The Internet Is No Longer Exempt

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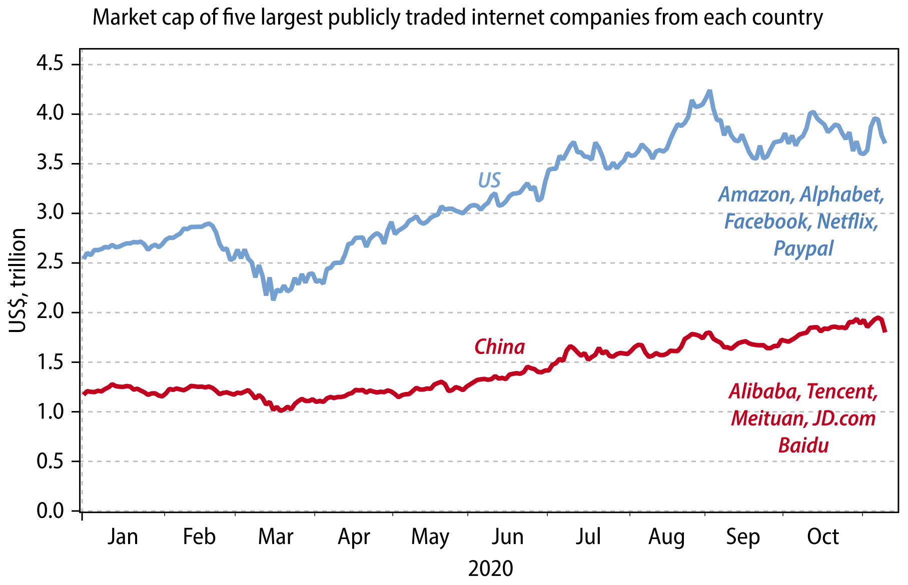
There is little evidence that the state wants to regulate Internet companies to death

Over the past two weeks, a series of major regulatory actions from the Chinese government has sent an unmistakable political message to the country's internet companies: you're not special anymore. For years, China has regulated technology with a light touch, in stark contrast to the aggressive administrative interventions it often deployed in other sectors. Now, the government is telling internet companies they must play by the same rules, from financial regulation to antitrust, as all other firms. They're no longer exempt just because they are high-tech. This shift is a significant one, and Chinese internet stocks—the world's biggest concentration of large tech companies outside the US—have taken a beating in the markets in recent days. But while the business practices of internet companies will clearly have to adjust, there is little evidence the state wants to regulate them to death.

China's internet giants are the only global peers of the US leaders



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China's internet regulator said the online economy was marked by unfair competition and illegal activities

On Tuesday, China's internet regulator, the Cyberspace Administration of China, disclosed that it had called 27 major internet platform companies—including Alibaba, Tencent, Meituan Dianping, Baidu, Didi Chuxing, and other household names—to a meeting to give them "administrative guidance" on how to bring order to an online economy it said was marked by unfair competition, counterfeiting and other illegal activities. The meeting delivered instructions on how to comply with a series of recent regulatory actions, including new rules on online promotions and live-streaming, as well as a draft document explaining which business practices of online platforms could fall afoul of antimonopoly law.

Practices such as price discrimination and exclusive sales agreements are common for online platforms

"Online platforms are not a place outside the reach of antimonopoly law, nor can they become a breeding ground for unfair competition," the regulator declared. The draft rules from the State Administration for Market Regulation state that various practices such as selling below cost, price discrimination and exclusive sales agreements could be in violation of the antimonopoly law. It is no secret that these practices are widespread. Ride-hailing services like Didi Chuxing and food-delivery apps like Meituan and Eleme have offered generous subsidies to users to expand their market share. Online retailers like Alibaba and JD.com have often required brands to sign exclusive contracts to sell only on their platform. And price discrimination—charging different users different prices for the same product or service—is commonly used on travel booking platforms like Ctrip.

Regulators have pointed out that practices deemed illegal in other contexts should also be illegal for online platforms...

Restricting these activities strikes at the heart of the business models of internet platforms, which are based on scale economies and two-sided markets. Platform companies bring together merchants, restaurants, or drivers on one side, and consumers on the other. Their success is dependent on aggregating enough participants on each side, so that, for example, neither drivers nor riders need to wait too long to be matched. The platforms have brought huge gains to merchants and consumers, but their operators' aggressive practices to expand both sides of each market and extract profits from participants have generated a growing chorus of complaints. The point of regulators' intervention is simple: these practices would be considered illegal in other contexts, so they should also be considered illegal for online platforms. That doesn't mean the government will immediately start prosecuting companies; the draft rules are not yet effective and will be open for public comment until November 30. But regulators have already delivered a public warning to get the internet companies to start cleaning up their act.

...nor are fintech firms exempt from financial regulation just because they are tech companies

The same message was delivered by last week's dramatic intervention in the IPO of Ant Group, which was carried out by a different set of regulators in the financial sector (see **Ant Stomped**). Worried by the highly leveraged lending practices of microfinance firms controlled by Ant Group and other internet companies, regulators rushed out new rules that require them to reserve more capital. Those rules on microfinance had been under development since at least 2019, but were fast-tracked after Ant founder Jack Ma publicly criticized China's regulation of fintech in a late-October speech. It might seem surprising that regulation of microfinance—a fairly small part of the financial sector—was considered important enough to scupper what would have been the world's biggest IPO. But the point regulators were making was a bigger one: that Ant is not exempt from financial regulation just because it is a technology company. Ant and other internet companies with financial businesses are now required to register as financial holding companies, a step that will put them under the direct supervision of the People's Bank of China and make them operate more like banks.

A shift in tone

This is far from the first time that unexpected regulatory moves have shocked investors in Chinese internet companies. Top leader Xi Jinping first flagged his concerns about irregularities in online commerce in a speech in April

2016, and throughout 2018 there were a series of regulatory moves against major technology companies, including halting approvals of new video games for Tencent for several months (see **The New internet Regime**).

The government is making a comprehensive effort to bring internet regulations in line with offline standards

This time, however, is different. Rather than making a series of moves against individual companies, as it did in 2018, the government is making a comprehensive effort to regulate internet companies on the same basis as other businesses. Financial regulators have stressed that all financial activities must be properly regulated, regardless of whether they are carried out by traditional banks or new fintech companies. And SAMR has declared that "the basic system, regulatory principles and analytical framework" of the Antimonopoly Law must apply just as much to internet-platform companies as to other companies.

What is behind this shift? It is not perhaps as sudden as it seems. After a series of interventions by various government agencies through 2018 and early 2019, the State Council flagged its intention to more fully regulate internet-platform companies in August 2019. SAMR, the chief enforcer of antimonopoly law, was formed in a 2018 government reorganization that gave it significantly more regulatory clout and began drafting rules on online commerce in late 2019. But that work, like almost everything else, was largely on hold in the first half of 2020 as the government focused on the Covid-19 pandemic. To some extent, these latest moves are the result of agencies picking up from where they left off.

Lessons from the pandemic

Yet the pandemic also contributed to a shift in the policy and political environment that encouraged the government to take a tougher stance toward technology companies. In a speech in April, Xi Jinping declared that "our online economy is a global leader and has played an active role in the prevention and control of this epidemic" by allowing people to work from home and shop online. "At the same, we must recognize that the real economy is the foundation, and we cannot lose all our manufacturing industries," he said. Since then, this focus on the "real economy" has appeared in several policy documents including the leadership's outline for the next five-year plan, which states that "the focus of economic development must be on the real economy."

Though online services are convenient, it was the strength of the manufacturing sector that powered China's recovery

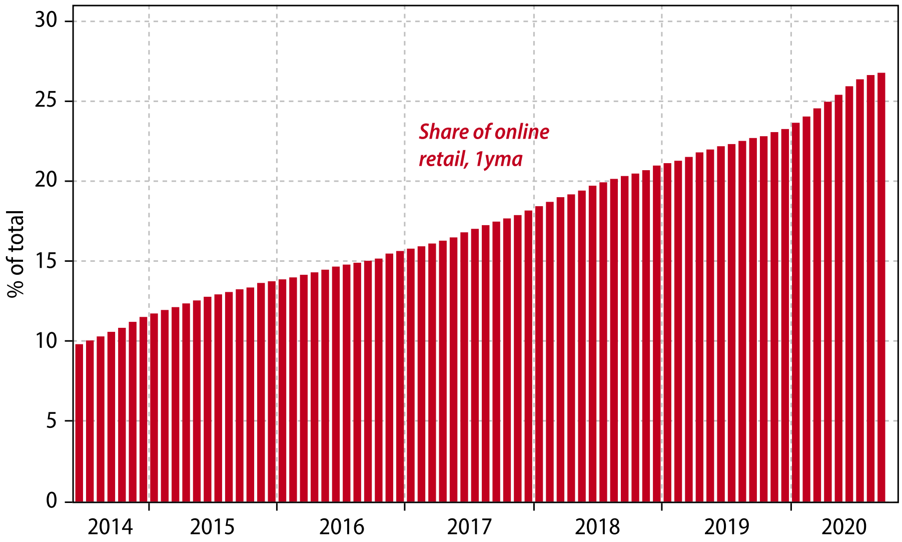
The lesson that China's leadership seems to have learned from the pandemic is that online services are indeed great and very convenient—but what really allowed China's economy to come back quickly is the strength of its manufacturing sector. The new focus on the "real economy" suggests that the prestigious and profitable sectors of finance, property and technology have now lost some of their privileged status in the minds of government officials. The focus is not on developing these sectors as ends in themselves, but on ensuring they support the fundamentals of providing goods and services to China's enormous domestic market of 1.4bn people.

The very fact that Chinese people now rely so heavily on online services means they must be properly regulated. The "dual circulation" framework that Xi has advanced for economic policy calls for understanding that China's prosperity ultimately depends on its domestic market, which means that market must function effectively (see **Understanding Dual Circulation**). Han Wenxiu, a top economic policymaker, recently summarized the government's stance as follows: "The platform economy, the online economy, the sharing economy are all booming in our country. At the same time, they are also prone to anticompetitive behavior, the loss of personal privacy, and other problems. In society there are a lot of worries and complaints on these issues, so we need to implement inclusive prudential regulation."

The fact that Chinese people now rely on online services means they must be properly regulated

The pandemic accelerated the rise of online shopping in China

Online retail share of total retail sales of consumer goods



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Despite the increased regulation, Beijing remains proud of its online giants and does not want to bring down the sector

This shift in the political stance, along with all of these new regulatory guidelines, are sure to hit the profitability of China's internet giants. But they will not bring down the entire sector, nor are they intended to. The government is proud of the success of these firms, and views them as national champions. They've provided employment for millions of people and created services beloved by consumers. That status means the government will happily support their development, as long as they are complying with government priorities. The cost of that compliance does, however, seem to keep going up.