

New China Perspectives



Welcome to the weekly issue of Morgan Creek's *New China Perspectives*. It is comprised of research from Morgan Creek's China-based investment team together with curated articles of interest. In addition to timely political and economic news covering greater China, Morgan Creek's China team seeks to provide in-depth perspectives on investing in the technology, consumer and healthcare sectors in the region. Our research leverages the "on the ground"

insights of our team together with Morgan Creek's decades-long experience in covering the region. Our team are focused, thematic investors primarily covering the technology, consumer, and healthcare sectors and investing in private companies and early-stage managers with deep local expertise. To learn more about our team and investment offerings, please email chinateam@morgancreekap.com.

Best Regards,

Handwritten signature of Mark W. Yusko in black ink.

Mark W. Yusko
CEO & CIO

NOTES FROM THE BUND¹

This is the final installment of a four-week discussion on the Chinese political system, and the implications for both China's economy and the broader world economy.

Like every other system designed by man, there are constraints to the model. The three important ones we will address are: (i) ossification, or the capture of the system by elites for their own benefit; (ii) continued willingness to commit to the model regardless of failure; and (iii) failure of feedback mechanisms due to overconfidence or fear from subordinates.

Ossification

One of man's most basic desires is the primal urge to accumulate resources for personal influence and/or wealth. As a result, absent intermittent reforms to any system designed by man, once special interest groups (whether businessmen or government officials) begin to understand how the system makes rules, such groups may begin hijacking it for their own benefit. In developed countries, the term to describe this phenomenon is "regulatory capture²"; in China, it is termed "corruption".

China's current system has shown tremendous ability to adapt – undergoing at least two great transformations to its internal structure since Chairman Mao's proclaimed the People's Republic in 1949.

Mao Era (1950 – 1976)

Some foreign observers point to the misguided policies during Mao's rule like the Great Leap Forward and the Cultural Revolution as a reason one-party regimes are destined to failure due to a lack of check and balances. While the great human and economic cost of those campaigns are undeniable, it is also important to acknowledge:

- Many of the ingredients enabling China's rise were established by Mao.
- The party absorbed lessons from those two incidents and successfully recalibrated and upgraded their system.

The typical narrative around China treats the era before Deng's reform as an

unmitigated disaster. This could not be further from the truth. The charts below compares the state of China with Asia’s two largest countries by population – India and Indonesia from 1950 (when Mao took over) to 1979 (when Deng replaced Mao):

- Even before Deng’s reforms, China had outperformed its developmental peers in life expectancy, adult literacy and was already the fastest growing economy per capita
- Without this healthy, educated labor base as a foundation, it is highly unlikely China would grow as fast as it did, as evidenced from the increasing economic gap between China and its two Asian peers.

Figure 1: China outperformed its developmental peers during the Mao Era^{3,4}

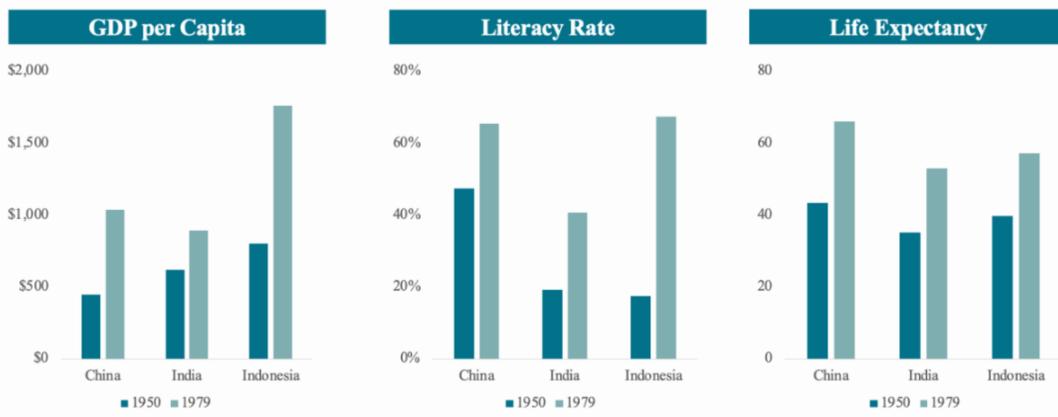
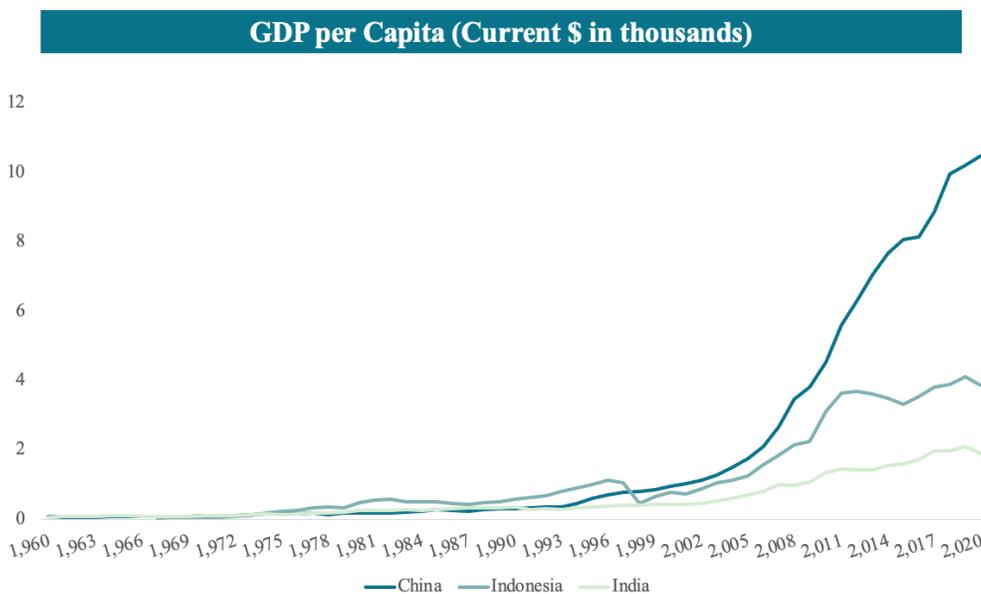


Figure 2: Mao’s early policies set the foundation for Deng’s reforms⁵



Deng Era (1978 – 1990)

The many reforms of Deng are well documented. As such, we will highlight only the lessons learned from the experiences of the Great Leap Forward and Cultural Revolution to illustrate how we believe the party has improved their machine with every iteration. In this case, they made sure to:

- Localize experiments until success was proven before replicating nationwide. This allows the cost of failure to be minimized.
- Decentralize decision making to local governments to unlock material incentives. This also allowed local officials greater leeway to implement appropriate policies.
- Implement term limits for officials.

Jiang, Hu Era (1993 – 2012)

The next two paramount leaders continued market reforms for the following two decades, overseeing China’s steady rise to the second largest economy in the world. However, the strains of the model were beginning to appear:

- Geographically unbalanced development, leading to significant inequities
- Reliance on exports and investments for growth, which is unsustainable in the long term
- Environmental degradation

The complexion of the party at this point has also changed significantly:

- [Two major factions emerged](#) within the party with divergent ideologies. Urgent reforms were stalled. In this gridlocked environment, [officials colluded](#) for their own short term interest
- Decades of decentralization [weakened the authority](#) of the central government, leaving local authorities (ministries) to run their independent fiefdoms
- This lack of accountability and supervision led to a series of [cover-ups](#) and [corruption scandals](#) that tarnished the image of the party

Xi Era (2013 – Present)

Recognizing the potentially precarious situation the organization was in, Hu broke with tradition by voluntarily surrendering all his positions (including the important Chairmanship of the Central Military Commission) to Xi Jinping upon retirement.

This provided Xi with the authority to clean up the party and begin consolidating central authority once more:

- Launched the largest organized anti-corruption drive in the history of the party
- Created the Central Comprehensively Deepening Reforms Commission to push urgent reforms through bureaucracy; launched [large scale administrative reforms](#) to end turf wars
- Introduced “lifelong” accountability systems to tackle important issues including [environment](#), local government debt, etc.
- Unveiled [“dual circulation” policy](#) to restructure economy and [“common prosperity” drive](#) to address imbalances
- Removal of term limits for longer runway to implement difficult reforms

Over the past seven decades when the party was in power, each successive administration had *evolved* in direct response to, and was capable of addressing, the shortcomings of its predecessor to move China forward. While only time will tell if this success can be maintained, the party’s robust track record of radically reinventing itself to remain relevant bodes well for China’s future.

Continued willingness to commit regardless of failure

Globalization, digitalization and the internet has irrevocably connected the world. China’s regional economies are more interlinked than ever. It may no longer be possible to insulate the impact of failed policy trials from the broader economy. Inappropriate experimental policies today may rapidly trigger unintended consequences with large, adverse outcomes. As an example, a recent [misconstrued coal energy policy](#) caused significant reverberations throughout northern China with rolling blackouts across cities. Fear of resulting social and economic backlash in such situations could discourage authorities from testing new reforms.

However, the external (US-China contest) and internal (rapidly aging demographic, wide economic disparities, etc.) pressure that China is facing today is substantial. The consequences of failing to address these challenges may be dire to China and, more specifically, to the party. As such, the resolve within the party today to tackle these issues is very strong.

Failure of feedback mechanisms

The system will fail to iterate if open and timely feedback stops. Hubris and/or fear, or disincentives, to report failure up the chain are a few reasons detractors believe this system will ultimately break down.

The system did indeed encounter this issue in the initial stages of the Covid outbreak, with local government covering-up the disease. When the central authorities discovered this, they [purged the officials involved](#) and enacted measures thereafter to successfully contain the disease domestically. This robust, albeit delayed, response resulted in China being the [only major economy to grow its GDP in 2020](#). A few months after controlling the outbreak, the authorities unveiled a blueprint to [upgrade their healthcare systems](#) to identify and treat infectious disease outbreaks to avoid a similar occurrence.

The world is undergoing tremendous change, and nowhere is this more evident than in China. To remain relevant, the Chinese authorities have had to continually reinvent their system. The future will tell if this current approach continues to deliver for China, but given the model’s great adaptability and strong historical track record of success, we think the odds are favorable. At the heart of the party’s drive for continued progress

is self-preservation, and this is mankind's strongest motivation.

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CHINA NEWS SPOTLIGHT

China's central bank pledges prudent macro policies in 2022: China will further improve its regulatory framework of monetary and macro-prudential policies, as part of efforts to step up counter-cyclical adjustments and curb risk contagion, according to the central bank. [Read more.](#)

China's Economy And Real Estate Market Have Yet To Bottom: According to Bloomberg, in an internal document cited last week by the South China Morning Post, China Vanke's CEO was quoted as saying the company was in a "life or death battle" and "On our last legs". [Read more.](#)

China's Meituan lowers commissions in response to regulatory guidance: Chinese food delivery giant Meituan (3690.HK) said on Tuesday that it would lower commissions for merchants on its platform, including capping fees for around a million small and medium sized merchants facing operational difficulties at 5% this year. [Read more.](#)

China drafts new rules to control notifications and pop-ups: On March 2, Chinese regulators published a new draft of rules on notifications and pop-ups. [Read more.](#)

BYD and Baidu team up for autonomous driving: China's largest EV builder by sales, BYD, has picked Baidu, China's largest search engine and AI company, as a partner in its attempts to rival Tesla and other domestic competitors in the autonomous driving market, reports the South China Morning Post. [Read more.](#)

I-Mab Receives FDA Orphan Drug Designation for its Novel Claudin 18.2 x 4-1BB Bispecific Antibody TJ-CD4B for the Treatment of Gastric Cancer: I-Mab (the "Company") (Nasdaq: IMAB), a clinical-stage biopharmaceutical company committed to the discovery, development, and commercialization of novel biologics, today announced that the U.S. Food and Drug Administration (FDA) has granted Orphan Drug Designation for TJ-CD4B, a novel Claudin 18.2 x 4-1BB bispecific antibody, for the treatment of gastric cancer including cancer of gastroesophageal junction. [Read more.](#)

Sanofi picks a 'safe' bet for Adagene's antibody tech in \$2.5B biobucks tie up: Sanofi seems to be in a betting mood and has been picking up card after card in licensing deals to bulk up its early-stage pipeline. [Read more.](#)

¹ The Bund is a historic waterfront area in central Shanghai, where Morgan Creek's office is located. From the 1860s to the 1930s, it was the rich and powerful center of the foreign establishment in Shanghai, operating as a legally protected treaty port. The picture above is part of the historical waterfront.

² Regulatory capture, also known as client politics, is a form of corruption of authority that occurs when regulatory agencies are dominated by the industries they were charged with regulating and advance the goals and interests of those industries instead of the general public. There are [studies which illustrate this.](#)

³ Data.worldbank.org, Chart and table of China, India and Indonesia's GDP per Capita and Literacy Rate in 1950 and 1979.

⁴ Marcotrends.net, Chart and table of China, India and Indonesia's Life Expectancy in 1950 and 1979.

⁵ Data.worldbank.org, Chart and table of China, India and Indonesia's GDP per Capita from 1950 to 2020.

Important Disclosures

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