expand Revenues And Tax Rates**

General government revenues/GDP in 2021*




*Does not include pension contributions. Source: S&P Global Ratings.

China may also seek to increase the involvement of SOEs within the economy. A likely key function for SOEs will be to support the government's social directives through leading by example. This means increasing resources and investments for key social directives, such as elderly services, education, healthcare, and other important social services. Though SOEs may not become directly involved in providing such services, it's likely that they could provide investments and other means of support.

Additionally, SOEs may take on social roles by creating more employment opportunities for the growing number of highly educated graduates, as well as providing job stability for older employees.

Cash-rich POEs could also see increased investments for social causes and face rising labor costs. Already many Chinese internet companies have increased their investments in improving the social welfare of the broader population (vocational training, social housing, rural communications, etc.); they are also boosting donations to social causes. We expect such community investments to continue and likely to broaden in the number of POEs involved and the scope of their investments and donations.

## Rising Protections For China's Workers

Labor law is another area where we could see accelerating changes, resulting in higher labor costs. This could have significant implications for China, the world's manufacturing hub. Low-margin and labor-intensive industries, such as textile manufacturers, will further shift to other countries. Meanwhile some of the more expensive labor is absorbed by an increasing shift toward advanced manufacturing and high-technology industries. The success of these advanced technology sectors is also shaped by international events and geopolitics, where tensions are likely to remain for a long time. Domestically, we see increasing resources for vocational training and R&D in support of this sectorial shift, adding to its sustainability.

Already the government has implemented tighter labor laws around gig-economy workers and increased social insurance contribution requirements for companies[5]. However, a lot more is likely to come in terms of future labor protections, which could include standards such as employee rights and safety, working hours, wages, vacations, and fairer conditions for female workers. Though it is difficult to predict specific policy actions around labor laws and policy, the implications are that labor costs are likely to grow. To counter the growing cost of labor, the government will simultaneously promote more advanced industries where higher labor costs can be more easily absorbed and higher-income jobs are more abundant.

## A Red Carpet For High-Tech And Related Strategic Industries

This may seem to run counter to the recent backlash and regulatory upheaval for Chinese internet companies. However, we note that supporting high-tech does not necessarily contradict the government's goals.

For one, the government has so far refrained from forcibly breaking up large internet companies or implementing significantly punitive measures. This is shown by regulatory fines that are largely manageable for internet companies (see "The Forces Buffeting Our China Internet Ratings," published March 1, 2022). Secondly, stricter enforcement of anti-monopoly laws, particularly for POEs, benefits small and midsize companies. It also drives more innovation since large internet companies are forced to invest in their core businesses rather than acquiring potential disruptors and rising competitors. Finally, we note the government has not intervened and has in fact encouraged development in areas such as artificial intelligence, cloud computing, chip manufacturing, and autonomous vehicles[6], areas of development that are being led by Chinese internet companies.

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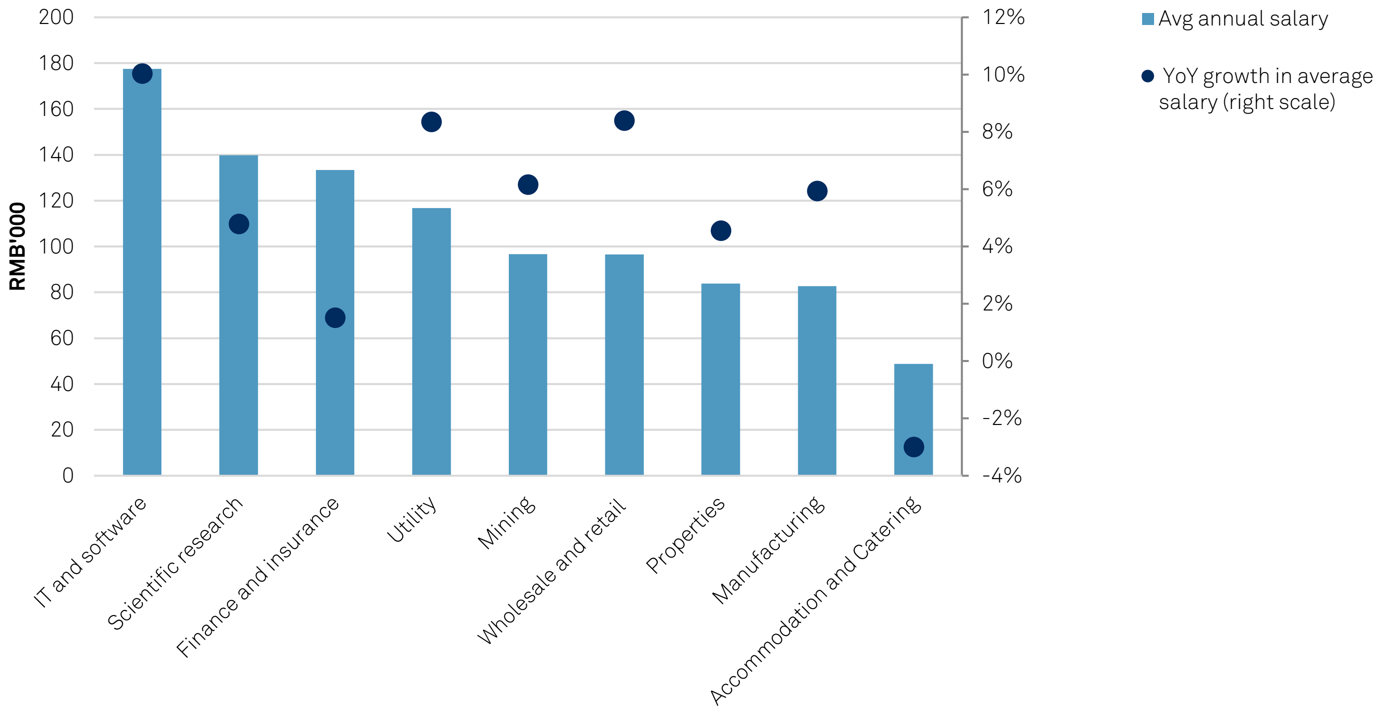
[5] http://www.gov.cn/zhengce/zhengceku/2021-07/23/content_5626761.htm
[6] Cloud, AI, chip manufacturing, and autonomous vehicles.

Chart 8

## High Tech Industries Are Driving Income Growth In China

2020 average annual wage and YoY growth of selected sectors




Avg--Average. YoY--Year over year. Source: Wind, S&P Global Ratings.

China government's increasing focus on demographics and balanced growth suggests that sectors where companies have previously benefited from speculative excess and uneven competition face greater risk of policy intervention and additional regulations over the next decade. The same is true for corporate strategies that clash with China's key policies--such as easing cost burdens for China's households (i.e. housing, education, medical services, and elderly care).

Should China succeed in balancing growth and reducing wealth and income disparities, it could reap a healthier and more stable period of economic growth. However, in the near-term, more volatility is likely for some business sectors--education and internet companies come to mind. Understanding the potential pitfalls and opportunities under China's policy direction sheds light on the future credit prospects for Chinese issuers.

Editor: Cathy Holcombe

Digital design: Halie Mustow