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THE CHIPS ARE DOWN

China's semiconductor industry is aiming for self-sufficiency in the face of headwinds, but it still has a long way to go

- There are a number of reforms available to China to help it deal with economic challenges
- China's relationship with the Middle East is growing, both economically and politically
- The auto industry in China is driving change in the global market

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Movers and Shakers

As has often been the case over the last few years, China's economy now finds itself in a period of rapid change. There are many reasons for this, but geopolitics is a prime factor, and that is particularly true for semiconductors. The turbulence of China's relationship with many Western countries, which includes US export controls on chips and chip-related equipment is one of the major reasons behind China's growing focus on semiconductor self-sufficiency. The country is already one of the largest global manufacturers of legacy chips, which are found in a wide range of modern devices, but the real competition lies at the cutting-edge and this is where China is having to adapt. We discuss the issue in more depth in our cover story "**Chipping Away**" on page 40.

Another major change that has become evident in recent years is the shift in focus of China's outbound foreign direct investment (OFDI). Overall outbound investment from the country peaked around 2016, with the main targets being the developed economies of the West. Since then, China's investment in the US and Europe has dwindled, and the growth of investment, through various means, in ASEAN, Africa and the Middle East and Latin America has grown rapidly. The article "**Mixing it Up**" on page 16 takes a closer look at the reasons behind the emerging trends within China's OFDI.

A particularly positive development in China's economy in the last decade has been the advancement of the country's auto industry. In 2023, China overtook Japan as the world's largest exporter of cars, by units exported, and this is representative of a consistent upward trend for the various manufacturers in the country. The development and delivery of new-energy vehicles (NEVs) has been a major part of the story, with manufacturer BYD, now the world's largest, announcing in early 2023 that they had produced their last non-NEV. Find out more in "**Driving Change**" on page 32.

As well as these topics, we also take a look at the potential economic reforms available to China's leadership (page 27) and the unique offerings coming out of the country's F&B industry (page 61). We are joined this issue by Siyao Jiang, Managing China Partner at sustainablity consultancy ERM, who discusses the concepts of ESG and sustainability, regulatory requirements and the growing business case for taking a sustainable approach in the global market (page 37).

Our hope is that you find these insights and reflections on the changing nature of Chinese businesses and the country's economy useful. If you have any comments or opinions to contribute, please feel free to contact us at (lzhou@ckgsb.edu.cn or ckgsb.knowledge@ckgsb.edu.cn).

Yours Sincerely,

Zhou Li
Editor-in-Chief, *CKGSB Knowledge*

For more insights on the Chinese economy and business, please visit the CKGSB Knowledge *site: http://knowledge.ckgsb.edu.cn/*

COMMENTARY

Re-humanization in the Era of Re-globalization

Reflecting on the key issues discussed over the past 50 issues and anticipating their trends for the future

Zhou Li, Editor-in-Chief of CKGSB Knowledge

All commentaries reflect the personal opinion of the author and are not necessarily the official position of the school and the magazine

This issue of *CKGSB Knowledge* is the 50th issue of the magazine and the last one I will be a part of as its Editor-in-Chief due my retirement from the Cheung Kong Graduate School of Business. With this being my last commentary, I want to reflect on some important topics from the past and discuss how they may evolve in the future.

Re-Globalization

In the commentary from Issue 24 of the magazine, published shortly after Brexit and just before Trump took office in 2017, we noted that, despite the various predictions of an end to globalization as a whole, we were sure that the process would continue, albeit in a different form, something we referred to as 're-globalization.' This new era, we said, would include a new business landscape shaped by technological breakthroughs, a shift in the role of leading nations from US-dominated to include more players such as China, and the need for an increased emphasis on all stakeholders, especially emerging economies and non-profit groups.

During the last round of globalization, Japan, Korea, Taiwan, and most notably China, demonstrated that it was possible for countries to develop new advantages using the resources accumulated through early-stage international trade to make progress at higher stages of the value chain. In the increasingly digitalized economy, as China has shown, emerging economies may have developmental advantages allowing them to move up the global value chain faster than ever before.

Today, we are also seeing the US and many other advanced economies introduce policies to aid a return of manufacturing capacity, to create more industrial jobs, improve supply chain resiliency and to correct the downsizing of domestic manufacturing undertaken in the last round of globalization. While in the short-term this appears to buck the trend of globalization, it is also clear that individual economies cannot provide a full supply-chain on their own and sooner or later they will reach the point where the cost of reshoring is too high to go any further.

What we expect to see as a result of 're-globalization' is more of a horizontal supply chain, with countries specializing in certain sectors, as well as traditional vertical separation based on labor costs. For example, China is a global leader in EVs and some green technologies, while it lags in other areas that can be made up for by expertise in other countries. In the future, we may also see India moving up the value chain in certain areas of pharmaceuticals, although their current advantage is around its low production costs.

It is clear that, in the irrevocably interconnected and interdependent world we live in, globalization in some form or other will always exist.

As part of the wider discussion on globalization, our magazine has often pondered over the evolution of the China-US relationship, arguably the most important relationship in the 21st century.

Many have attributed the deterioration of the relationship since the early 2010s to China leaving behind Deng Xiaoping's policy of "hiding its strengths." Realistically, however, by 2016 China was no longer in a position to hide those strengths, especially as it became the largest economy in the world in terms of purchasing power parity.

A more relevant reason for the change in the China-US relationship may have been the announcement of the Made in China 2025 policy, also in 2016. It was clear to Chinese leaders at the time that the traditional low-cost manufacturing model was losing steam, the average profit rate of manufacturing firms was just 2-3%, and declining. Labor costs were rising and the impact of pollution on major cities, especially Beijing, was becoming untenable. There was an urgent need, also proposed by many global economists, for a shift in the development model towards an innovation and consumption-driven economy, and this is what Made in China 2025 sought to provide.

Without adequate communication, the introduction of the plan led to a misunderstanding of China's priorities in the international sphere, as well as some confusion domestically. This became one of the deciding factors in the end of US policy engagement with China, as US and European companies saw it not only as the end of a number of benefits that had made the Chinese market so attractive for decades, but also the beginning of China's competition with them in the global market.

The relationship between the two largest economies is currently primarily driven by domestic political agendas on both sides, and this looks set to continue whatever the outcome of the 2024 US election. It is important that those with the power to make changes in both countries recognize this, work on clarifying which national security issues are real and which are simply borne out of protectionism, and accept that open and fair competition is beneficial for all.

Encouragingly, we have seen some increased China-US communication which has generated initiatives and collaboration in the climate realm, as well as a new bilateral channel for consultation on artificial intelligence. And, it should also be noted that trade between the two has increased, despite the optics and impact of the trade war.

China is, of course, an important player in the era of re-globalization and the central subject of our magazine. In 2017, the Issue 27 commentary addressed the core question of that time: Is China ready to lead? I did not believe it was ready then, and that is still arguably the case today.

A lot of the arguments that supported that view at the time are still valid, and many have risen in relevance. For example, at the time China was still in the process of changing its economic development model from export and investment-driven growth to one led by consumption and innovation, a transition that is still underway. China still also has a large, but mostly poor population, with, according to past premier Li Keqiang and economist Keyu Jin, around 870 million Chinese in 2020 still only earning around ¥2,000 a month ($282) and 600 million on $146.

As we have repeatedly said, a key factor necessary for the future development of the Chinese economy to be competitive in the world is providing private enterprises with a level of assurance to ensure a healthy balance between SOEs and privately-owned enterprises and their complementary development. While attempts have been made to do this, internationally Chinese regulation designed to manage this balance in certain sectors of the economy has often been viewed through a negative lens. But there have been many cases where analysts and commentators have missed much of the nuance in the situation, again arguably as a result of ineffective communication from regulators.

For example, some of the practices of internet and real estate companies in China, prior to state intervention, were well beyond what would be considered appropriate or

Continuing threads: Some macro issues for China and the world have remained the same over time

fiscally responsible in any market. Ride-hailing firm Didi's troubles after its massive US IPO, for example, were the result of the company failing to wait for the completion of Chinese cybersecurity reviews, an issue it had been warned of multiple times by regulators, but perhaps not as publicly as they could have been.

Despite the various challenges and widespread pessimistic sentiment, even among the Chinese economists, I am still confident in the future of the Chinese economy, as the fundamental driving forces behind it are still valid and many are growing ever-stronger. China's population may be starting to decline, but it is still huge and the market is still growing at a rate higher than that of most economies. There are also the evergreen arguments that China's entrepreneurial spirit and its hard-working and well-educated people have the ability to innovate and drive economic growth to the next level in a world that is being re-globalized. Chinese companies, large and small, are also acclimatizing to global market values and realizing the potential of integration all over the world, particularly in faster-growing countries beyond North America and Europe.

Again, it is innovation and globalization that offer the opportunity to create more markets that will be receptive to the products and services China has to offer. In our Issue 46 commentary in early 2023, we discussed four new drivers of China's economy and the acronym GRID. This included the Green economy to help the country achieve its goal of sustainable development, the Real economy's role in upgrading China's position in the global supply chain, the Inclusion of a new business model that leverages the expansion of China's middle-income consumers, and the Digital transformation of Chinese companies. Each of these drivers have continued to prove vital to China's economic development over the last year and this trend looks set to continue.

Re-humanization

The past and present can offer many interesting insights, but we also need to think about what comes next, and one change we began discussing in 2017 was the emergence of AI and its impact on the unfolding fourth industrial revolution (4IR). One dimension that we may need to add is that, while previous technological industrial revolutions have addressed the needs of our body, providing more food and clothing, and our minds, with information and entertainment, there is now an opportunity for innovative developments such as AI to nourish our spiritual selves. Solving anxieties, insecurities and a need for belonging was long under the remit of religion, but a rise in secularism over the past century and more has led to a deterioration in communities that meet these needs. It is very possible that AI will lead to a blurring of lines across the physical and psychological as well as the spiritual realms, led by advances in AI and the possibilities presented to us by biotechnology developments.

> There is now an opportunity for innovative developments such as AI to nourish our spiritual selves

This presents us with the question of how to better embrace the fundamental aspects of our humanity, which we seem to have lost with the ever-increasing dominance and desire for money and consumer products borne out of the global economic system. AI provides people with new opportunities of re-humanization by actualizing or realizing themselves as individual persons, something that has been lost in the greater global system over the past few centuries.

As I am writing, the fires in Ukraine and the Middle East are intensifying and there is a greater threat of confrontation in East Asia and the South China Sea. The background to these conflicts is complicated, but a consistent factor in all is the desire for access to more resources that underpins the capitalist system, which has, over the years, led to a polarization in wealth and resource access both across and within countries, although it has also led to a rapid increase in total wealth and the average standard of living around the world.

There have been growing calls for 'inclusive capitalism,' which aims to produce equitable and sustainable growth that empowers others and addresses society's needs. This is not something that just one country can do, but requires a global effort. It is a difficult proposition, but not impossible, especially given that the data-driven development we are seeing has meant a shift from economies of scarcity toward economies of abundance, and the basic needs of an increasing number of people are being met. The spiritual yearnings of all of humanity are fundamentally the same. We all want peace and prosperity, but to achieve such successes, strong lines of communication and understanding between various parties are required. Individuals, private enterprise and governments can all play a role in their various sectors and it is important that they do so to improve the quality of development of society and the economy, and create more linkages across borders to bring people together.

Finally, we have repeatedly stated in our magazine that business schools can also play a positive role in this development. I am leaving CKGSB with the hope that business schools or new kinds of institutions can find a way to help the next generation of leaders by providing them with an education that helps them focus on more humane development for themselves and the world around them, so that the technology-equipped people of the future will live in a truly more humanized and civilized world.

MEETING IN THE MIDDLE

The financial and political relationship between the Middle Kingdom and the Middle East is growing, but the traditional mainstays of oil and gas still dominate

Image by José Luna

By Shi Weijun

China is now the main trading partner of almost all Middle Eastern countries, exemplifying the growing relationship

The number of foreign embassies in the diplomatic quarter of Riyadh increased by one in June 2023, when Iran reopened its embassy after resuming its diplomatic mission to Saudi Arabia after seven years. The surprise détente between the regional rivals stunned the world—all the more because it was China that brokered the rapprochement.

The breakthrough mediated by the Middle Kingdom followed years of attempts by other Muslim countries, and a triumphant Beijing could barely contain its delight at having outmaneuvered the US.

The renewed relations were perhaps less of a Chinese coup than it appeared at first glance, as Riyadh and Tehran had their own reasons to defuse tensions, but the rare direct intervention nevertheless provided an important win for China as its first credible piece of diplomacy in the Middle East.

The success highlights China's growing clout in the region despite longstanding US dominance. Economic engagement is also on the rise—China is already the biggest trading partner for most of the countries in the Middle East and now suddenly the largest investor amid waning investment and growing hostility from the US and EU.

"The countries of the Arab Gulf—Saudi Arabia and the United Arab Emirates (UAE) in particular—are very important partners for China not only in energy but also in technological cooperation," says Dawn Murphy, author of *China's Rise in the Global South: The Middle East, Africa and Beijing's Alternative World Order*. "And China's economic approach to the region is very complementary to the vision that the Gulf states have for their longer-term economic development."

East meets East

Well before the Saudi Arabia-Iran deal, China had already established itself as a vital partner to the oil-rich Gulf theocracies and monarchies. The country is the biggest buyer of oil from Saudi Arabia, Iran, Iraq and the UAE, and Beijing has further cemented these relationships in recent years with comprehensive strategic partnership agreements.

With the exception of Iraq, these countries, along with Qatar and Kuwait, are also members or observers of the Shanghai Cooperation Organization, a political, economic and security forum founded by China, Russia and four other countries.

China's relationship with the region extends beyond just energy, due in large part to its Belt and Road Initiative (BRI), launched a decade ago aimed at better connecting Asia, Europe and Africa through a China-backed network of ports, railways, highways and other infrastructure projects.

"The BRI has been the catalyst for enhanced connectivity, facilitating infrastructure development and trade linkages," says Gan Mei, director of China business development at PwC Middle East. "The Middle East's strategic geographic location has positioned it as a vital hub within the BRI framework, further boosting trade between China and the region."

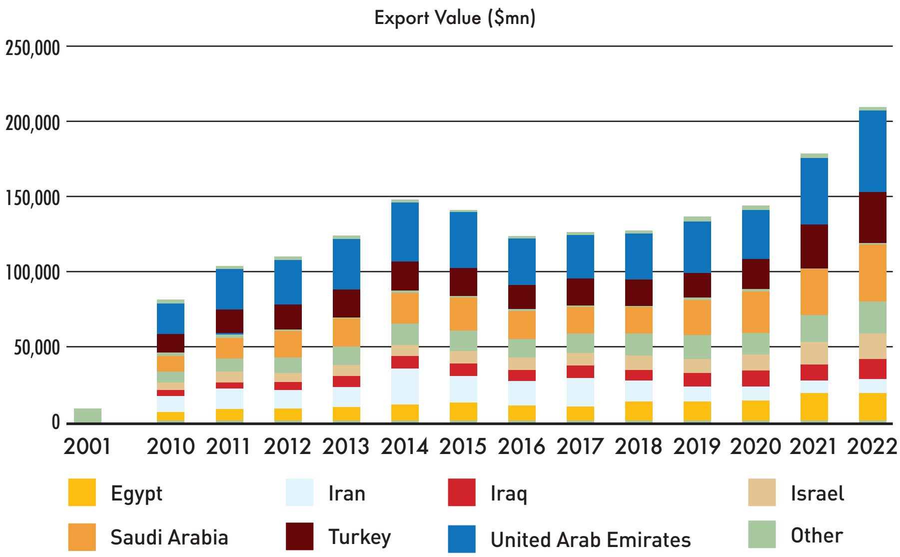
Beijing built the $1.8 billion metro system in Mecca and is helping Egypt build its new lavish capital outside Cairo, although there are doubts over the latter's commercial potential. "Egypt is in deep crisis and many would argue that throwing money into Egypt is like throwing money into a black hole," says James Dorsey, a senior fellow at the Middle East Institute of the National University of Singapore.

"For China, what's attractive about the Middle East is that on one hand, there is the longstanding energy trade, and then on the other, the regional markets for Chinese goods and services are just as important as resources," says Murphy.

Bilateral trade between China and the Middle East nearly doubled in the five years from 2017 to 2022, from $262.5 billion to $507.15 billion. It grew by a record high of 35.7% last year, significantly faster than that of China's top three trading partners, namely ASEAN on 15%, the EU on 5.6% and the US on 3.7%. By comparison, US trade with the Middle East and North Africa increased much more modestly over a longer time span, from $63.4 billion in 2000 to $98.4 billion in 2021.

But China's outbound foreign direct investment (OFDI) in the Middle East is

EXPORTS UP | Chinese exports to the Middle East have been increasing since 2016



Source: ChinaMed

considerably smaller, reaching just $2.397 billion in 2019, and accounting for just 1.75% of China's total OFDI flow in 2019. That year, only the UAE ranked among the top 20 destination countries. But in 2022, China's direct investment in Arab states jumped by $2.62 billion or 13% year-on-year, while Arab states increased investment in China by $1.05 billion, a near ninefold year-on-year rise.

In December 2022, Chinese leader Xi Jinping visited Saudi Arabia for three days, during which he also held Beijing's first-ever summits with the Arab League and the Gulf Cooperation Council (GCC). Saudi Crown Prince Mohammed bin Salman described the visit as marking "a new historical era" in ties between China and his country.

Economic and trade cooperation have expanded in recent years to new frontiers such as aviation, aerospace and the digital economy, and fostered new growth resources such as green and low-carbon development, health and medical services, and investment and finance. For example, China's rapid advances in cutting-edge tech in recent years mean that Beijing can offer access to services like 5G connectivity through companies such as Huawei.

This aligns with Middle Eastern efforts to emphasize non-oil sectors such as renewable energy, clean technology, tourism and infrastructure, all of which provide China with a potential role. Saudi Arabia last year set a goal to boost the share of non-oil exports in non-oil GDP from 16% to 50% by 2030, while the non-oil sector already contributes more than 70% of the UAE's GDP.

"Several Gulf countries have relatively advanced economies in areas ripe for technological cooperation with China, such as artificial intelligence (AI), green technology and biotechnology," says Murphy. "There are many areas where China, given its desire to also advance in those particular sectors, finds cooperation with those countries to be particularly productive."

Saudi's eagerness to diversify reaped dividends in 2023 when $10 billion worth of investment deals were inked during a two-day Arab-China business conference held in Riyadh. Amongst the most notable was a $5.6 billion agreement between Saudi Arabia's Ministry of Investment and Chinese electric vehicle (EV) manufacturer Human Horizons Group to jointly develop cars.

Still, energy is expected to remain the main source of business between China and the Middle East for many years to come. In 2022, China imported 270 million metric tons of crude oil from the Middle East, representing 53.13% of total imports, while inflows of liquefied natural gas (LNG) topped 17.23 million metric tons or 27.1% of total volumes. Chinese demand for Middle Eastern fossil fuels shows no signs of slowing down either, as state-owned oil company Sinopec signed a massive deal in November 2023 for further supplies of LNG from gas-rich Qatar until the early 2050s.

A new balance of power

China's expanding economic footprint is butting up against longstanding US influence in the region, making the Middle East the latest battleground between the two superpowers. Last year, both Joe Biden and Xi Jinping visited Saudi Arabia and the surrounding region, but it is no secret that the current US administration and regional lynchpin Saudi Arabia do not see eye-to-eye. More broadly, Washington's staunch and unconditional support of Israel and unswerving animosity toward Iran have rankled Arab leaders.

"It certainly helps Beijing that China is perceived with less historical baggage than the US," says Benjamin Ho, author of *China's Political Worldview* and *Chinese Exceptionalism* and an assistant professor at the China Programme at Singapore's S. Rajaratnam School of International Studies. "Countries in the Middle East are also happy to keep the more contested issues outside the relationship in favor of a more transactional approach. The Middle East doesn't interfere in what is happening in China, and China doesn't interfere in what's happening in the Middle East."

The dynamics are providing an opportunity for China—historically not involved significantly in the Middle East's affairs—to grow its influence. Trade and investment partnerships in recent years have elevated ties between China and Saudi Arabia, Iran and Djibouti. The latter also hosts China's first overseas military base not far from the Bab al-Mandab Strait, a narrow waterway that is a critical artery for transporting goods between Europe and Asia.

Relations with Israel—a stalwart ally of the US in the Middle East—had also been on a steady upward trajectory since 2017, when Prime Minister Benjamin Netanyahu met Xi for the second time during a state visit that included the establishment of a China-Israel innovative comprehensive partnership. A second trip to Beijing by Netanyahu was scheduled for October 2023, but scotched by the outbreak of war in Gaza the same month. China's response to the conflict between Israel and Hamas has been cautious and diplomatic, and a historic pro-Palestinian stance and a refusal to condemn Hamas for its terrorist attack has not endeared Beijing to Tel Aviv.

"China's relationship with Israel right now is pretty tricky but I don't think the Chinese are worried about that too much unless the Hamas war ends up becoming long-drawn-out," says Ho.

China has looked to develop its regional presence in areas beyond business and trade. There has been security cooperation between Washington and Beijing in the Middle East, in the form of China's participation in anti-piracy efforts off the coast of Somalia in the Gulf of Aden. And diplomatic overtures led to an Arab-centric expansion of the China-dominated BRICS group in 2024, with the addition of Saudi Arabia, Iran, Egypt and the UAE.

Growing economic stakes

China's investments have increased in the Middle East in recent years, mostly centering on ports and infrastructure that have strategic value for ensuring safe passage of Chinese goods to Africa and Europe. Much of this has been channeled through the BRI, understandable given China's dependency on energy imports from the region.

"There are a broad range of sectors capturing Chinese interest but a definite standout is infrastructure development," says Murphy. Middle Eastern countries received $8.1 billion of investment and construction contracts from China in the first half of 2023, representing about 19% of the total for the six months, although it was down considerably from $12.3 billion a year earlier.

Chinese money is behind some of the Arab world's biggest projects under development. These include the Red Sea Gateway Terminal, a joint venture between China's COSCO Shipping Ports Ltd. and Saudi Arabia's Public Investment Fund to develop and operate a container terminal at Jeddah Islamic Port. Egypt—strategically located at the crossroads of the Middle East, East Mediterranean and Africa—has been a focal point too, as Chinese investment in Egypt rocketed by 317% from 2017 to 2022, while American investment during the same period slumped by 31%.

Iraq was the top recipient of China's BRI financing for infrastructure projects in 2021, with about $10.5 billion in construction contracts. China further sought to invest $10 billion in infrastructure projects in the Autonomous Kurdistan Region in northern Iraq.

Additionally, China was set to help reconstruct war-torn Syria. While Russia remains the dominant foreign power in Damascus, Moscow cannot compete with Chinese companies' impressive infrastructure record. But Chinese assistance in rebuilding Syria has not yet materialized since Bashar al-Assad declared victory in the Syrian civil war in 2018, casting doubt over Beijing's willingness to help.

"The Chinese really have not had much more than a trade transactional relationship with Syria," says Dorsey. "They may well be interested in ports but the Russians have a grip on that because of the military intervention in Syria."

A China-Syria strategic partnership was announced in October 2023, which will include Syrian participation in the BRI, but what will result from it is not yet clear.

Outside of megaprojects, Beijing also has big plans to extend its digital footprint to the region. The Middle East plays a prominent role in China's Digital Silk Road (DSR), under which Chinese companies have secured 5G deals with the GCC countries. Tech linkages between China and Saudi Arabia and the UAE have blossomed in particular—both countries have signed DSR memoranda with Beijing and are cooperating on telecommunications networks, AI capabilities, cloud computing, e-commerce and mobile payment systems, surveillance technology, smart cities and other high-tech areas.

"While China seeks to expand its role as a high-tech power and use data as a tool to promote economic transformation and development, Middle Eastern countries are increasingly looking to digitize and diversify their economies," says Murphy. Within its digital cooperation with the Middle East, China has become a prominent player engaging in joint research, technology transfers and knowledge sharing, Murphy adds.

But Washington is only willing to let this burgeoning cooperation develop so far. "You're starting to see the limitations

TOP TRADES | China now ranks among the top three trade partners for all Middle Eastern countries

China's trading role in the Middle East in 2021

No. 1 trading partner	No. 2 trading partner	No. 3 trading partner
Egypt, Iran, Israel, Jordan, Kuwait, Qatar, Saudi Arabia, Turkey, UAE, Yemen	Syria, Oman	Bahrain, Lebanon, Iraq, West Bank and Gaza

Source: ChinaMed

because on issues like technology and military cooperation, the boundaries are being set," says Dorsey. As an example, he cites G42, a leading AI company in the UAE, with a Chinese CEO, that said late last year it would cut ties with Chinese firms under pressure from the US. "It was forced to choose between access to US technology and dealing with China. That was a balancing act it was no longer capable of doing," says Dorsey.

Business beyond petroleum

Finance and capital markets are also emerging as promising points of cooperation. Saudi Arabia's first exchange-traded fund in Asia successfully debuted on the Hong Kong Stock Exchange (HKEX) at the end of November 2023, offering investors exposure to the Kingdom's $1 trillion economy and world's biggest oil company, Saudi Aramco. The debut came after the HKEX and the Saudi stock exchange signed a memorandum of understanding to explore cooperation in areas including fintech, cross listings and ESG.

There has been "substantial collaboration growth" in finance, agrees PwC's Gan. "Mutual investments, currency swap agreements—like the one worth $7 billion signed between China and Saudi Arabia in November 2023—and the establishment of financial hubs have further solidified economic ties, providing a foundation for enhanced economic cooperation and stability," says Gan.

China has stepped up efforts to court Middle East money, and investment is blooming, with Middle Eastern wealth capital topping up the funding of Chinese venture capital firms, and Arabian sovereign wealth funds (SWFs)—which together had more than $4 trillion of assets under management at the end of November 2023—are eyeing stakes in Chinese businesses. In June 2023, the head of the HKEX predicted that the China allocation of Middle East's biggest SWFs, expected to reach $10 trillion of investment capital by the end of this decade, would expand to 10-20% compared with just 1-2% now.

In recent years, Middle Eastern countries have also pumped billions of dollars into Chinese industry leaders. Near the end of 2022, Abu Dhabi Investment Authority, one of the world's biggest SWFs, became a top-10 shareholder in China's biggest coal company Shenhua Energy and its top gold and copper miner, Zijin Mining.

More deals followed in 2023. In June, the investment arm of the Abu Dhabi government paid $738.5 million for a 7% share of Chinese EV maker Nio, while Riyadh clinched the $5.6 billion deal with Human Horizons. Energy ties deepened the following month when Aramco completed a blockbuster ¥24.6 billion ($3.45 billion) acquisition of a 10% stake in Shenzhen-listed Rongsheng Petrochemical, which controls China's largest integrated refining and chemicals complex.

As Arab wealth flows into new areas of fruitful cooperation with China, it has been withdrawing from others that are struggling. "Real estate, including commercial and residential, used to be an area that attracted significant Middle Eastern investments," says Gan. "However, we have noticed that the new investments in this sector have slowed down, especially during and post-COVID-19."

But, energy, primarily oil, remains the key to the relationship between China and the Gulf. Of the $89.4 billion of bilateral trade between China and Saudi Arabia in the first 10 months of 2023, $45.56 billion or just over half was taken by Chinese imports of Saudi oil, according to customs data. It is a similar story with the UAE, as crude oil and LNG imports made up 29% of $77.7 billion in two-way trade with China over the same period. And with Qatar, energy exports comprised 68% of total trade of $20.4 billion. The recent slew of oil and gas deals means energy trade will only grow.

"It's an interesting dynamic because China is moving to alternative energy sources within its own borders and at the same time, through its cooperation with the Arab world, promoting a lot of green technology," says Murphy. "But there is a tension in that China is currently vulnerable in being so dependent on energy imports, and these countries being much too dependent on one particular resource in their broader economic portfolio. I think that's part of why China is attractive to them and why they're attractive to China."

Both sides are laying the groundwork for a future when China is less dependent on foreign oil and gas, and Middle Eastern states have diversified their economies away from exports of hydrocarbons. "This is why they focus much more on the other aspects of economic engagement, and having them as a foundation of relations going forward," says Murphy.

Cautious optimism

Israel's war against Hamas in Gaza and Houthi rebel attacks against shipping in the Red Sea are amongst the factors that could hold back greater Chinese investment in the Middle East. "Potential impediments might include geopolitical uncertainties and evolving global economic dynamics," says Gan. "Regulatory updates and cultural differences may also act as hurdles."

Still, there is an economic complementarity in China-Middle Eastern relations that suggests Beijing's regional clout will continue to grow, offsetting growing discord between China and the West. "If there is a rupture in relations between Beijing and Washington and/or Brussels, the Middle East and the Global South more broadly becomes much more important to China in the longer term, as a source of resources, markets and broader engagement," says Murphy.

While business ties are booming, Beijing will still want to tread cautiously in a region notorious for its complexity and high levels of tension and conflict. "The Middle East has never been an area where any kind of long-term engagement is possible," says Ho. "Its history of conflicts predates Chinese civilization depending on how far you want to look back."

"China is not going in with any kind of rose-tinted glasses," he adds. "For them, it's better to just go in for whatever interests are desirable, never think they will be permanent, and always be prepared to leave the region."

Funding Ambition

Zongyuan Zoe Liu, author of *Sovereign Funds: How the Communist Party of China Finances its Global Ambitions*, discusses the makeup of China's sovereign funds and how their purpose and investment strategies are shifting

One of the major parts of China's international financial statecraft over the past decade has been the development of the country's sovereign funds. Using these funds to leverage its foreign exchange reserves, the country has been able to shape global markets, advance the Belt and Road Initiative and funnel state assets into strategic industries such as semiconductors, fintech and artificial intelligence (AI).

In this interview, Zongyuan Zoe Liu, author of *Sovereign Funds: How the Communist Party of China Finances its Global Ambitions*, discusses the breakdown of China's sovereign funds, the balance of deployment both domestically and internationally and how the funds are dealing with an increase in investment screening in the US and EU markets.

Q. What constitutes the sovereign funds you discuss in your book and to what degree are they related to China's forex reserves?

A. The sovereign funds in the book include the China Investment Corporation (CIC), both its international arms, including CIC International and CIC Capital, and the domestic arm known as Central Huijin. The latter was established in the early 2000s for the purpose of stabilizing or recapitalizing Chinese state-owned commercial banks burdened by non-performing loans.

CIC as an institution was capitalized by China's foreign exchange reserves. But the way it was capitalized was very different from traditional commodity-based sovereign wealth funds, and this is why I refer to China's sovereign funds not as wealth funds but as leveraged funds. CIC is a good example because the process of setting it up involved the Ministry of Finance issuing special purpose bonds and using the bond proceeds to purchase foreign exchange reserves in order to capitalize CIC. So the whole process involves the use of explicit leverage and the expansion of the government balance sheet.

Aside from CIC, there is also the State Administration of Foreign Exchange (SAFE) which is the foreign exchange management arm of the PBOC. These two make up the state-affiliated sovereign funds.

Q. What is your view on the opinion expressed by some economists that beyond China's reported forex reserves, state banks also hold significant amounts of forex?

A. The PBOC, in their various statements and press releases, have made it very clear that China uses IMF accounting standards for

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foreign exchange reserves. This means that foreign exchange reserves refer to the forex assets managed by the monetary authority of a country, in China's case the PBOC, and those assets are supposed to be invested in liquid and risk-free or low-risk assets. In other words, if these foreign exchange assets are no longer managed by the monetary authority or invested in higher risk or risk-bearing assets or are illiquid assets, they are no longer counted towards the official reserves statistics. Therefore, following this standard, it's natural that the funds managed by the CIC or SAFE-affiliated investment funds, or for that matter China Development Bank or the Export-Import Bank of China, would not be counted towards official forex reserves.

Q. What is the trendline in terms of the size of China's sovereign funds and what do you expect the trend to be over the next five years?

A. I think the number of individual funds under the remit of CIC or SAFE will increase, in part because the funds are increasingly being used to finance industrial policy or help SOEs to achieve their purposes internationally. For example, through the SAFE co-financing office SOEs can borrow foreign exchange assets in the form of entrusted loans through designated commercial banks to get the foreign exchange money they need for their overseas M&A, or purchases of factories, mines and other natural resources. This business model of the sovereign leverage fund has led to the relative success of Central Huijin's domestic operations, as it is now the chief shareholder of more than nineteen state-owned banks, policy banks and insurance companies.

> A good relationship with one of the sovereign funds is a ticket into the market as well as providing connections you may not otherwise have

Basically, in the current era when industrial policies are becoming more widespread and a tool to increase a country's international competitiveness, the number of sovereign leverage funds is going to increase.

The size of assets under management (AUM) is also probably going to increase. When it was established, the CIC's initial capitalization was around $200 billion, but now it has expanded to somewhere closer to $1 trillion, and it was even at one point in the last few years the world's largest sovereign fund in terms of AUM. It is now number two, but its assets are still approximately the size of Saudi Arabia's GDP.

The other caveat here is that a very large amount of CIC's total AUM is under the purview of Central Huijin, and Central Huijin is only managing the domestic portfolio, depsite the large size of total assets, it doesn't mean that they are all within CIC's international portfolio. And in fact, if you look at that international portfolio, oftentimes it actually underperforms the S&P 500.

Q. What is the balance of deployment, both by region and sector, of China's sovereign funds and how has that changed in recent years?

A. Both CIC and SAFE have, over the years, developed both domestic investment funds and offshore funds. For SAFE, their onshore investment fund is called Buttonwood Investment Company and it was established for the purpose of capitalizing the Silk Road Fund. Through Buttonwood, SAFE provided about 65% of the initial capital for the fund, which in turn was established for the purpose of supporting the Belt and Road Initiative. This is a very good example of the shift in the function of Chinese sovereign funds. At the start they used forex reserves to capitalize things like Central Huijin for the purpose of preventing a financial crisis within China, and now we have seen the establishment of various funds for the purpose of things like BRI-related projects, so the functions have obviously changed a lot.

In terms of their global portfolio distribution, CIC and SAFE's international arms, in particular their American and European offices, are focused more on developed economies, and from publicly available resources you can see their investments are very much located in advanced economies such as the US, Canada, Germany and the UK etc. And they are invested in sectors such as public equities, real estate and infrastructure investment funds. However, the more specific funds, such as the Silk Road Fund, are invested mostly in infrastructure projects around the world related to the BRI because that is what they were established to do.

As for the domestic portfolio, Buttonwood has established four domestic investment arms that invest in Chinese public equities as well as supporting Chinese companies at home. But overall, in times of Chinese stock market volatilities such as in 2015, as well as more recently, people talk about the national arms as something that is used to stabilize the Chinese exchanges. The increase in SOE investment into the markets in recent months is not directly driven by the sovereign funds, but the money likely stems from them in the form of forex loans that were previously given to SOEs to support their overseas ventures.

Q. To what extent are the sovereign funds essentially large VC funds and how does the management and visibility of the sovereign funds differ from those of other major economies?

A. The CIC in particular as a brand is very much visible internationally, and they are also a voluntary signatory of the Santiago principle, regarding investment for strategic purposes. But Chinese funds often do invest for strategic purposes and that has become a point of tension, resulting in the increase in investment screening for Chinese investments by the US and EU in particular.

But I think that the SAFE-affiliated funds, from Buttonwood to all the various offices around the world, are not necessarily well-known publicly. Many of them don't even show up on SAFE's annual reports. But that does not mean that they are not important and they still manage a huge amount of money.

In terms of to what extent they function as large VC funds, I do think that in certain circumstances, especially for their investments in startups, you can say that they do behave very much like a VC. But unlike VC funds that invest in early stage companies, the sovereign funds, broadly speaking, don't invest in early stage companies, and are more likely to join in the second round of fundraising or partner with institutional investors such as Goldman Sachs. This is a bit more robust as it provides what is hopefully a better investment opportunity, both in terms of mitigating the investment screening risk and getting the deals done as some companies will be happy to take a longer-term investor, but others may be worried about strategic motivations.

Q. To what degree is some form of relationship with Chinese sovereign funds required for businesses to access the Chinese economy?

A. I would say that it is more desired than required, because the sovereign funds are premier institutional investors in the Chinese market, with a wide variety of connections throughout the system. Meaning that a good relationship with one of the sovereign funds is a ticket into the market as well as providing connections you may not otherwise have. But it's not something that every business can, or has to, have.

Q. To what extent do you see China's sovereign fund makeup and strategy changing over the next five to 10 years?

A. In terms of the international portfolio, I would expect to see a shift away from direct investment, with an increase in investing through joint investment funds. We are already seeing this happen in the context of CIC. CIC Capital, which was established for the purpose of making direct investment, has been re-merged back into CIC International because investment screening made this a much less tenable strategy. So we will see a lot of the relatively high-profile Chinese investment funds probably use more joint investment platforms.

> **CIC and SAFE's international arms, in particular their American and European offices, are focused more on developed economies**

On top of that, it is possible that all of China's sovereign funds are going to establish their own subsidiaries that have less of a public profile, again to mitigate the risk of investment screening.

In terms of geographical distribution, I still think that the US and EU markets are highly desired, but the deals are not necessarily as easily done as before, so perhaps they will shift more towards domestically-oriented investment. Especially now that investing at home is much less of a faux pas.

At the time of the Global Financial Crisis, it was a faux pas for sovereign funds to invest at home because the purpose was to invest counter-cyclically and to diversify away from oil and gas, which would have made up the large majority of domestic investments. But now the funds can be used to finance industrial policy, as they do around the world to some degree, and this will likely be the same for China, specifically in areas such as semiconductors, AI or quantum computing.

Interview by Patrick Body

MIXING IT UP

Chinese outbound FDI is shifting away from the West and towards the Global South

By Patrick Body

Image by José Luna

China's OFDI into the Global South has been focused mainly on infrastructure projects and resource aquisition

In 2022, a subsidiary of Chinese battery giant CATL signed an agreement that secured it long-term access to one of the world's largest nickel reserves. The Indonesia EV Battery Integration project that resulted, worth almost $6 billion, is emblematic of an increase in Chinese companies turning to the Global South to secure key resources, as part of a shift in outbound investment.

Overall Chinese outbound foreign direct investment (OFDI) is down around 30% from its peak in 2016, both due to domestic regulatory changes and growing geopolitical tensions. But with China's strict zero-COVID policy now behind it, the world's second-largest economy is returning to global investment, albeit with different targets in mind.

After China's accession to the WTO in 2001, Chinese OFDI was largely targeted towards the US and Europe, but that has declined dramatically, and while increased investment in the Global South has so far only made up some of the difference, it appears to be the future direction for Chinese OFDI.

From solar panel plants in Southeast Asia to mining projects in Latin America as well as a plethora of deals in Africa and the Middle East, Chinese investors, driven in part by the Belt & Road Initiative (BRI), are securing critical resources, broader market access and technology portfolios in an ever-changing global landscape.

"While China has continued to focus on securing resources, there have been a number of changes taking place," says Richard Bolwijn, Officer in Charge at the UNCTAD Investment and Enterprise Division. "There has been a shift in the modalities of how the investments are being made, an increase in infrastructure investment and a shift in geographical targets."

A new stage

The total amount of Chinese OFDI varies quite significantly, depending on which numbers you consult. The Chinese Ministry of Commerce (MOFCOM) statistics tend to be on the higher end of estimates, while others, such as the American Enterprise Institute, have reported numbers that are as little as one-third of MOFCOM estimates. But while the statistics vary, the trend of lower OFDI since 2016 is consistent.

Chinese overseas investment mostly began in the 1990s with state-owned enterprises (SOEs) buying natural resources that were in great demand in China, such as oil, timber and ores, in order to help control pricing and supply. As private enterprises boomed through the 1990s and spurred on by the introduction of China's 'Going Global' strategy in 1999 and the country's accession to the WTO in 2001, they too started looking for acquisitions outside of China, with goals directly related to their own individual business needs.

Then came the global financial crisis (GFC) in 2008, which the Chinese government saw as an opportunity for both "China Inc.," and the country's private enterprises, to buy up a wide range of assets in the West, including manufacturing and energy, at cheap prices. Outbound investment grew dramatically after the GFC, with Beijing further loosening investment restrictions in 2014, making approvals for the export of funds to cover the purchase of assets around the world relatively easy to obtain.

But this more laissez-faire approach was short-lived, and with the advent of China's own, smaller, financial crisis in 2015—with some estimates putting the amount of money leaving the country at more than $1 trillion per year adding pressure to the RMB exchange rate—the approval process became much tougher.

Wary of capital flight risk and the high leverage levels of many of the conglomerates doing the investing, and a high number of trophy asset acquisitions, the Chinese government adjusted its policy to a more cautionary stance after 2016 by tightening capital controls and stepping up supervision on companies' deal-making. Thanks to these policies, and a growing regulatory scrutiny abroad towards foreign investments in certain countries and sectors, Chinese OFDI fell to a low of $136.9 billion in 2019.

Prior to this, investments during this growth phase were targeted at the US and in particular the technology, real estate and entertainment sectors. According to a Rhodium Group analysis, the US alone was the recipient of $46 billion in Chinese investments in 2016—the year China's OFDI peaked at $200 billion.

Europe was also a target for Chinese investment, with an initial focus on Germany, France and the UK, but a growing spread among other countries on the continent. But again, investment into Europe peaked in 2016 at €37.3 billion ($40.21 billion). China's outbound investment in Europe (EU27+UK) hit a decade low of €7.9 billion ($8.8 billion) in 2022, according to a Rhodium Group report, and the numbers released by China's MOFCOM also show the lowest investment levels since 2016. And thus began a decline of investment in major Western economies.

"The decline in investment in the US and Europe was as much because of intervention from Chinese politics as it was Western politics," says Bolwijn. "Early on there was a push by the Chinese government to reduce outward investment when foreign exchange reserves started to dwindle. And today we see more reluctance on the part of Western politics to keep markets completely open to any type of Chinese investment."

Despite this drop, China remains among the world's leading investors, and in the first 10 months of 2023, official statistics placed total OFDI at $123.9 billion, up 5.4% on the previous year. But it is where the money is flowing to that comprises the biggest change from the 2016 peak.

Away from the West

As total investment slows down and the geographical and industry-specific focus of Chinese investment shifts, Chinese firms are increasingly investing in infrastructure projects and sectors aligned with the country's national development goals.

"I think China has always looked at outward investment strategically, and part of this is because so much of it could be driven by state-owned enterprises," says Bolwijn. "As a result, you can draw a line between their needs and the investments they make. They need market access, technology access and also to strengthen political links throughout the world."

While the decline in Chinese investment to Europe is largely due to changes in Chinese domestic regulation, European countries have also continued to increase scrutiny of Chinese investments across the board. By the end of 2022, all except two EU member states had investment review mechanisms in place or were in the process of establishing them.

By tightening investment screening measures, Europe is limiting investment into strategic technological assets such as semiconductors. In a related development, there was also heightened scrutiny of a Chinese investment into a port terminal in Hamburg, Germany, in 2022, but the deal was still approved by the German government.

While investment into the United States from China has also shrunk significantly, the US continues to maintain its position as the top national recipient of Chinese investment. But from a US perspective, China has gone from being one of the top five investors to being only a second-tier player.

The Committee on Foreign Investment in the United States (CFIUS) now strictly reviews Chinese investment into the US, especially in cutting-edge technology and critical infrastructure, such as semiconductors and telecoms systems. Looking ahead, headwinds are only likely to increase.

"China's global strength in high-end manufacturing products—smartphones, EVs, and renewable energy products—will inevitably seek global markets and are increasingly succeeding in MENA, Asia and Africa," says Shirley Ze Yu, Professor and Senior Practitioner Fellow with the Ash Center of Harvard Kennedy School. "The products have not been successful in entering the US and European markets due to trade restrictions and various sanctions on grounds of national security and human rights violations."

Investing in advanced economies generally brings investors increased revenues and higher profit margins, and M&A is often a quick way of increasing technological knowhow. But, growing geopolitical tensions and increased decoupling between China and the West—particularly the US—is dampening investment returns and hampering the further international development of many Chinese companies.

Embracing the new

Much of Chinese outward investment in recent years has been spurred on by the Belt and Road Initiative (BRI), and despite changes, it continues to be a driving force. "There was certainly a slowdown in the implementation of BRI projects a few years ago, mostly because of the concerns with debt problems," says Michelle Lam, Greater China Economist at Societe General. "But more recently there has been a pickup in BRI interest and projects, particularly in green investments."

Contrary to the fluctuating global trend in China's outbound investment, Chinese investment within Asia—especially Southeast Asia—has increased, surpassing the 2016 peak. In 2022, according to the MOFCOM Statistical Bulletin on ODI, China invested $18.6 billion into ASEAN countries, accounting for 11.4% of China's total outbound investment flows.

Singapore has historically been, and remains, the largest recipient, accounting for around 33.5% of the total ASEAN-bound OFDI, but countries like Indonesia and Malaysia in particular have seen a notable rise in investment since 2017. Thailand and Vietnam are also of growing interest to Chinese investors.

"In the ASEAN area, if you go back a decade, much of the Chinese investment was in mining," says Tommy Xie, Head of Greater China Research & Strategy at OCBC Bank. "While there is still a lot of that going on, there has been big growth in commercial services and, more noticeably, manufacturing."

The ASEAN manufacturing sector, particularly related to EVs and renewable energy, is the largest recipient of this investment, accounting for around 44% of the total. Carmaker Geely has invested in Malaysia's Proton, battery maker CATL entered into a joint venture in Indonesia to secure nickel supplies and produce batteries, and in 2022, four of the top five full EV car models produced in Thailand were Chinese.

"There are areas of overcapacity for some Chinese companies, and, for example, the prices of EVs and solar panels in China are very low right now," says Chim Lee, Analyst at the Economist Intelligence Unit covering China and Asia. "At the same time, many of these developing markets have similar ways of organizing their economies as China, so if companies are looking for a new market, these developing markets offer any number of opportunities for Chinese companies."

There has also been a growth of cash flowing to sectors such as critical raw materials processing and internet platforms, compared with the emphasis on conventional real estate and light manufacturing investment in past years. E-commerce in particular is a major target, with the non-food and beverage section of the market projected to triple in size and reach $230 billion in gross merchandise value by 2026, according to McKinsey & Co.

All of China's e-commerce giants have made some form of inroad into the Southeast Asian markets, with Tencent, Alibaba, Byte Dance and JD.com all either signing partnerships, launching products or setting up operations in various countries across the region.

"If you are a tech company in China, you are also looking for other areas in the world that have a somewhat similar style of economy as China that will provide good investment returns," says Lee. "As a result, we have seen a huge growth of Chinese e-commerce companies operating across Southeast Asia. For example, TikTok Shop has been hugely successful in Indonesia."

The Middle East has also seen an uptick in Chinese interest in trade, deals and investment, but it remains the recipient of only a small portion of the total OFDI. Investment into Middle East as a whole in 2022 was only around $2.62 billion.

"China has long been dependent on oil imports and that has dominated its trade with the Middle East in the past, but we're starting to see a wider range of trade sectors and an increase in bidirectionality," says Duncan Wrigley, Chief China+ Economist at Pantheon Macroeconomics. "For example, Saudi Arabia has a long-term ambition to diversify away from oil, and it also has a lot of spare money because of recent oil price surges, and as a result, we've seen an increase in bilateral agreements. As US private equity firms pull back from investing in Chinese tech startups, Saudi investment funds are considering filling the gap, with a mind to bringing Chinese knowhow and technology into the country."

There have been larger shifts in investment into other regions such as Latin America and Africa, which had the two highest increases in 2021, largely driven, at least initially, by the BRI. For example, China's annual flows of OFDI to Africa peaked in 2018 at $5.4 billion, up hugely from just $74.8 million in 2003. Despite a dip to $2.7 billion in 2019, recent years have seen a recovery and by 2021 it was back to around the $5 billion mark.

"One of the ways that we see Chinese OFDI recalibrating global supply chains is extending middle-to-low-end supply chains to the developing world, most prominently in ASEAN, Latin America, and increasingly in Africa," says Yu.

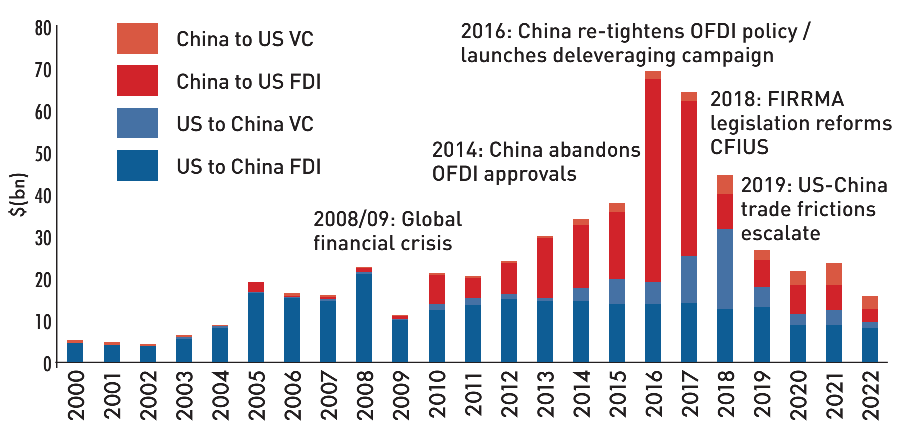
Chinese companies operate across a wide range of sectors in Africa, with around one-third involved in manufacturing—including resource production, a quarter in services and a fifth each in construction/real estate and trade. The split of Chinese OFDI by country largely correlates to China's resource interests with around three-quarters of the investment split between 12 resource-rich countries in 2020. Overall, according to McKinsey estimates, around 12% of Africa's industrial production is now done by Chinese firms and Chinese companies make up around 50% of the continent's internationally contracted construction market. For example, in 2022, Huawei technology constituted around 70% of Africa's 4G infrastructure.

"If you look at investments in rare metals such as nickel or lithium in the Congo, and elsewhere, China has just been a step ahead of everyone else, just faster and bigger," says Bolwijn.

For Latin and Central America, 2021 saw an almost doubling of investment from China, reaching $27.3 billion. Brazil was the lead recipient thanks to a huge investment in the oil sector, followed by Colombia, Chile and Mexico. Deals in the region are largely focused on natural resources, such as oil, but many of the investments in Peru and Chile have been focused on copper, and other mineral mining operations.

"Chinese OFDI in acquisition of energy, natural resources, and agricultural products are increasingly shifting from North America to Latin America and Africa, in response to the geopolitical risks," says Yu.

TRENDING DOWNWARD | Chinese-US investment has been trending rapidly downward since 2016



Source: Rhodium Group

Accepting change

The Global South's embrace of Chinese investment is no surprise. Compared with the reluctance toward Chinese capital in the West, local regulators, whether in Southeast Asia or Latin America, still mostly welcome Chinese investment. Governments in the developing world are also expressing interest in working with China as a business partner. Shifting production to countries such as its Asian neighbors and Mexico will not only offset high labor costs in China, but also enable Chinese firms to avoid trade tariffs, remain close to Western markets and even enjoy duty-free treatments.

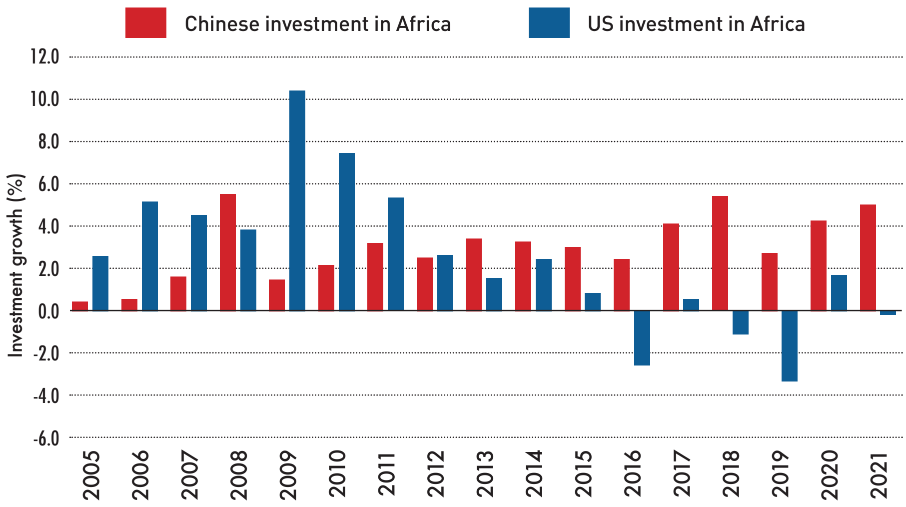
"It is very much the case that Chinese companies want to maintain access to the markets in Europe and the US, and we can see that in supply chain investments," says Lee. "China often remains a major part of the upstream supply chain, then a product is completed somewhere like Mexico, Turkey or Hungary, and exported to one of the Western markets. Although there is always the risk that the US or EU may scrutinize this process more."

"To some extent, the ASEAN markets have become something of a refuge for Chinese companies that want to continue doing business with the US population," says Xie.

Securing access to critical resources is of strategic importance for China—especially companies in renewable energy sectors. Metals such as copper, lithium, cobalt and nickel, are essential for solar photovoltaic, wind energy, electric vehicles and energy storage, and China is determined to ensure its dominance by controlling overseas mines containing critical minerals. But there are several examples of larger countries being more demanding with their side of potential contracts in order to ensure a certain level of local development from Chinese investment, rather than simple resource extraction.

"We see, for example, Indonesia and some Latin American countries setting up barriers in terms of exporting materials, requiring Chinese players to set up some processing plants locally," says Lee. "This is mostly to ensure that they provide economic value locally, rather than just going in and removing the resources."

TAKING THE LEAD | Chinese investment flows into Africa far outpace those of the US



Source: CARI

The significance of the shift in China's investment pattern does not stop here. In many cases, particularly in Africa, China is trying to foster local markets through its investment strategy and grow together with the developing countries. By doing so Chinese companies have the chance to get in on the ground floor of new markets, with little competition. China's ambition is to invest in the infrastructure and industry sectors in the BRI countries, drive economic growth, and ultimately increase the consumption power of the local population.

"Taking the renewables market as an example, if you want to expand the sales of that kind of infrastructure, you also need to build the energy infrastructure to deliver the grid space," says Bolwijn. "That can also lead to building more ports, airports and roads to build power infrastructure. It is synergistic in a way because if you want to be successful in certain areas, you need to expand in others."

By being a part of market development rather than simply a participant in the market, China wins preferential access to contracts, consumer goodwill and even soft power influence.

A wider issue

While investment continues at a lower level into the West, the shift towards developing markets for China's OFDI is a reflection of a wider decoupling and looks set to continue.

"The tensions with the US and to a lesser degree Europe, have highlighted the need for China to become self-sufficient in some areas, but realistically it cannot be completely isolated," says Wrigley. "This has resulted in a diversification of investment, trading and political links and the promotion of its currency."

Lam agrees. "The trade difficulties in 2018-2019 were a turning point, which pushes the government to focus more on security and I don't think that priority will change in the near future," she says. "One thing it may mean is that some of the investment targets China is approaching will have to think about choosing sides."

China is taking a more holistic approach to its OFDI, looking to play a part in the creation of markets rather than simply being a participant in already developed markets, but the shift will be neither quick nor easy.

"In the short term, it's very difficult to replace developed markets as investment targets," says Wrigley. "But if you look a few decades down the road, then it does become more plausible that some of these developing regions can be equally important for China as the most developed markets currently are, for both trade and investment flows."

The Underlying Logic of Customer Growth

Acquiring new customers is important, but in the long run, consumer stickiness is more critical to the growth of an enterprise's user base

by Liu Jing, Professor of Accounting and Finance, Cheung Kong Graduate School of Business

For a business to be profitable, revenues must exceed costs. Where revenue is a prerequisite and comes from outside the business, the most important driver of cost is productivity and comes from within the business. Because revenue comes from customer payments, having a large number of quality customers with the ability and willingness to pay is a basic prerequisite for a profitable business. So how do you gather and maintain a large number of quality customers?

The ability to acquire new customers is certainly important, but a more critical factor is creating stickiness with your customers. If a business has a high level of customer stickiness, old customers are retained and new customers are more likely to stay. In the short term, the ability to acquire new customers is very important and the effect of stickiness is not initially obvious. But in the long run, the most important factor in determining the size of an organization's customer base is consumer stickiness.

The reasoning behind this is very similar to that found in investing. In order to build wealth, you need capital in the form of principal and return on investment (ROI). The more capital and the higher the return on investment, the greater the wealth that will be accumulated in the future. In the short term, the capital determines the size of the increase in wealth, but over time, the long-term accumulation of wealth is determined primarily by the ROI and has little to do with the size of the added capital.

The role of principal is temporary, the role of ROI is long-term and continuous. The stickiness of a business to its customers is also long-term and continuous, and thus is the most important factor in determining the size of a business's customer base.

Perspectives on Stickiness

To analyze how companies can increase customer stickiness, we can look at it from both the customer's and the enterprise's perspectives. Our purpose in writing this article is to show that the customer's perspective is more fundamental and clear, while the enterprise's perspective is derivative and relatively vague, which is not conducive to analyzing the problem.

If a company wants to have customers, from the customer's point of view they must be deeply bound to the company's products, which includes services. This binding has an active component, a passive component and a psychological component.

The active binding of customers to a product happens because the quality of the product is satisfactory: the product not only meets the needs of customers, but its cost is attractive compared to that of the competition.

Quality here refers to the customer's overall experience of using the product, which also includes the buying and after-sales service experience, because consumer demand ultimately relates to both service and experience, the product is only a part of the service. Product quality and price are equally important.

With the exception of luxury consumers, customers generally want high quality and a low price. But, if this is not possible, customers who emphasize quality will naturally concede on price, and customers who emphasize price can also lower their requirements on quality. Different consumer groups have different requirements on quality and price, so enterprises can find core users through the correct positioning between the two. Obviously, enterprises that are uncompetitive in both will lose favor with their customers and therefore run the risk of being eliminated.

It is also possible that some less-competitive firms will survive for a period of time due to customers becoming passively bound to the product. The most prominent case is where a company's product has created some form of monopoly in a market segment, with no legitimate alternative. For example, the manufacture of semiconductor chips with high-end photolithography requires machines that only the Dutch firm ASML can produce. So, even if customers were to be dissatisfied with its products, services or prices, they do not have any other options.

It is also possible for this to happen if the cost of replacing a product is too high, despite there being numerous competing products in the market. In the business field, software can be a very sticky product. Long-term use of software can result in the accumulation of a large amount of data and knowledge assets within the system, meaning that the cost of abandoning the old software for a new system is more than just the price of buying new software. It can also incur data migration and personnel learning costs. Comparatively speaking, the replacement of hardware is much simpler, as costs arise mainly from purchase price and installation costs.

These two ways in which customers are bound to products are based on the rational analysis of customers, but customers are not always rational in their choice of products. Choice is a product of human thinking, which is not entirely rational.

The human brain's ability to compute and store information is limited, so when people make choices, they naturally favor products that are easy to understand, familiar to them and easy to obtain. In the same vein, they will avoid products that are not well understood or are difficult to obtain.

In addition to the limitations of arithmetic power and information storage, human thinking is also emotionally influenced, and fluctuations in feelings and rational thinking do not completely overlap. Thus, there is both a rational and emotional component in the process of making product choices. For example, when Coca-Cola advertises it always links drinking Coke with happy times, while Nike always binds its products with the thrill or adrenaline of sports.

> If we look at consumer binding from the enterprise side, there are four key factors to analyze: product, price, channel and brand

While rationality applies to product decisions based on function, quality and price, a product's story, aesthetics and related customer service will appeal to the more emotional side of decision-making, often being more effective in eliciting customer stickiness.

It is because of this psychological binding of customers to products that effective product design, advertising and promotion by enterprises often does not focus entirely on the function or ease of use of products, but rather tries to connect with customers emotionally.

Luxury goods are a unique commodity, as they bind themselves to customers mainly through their impact on consumer psychology. There is no doubt that consumers demand quality from luxury goods, but this is because the main function of luxury goods is not practical, but to satisfy the psychological needs of consumers.

Luxury goods often convey a complex set of messages, an expression of success, a symbol of social status, the realization of personal values and so on. These attributes require that luxury goods not only be of impeccable quality, but also carry a high price point, because the exclusivity this brings is what really distinguishes consumers from each other in this sector.

In order to strengthen this exclusivity, luxury companies, in addition to setting jaw-dropping prices, often launch limited edition products that are not readily available even to customers with spending power. Instead of losing customers, this kind of hunger marketing can increase overall revenue and profits.

So why haven't other businesses emulated this higher-price model?

There are of course countless companies trying to do a similar thing, but very few are successful because although replicating quality, price and consumer experience is possible, the defining elements of luxury

Going live: Livestreams are increasingly used for product advertising in China

goods, such as storytelling, culture and societal recognition, take a long time to build. Without decades of hard work, combined with being in the right place at the right time with the right people, it is almost impossible to build a world-class luxury brand.

Stickiness from Economic Costs Drives Competitiveness

If we look at consumer binding from the enterprise side, there are four key factors to analyze: product, price, channel and brand. These four dimensions try to describe enterprise stickiness to consumers from the enterprise point of view.

These four dimensions have a high degree of overlap with each other, and thus are prone to confusions and misjudgement in analyzing issues. It is because of this, and the fact that the three dimensions of consumer stickiness that apply from the consumer's perspective are independent of each other, that leads us to the conclusion that the latter is a superior analytical approach.

For example, take the relationship between the product and the channel.

If we understand the product as including the overall consumer experience, it is easy to see that the advertising channel is a very important part of the overall experience. Even if the product quality is good, if the channel's ability to reach consumers is poor, consumers are not likely to buy the product. The same can be said for after-sales service. If it is not good, the overall product experience will not be good, making it difficult to produce active binding.

There is also a very strong correlation between the product and the brand.

Without a good product, there is no way to talk about brand value. But having a good product does not necessarily lead to a high brand value. A brand is not just about quality, it also has to have consumer familiarity with the product, an emotional connection between the product and the consumer, a story and a cultural component and so on.

Then there is the relationship between channels and brands.

For a company to gain market share, both must work together to be effective. If a company's brand is strong but its channels are weak, the company may either not be able to reach some of its key customers, or its customer service may not be adequate, and it may therefore encounter difficulties in expanding its market.

If a company's brand is weak but the channel is strong, the company's products are unlikely to have a good reputation. And if the products are indistinguishable from competitors' products, they may not be attractive to consumers, thus losing the opportunity for growth. Therefore, if a company encounters difficulties in marketing, it could be either a branding problem or a channel problem, or of course, it could be a problem with both.

The perspective of the firm is most likely to overlook the passive bonding of the customer to the product. This stickiness comes from the firm's most basic business strategy, i.e., what products give the firm a local monopoly or high replacement cost, rather than from the marketing strategy itself. This stickiness, which comes from economic costs, can be more powerful than active and psychological binding, and is therefore often the core driver of a firm's long-term competitiveness.

For example, if we look at the cell phone industry, there are many well-known brands, including Apple, Huawei, Samsung, Xiaomi, OPPO, vivo, etc. Each brand has its own characteristics, but the most important factor that generates great stickiness for consumers is the operating system these phones use.

Before Huawei launched HarmonyOS, it was a competition between iOS and Android, so it was also a competition between Apple and Google, with all the other brands effectively on Google's side of the competition. Now that Huawei can't use Android, it has to start its own and has come up with the standalone HarmonyOS. If Huawei succeeds, it is bound to fundamentally change the competitive landscape of cell phones and a range of smart products. Such an important thing for increasing customer stickiness is not visible from the four-dimensional enterprise perspective of product, price, brand and channel. But looking from the consumer perspective, it is a key issue to be addressed.

It is for these reasons that it is clear that conducting analysis from the consumer's perspective is best for companies that want their products to stick with consumers.

Translated by Patrick Body

Defining Human

Wang Yijiang, Professor of Economics and Human Resource Management at CKGSB, discusses violence as the fundamental driving force behind societal development and the implications that it has for the modern world

The nature of humanity and its underlying motivations have been a source of discussion for millennia. There are many different philosophies, with some saying that humans are simply animals with a language, others that we are animals with tools or that we are unique beings with beliefs and spiritual goals. In his recent book, *Defining Humans: A Violence-Centric and Structured Approach to Human Development*, Professor Wang Yijiang puts forward the idea that all of the different approaches to human nature are centered on the simple, fundamental idea of violence and the need to survive and that we need to accept the violent nature of the world as a fact in order to deal with the issues and challenges of the modern world.

In this interview, Wang Yijiang, Professor of Economics and Human Resource Management at CKGSB, discusses what defines a human being, how violence underpins the development of different cultures and belief systems and the implications of his philosophy on how we view economic and market relationships.

Q. What would you say defines a human being?

A. A driving force of human evolution is violence, i.e. humans evolved in a violent world and needed to develop as much a capacity for violence in order to survive attacks by violent animals as well as fellow humans. Such a capacity is made up of physical, social and phsychological aspects.

One way to define a human is a three-ring model, with each of them representing a particular type of existence of a human being. The first ring describes the human as a natural being, similar to all animals, in which we have two essential conditions: we need food to survive and to reproduce. The second ring describes our social beings. We all belong to social groupings of one type or another. Nobody can survive in this world unless they join a group and fight and work together. The third ring discusses our internal being, consisting of our psychology and spiritual existence, our knowledge stock and our beliefs. A human being is the [result of the] coexistence of these three things, but the question is how they relate to each other.

The answer is, that because food and sex for reproduction are scarce resources, we want to aggregate as much of these as possible. But given their scarcity, one must distinguish oneself in some way to access them. And I believe that those who are more violent prove to be more successful in doing this, and that people fight to prioritize themselves in this area of distribution. But as individuals we are not necessarily the strongest creatures in nature, so it is those who are better organized that can succeed and this is why we need to be social to continue our existence.

Q. Violence in the form that most understand it makes sense from an evolutionary standpoint, particularly in the first ring, but how would you say that violence manifests itself in the social or spiritual realms?

A. It extends from the physical violence required to survive throughout history. We needed to protect and support ourselves via the use of, say, a tribe in years gone by, and we are now simply further down the evolutionary line. As human civilization evolves, we have seen the growth of larger and larger social groups, from tribes, to primitive forms of government, to modern states, as well as religious groups and so on. Each of which has some history of violence with others.

One basic fact about violence is that those who are part of larger groups tend to have advantages when people start fighting each other. And those more capable of forming and managing larger social organizations to do so, are whoever has a higher understanding of social relations and the world around us. In other words, it is our consciousness and knowledge stock that allow us to better form and manage larger social groups, as well as allow us to ask questions regarding why this violence exists and what it is used for.

Q. There has been a rise in loneliness in younger people as well as a drop in birth rates in many countries around the world. To what extent are these challenges to this natural grouping?

A. Most of the time throughout our evolutionary history, having too few people has been the main challenge for the survival of existing groups. This means that all social goals were in some way designed to try and expand numbers. But today, we have suddenly reached a point where human survival doesn't seem to depend as much on how large a group you have, and we are in a position where the assurance of survival is present—unless you are a victim of a crime or an illness, you are likely to survive through life—so people are choosing different approaches than before.

These are certainly new challenges, and we don't have a clear roadmap of where human development is going today. The development of AI, for example, is a potentially fundamental shift, one that we haven't really seen before.

Q. How would you say that these characteristics differ depending on cultural contexts?

A. I think all human cultures serve the same purposes, and this is defined by our need to survive. For example, all cultures teach us how to deal with other people in the same social groups, as well as those who are not in those groups. We are taught to be honest, friendly, altruistic and so on, all ingredients needed for a group to stay strong and better cooperate in fighting for survival.

The main difference may be that how to achieve that kind of relationship may be taught differently depending on cultures or ideas behind the social group. For example, many religions utilize the idea of people in the grouping being children of God to justify bringing that particular group of people together. Whereas Chinese traditional culture guides people's relationships using the idea of *Sāngāng Wǔcháng* (三綱五常), or three fundamental bonds and five constant virtues. The bonds emphasize the importance of relationships including that of father and son, while the virtues are ideas such as benevolence or trustworthiness.

These are both slightly different sets of moral principles, and there are many others around the world, but they all serve the same purpose, which is to promote internal coherence and unity so that a group can better fight other groups.

As individuals we are not necessarily the strongest creatures in nature, so it is those who are better organized that can succeed and this is why we need to be social to continue our existence ”

Q. We live in an increasingly interconnected world with more communication tools than ever. How would you say that this has affected the separation of cultural contexts?

A. A major change is that people now largely have the option to decide which group they belong to. In the past, if you were born into a tribe, you would stay there. But today, there are options to change your nationality or your religious beliefs. As people take in more information and are influenced by others, their eyes are more open to look around and decide which group fits them best, where they feel they belong and can contribute more. The US is a good example, with people from all over the world moving there to join the group and become Americans.

Better communication allows people to better understand each other and see things from different perspectives. However, control of technology has a significant impact in this area, and algorithms can have an influence on what you see and how you see it, changing the way you see social groups as potentially friendly or hostile. The impact of technology on relationships within and between groups is hard to measure and it can be both a positive and negative, it really depends on who controls it.

> Algorithms can have an influence on what you see and how you see it, changing the way you see social groups as potentially friendly or hostile

Q. As a professor of human resources, what do you see as the business implications of these ideas?

A. In terms of economics and management, what this philosophy tells people is that there is probably never a pure market relationship, nor a pure economic relationship. All relationships have their political and social aspects, and in order to make effective business, economic or management decisions, we need to keep in mind these aspects, rather than looking at them purely through the lens of the market.

Technology, AI, semiconductors and other similar businesses are also good examples of game-changers, because they are very closely linked to geopolitical differences. Not very long ago, the world was looking at all the benefits of increased globalization such as improved efficiency and resource allocation resulting in a better life for most people. But now that people have started to do better economically and they have more resources, how are they going to be used? It has political and strategic implications on the world and determines who is going to be the dominant force. Clearly this is not just a purely economic issue and the thinking switches from globalization for better efficiency to how to prevent others becoming stronger than oneself.

From a management perspective, when thinking of human motivation, we often turn to Maslow's Hierarchy of Needs, which suggests more material means to motivate those on the lower levels (e.g., people with lower incomes) and more social and spiritual motivations for more successful people.

My three-ring model suggests that all humans are born with all three needs—i.e., material needs for physical survival, social needs for recognition and acceptance, as well as psychological needs for dreams, ambitions and creative thinking, all simultaneously exist in every human at the same time. Great leaders and great organizations are those who can wake up people's dreams and persuade them to pursue their dreams rather than motivating people only with material incentives and moving up Maslow's hierarchy only after people's material needs are satisfied.

Q. How can these concepts and ideas be used as tools to deal with current global issues?

A. Well, to some degree I think that although these ideas and research findings can help illuminate how and why we act in certain ways, it is unlikely that we can unpick the natural laws that have governed humanity throughout our history. People will continue to build their social groups in order to protect themselves from violence and at a certain point, they might use the tools they have created for more than just defense. The only real hope that we have is a greater use of the tools provided by the aspects of our third ring of being, our psychological and spiritual selves, and to try and help rationality to prevail.

Interview by Patrick Body

ECONOMIC REFURBISHMENT

China's economy is facing headwinds and there is a growing feeling that reforms are needed, but what exactly these changes should be is still under debate

By Sean Williams

Image Jamie Stevenson

There are a number of reform options available to help China deal with its economic headwinds

Predictions about China's economy and its trajectory have polarized observers in recent years even at the best of times, but a rare moment of near unanimity occurred late in 2023 when leading global institutions and prominent forecasters took turns to downgrade their growth outlook for the world's second-largest economy.

At its annual meeting in early October, the International Monetary Fund (IMF) said it expected China to grow by 5% in 2023 and 4.2% in 2024—less than previously predicted—due to a moribund real estate market and weak external demand. The cuts came after two out of the 'Big Three' credit ratings agencies, Fitch and S&P Global, also lowered their growth expectations. The third agency, Moody's, maintained its projection for 2023 but slashed its 2024 prediction the sharpest out of the trio.

Less than a month after its downbeat outlook for China, the IMF upped both estimates by 0.4%, reflecting improved prospects after an upbeat Q3, and there are still some players, including some Wall Street banks and China forecasters that are more positive. It is also important to remember that reported growth of 5% would be considered solid in any other economy. But there is clearly an unusually high level of uncertainty in China's economy, which enjoyed fast and virtually uninterrupted growth for the past 40 years.

China's economy is still searching for more stable footing, and prospects for 2024 and beyond are darkening. Lackluster growth driven by a deep and sustained real estate slump has led to renewed calls for reforms to address long-standing imbalances and unleash new growth drivers. But there are a number of different ways to go about reshaping a country's economy and experts are divided on how China should approach its problems.

"China is now being urged to transition to a demand-driven model, but unless there are structural reforms to enable the economy to sustain the transition, it just won't happen," says Alfredo Montufar-Helu, head of the China Center for Economics and Business at The Conference Board, a US-based private research group. "When countries don't have that structure, they fall into the middle-income trap—like what happened in Latin America."

The Middling Kingdom

The challenges stressing China's economy are numerous and formidable, ranging from a sluggish property market and trillions of yuan in local government debt, high urban youth unemployment, weak consumer confidence and spending, declining appeal for foreign investors and rising trade protectionism. And China has little time to waste.

"We actually project that without structural reforms, medium-term growth in China could fall below 4%," IMF managing director Kristalina Georgieva said in September 2023, urging Beijing to shift toward a consumption-based growth model.

While the list of obstacles is daunting, China has proved resilient, having weathered the Asian Financial Crisis, the Global Financial Crisis, the one-off yuan devaluation shock in 2015, and the initial COVID outbreak nearly four years ago.

"The key difference this time is there are no reforms that are relatively easy to implement to act as growth drivers," says Linda Glawe, author of *The Economic Rise of East Asia*. "Innovation-based growth is more difficult to achieve."

While Beijing has managed to adroitly sidestep shocks to the system in the past, it is in uncharted territory this time as there is no precedent for an economy of China's size and governance system facing so many headwinds simultaneously.

The country's economy is highly centrally controlled, which is an enormous advantage in the good times but poses a problem when the economy is struggling. Economists also point to China's history of cycling through centralization when control is tightened, and decentralization when an easing-off enables reforms. Chinese society and politics have arguably been in a lengthy cycle of tightening since an important party meeting in 2013, which pledged significant market reforms, most of which have not been implemented.

"What we've seen since then is not only

that control and power have actually been further centralized within the Party," says Montufar-Helu. "There are many reasons why this transpired, but it tells us that reforms will be implemented on China's own time and in line with China's own development priorities, and a Western-style market economy is not one of them."

Reasons for cheer

The longer-term challenges do not mean it is all doom and gloom for the Chinese economy as Beijing has managed to cultivate several new growth points. For instance, China leads the West when it comes to many clean energy technologies, and Chinese automakers have taken pole position in the fast-growing global electric vehicle (EV) industry.

China's current EV leadership complements its stranglehold over technologies critical for the energy transition such as solar photovoltaics, wind turbines and batteries for EVs and energy storage—a grouping known as the 'new three' that has become a market buzzword.

The world's biggest clean energy producer and consumer already controls 80% of the global solar market, occupies 60% of the market for wind turbines, and produces three-quarters of all lithium-ion batteries. And with China's installed solar and wind capacity on track to reach 1,200 GW by 2025—five years ahead of schedule—the country will continue to be a clean energy superpower with a manufacturing base that underpins renewables rollout in the rest of the world.

Other bright points that will help China overcome its issues include digitalization and artificial intelligence (AI) deployment. Greater AI implementation in industries ranging from automotive, transportation and logistics, to manufacturing, enterprise software, healthcare and life sciences could create $600 billion of new economic value annually in China, according to McKinsey.

"A combination of automation, digitalization and AI is not a panacea to solve all of China's problems, but it could be a good step in the direction of an innovation-based growth strategy," says Glawe. "If China could then solve its other structural problems one by one, I would be quite optimistic in the long run."

But Chinese dominance in future-facing industries has also put it in the crosshairs of other governments. Following an influx of cheap Chinese EVs into Europe this year, the European Commission (EC) is formally investigating imports of EVs made in China to check if they benefited from unfair state subsidies. The probe, which China's Commerce Ministry has opposed, could lead to tariffs to protect European automakers against cheaper imports. The EC also plans to scrutinize subsidies for foreign wind turbines, which would similarly ensnare Chinese models.

And while Beijing has touted the performance of new growth drivers, it is unlikely that they will be enough to replace the 'old three' growth drivers of property, infrastructure and manufacturing that propelled China's economic rise.

Reforms to the rescue

Reforms could be the antidote to securing the high-quality development that Beijing craves, and while the recovery could be bumpy, it could also provide opportunities for further reducing financial risks, strengthening the social safety net and implementing market reforms to encourage private investment—all of which could address long-standing structural changes.

1. Tax

An overhaul to China's tax and fiscal system so it is more reflective of a modern major economy is much-needed and could be achieved via a carbon tax, property tax or broader application of personal income tax. Tax revenue equaled 21% of China's GDP in 2021, compared with about 27% in the US, and less than 10% of China's population pays any income tax at all.

"The necessity [for fiscal system] is self-evident," says He Wei, China economist at Gavekal Dragonomics. "The local government funding situation is not looking good and land sales are unsustainable, so China needs to find other sources to plug the hole."

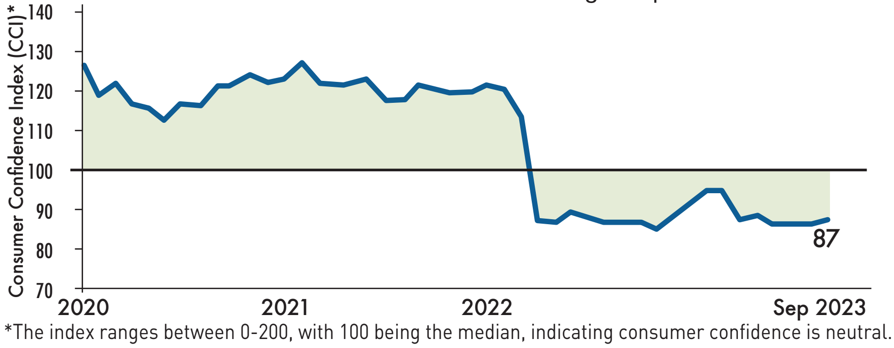
The financing problems affecting the real estate market and local governments are interrelated and stem from "a structurally misaligned fiscal system that not only failed to generate adequate revenue, but also does not match the revenue needed with the expenditure responsibilities of local governments," according to Michael Pettis, professor of finance at Guanghua School of Management at Peking University and a senior fellow at the Carnegie Endowment for International Peace. "The central government gets most of the fiscal revenue, but local governments are burdened with the bulk of the expenditure responsibilities."

This means any expansion of the tax base to boost revenue for local governments would need to be paired with a rethink of their general economic functions.

2. Finance

Another possibility is the reform of China's financial sector, worth ¥449.21 trillion at the end of June 2023. Domestic banks, almost all state-owned, can currently count upon a huge cushion of savings that included ¥135 trillion of personal deposits at the end

IN THE DOLDRUMS | Chinese consumer confidence is struggling to rebound after a huge drop in 2022



*The index ranges between 0-200, with 100 being the median, indicating consumer confidence is neutral.
Source: McKinsey & Co.

of September 2023, but if China wants to rebalance toward consumption-led growth, this buffer will have to decline. Lowering total savings first requires improved asset allocation choices.

There are several options for deeper reform of China's financial sector, including a diversification of the bank-dominated system and the de-linking of local governments and local banks.

3. Employment

China's decades-old policy that lets women in some jobs retire as early as 50 and men at 60, is also ripe for change. Raising retirement ages would temporarily reverse a contraction in the working-age population, which has declined annually to 875.56 million in 2022, since peaking in 2011.

The State Council said in February 2022 that China would "implement a gradual extension" of the retirement age by the end of 2025, but authorities have yet to announce any formal adjustments. Although it would be deeply unpopular, Wong Yong, academic deputy dean of the Institute of New Structural Economics at Peking University, believes a hike could be the most immediately consequential reform that Beijing could implement.

"This is not just one option, but the only option," he says. "China is aging and the official retirement ages are absurdly low. It is imperative to increase them—it's just like the one-child policy, which should have been abolished much earlier, but was not done until it was too late."

Another proposed reform that has been front and center in recent years is the relaxation of China's *hukou* system, a household registry that makes it difficult for rural residents to obtain social benefits in cities, thereby preventing them from moving permanently. Equalizing urban benefits could transform the lives of up to 180 million migrants, enabling them to access basic services and social welfare tied to their *hukou*.

The idea has considerable backing in Beijing—former People's Bank of China (PBOC) governor Yi Gang said in September 2023 that *hukou* reform should be advanced as research has shown it could boost consumption among migrant workers and new arrivals by 23%.

4. Welfare

Shrinking the divide between haves and have-nots in Chinese society would encompass welfare reform too. China's current social safety net favors urban white-collar workers. Only around one-third of the working population was covered by their employers for unemployment insurance at the end of September 2023.

Behind China's massive household savings is the overall cautious attitude toward spending, which also has a big impact on consumption.

"If China really wants to have a sustainable recovery in consumption, it needs to reduce its population's need for precautionary savings," says Montufar-Helu. "But in order for this to happen, governments have to provide a structure that gives people confidence. For example, a strong social security net and robust pension system, which China does not have. Neither does it have equal access to high-quality healthcare and education services across all of the country. But they are all essential to increasing confidence."

5. SOEs

China's state-owned enterprises (SOEs)—which included 27 out of the world's 100 biggest companies by revenue in 2022—have undergone a series of progressive reforms since the 1970s aimed at remaking them into more modern corporations. The SOEs are a critical part of China's economy and there is broad agreement that they perform poorly overall.

"In the past SOEs were encouraged to expand, their size mattered," says He. "More recently, there has been more emphasis on profitability. But SOEs exist in China for a reason—they're not purely market-driven institutions rather they need to contribute positively to society, so there is a certain limit on how far SOE reforms can go."

6. Private Sector

China's economic malaise this year has highlighted the importance of the private sector, which contributes over 50% of tax revenue, 60% of GDP and 70% of technological innovation achievements.

Low confidence levels among cautious entrepreneurs and private business owners, coupled with skepticism of Beijing's friendliness toward the private sector, spurred the State Council to issue a 31-point plan in July 2023 to revitalize the private sector, pledging to build a "bigger, better and stronger" private economy.

More support to shore up confidence came in September 2023 when Beijing published a list of public-sector projects targeted at private businesses and the National Development and Reform Commission (NDRC) received official approval to form a new bureau to monitor and advocate for the private economy, a development that one expert described as "groundbreaking" because it is the first national-level body dedicated to private business.

But there appears to be a limit on how much Beijing is willing to talk up the private sector—an article in August by PBOC adviser Liu Shijin that called for private sector reform and for leaders to "make it clear politically" that entrepreneurs are the "precious resource of the socialist economy" was deleted from social media.

Walking the talk

Broad-based and pro-market structural reforms could help boost productivity, facilitate rebalancing and ignite new growth drivers, according to the IMF—but even getting them started won't be easy. Each of the aforementioned reforms carries considerable structural risk, and cuts into the interest of groups in society that have managed to block these reforms thus far—including some parts of the system, but also urban citizens and the relatively well-off.

A long-discussed property tax and broader application of the personal income tax system would help local governments make up some of the lost revenue from muted land sales, but would also deal a blow to already weak business and consumer confidence. In China—long home to the conviction that property is the most reliable store of wealth—homeowners would almost certainly balk at any attempt to tax their properties, despite Beijing's completion of a unified, national property registration system in 2023.

"A property tax is basically off the table for the next five years," predicts Gavekal's He. "There's no strong reason why they would implement one now, especially given current growth is quite sluggish. If you want to increase local government revenues, you either have to increase taxes or get a bigger slice of existing tax revenue from the central government. I don't see either happening."

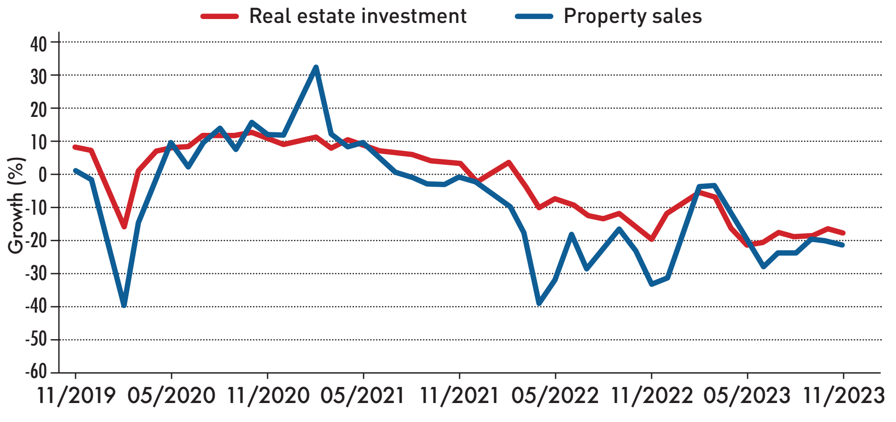
But Beijing did make sweeping regulatory changes to the financial sector in mid-March 2023, essentially bringing the financial regulatory system under tighter, centralized control.

Among the biggest changes were the establishment of the National Financial Regulatory Administration (NFRA) and the abolishment of the PBOC's nine regional branches, to be replaced by 36 branches across the country. The two changes indicate a shift to an empowered, centrally-controlled architecture that should help Beijing address some of the risks surrounding small lenders that have been plagued by poor governance, fraud and weak balance sheets.

"You can't let small banks default because if they go under, it's ultimately the depositors who pay for it," says Pettis. "No government today, in China, the US, Europe or elsewhere, would allow its banks to default on its depositors. You don't resolve the problem by cutting the banks free until they're cleaned up and recapitalized."

Social security reforms have also been progressing, though often piecemeal. Several cities including Shanghai and the provincial capitals of Hangzhou and Zhengzhou have relaxed stringent *hukou* policies for certain groups of society, while the Ministry of Public Security announced in early August 2023 that it would promote the nationwide implementation of reforms to the *hukou* household registration program that were originally outlined in 2021.

HOUSE OF CARDS | Property sales and investments in China have been dropping rapidly over the past few years



Sources: CNBS, PBoC, Wind

"*Hukou* reform is a classic example of what China needs to do and why it's difficult," says Pettis. "If the *hukou* was eliminated overnight, the working population would shift to the better cities and that creates a problem because those cities would have to either cut back on services to all residents to be more egalitarian or significantly improve services for those who previously weren't treated as well. You run into the same problem—how will it be funded?"

Many of the changes such as delaying the retirement age are sensitive and carry economic trade-offs. For instance, retirees often provide childcare for their grandchildren, but putting off retirement would upend this arrangement.

Besides the inherent difficulties of some reforms, there are also many systemic barriers. Powerful institutional or business interest groups populate the party-state and have acted as a roadblock to reforms in the past as they have a vested interest in maintaining the status quo—the late premier Le Keqiang once memorably said: "shaking up vested interests could be more difficult than touching the depths of souls."

For instance, China's national oil companies wielded considerable political sway up until the early 2010s, enabling them to influence national policies and projects in the energy sector and beyond until a major anti-corruption campaign a decade ago reined in their power.

The scale of the issues that the reforms aim to overcome is also vast due to the size and complexity of China's economy, and the interconnections of the system are such that changes in one corner can upset other areas, according to He.

"China has to prioritize," says Glawe. "There simply isn't enough money to reform everything at once."

The biggest test yet

Often overlooked in trite descriptions of China as a monolithic authoritarian country is that it is home to a vibrant economy with a storied history of reform—from state-led production under the planned economy to Deng Xiaoping's open-door policy 40 years ago, to investment-boosting manufacturing and innovation in the past two decades.

Implementing solutions to the present imbalances and structural drags will be tougher than anything Beijing has previously overcome, as it will involve painful changes that may not pan out for years to come.

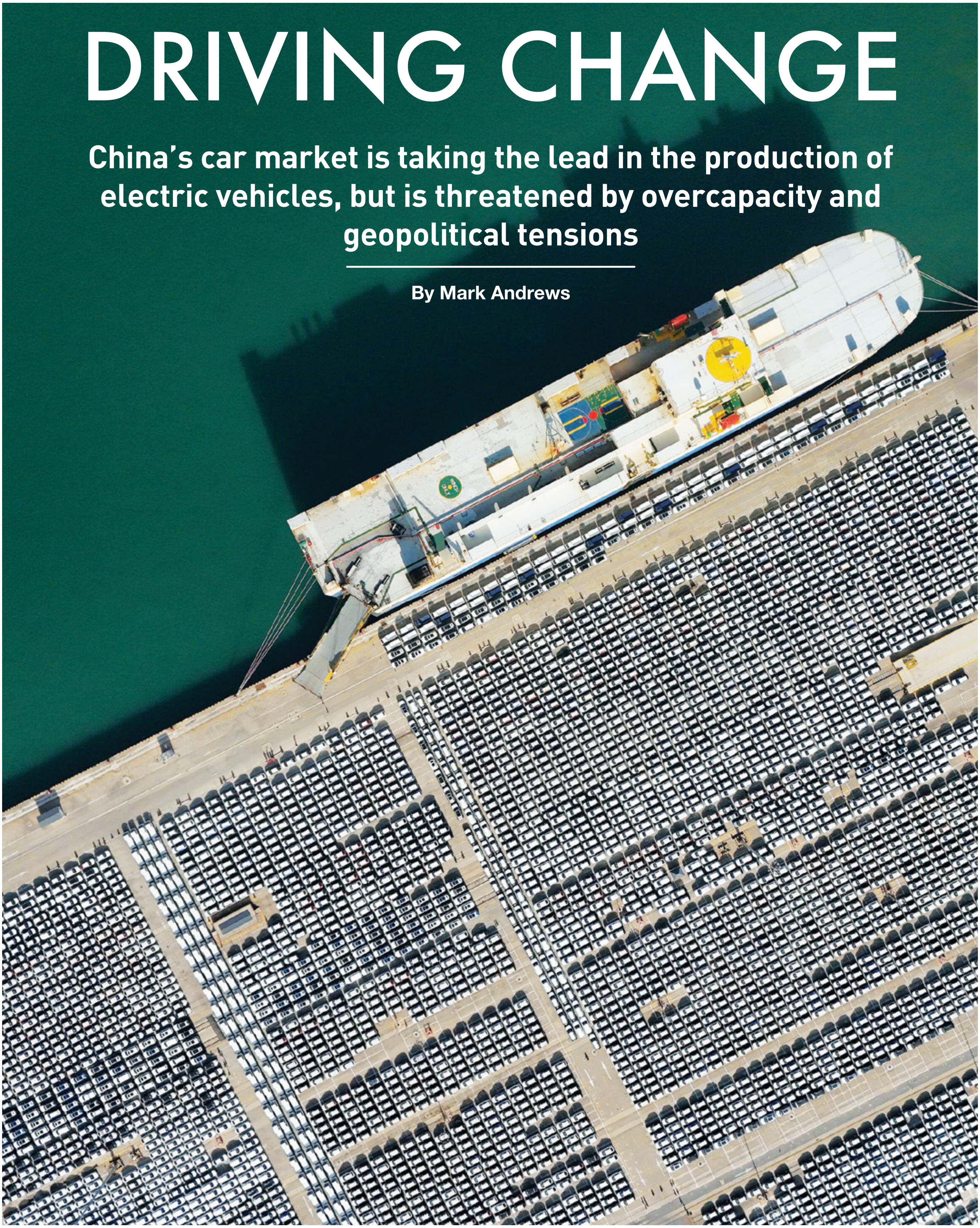
What's past is prologue, as the saying goes. But China's capacity to muddle through should not be underestimated.

"No matter whether in 2013 or 2023, the most important challenge China faces remains the same: growing the economy and increasing the living standard of Chinese people," says Wang. "History has already proved that following the market mechanism is the only way to achieve sustainable economic development."

DRIVING CHANGE

China's car market is taking the lead in the production of electric vehicles, but is threatened by overcapacity and geopolitical tensions

By Mark Andrews



China has transitioned from being an automotive backwater to a world leader over the last two decades

China became the world's largest car market as far back as 2008, but it has been a long road for the country's domestic producers to really rival global players such as Toyota, Volkswagen (VW) and Hyundai Kia. And it wasn't until August 2023, when BYD overtook Ford to become the world's fourth best-selling car brand, that China's auto, and in particular electric vehicle (EV), revolution started to take center stage.

Plotted on a graph, the growth of China's auto market forms an almost perfect example of exponential growth, particularly in the early years of the new millennium. Automobile sales increased from just 1.2 million in 2002, to around 12 million in 2010, and by 2017 sales more than doubled to over 25 million a year. Growth then slowed for a few years, but in 2023 total auto sales exceeded 30 million for the first time, including over 26 million passenger vehicles.

The seismic gear shift in the nature of the market is not over either. A government-mandated push toward new energy vehicles (NEVs)—mostly EVs and plugin-hybrids (PHEVs)—has helped a wholesale shift away from a market dominated by foreign companies in joint ventures (JV) to one where Chinese brands are the cutting-edge. And for some of the country's manufacturers, even fossil fuels are already a thing of the past—BYD is now an NEV-only company and has moved away from traditional models.

And domestic success has spurred international growth, with China emerging as a notable exporter of vehicles. In 2022, China became the world's second-largest exporter by revenue and in 2023, the country trumped Japan to take first place for the volume of vehicles exported.

"China has transitioned from a joint venture (JV) partner to the US, European and Japanese legacy automakers to unquestioned leader in the global EV space," says Tu Le, Managing Director of Sino Auto Insights. "Just like that, it went from a trickle to a gush in the span of about 4-5 years, during a pandemic no less."

Changing gears

Recognizing the need to shift away from internal combustion engine (ICE) cars is key to China's recent and future success, as the market currently finds itself in a time of upheaval. New car registrations in China hit an all-time peak of 24.7 million in 2017, staying reasonably level in the years since, but despite its development, the industry is currently suffering from overcapacity.

In March 2023, dealer vehicle inventory was at 62.4%, meaning that dealers have far more cars on the lot than required—50% is considered the breakeven point. Partly to blame for the glut was China's switch from 6a to 6b emissions standards, meaning that some models would no longer be eligible for sale in the country. The regulations were due to come into effect at the start of July 2023, but this was extended for six months for some vehicles. The country's flagging economy and a drop-in consumer spending have also been identified as contributing factors.

The last five years have seen a major pivot towards NEVs in the domestic market, and sales already outnumber those of ICE vehicles in some major cities. In the first eight months of 2023, NEV sales made up 38% of the total, up from around 2% in 2017. On the manufacturing side, there has been an accompanying switch from JVs to wholly-local brands, with the latter accounting for 55% of the market, up 19% in just three years.

But the key growth markets for China's auto expansion are beyond its borders. The sales behind China's ascension to the car producer top spot in 2008 were mostly domestic, and exports only rose past the 1-million mark in 2021, but they have since grown rapidly, falling just short of 5 million units in 2023. In the first six months of 2023, Russia was by far the largest export market (370,000) followed by Mexico (190,000).

Unlike in countries such as Thailand, where exports make up around half of production, the figure in China is currently around 15%, meaning that there is plenty of room to grow, as long as they can navigate past the growing geopolitical roadblocks.

"Demand in China has not grown since 2017, and as China seeks growth internationally, it will have to overcome geopolitical resistance from countries that fear the rising strength of Chinese brands, especially with their dominance of the EV supply chain," says Bill Russo, CEO of automotive strategy consulting and investment advisory firm Automobility.

China's acceleration

Until the 1980s, car production was nearly non-existent in China. As China became richer, there was an increasing demand for modern cars that local producers couldn't meet. In 1984 Japan sold 85,000 cars to China, up from 10,800 a year earlier, and by the middle of 1985 China was Japan's second-largest car export market. Faced with burgeoning imports and a balance of payments problem, China needed to kickstart its own automobile industry. To do so, the country turned to joint ventures with foreign automakers, the first of which, between American Motors and Beijing Automotive Industry Group, started production in 1983.

"The passenger vehicle market was largely driven by foreign brands that have manufactured and sold their vehicles in the Chinese market under a JV agreement with domestic car makers," says Klaus Paur, Managing Partner at MaLogic, a Shanghai-based professional services firm. "Overall, domestic Chinese brands were considered inferior because they could not compete with those foreign brands in terms of driving quality, comfort, level of workmanship and design."

During the 2000s, Chinese companies began to purchase both foreign automotive companies and intellectual property; the SAIC purchase of MG Rover assets was an early example, but Geely's takeover of Volvo in 2010 is arguably the most significant.

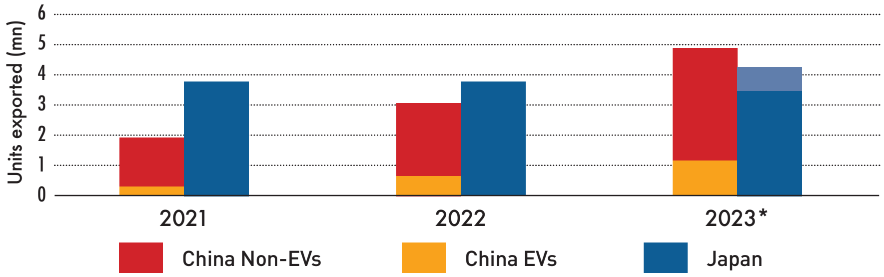
"The local manufacturer was able to gain production knowledge based on close cooperation and has now gained the skills to manufacture a vehicle at the same level," says Matthias Schmidt, founder of Schmidt Automotive Research.

R&D spending also played a crucial role in getting the industry to where it is today. As early as 2010, BYD ranked eighth in Bloomberg's list of the world's 25 most innovative companies and in 2008 it beat the Chevrolet Volt to market with the F3DM, to become the world's first production plug-in hybrid sedan.

By the early 2010s, the knowledge acquisition and incremental technological development that accrued from diversification and investment, helped China's auto industry move up a gear and gain leadership in the global market, particularly in NEVs.

"Over the past decade, China's auto industry has grown from a follower to an innovation super scaler," says Russo. This has been possible, he says, by leveraging the deep understanding domestic automakers have of shifting consumer preferences, differentiating themselves from the foreign JV brands. According to Russo the local brands did this by being faster to lower-tier regions and by first targeting the SUV sector and more recently NEVs for growth.

EXPORT ENGINE | China overtook Japan for the number of cars exported in 2023



*Japanese customs confirmed 3.5 million car exports in the first 11 months of 2023, with analysts predicting a total of 4.3 million by the end of the year
Source: CAAM, Japanese Customs Data, CPCA

During the 2010s, the NEV market went from near non-existent to the world's largest in terms of volume, and behind this development was a mixture of government subsidies both to purchasers and producers. More crucially, though, the government-led drive extended across the whole ecosystem, including required infrastructure such as charger access as well as the creation of national battery champions like CATL.

"China has used investment, more investment, patience, perseverance and competition to really bolster and take the global lead in the EV space," says Le. "It helps that China is the largest passenger vehicle market in the world and that's helped them quickly push battery and EV manufacturing costs down."

Unlike brands in the West, Japan and to a lesser extent South Korea, there was no brand heritage or history to deal with and perhaps similarly important, no entrenched workforce. As a result, leading Chinese brands have proved agile and quick to embrace change.

Startups like XPeng, Nio and Li Auto have, via technology, changed how families interact with their cars more than companies in other countries. At the same time, like Tesla, they are making some significant updates to the vehicle production process.

"They have the advantage of being able to invest in alternative manufacturing techniques," says Schmidt. "For example, Geely is developing a similar production technique to Tesla called aluminum mega-pressing for various components, which increases speed and efficiency and requires far fewer employees. Not having to restructure a legacy business model in order to get to these new production systems is a huge bonus." BYD, XPeng and Nio are also utilizing similar techniques.

But it has not always been an open road for the China car market, and over the last few years there have been a number of roadblocks to overcome.

It is difficult to fully measure the impact of the COVID-19 pandemic. Although sales decreased by 6.0% in 2020, this was not as bad as the 9.4% drop in 2019 and by 2022 sales had begun to improve, and were only 121,000 off the 2018 level. Nonetheless supply chain issues, particularly with semiconductors, caused a problem.

"Semiconductor shortages and China's zero-COVID policy were the two major roadblocks so far," says Schmidt. "A slowing economy and overcapacity, which is likely to lead to even more discounting, will also act as a headwind going forward."

Continued domestic economic weakness, exacerbated by overcapacity, is likely to act as a limit to growth, and in terms of exports, China needs to increase the export of more expensive models to developed markets.

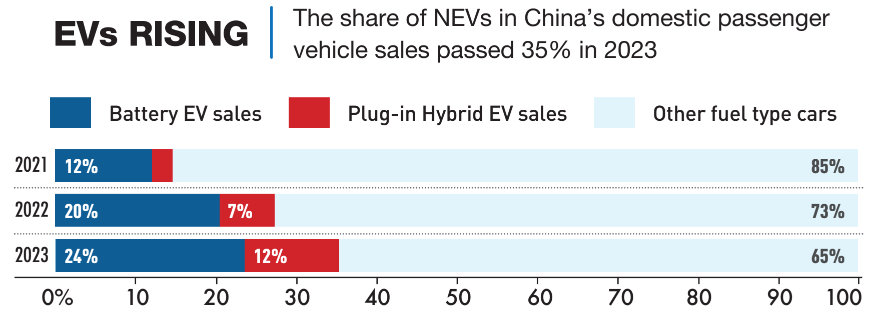
Australia is now China's fourth-largest export market, and Chinese brands command 16.4% of the country's market. But markets with more entrenched automotive legacies will likely be more hostile to Chinese imports. For example, in September 2023, the EU, where Chinese imports account for around 8% of EVs sold, launched an investigation into Chinese government subsidies for the manufacture of electric vehicles.

Nonetheless, thanks to its recent progress, the Chinese auto market is likely on its strongest footing ever entering 2024. "Unlike conventional ICE vehicles a decade ago, Chinese EVs are now considered something of the gold standard for electric vehicles, capable of threatening foreign car brands even in their home markets," says Paur.

Rearview mirror

There was once a clear division in the cars seen driving across China. Major cities were dominated by China-produced models of international brands and to a lesser extent imports, whereas in the countryside Chinese brands prevailed. China's shift to NEVs has turned this on its head and brands like Buick and Ford, which would in the past have found a ready market in places like Shanghai, now struggle for sales. Already some brands including Jeep, Suzuki and Mitsubishi have exited their JVs. Hyundai only sold 256,400 cars in China in 2022, down from 1.13 million in 2016.

Put simply, foreign brands were too slow to react to the pivot to NEVs and no longer sell cars suited to Chinese market



Source: CPCA

demand. Also holding them back is the inability to adapt to the speed of China's product development cycle.

"The rate of new Chinese products coming to market is far faster than from established players," says Schmidt. "These players are still operating on a 4-5 year development-to-market timescale, whereas Chinese OEMs are capable of doing this in half the time."

Leading Chinese brands have put a big emphasis on how users can interact with their cars via such means as voice control and also invested heavily in bringing self-driving features to the market. Other manufacturers, on the other hand, have been much slower with technology adoption as well as bringing convincing EV offerings to the market.

"None of the legacy brands were thinking EVs would gain popularity the way they have in China," says Le. "Because of this, they quickly tried to Frankenstein together EV products. The Chinese consumer is too sophisticated to be fooled by the Band-Aid solutions from the foreign legacy brands."

And as the JVs leave or downsize their operations, Chinese brands are taking advantage. Factories are sold off typically to startups or taken over by the Chinese JV partner – GAC Motor is currently repurposing the former Mitsubishi plant to add more capacity for its Aion EV range.

The open road

Tesla is an outlier among foreign OEMs in China. Focused on tech-oriented EVs, it has managed to maintain sales and is the largest foreign company currently operating outside the constraints of a JV. The efforts of all other foreign OEMs to try to sell EVs in China have largely fallen flat. Volkswagen's ID. series is relatively popular in Europe but has struggled to find traction in China. In July 2023, the ID.3 was discounted to ¥119,900 while the cheapest version in the UK sells for around ¥325,000—almost three times the cost.

While the current EV price war in China is obviously good for consumers, the impact

> **The rate of new Chinese products coming to market is far faster than from established players**
>
> Matthias Schmidt
> Founder
> Schmidt Automotive Research

upon producers is less positive. Most of the startups are struggling for cash and there are simply far too many producers and brands in the marketplace, but the price war may help show which ones have a future by way of sales volume. Foreign OEMs are increasingly looking to do deals with the startups as a way of either rectifying their shortcomings in the Chinese NEV market or helping their offerings elsewhere.

In September 2023, Volkswagen bought a 5% share in XPeng and will develop models for China based on XPeng technology, and in October Stellantis bought a 20% stake in Leapmotor in a move that will take the Chinese brand to Europe in 2024.

"The price war, the inability of foreign automakers to compete with China EV Inc. and the realization that the skills necessary to compete effectively can't be learned in time has left foreign legacies trying to salvage the share they still have in the China market," says Le. More deals from foreign OEMs and even from more established Chinese OEMs struggling in the NEV arena are likely.

Despite the successes, Chinese car export numbers do require some caveats, particularly when it comes to NEVs. In 2022, Tesla was China's third-largest overall exporter and was the largest for EVs. Foreign OEMs are increasingly using China to produce their cars for export, including the BMW iX3 and the Citroen C5 X. Of all Chinese EV imports into the EU in 2022, only 2% carried a Chinese name, with the remainder being either from international OEMs or from Chinese-owned but foreign-associated brands such as MG and Polestar.

Today China's car market can roughly be divided into three sectors, firstly the traditional ICE market, which is rapidly declining, then the low-end NEV market and finally the higher-end NEV market, particularly made up of intelligent connected vehicles (ICV).

"They are betting the kitchen sink on pure electric technology and extended-range models," says Schmidt. "With a huge amount of the value chain based in China, they already have a procurement advantage, having established relationships with EV suppliers."

Internationally, China is targeting the developing world with lower-end NEVs where traditionally they have had the most success with exports of ICE cars. As part of this strategy there is localized production in places like Thailand.

"Latin America has also increasingly become an interesting region for Chinese car manufacturers, not least because of the presence there of metals like lithium, which are required for battery production," says Paur. "However, exporting on a large scale to Latin American markets is difficult due to the large geographical distance, making local production a more logical option. BYD, Great Wall and Geely are already building factories in Brazil and Argentina." Mexico is also a possible beachhead into the US market.

Developed markets will be the target for the more high-end NEV offerings. However, Paur cautions, "consumers in these markets have different expectations, are more brand loyal and their approach to e-mobility may be more nuanced. It will be a challenge for Chinese car brands to adapt to local needs, and breaking into the market will require more than just lower-priced vehicles."

In China, there has been a definite push towards advanced driver assistance systems, for example collision avoidance techniques, but how interested European consumers are in such features is debatable. So far XPeng and Nio don't appear to have many such features activated on their European offerings.

But whether China can truly dominate remains a question of geopolitics. Data from the cars and where it is sent will likely also create a problem in such markets. Furthermore, China's transition to ICVs is dependent on access to semiconductors and this, along with the data security issue, could yet limit potential.

Despite possible headwinds, China seems to be triumphing in the automotive market thanks to EVs and associated technologies. "China has achieved a huge cost advantage through its dominance of the EV battery supply chain," says Russo. "By dominating the EV battery supply chain, China has made new energy vehicles affordable and is breaking the almost 140-year dominance of the internal combustion engine."

Gearing up: China's auto manufacturers are taking a leading role

Sustained Growth

Siyao Jiang, China Managing Partner at consultancy firm ERM, elaborates on the growing business case for taking a sustainable approach in the global market

Sustainability and ESG are growing concerns for businesses across the world, but how the issues are prioritized and approached by different businesses and regions varies widely. Many of China's ESG-related goals focus on the environment, and in particular, the country's drive for decarbonization, highlighted by the dual carbon goals, and that is where many companies are focusing their efforts. The business case for sustainability is becoming increasingly clear, but for many there is either a lack of knowledge on the subject or no real buy-in, which is slowing progress.

In this interview, Siyao Jiang, China Managing Partner at global sustainability consultancy firm ERM, discusses the concepts of ESG and sustainability, the regulatory requirements put in place by different governments, organizations and market regulators, and the subsequent challenges and opportunities for companies looking to operate sustainably in the international market.

Q. What is the level of awareness in Chinese companies regarding sustainability and how does this vary between purely domestic or more international companies?

A. For Chinese entities there is a very wide spectrum in terms of sustainability or ESG awareness. On one end are those entities purely focused on the domestic economy, which are at rather early stages of their sustainability journey, whose understanding of ESG stays in the form of reports produced to satisfy stakeholders, but lacks substantive matters. On the other end of the spectrum, Chinese companies that are involved in the new economy, both domestic and international, take it much more seriously because they face increased pressure from capital markets or consumers, and often from both.

Q. To what degree have ESG or sustainability requirements for operating a business in China changed in recent years, and how does this compare to international requirements?

A. There is a set of international standards which most companies have to follow, but there are also country-agnostic elements. For instance, environmental regulation will vary from country to country, with China's actually being quite stringent. Whilst the 'E' element of ESG is more measurable and quantifiable, the other 'S' and 'G' elements tend to be more ambiguous, despite the fact that social and governance considerations can have a substantial long-term impact. If you don't do them well, in the right places and at the right times, they are very hard to remedy at a later stage. This is actually why ERM employs social experts such as sociologists, archaeologists and anthropologists to help deal with different issues for companies.

The other observation of country-agnostic sustainability elements is a convergence of international standards, such as the recently released ISSB (International Sustainability Standard Board) that would become part of the IFRS (International Financial Reporting Standards) accounting standards. One of the most noticeable features of the ISSB is the incorporation of climate change and nature-based solutions, in the form of TCFD (Taskforce on Climate-related Financial Disclosures) and TNFD (Taskforce on Nature-related Financial Disclosure) disclosures.

Q. While environmental issues are easy to comprehend, how would you explain the factors that make up social and governance issues?

A. It's quite a wide-ranging issue, but can also be very industry-specific. To start with, governance, if you talk about tech companies such as data centers, then data privacy is a very important governance topic. And, of course, for the company, corporate governance, the separation of the board and management, remuneration, audits and risk management, among other issues, are all relevant to the G in ESG. That being said, exactly how these manifest themselves is very industry-specific.

> **Different companies are at different stages of maturity in their ESG journey...so education can go a long way here**

In terms of the social issues, there are a few common topics that most companies face which I would say are the bottom line in terms of social compliance. One is labor conditions and human capital development, which is why companies have HR departments. The other is safety, for which there are any number of regulations and company policies in place.

There are also the topline considerations, which include the more active social impact-driven approaches or business areas such as redevelopment, microfinance or poverty reduction. Another big social issue is resettlement. For instance, if you want to build a road you might have to move a few houses away from their original positions, and for this, many of the international commercial banks and multinational development banks have rules, called the Equator Principles, regarding how this should be approached and compensated for.

Q. What are the common ESG-related barriers faced by companies looking to enter a new market, both for Chinese companies looking outwards and foreign companies looking to working in China?

A. The first challenge is getting genuine buy-in to the concepts. We have worked with companies that only want to do the bare minimum, to tick the box, but we have also worked with clients who have a strong internal motivation and organic drive to do things right. And that makes a huge difference.

The second challenge is the country-to-country difference. You have international regulation on top, but also country-specific requirements, which require local experts from various fields to help you understand the key differences.

A third challenge is within particular companies, and it is similar to any kind of organizational behavior change. If you only adopt a top-down approach, from the senior leaders, it is very hard to penetrate downwards. The change needs to go both ways, top-down and bottom-up. And the only way to have an effective bottom-up mechanism is to put in place a well-designed compensation incentive system, or KPI-driven system, which allows day-to-day operators to really see the benefits, financially or otherwise.

Also, ESG is something of a buzzword and actually covers a really broad range of things. Environment and social issues can relate to pretty much anything, which makes it an easy concept to comprehend, but difficult to implement at an operational level.

As such, ERM advises international corporations on compliance with EHS (environmental, health and safety) regulations in China and helps Chinese clients comply with host country regulations for their outbound investments. In addition, we assist Chinese clients to understand and align with international ESG frameworks, for example, to access international capital markets and customers.

Q. How are the ESG and sustainability requirements of financial markets changing in China?

A. Hong Kong is definitely a spearhead in the Greater China region. The Hong Kong Exchange has eight environmentallyrelated standards and four that are socially-related, as well as some governance standards. Also, the Hong Kong Exchange has implemented mandatory climate-related financial disclosure requirements that will come into force from 2025, where companies will need to disclose both physical risk and transition risk. Physical risk is basically how much money you will lose if your asset becomes stranded because of a natural disaster. Transition risk is similar, but it is the risk and the opportunities driven by policy changes during a shift toward a low-carbon and more climate-friendly future. Listed companies will need to start quantifying both of these for investors. The Singapore and European markets are also very stringent in these areas. Whilst the mandatory ESG disclosure requirement in the Shanghai and Shenzhen stock exchanges appear to be less stringent compared to their offshore counterparts, they are picking up and it won't take long for companies listed in Mainland China to fulfill a similar set of disclosure requirements.

We have also worked extensively with major equity investors (in the forms of PE, VC and infrastructure funds) and debt investors (in the forms of commercial and investment banks, multilateral development banks, and export credit agencies). Both debt and equity investors have put significant emphasis on ESG due diligence pre-investment and ESG performance monitoring and value creation through ESG improvements post-investment.

Q. How do you put forward the business case for sustainability?

A. Different companies are at different stages of maturity in their ESG journey, so we won't force people or companies to make choices unless they feel that it's the right thing to do, so education can go a long way here.

For us as a business, the market is big enough, so if someone only wants to do an ESG report there are lots of local companies or competitors who can do a report at a much cheaper price. But if you really want to tackle the hardcore, then we help with painting a picture of the problem and showing them different pathways forward. We can show them what is likely to happen over the next five to 10 years, depending on the decisions made and show them the cost benefit analysis of various investments in different areas over different time periods.

This is reflected in the approach we take when trying to operationalize sustainability. Our motto is 'Boots to Boardroom,' meaning that whilst we pursue first-hand project-level experience delivered in a bottom-up approach, we could simultaneously conduct a top-down strategy approach to embed ESG into all key functions of business operation and leverage organizational behavior changes in strategy, marketing, human resources, R&D and finance.

Q. How do you see the overall trends in ESG in China changing in the coming years?

A. If you read the speech made by President Xi Jinping at the 20th Party Congress in 2022, he used nearly 60 environment-related words including environment, carbon and ecological conservation, over 90 social-related words including rural, education and health, and many governance-related words such as anti-corruption. Of course, in the Chinese context there is a different emphasis on ESG, so much of the environmental discussion was centered on decarbonization, while the social-related topics emphasized the rural economy, redevelopment and poverty reduction. Anti-corruption was the main focus in terms of governance.

There are also echoes here of ancient Chinese and Taoist philosophy, and the ideas that everyone should be able to find and live a decent life. This is an ESG-related topic and also, I think, universal. In Europe, there are many ways to trace back ESG development through Christian principles, for example.

ESG is one of the rare topics that it doesn't matter where you are from, it is a fundamental value that we all agree upon to some degree or level of intensity. And I think Chinese companies are currently on a ESG-conversion journey. There are different levels of buy-in, but if a compelling business case can be made for it, with relatively controllable costs and benefits that outweigh those costs, any business will make the choice to undertake some form of positive impact.

Interview by Patrick Body

ESG is one of the rare topics that it doesn't matter where you are from, it is a fundamental value that we all agree upon to some degree

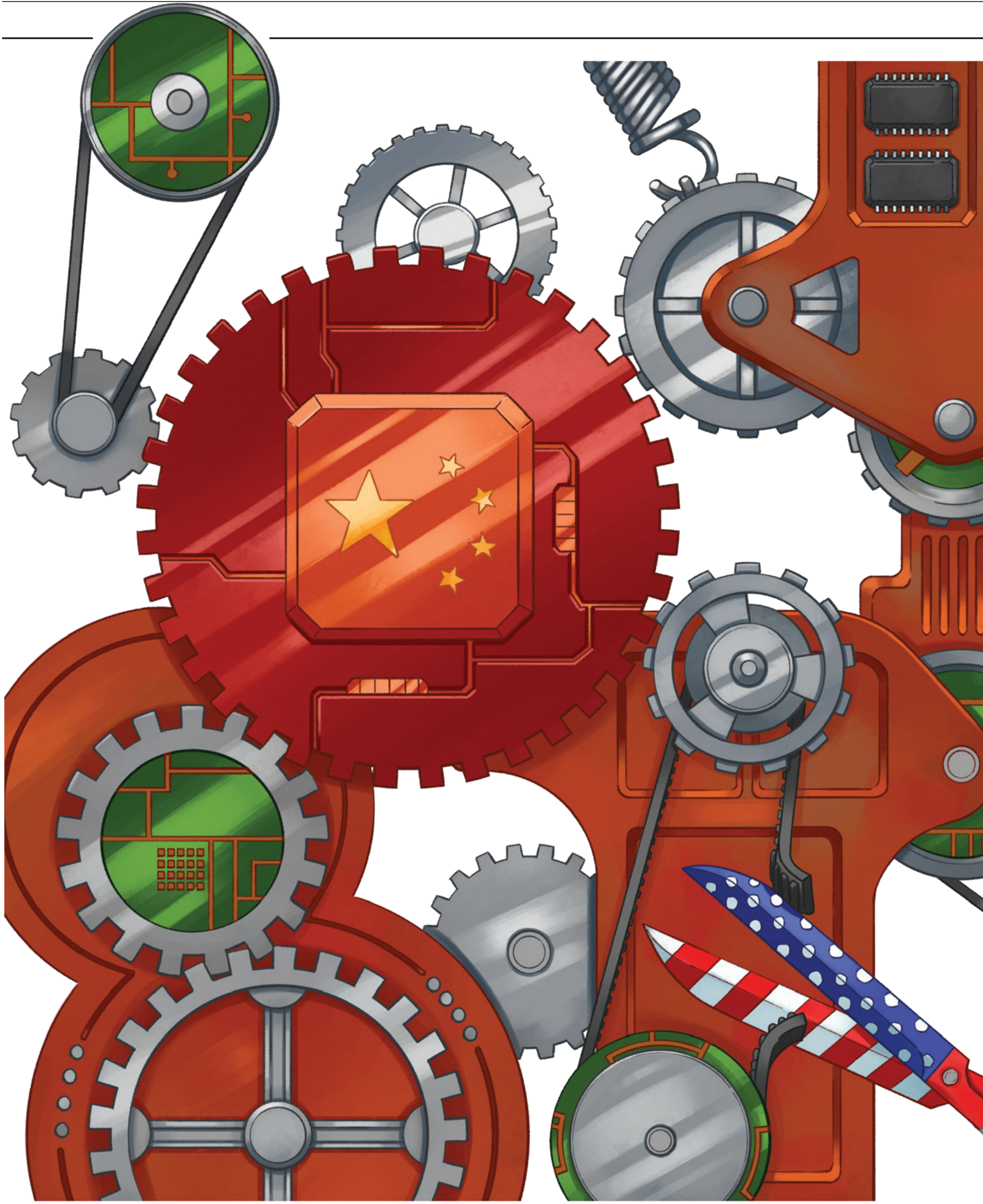


Image by José Luna

CHIPPING AWAY

China's semiconductor industry is faced with dwindling access to equipment and products. How can the country deal with this challenge?

By Patrick Body

It is unusual for a mobile phone launch to draw the attention of national security experts globally, but upon its big reveal at an event in September 2023, Huawei's new Mate60 Pro had analysts scratching their heads. After over a year of controls limiting the flow of semiconductors and related manufacturing equipment to China, the chips in the phone were not *supposed* to exist.

Semiconductors are the modern-day battleground for global digital supremacy, with the development of bleeding-edge technologies almost entirely reliant on cutting-edge chips. The wide-ranging export controls placed on China, mostly by the US, have been designed to limit China's access to new technology as it is increasingly viewed by the West as a strategic adversary.

"Following the US restrictions, the importance of domestic equipment suppliers in China has gradually increased," says Lucy Chen, Vice President at technology consulting firm Isaiah Research. "China can avoid being further constrained by US policies in the future only by accelerating the establishment of its domestic supply chain."

The Mate60 Pro, for example, is said by analysts to use an unexpectedly advanced 7 nanometer chip designed by Huawei subsidiary HiSilicon and manufactured by the country's largest chipmaker, Semiconductor Manufacturing International Corp. (SMIC). What's more, the phone now also contains 47% China-made components, up from 29% in the previous model, showing a surprising growth in China's tech manufacturing capabilities.

Chips are simply too important for the future of the country's economy to fall by the wayside. And China, the world's largest semiconductor market, is spending an enormous amount of money to bring its domestic manufacturers closer to the cutting-edge. Take for example, SMIC's 2023 budget, which rose 18% year-on-year to $7.5 billion. But will that be enough?

Chips with everything

Semiconductors are the backbone of the Internet of Things (IoT) and the wider digital transformation of industry, and indeed life, across the world. They act as the decision-making center of every electronic device or system, from smart fridges to data centers. A single electric vehicle (EV) can contain over 1,000 chips, each responsible for running a different operation.

Chips vary in classification, with the

density of transistors on each chip denoted by a nanometer (nm) measurement. At the time of writing, chips around 3nm are considered state-of-the-art, while legacy chips are typically considered those made with 28nm equipment or above, which is now a decade-old technology. Apple's iPhone 15 runs on a 3nm chip.

The most advanced chips available are used in AI R&D and quantum computing, and will be key to any major future breakthroughs. According to Precedence Research, the global semiconductor industry was worth $591.8 billion in 2022, and is expected to pass the $1 trillion mark in 2027.

The largest semiconductor company globally is Taiwan Semiconductor Manufacturing Company (TSMC). According to *The Economist*, Taiwan produces around 60% of the world's semiconductors and over 90% of the most advanced chips, with TSMC making the lion's share. Other major global players include Intel, Nvidia and Samsung, but TSMC's production capacity of the top chips overshadows the rest.

The other key component of the global semiconductor supply chain are the companies that produce chip manufacturing equipment. The leading player here is Dutch firm ASML, which produces some of the most advanced photolithography machines that are an integral part of advanced semiconductor manufacturing.

A semi-full plate

As with many industries today, semiconductor production has a truly global supply chain. Chinese chipmakers have established themselves as competent mass producers of legacy chips, with multiple foundries able to meet the demand from the country's domestic manufacturers of simple technologies.

"China is already a big player in terms of lower-tech chips, and it's made real strides in the past couple of years in catching up in certain spheres," says Chris Miller, author of *Chip War: The Fight for the World's Most Critical Technology*. "It's still quite reliant on others overall, but in certain aspects of the chip industry it has, to some extent, caught up."

China's largest and most advanced chip company is the partially state-owned foundry SMIC. The company produces logic chips, which process information, rather than memory chips which store information.

But even prior to US trade restrictions, SMIC was not yet at the cutting-edge of chip manufacturing. "Most people would probably consider 7nm chips as being at the lagging-edge globally," says Jacob Feldgoise, Analyst at Georgetown's Center for Security and Emerging Technology (CSET). "They are a couple of generations behind."

Other major players behind SMIC are Yangtze Memory Technologies Corp. (YMTC), a company founded in 2016 as part of the country's drive to reduce dependence on foreign firms; and UNISOC, China's largest mobile phone chip designer. Also of note is Naura Technology Group, which is the country's largest chip production equipment manufacturer and the power behind the companies in China that perform Integrated Circuit (IC) packaging and testing.

There is also smartphone chipset manufacturer HiSilicon, a wholly-owned subsidiary of Huawei, that boasted a 16% share of the global market in Q2 2020, with revenues outstripping even SMIC. Due to Huawei's struggles in recent years, that market share dropped to almost 0% in Q3 2022, but similar to Huawei, HiSilicon was back on an upward trajectory in 2023.

But homegrown producers cannot fully meet the needs of China's rapidly-developing manufacturing sector. "In the view of global, and even domestic competitiveness, they do not meet demand," says Ben Bajarin, CEO and Principal Analyst at tech consultancy Creative Strategies. "Chips being designed and made by local Chinese companies are not competitive compared to counterparts from outside of China, but any needs at the trailing edge are more easily met than at the leading edge."

For the most part, China remains behind in the global race, and remains dependent on sourcing advanced chips and manufacturing equipment from the major international players.

According to market research firm IC Insights, China sourced only 16% of its semiconductors domestically in 2020, and the figure is only 6% after excluding foreign companies with facilities in China, such as TSMC and Samsung. While Chinese authorities put the domestic share of supply at around 30%, it still fell short of the "Made in China 2025" interim target of 40% by 2020. The target for 2025 is 70%.

Codes of conduct

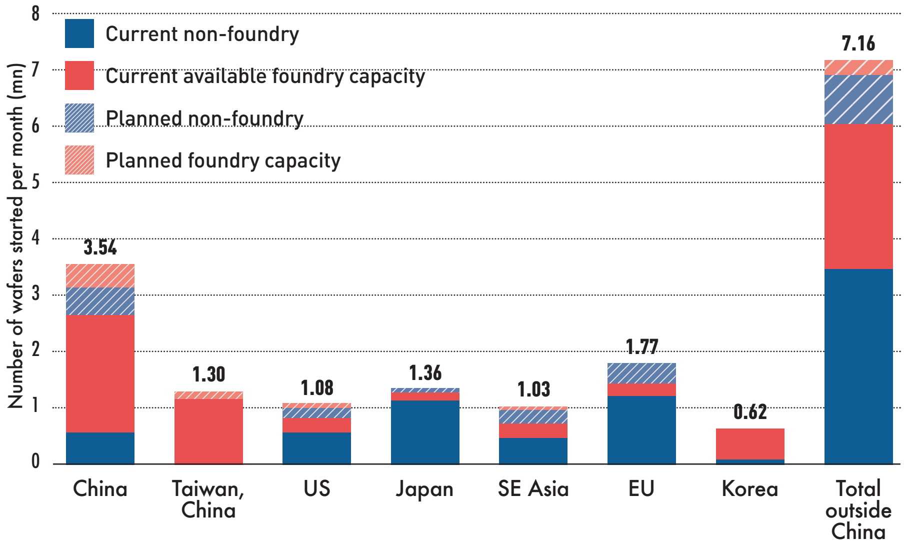
For the Chinese semiconductor industry, times are getting increasingly difficult, due in part to the US government limiting companies' ability to expand capacity in China as well as export chips and equipment to the country. In recent years, many Chinese firms have been added to the US Entity List, limiting their access to a variety of key technologies, but the signing into law of the CHIPS Act in August 2022, and the updates to export controls in October 2023, saw a more specific focus on the semiconductor industry.

While the impetus behind the CHIPS act is to strengthen the US' own chip industry by providing subsidies for domestic development, there are also conditions designed to curb China's ability to make further progress in the sector. As part of the act, research collaborations are limited and companies receiving money from the US for chip development are no longer able to expand their production capacity in China.

"It's basically a contract that says, whether you are a foreign or US semiconductor company, if you are going to receive money from the US government, then we are going to place conditions on you because we don't want to give you a subsidy as part of the new program and then have you turn around and build a giant fab in China," says Feldgoise.

The US has also introduced export rules that target China's access to equipment and technology for advanced semiconductors, including license requirements for items destined for Chinese production facilities capable of fabricating advanced chips as

MASS PRODUCTION | Mainland China and Taiwan control around 70% of global 50-180nm chip production



Source: SEMI World Fab Forecast

well as components for the production of advanced chip manufacturing equipment. These export rules can also impact non-US entities. For example, the legislation gives Washington the right to restrict the export of ASML's machines if they contain any US parts. Several Dutch lawmakers have since challenged the US' unilateral imposition of such rules.

According to US Commerce Secretary Gina Raimondo in a call with reporters in October 2023, the importance of chips for technological development and their potential military applications, that is at the heart of the US' recent attempts to limit China's ability to produce cutting-edge semiconductors or purchase both chips and chip-making equipment.

The impact of the controls is already beginning to show in the form of slower growth. A report from media outlet *Semiconductor Industry Observation* cited by Wei Shaojun of the China Semiconductor Industry Association (CSIA), noted that China's integrated circuit (IC) design industry's total revenue was up 8% in 2023, roughly half of the growth of the previous year. Wei also noted at a November 2023 forum that many of the enterprises were not in good shape.

It may prove hard to measure the full impact of the restrictions in China, particularly given the lack of transparency in the country, especially in relation to military technologies. "The biggest impact will be the limitations on advanced computing for the government and the cloud hyper-scalers like Tencent and Baidu," says Bajarin. "They need access to the latest computing technology from Nvidia, Intel and AMD etc. to stay competitive in the global AI race."

In the short term, the US restrictions will have an impact due to the clear link between China's cutting-edge chip manufacturing and US IP. "In every facility that's remotely close to the cutting edge, you can find US intellectual property, tools and software," says Miller. "The entire industry is dependent on US inputs."

"The single biggest thing the trade limitations have caused is the need for China to develop domestic sources of these capabilities, which is extremely difficult and not something any nation can really achieve on its own," says Bajarin.

From the perspective of the manufacturing processes for end products, it appears that mid-to-high-end mobile application processors (APs) are currently experiencing the most significant impact. Many of these processors are manufactured using advanced processes with chips at 6-7nm or below, which are the nodes most affected by the US restrictions.

"The products for AI-related applications, such as GPUs, may also experience significant impacts, whether they are purchased from Nvidia, AMD, Intel, or designed by Chinese local IC designers like Shanghai Biren Intelligent Technology," says Lucy Chen. "All of these products are heavily constrained by US restrictions."

On the other hand, manufacturing processes for products such as CIS (CMOS Image Sensors) and ISP (Image Signal Processors) typically use chips at 40-55nm or higher, and therefore, are less likely to be affected by the restrictions.

"The big question is how China produces chips at more advanced nodes than 7nm and that is much more difficult with the current limitations on imports of ingredient technology," says Bajarin. "It will not only be difficult to produce the chips, but even if they do, I'm not sure they will compete on all performance benchmarks."

Out of the frying pan...

The US controls have been a shock to China's semiconductor system, but also act as an impetus to bring forward an already inevitable shift. "The controls definitely have a degree of influence," says Bajarin. "But I remain convinced China would have gone down the self-sufficiency path anyway due to their desire to not be reliant at all on the rest of the world for semiconductor-related needs."

According to Chen, China's semiconductor strengths lie in its massive consumer market scale, a pool of promising technical talent and government subsidies. In 2014, the Chinese government set up the National Integrated Circuit Industry Investment Fund, now widely known as the "Big Fund." The fund raised ¥139 billion and ¥200 billion respectively in its first two funding rounds, but is currently struggling to meet the ¥300 billion ($41 billion) target in its third.

"Eventually they will get the third fund set up," says Linghao Bao, Senior Analyst at Trivium China. "There is certainly enough political will to get it done, and the knock to business confidence if it doesn't happen would be too great to risk." In the first two fundraising rounds for the "Big Fund," the country's finance ministry was the largest contributor, adding 44% and 15% of the funds, respectively.

Other recent policies introduced by the government include a 20% subsidy for domestic semiconductor foundries that purchase locally-produced equipment.

The main barrier to China moving forward is the lack of semiconductor technology in the country. "China now needs to expend greater efforts or make more significant concessions to acquire technology or collaborate with international giants," says Chen. "Adapting to closed environments and acquiring new technology based on existing experience will be a major challenge."

"The US actually banned the export of some extreme ultraviolet lithography (EUV) machines to China in 2019, so many of the people working at places like SMIC have never even seen one," says Bao. "The issue here is that it's much easier to reverse engineer something if you have it in front of you, but having no knowledge of it makes it much harder. This means that the Huawei chip might be the best they can make for a while."

The grace period on the greater import restrictions ended in January 2024. And although there appeared to be a last-ditch effort by China to import advanced equipment from ASML prior to the deadline, the company was forced to cancel a number of shipments to China after pressure from the US government.

With this option now closed to China, there is a need for domestic companies to step up.

"From the equipment we have seen, China has shown promising performance in domestic alternatives provided by companies like AMEC, Naura and Piotech, but they are still not quite at the cutting edge," says Chen. "In the field of lithography, SMEE is actively working on the development of domestic photolithography equipment. At the same time, both SMIC and HHG have established their own integrated circuit R&D centers to develop localized product lines for domestic tools and equipment."

Companies like SMIC also have the benefit of almost unlimited demand from its home market. The company generated 84% of its 2023 Q3 revenue from China, up 75% year-on-year.

And although the controls obviously are a barrier, China's history of innovative thinking and its established business ecosystems could prove a boon in circumventing its current predicament. "All indications are that we should expect SMIC to roll out a 5nm node," says Feldgoise. "It may not be for a few years, and the yield will likely be sub-par, but because some of China's best chip designers have now been cut off from using foreign fabs, there are very strong incentives for those designers to help SMIC improve its domestic fabrication processes."

One major advantage China does have in the race for global semiconductor development is the sourcing and control of rare-earth metal supplies. Rare-earth elements play an integral role in the manufacturing of most electronic devices, semiconductors included. In 2022, China accounted for 70% of global mine production of rare earths and is home to 85% of global processing capacity.

The US' reliance on Chinese rare-earth exports is declining but from a high starting point—between 2018 and 2021 the country sourced 74% of its rare-earth imports from China. This is also where China has chosen to levy tariffs on the US. In July 2023 the country introduced a requirement for export permits for gallium and germanium products used in chips, following this up with similar rules for graphite in October.

Maintaining control over these supplies is a boon for China's chipmaking industry, particularly in the short term. But manufacturers elsewhere are already looking for alternatives to rare earths to mitigate the massive environmental burden that rare-earth mining and processing causes, as well as the clear supply chain risks.

"Rare-earth metal controls seem to be the go-to response for China in the hopes of deterring more export controls," says Bao. "It's one of the few bits of leverage China has, for now."

...into the fire

It is clear that in the short- and medium-term China has a mountain to climb in order to solidify its chip industry and secure its ability to work at the cutting-edge of research, technology and product development. Given the speed of development in sectors such as AI, for example, falling behind at this stage could lead to a growing gap between China and other world-leading countries.

But looking at the long-term there is less certainty as to the efficacy of the US controls. Forcing China to innovate on its own has, in the past, led to the country leap-frogging competitors in a number of sectors such as green technologies and EVs, and this could also be the case for things like semiconductor equipment.

"It is entirely possible that five or 10 years from now there is a far more developed indigenous ecosystem for Chinese chip equipment suppliers than we have today," says Feldgoise. "So from that perspective, and of course with the caveat that we don't know exactly how it will play out, it might be that some of the US controls actually help accelerate China's development in certain parts of the supply chain."

Looking even further ahead, given the exponential improvement of chip technology, as aptly predicted by Gordon Moore decades ago, there is a chance that the semiconductor challenges as we know them now, cease even to be an issue in the long-term.

"While we're not there yet, we are certainly getting closer to the potential end of Moore's Law," says Feldgoise. "It is entirely possible that we get to a point in the next 30 years where there will be increasing pressures for a complete change in direction of this technology, and that could be an opportunity for Chinese companies to define the next generation of semiconductor design and manufacturing."

Painting a Picture

The Chinese art market has grown dramatically over the past two decades, and tracking that growth may provide insights into the strength of the economy as a whole

By Mei Jianping, Professor of Finance, Cheung Kong Graduate School of Business

The global art market has long been dominated by Western artists and creators, but over the last 20 years there has been a significant growth in the sales of art by Chinese citizens or artists of Chinese descent. In 2022, the country's art market accounted for 17% of global sales, ranking third in the world after the US and the UK.

The rapid creation of wealth within the country itself is a major reason behind the growth in sales, and China's collectors are influencing the increase in value and sales of art, including that of Chinese origin. In the first half of 2023, mainland Chinese collectors had the highest median spend of any in the world, at $241,000, according to the Art Basel and UBS Survey of Global Collecting.

Measuring and tracking the value of high-end art has been commonplace for many years, but for the most part the available metrics and indices have not included works from Chinese artists. In fact, we created a number of indices for impressionist and contemporary art including that of British, Latin American or European origin at the turn of the century. But with the proliferation my colleagues and I have seen over the last two decades and more, there is now an opportunity to do the same for the Eastern world, and with this comes a glimpse at the relationship between Chinese art and the country's wider economic development.

Motivations

As with many endeavors such as this, the recent production of the Chinese art indices actually came about as an attempt to prove someone wrong. I had jokingly been accused of bias towards Western art by a friend, who was convinced that the Chinese market was now at a stage where it warranted just as much attention. At the time we started the original indices, there were simply not enough transactions to construct a standalone index for Chinese art, but the explosion in sales numbers over the last 20 years has proved to be significant enough to warrant a reconsideration.

The Chinese indices, first published last year, are designed to track the fluctuations in various segments of the Chinese art market, specifically pieces produced by Chinese artists or artists of Chinese descent, with an overall index that gives a view on the market as a whole, as well as others, such as the Ink Painting Index that sheds more light on the traditional Chinese art market and how it is doing compared to the whole. For example, over the last 20 years, the Chinese art segment has outperformed the traditional market indices such as the contemporary art market or the impressionist market, which are mostly made up of artists living in Europe and the US.

There are a lot of interesting segments that make up the Chinese art market, and we have defined several sections that have become sub-indices. The first is for Chinese ink paintings or what can also be seen as more traditional art, while another sub-index is focused on oil paintings, which is a more recent introduction from overseas. But it is also important to categorize or define the art according to time periods. The section we refer to as 'Modern' is actually art produced prior to 1911, and then there is the 'Contemporary' art index which are all pieces produced after that date.

There are obviously more categorizations possible, such as landscape or portrait paintings, and these are things that can be added in the future. And we are also producing individual artist indices for some of the more well-known artists, for example, we have an index for the late Zao Wou-Ki (赵无极), and there are opportunities to do more, especially because there are a number of quite liquid artists in China, and this would also enable us to compare them in more detail to well-known international artists.

Producing the Indices

The key to the usefulness of the indices is making sure that the data behind them is both easily accessible and of uniform quality. This transparency and consistency should mean that others could, if they so wish, reproduce the indices using the same methodology, which in turn applies a level of legitimacy to the results.

Because of this requirement, creating the indices was first a process of reducing down the number of data sources, and the data set has been drawn from the three major international auction houses, Sotheby's, Christie's and Philips, covering six major markets, Beijing, Shanghai, Hong Kong, Singapore, London and New York. But this does mean that the indices only cover the very top end of the market.

There are probably hundreds of thousands of active artists in China or of Chinese descent, but it is difficult to cover all of them because few will have their pieces sold at auction, let alone by the major international auction houses. There is, however, a fairly active auction market in China, with hundreds, if not more, auction houses selling Chinese art. But there are limitations to the available data. Many of the houses are relatively new and there is something of a lack of consistency between the pricing standards and data sets they release, making it difficult to compare and contrast the results.

Assigning value to art can be a complex process. On the surface, it is the role of professionals at an auction house, who provide value estimates when accepting a piece for auction. But underlying this there are several economic, cultural and other factors that have an influence on valuations or that drive the market.

First of all, there is the impact of the overall economy at the time of sale. Much of the demand for art comes from wealthy individuals and institutions and that demand depends on the health of the economy as a whole. If global wealth creation is going well and the stock markets are performing, then that will have a knock-on positive impact on the value of art.

Another factor is interest rates because art as an asset does not inherently produce dividends or interest. As a tool of wealth creation, if it is possible to earn a high return via the stock market or by putting money in the bank with a high interest rate, you are functionally giving up that opportunity by purchasing a piece of art instead. So certain interest rate changes can have a negative impact on the market and dampen enthusiasm.

Having said that, it also depends on preference. A lot of Chinese collectors, especially those in the older generations, have a preference for Chinese ink paintings, whereas younger collectors prefer oil paintings. So demand can rise or fall in relation to personal preference.

> **Over the past 20 years, the market for Chinese art has grown dramatically from quite a low starting point**

Results

It should be noted that we are in the early stages of the Chinese indices, having only released them last year, but there are several trends that have already become clear. One of the major trends we have seen as a result of producing the indices is that prices and the collection of Chinese art are closely linked to the performance of the Chinese economy, and the data we have falls into three periods that demonstrates this quite clearly. The first period, from 2002 to 2007, sits before the Global Financial Crisis in 2008, and was a period in which both the economy and the art market experienced a boom, with the latter growing almost eight-fold during that time.

The second period spans 2008 and 2013, and was mostly a period of recovery. After 2008, the art market dropped by around 26% but in the following years saw a reasonable level of growth—around 9% per year—in order to get back to the level it was at pre-crisis. The final period, post-2014, has seen the market basically zigzagging, with peaks and troughs particularly evident in the serious market correction during the pandemic.

In terms of specific market sections, both ink and oil paintings have done quite well, with an 8.8% and 11.5% return, respectively, over the lifespan of the indices. And there are some indications, and the data here needs to be confirmed, that the price of Chinese ink paintings are highly-correlated with the state of the Chinese real estate market. There is anecdotal evidence that the ink paintings have a large following among Chinese real estate developers, as well as some other, relatively old collectors.

Overall, however, it is hard to create an accurate image of a typical buyer profile, and this is not just the case for those purchasing Chinese art, because even internationally, many buyers choose to stay anonymous. There is some evidence to suggest that the collectors of Chinese art are both Chinese and international in origin, and some specific Chinese artists, again, such as Zou Wou-Ki, quite clearly have a large international following. But then there are also many successful Chinese entrepreneurs who are pursuing Chinese collections.

Price volatility is quite hard to measure for several reasons. The prices for higher-end pieces of art can generally range from tens of thousands of dollars, all the way up to $200 million. Outside of the wider economic situation, we can also see variations in pricing due to where a piece is auctioned, and even down to whether it is sold during a daytime or evening auction.

In terms of holding periods, the typical ownership span for a piece of Western art rests somewhere between 15 and 25 years, but from the data we have seen for Chinese art, the average is much shorter, with many cases where people have held the art for just one or two years. There are even extreme cases where a collector purchased a piece in the spring auction and then sold it in the fall of the same year. It is unclear exactly why this happens, but there is a greater appetite for risk in emerging economies and therefore the shorter holding periods may be related to the early stage that the Chinese economy is in. It would be reasonable to expect that as the economy matures, the market will mature with it.

Sold: Both Chinese and international collectors are driving demand

Conclusion

Over the past 20 years, the market for Chinese art has grown dramatically from quite a low starting point, but the pandemic caused a substantial correction, and with any illiquid asset after such an event, it usually takes time to find its footing again. Because of this, the market will take some time to return to robust growth, and this is something worth watching over the next few years.

In the coming years, the Chinese art market will likely be driven by the wealth created in the high-tech sector, thanks to its rapid development and large number of entrepreneurs, many of whom will become collectors down the road. More widely, the expansion of many of the market segments will be driven by international wealth creation and the dynamics of the overall world economy.

There are quite a lot of opportunities for expanding the collection of indices in the future. There are very few, if any, indices also looking at the China market, and that also goes for a number of other countries, so opportunities lie in creating similar Indian or Japanese lists, for example. Other options may be in the creation of NFT-related indices, but that requires more data and a longevity for NFTs that hasn't yet become apparent.

Outside of the art itself, the indices can offer an interesting insight into the state of the Chinese economy itself, as well as the creation of Chinese wealth, not just in terms of the money generated in China, but also more broadly as money generated by people of Chinese descent. As China is continuing to play an important role on the global stage, it could be pertinent to keep an eye on the art market to gauge its success.

Equity Check

David Yang, Managing Director and Head of China at investment firm Eurazeo, discusses investment and exit strategies, the PE investment environment and the need to stick to what you know and understand

The impact of the COVID-19 pandemic and geopolitical issues had a noticeable effect on private equity (PE) investment in 2023. While there were many positives in the market, there is room for greater recovery across a number of sectors and global markets.

In this interview, Managing Director and Head of China at private equity investment firm Eurazeo, David Yang, discusses the considerations for making investments, the different factors affecting the global PE investment market and the need for internationalization for businesses anywhere to succeed.

Q. Can you give a quick overview of the global PE investment environment?

A. In general, the US, Europe and APAC markets follow similar trends but remain quite different. We just wrapped up 2023, which has been a very interesting year for most of us in this industry. From a purely investment-focused perspective, it wasn't too bad a year, but there was certainly an impact on the fundraising side, particularly due to the persistent interest rate hiking which made lending more difficult. It is quite a shift from a few years ago when there was a frenzy of dealmaking, and the private equity market has been impacted.

Despite not being the best year in PE history, some of the bonds performed well while others performed worse than desired. In general, it has been a pretty challenging year for Europe, and the APAC markets, both because of the things I mentioned, but also geopolitics is playing an important role. People are much more cautious about doing cross-border deals, which understandably has quite a big impact on big global funds.

Q. What are your main strategies when looking to make an investment?

A. We have around €35 billion under management, so we utilize various investment strategies. Our flagship fund strategy is focused on mid-large buyouts. We take control, or sometimes co-control, of the investment target, work with them for a few years and then exit. Another strategy is Eurazeo PME, a small- and medium-buyout fund, also taking controlling stakes in investment targets. Having said that, we have multiple other investment strategies ranging from venture, growth, ESG, infrastructure, private debt, etc.

For those strategies, of course their names imply what many of them do. Some of them focus on early-stage companies and take a small stake here or there and then work with the founders, and some work with companies at a growth stage, taking 20-30% and help push them to the next level. For private debt or secondary investment, the strategies are totally different. And in terms of a breakdown, around 75% of our assets under management (AUM) is in the private equity section and 20% of the overall is in private debt.

Q. What is your go-to exit strategy and to what degree have you been successful with different entities?

A. When we talk about PE markets, people often first think of a few of the major names such as KKR and Blackstone, that mostly do deals involving large-cap companies, with assets of $2 to $5 billion or even upwards, and eventually taking those giant companies private. After this, they then mostly end up going back through the stock market and exiting after the IPO, with the expectation of an extraordinary return. However, those kind of returns no longer always exist. Sometimes they'll keep the companies private for a varying period of time, but their end game is likely the public markets.

But for us, we're more focused on mid-cap businesses, with flagship investments likely to look at the middle or upper-mid markets, and this means the use of a different strategy. We are working with smaller companies that have a lot of room to grow, and this makes it much easier to identify buyers beyond the IPO markets, which also provides us with many more strategic angles to play through. And by working with smaller companies, you require a lot of relationship-building, taking insider seats and growing with the entrepreneurs and developing a level of trust, which in turn can create a lot of arbitrage opportunities.

Whereas when you are working with large companies, everyone knows who they are which affects the bidding process, leverage and valuations, among other things. But for mid-cap, we have significantly more leverage and many more resources to work with, particularly from our own balance sheet, with the sizeable AUM, which has allowed us to build a global team. The global footprint allows us to open eyes to the companies we work with which may well have been focused on their home market up until that point, giving them potential opportunities around the world that they may not have thought of.

So the globalization angle is a pretty good strategy for developing these companies, equipping them with all the tools they need to expand, whether that be digitalization, HR management resources or financial analysis, resulting in a growth in value three, five or seven years down the line. But this is also why we focus on taking control of the company in the first place, as it allows us to properly utilize the resources at our disposal, because if you have to consistently fight with shareholders or a controlling entrepreneur then this becomes significantly more difficult.

> I think the overall trend of internationalization will continue as globalization is something that will never realistically be stopped

Q. What do you look for in a prospective investment target?

A. Most of our investments are tech-related in some way. We try to stay away from following the herd. In China, three to five years ago, many firms were fighting over new F&B companies that they thought could grow from 10 stores to 1,000 stores off the back of rising incomes and the large population. But many of these turned out to be disasters, and the many popular food and fashion brands that have closed their doors and have fallen out of favor exemplifies this. The other thing we don't pursue are businesses that we don't understand, for example biotech, which requires intensive and extensive PhD-level understanding.

An example of something we have focused on is MedTech, which requires strong R&D understanding, but is generally something that is easier to comprehend, model out and you can work with entrepreneurs and hospitals to gain such an understanding. Another area is tech-enabled services, which is often B2B and proved its resilience during the COVID downturn.

Another important investment principle is having an understanding of potential future buyers when the investment is being made. IPOs is an easily understood market, but they can be hard to implement due to rigorous regulatory requirements, shifting financial performance markets and also geopolitical issues, all of which have hampered IPOs in recent years.

In that we look at mid-cap companies, we have bigger investment firms between us and the IPO stage, who want to buy companies with higher valuations. There is also another very important group of players who are the strategic buyers looking to purchase companies that closely relate to their own business. The benefits of the strategic buyer tend to be better multiples, better synergy and much smoother transaction processes because you don't have to go through so much scrutiny, compared to an IPO.

Q. To what degree is there a difference in approach to analyzing a Chinese company versus a non-Chinese company as a potential investment?

A. There are, of course, idiosyncrasies that we have to bear in mind when we're making an analysis. I think for us, with the European companies we target we're more focused on the technology and whether they are planning to expand globally. But with Chinese companies we will pay more attention to how they have built up their team, how sustainable and stable their teams are. We have to bear in mind that monetary policies across the globe vary significantly and are sometimes moving in opposite directions. This requires a high level of management skills within the teams and an understanding of how to navigate and avoid credit crunches in different environments.

China has experienced very rapid growth in the past 30 to 40 years and there is potential that some Chinese entrepreneurs are more eager to see faster expansion, compared to their counterparts across the world, rather than spending more time to do R&D or fine-tuning their technology. While at the other end, the European counterparts are more conservative, there is a different approach and everything is taken step-by-step. So this is where we have to strike a balance, and I would be hesitant to say that either approach is good or bad.

> [An] important investment principle is having an understanding of potential future buyers when the investment is being made

Q. How would you say the trends in internationalization of Chinese companies and the entry into the Chinese market by foreign companies has changed in recent years?

A. The trends for both Chinese companies going abroad and foreign firms coming in, has slowed down quite a bit. COVID-restricted travel and geopolitical sensitivities are relevant factors. Some sectors have been impacted more than others, but in general I think the overall trend of internationalization will continue as globalization is something that will never realistically be stopped.

At the end of the day, if there is a free market, those entrepreneurs that want to be successful will seek ways to expand, and cross-border expansion is a must. This has been proven in recent years by companies like CATL or Huawei etc.

Together with our strategic partners, we recently held a China-France entrepreneurial summit in Paris. We didn't have huge expectations given the cloud of COVID which was still around and all of the geopolitical issues present, but the results of the face-to-face exchanges between business leaders from both sides really cemented the idea that, especially in areas such as new energy and EVs, there is still a bright future for cross-border business.

Q. Where does your optimism lie in terms of the future of PE investment?

A. Setting China aside, there is some speculation of rate cuts, which, jointly with other factors, could create a better environment for financing, compared to 2023. This could create an economic model where deal transactions would be more viable. Also, given the dissipating of COVID, hopefully international travel will continue to get easier, which should, in turn, boost the recovery of a lot of businesses and sectors. I have to admit that in 2023, the recovery wasn't as fast as some people thought it might be, but in 2024 I think things will gradually improve.

Interview by Patrick Body

TAKING FLIGHT (AGAIN)

Although the worst of the pandemic's impact on travel is over, stimulating demand is still a challenge for Trip.com Group

By Patrick Body

Now that the world has reopened, Trip.com Group is looking to return to previous heights

More than a year after China's border reopened for international travel, parts of Shanghai's Pudong Airport still feel like a ghost town. The aftermath of COVID was so strong that in 2024 the airport has still not moved back into the top 10 busiest airports in the world for international travel, a reflection of the slow recovery of cross-border trips in China.

Prior to the pandemic, the country's travel and tourism spending had been among the highest in the world and had been rising steadily for years. But today, outbound tourism has only recovered to around 40% of pre-COVID levels. Travel businesses everywhere suffered a massive drop in turnover, but those in China have suffered the longest due to prolonged restrictions.

Trip.com Group, China's most popular online travel company, is one of those. In order to survive during the worst of the pandemic, the company, like many others, had to adapt. It digitalized rapidly and swiftly shifted its focus to the domestic market and seeking out untapped consumer demand. The company appears to have made it through the toughest of times, but the shadow of the pandemic has not completely disappeared.

"The travel industry in China had to find ways to survive, reduce costs and find new business," says Oliver Sedlinger, CEO of specialized tourism consultancy Sedlinger & Associates. "It was a very difficult time, especially since no one knew when and how business could restart."

What a trip!

Co-founded as Ctrip in 1999 by four Chinese entrepreneurs, the company is now arguably China's best known online travel agency. It listed on NASDAQ in 2003. Ctrip then acquired other online travel agencies Trip.com, Qunar and Skyscanner, all of which offer the ability to compare and book travel tickets and accommodation, and rebranded as Trip.com Group in 2019. In 2021, the company completed a secondary listing on the Hong Kong Stock Exchange.

The company's various subsidiaries offer a multitude of travel-related services for both the China and international markets, including flight, tour and hotel bookings as well as car rental and complete vacation packages. It also has a huge network of affiliate businesses across China and around the world, from travel agents to luxury hotel chains, which provide consumers with access to special offers and unique products.

"What the company did, particularly in the decade before the pandemic, was increase not just its international branding and marketing, but also its partnership with international tourism companies, destinations and tourist boards," says Gary Bowerman, Director of Check-in Asia, a tourism intelligence & strategic marketing firm.

Internationally, the company competes with well-known online travel agencies (OTAs) such as Booking.com and Expedia, while at home there is a vast array of competition, from smaller OTAs to subsidiaries of the country's internet giants such as Alibaba's Fliggy and Meituan.

Trip.com Group's annual revenue was showing consistent growth prior to the pandemic, and the company pulled in $5.12 billion in 2019 with a net income of just over $1 billion. After an almost 50% drop in 2020 in revenues, the company is yet to return to such heights and the last few years have been somewhat rocky. In 2022, company revenues were still only $2.9 billion.

Much of this income comes from four main revenue streams: accommodation reservations, transportation ticketing, package tours and corporate travel, in particular for outbound travelers from China.

"A lot of how Trip.com Group developed was done with the intention of increasing outbound Chinese tourism," says Bowerman. And the pandemic forced the company to turn the premise on which it was built on its head, forcing it to think on its feet and pivot into new areas of opportunity.

Holidaying at home

China's pandemic-related travel restrictions far outlasted those in other parts of the world. In early 2020, while its borders were closed and international travel was all but impossible, domestic movement was relatively uninhibited after the initial lockdown—as a result, China maintained its status as the world's second-largest air market throughout the pandemic. For Trip specifically, this meant a major strategic shift away from its erstwhile focus on outbound travel.

"They had hired a lot of people whose focus was entirely outside of the country, and when the borders closed, they had to turn these into domestic positions, which requires a completely different skillset," says Bowerman. "They had to completely restructure what they do in a very competitive market, with companies all targeting the same people with largely the same offerings."

The first major financial hit to the company came in the form of refunds for the upcoming Chinese New Year holiday in 2020, which came just after pandemic travel restrictions were put in place. But it was also an opportunity for Trip.com Group to build goodwill with customers and partners.

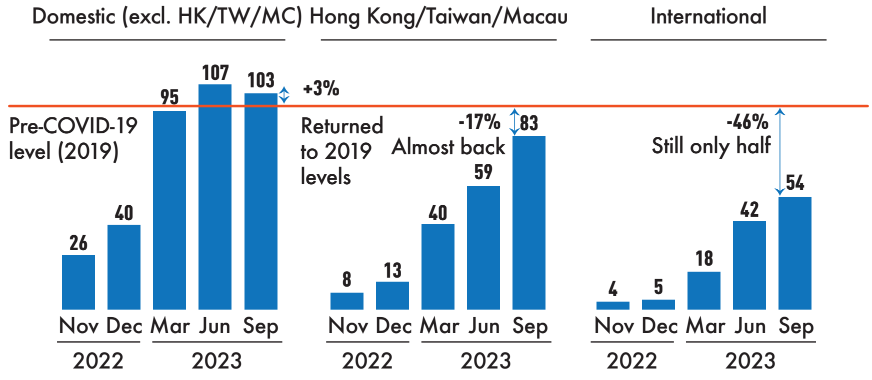
"We tried to build trust with consumers through the billions of ticket refunds we processed in the early months of the pandemic," says a Trip.com Group spokesperson. "We also set up a ¥1 billion partnership fund to ease the cashflow worries of our small- and medium-sized partners."

In general, it was a positive move, but due to massive short-term liquidity demands, some customers were left waiting for refunds. "I was stuck in Shanghai and cancelled my flight tickets in early March, but I didn't actually receive the money in my bank account until later in April," says Helen Fu, a 33-year-old Shanghai resident. "The communication with the company was quite good in that even though they couldn't give me a date for the refund, because they had no idea when the money would be released by the airline, they were open about not knowing."

In June 2020, the company announced "Travel On," a range of initiatives aimed at reinvigorating travel. This included waiving change fees for bookings,

UP IN THE AIR

China's domestic air travel has returned to pre-COVID levels, but international travel still lags behind



Source: CAAC

providing customers with discounts of up to 60% on flexible advance reservations to a number of hotels across the world and providing continued access to funding for its global partners.

To make domestic travel as seamless as possible, Trip.com Group, along with other OTAs began to focus on a few key areas, in particular accelerating the mobile-first nature of services during the pandemic. By 2022, Trip.com Group reported that 90% of its bookings were made via mobile devices.

The bookings themselves also came from a new audience in the country's lower-tier cities, residents of which make up 70% of the country's urban population and were expressly targeted by OTAs, having been previously underserved by travel companies.

"Lower-tier cities were a captive market during the pandemic because it was functionally a closed market," says Bowerman. "It also helped that they could initially focus on small-basket travel purchases rather than expensive trips."

Self-driven road trips, given their lower level of risk and greater control compared to public transport also became popular, as well as shorter trips and local destinations for similar reasons.

For international travel, the key focus for the company was to stimulate continued interest in travel for customers despite the lack of international travel opportunities, while also maintaining the interest of its overseas partners in attracting future Chinese tourists.

In conjunction with international partners such as the Metropolitan Opera in New York and London's National Theatre, the company promoted livestreams of shows performed from the home of actors and musicians, as well as tours of world-famous museums, art galleries and zoos. Both co-founder James Liang and CEO Jane Sun also ran personal livestreams, promoting and selling products.

The "Travel On" initiative in late 2020, also included steep discounts through their subsidy fund for bookings to countries such as Singapore. The bookings were low-cost and highly flexible, but kept user and partner interest high.

Fight or flight?

Chinese travellers have been slowly returning to the rest of the world since January 2023, when the country's borders were reopened for international travel, but international flight capacity had only reached 50% of pre-pandemic levels by mid-2023. Bookings are also starting to show signs of recovery, and in Q2 2023, Trip's outbound hotel and air reservations reached 60% of pre-pandemic levels, surpassing the industry-wide recovery rate of 37% in terms of international air passenger volume for the same period.

"Chinese outbound tourism is mostly being driven by 'revenge tourism'—the pent-up desire to travel after three years of restricted mobility," says Eduardo

Santander, Executive Director of the European Travel Commission (ETC). "Though numbers are still well below 2019 levels, the lifting of travel restrictions unleashed a sizable amount of suppressed wanderlust."

Despite the slow business uptick, there are still a number of hurdles to overcome. Domestically, China is facing geopolitical and economic headwinds that have compounded problems, and dented consumer confidence and spending has affected willingness and ability to travel.

"Even though I've always had an interest in travelling, the last few years of the pandemic and a tough time finding a good job has meant that money is quite tight at the moment," says Helen Fu. "I'll travel when I can afford to, but there aren't any big trips on the itinerary at the moment."

China's world-beating high-speed rail system and self-driving holidays are still proving popular, and have mostly returned to pre-pandemic capacity. But the number of flights into, out of and around the country remains on the lower end, partly because the utilization of planes and crew numbers were cut during the pandemic. For many airlines in China, international flights, particularly to Southeast Asia, used to be the big money spinners, and the financial impact incurred by the loss of these flights was significant.

"International flight capacity continues to ramp up, but is yet to recover to pre-pandemic levels," says a Trip.com Group spokesperson. "It will take some more time for airline and hotel partners to recover their staffing levels and build up the infrastructure needed to facilitate this demand level to cater to tourists."

The centrally-planned nature of the Chinese economy is also a constricting factor for travel businesses. "China controlled its reopening very carefully in 2023," says Bowerman. "There were constraints on travel companies, how they could operate internationally and how airlines were able to renew international routes as well as licences to fly overseas again."

Geopolitical tensions with the West have also had a negative impact on outbound travel, particularly on flights to the US, which have dropped from 340 a week in 2019 to only around 70 a week in November 2023. But also, and more acutely, they have had an effect on inbound travel, and most visits to China are now business-related.

The leisure market remains slow for a number of reasons. General sentiment towards China, particularly in the West, is negative and this is compounded by concerns around safety and the high financial and time costs associated with the visa process for visitors. China has announced periods of visa-free travel between a number of countries including Thailand and several European nations, but recovery is expected to remain slow.

Looking at outbound travel, there were hopes from popular destinations such as Southeast Asia that visitor numbers would quickly bounce back, but that has not been the case. A lack of flight capacity remains on top of the economic and geopolitical issues present, and industry experts don't expect to see the number of available seats for international travel returning to normal until at least 2025.

For travel to Europe, according to the ETC, high costs are the biggest concern for tourists when considering a trip to the continent. "Air capacity between China and Europe is still well below pre-pandemic levels and since Russian airspace was closed to European carriers at the start of the war in Ukraine, flight times between Europe and East Asia have significantly increased, leading to inflated prices for consumers," says Santander.

Small Groups: More intimate tours remain popular with Chinese tourists

Tentative steps

Trip.com Group has clearly learned from the pandemic period and is digitalizing their approaches to both marketing and customer support, as well as maintaining strong connections to domestic and international partners. China's consumers are a notoriously discerning group and they are also very active online, and Trip.com Group has capitalized on this through both their sales livestreams and also their promotion of user-generated content (UGC).

"We have tried to enhance engagement between travelers and partners through the use of content marketing, and a lot of this is UGC," says the Trip.com Group spokesperson. "There is a community travel sharing space on Ctrip and Trip Moments on Trip.com, which both showcase trips and ideas from users."

The company has also introduced more customizable options for customers seeking less traditional and more 'authentic' experiences. The company promotes real-time-updated trends, deals and popular options across its online presence.

In July 2023, Trip.com Group also jumped on the growing popularity of AI, launching an AI-powered assistant called TripGenie which is incorporated into the mobile app for users around the world. The tool uses large language model (LLM) technologies, similar to those behind

ChatGPT, to help craft travel itineraries, provide booking information and shorten the overall booking process.

A month later, the company signed an MOU with Amazon Web Services (AWS) to build a joint innovation lab with the aim of improving their AI, cloud technologies and flight, hotel and international business sectors.

> Chinese outbound tourism is mostly being driven by 'revenge tourism'—the pent-up desire to travel after three years of restricted mobility
>
> Eduardo Santander
> Executive Director
> European Travel Commission

Going global

Prior to the pandemic, Trip.com Group was working on entering and building its presence in markets across the globe. During the pandemic, attempts to keep marketing and other partnerships active through livestreams and pre-booking were successful to some extent, but in 2023 the company was faced with the challenge of restarting many international partnerships.

"They have pretty much returned to the 2019 plan, which did work at the time, and have said that they also see additional new opportunities for inbound travel growth into China," says Bowerman. "We are now in a new era, and analysts and investors are worried about how difficult it will be for them to grow their global marketing sales, because relying heavily on outbound Chinese travel isn't going to work in the near future."

The company has its own content channels through which it promotes partners and offers, something that is unmatched by other OTAs, and this appeals to travel partners around the world who often have to use third-party applications. Additionally, it supports the UGC model that Trip is increasingly utilizing and allows for purchases at every touchpoint for consumers on what is designed to be a seamless journey from idea to purchase.

But, whatever the technological offerings, for partnerships to be successful, they need to be supported by demand, and demand from Chinese consumers has shifted. There are still some pre-pandemic parallels, with continued interest in group tours, for example, albeit on a smaller scale. But the travel preferences of younger generations in particular are changing as they are looking for new, experimental and different experiences.

"These are long-term trends that will persist and only grow stronger, since these constitute fundamental lifestyle and consumption changes," says Sedlinger.

The major change is that the booking window—the time between the booking and the trip itself—has become significantly shorter. This causes issues for partners in predicting and preparing for demand, particularly given the slow rate of recovery. But while this can partly be attributed to the general feeling of uncertainty in Chinese society at the moment, it is also a symptom of the on-demand nature of Chinese consumerism in general.

Once again, livestreams and flash sales are a large part of the company's approach to stimulating demand. In early 2023 they launched a "Super World Travel" livestream series in collaboration with destination partners such as Singapore, Thailand and South Korea, which showcased the destinations and offered related deals.

"We also run flash sales in almost every local market in APAC for customers in the country," says the spokesperson. "We've been doing it bi-monthly since 2022 in Singapore and Malaysia and recently we had our first Indonesian sale."

Delays and cancellations

Thanks to its strong position prior to the pandemic, quick adaptations and diverse investments, Trip.com Group has seemingly ridden out the biggest period of pandemic-related turbulence and is on the road to recovery.

But challenges remain and the company had a slip-up domestically when they released their 2023 H1 results, commenting that the business travel market was consistent with an economy that wasn't doing as well as expected, leading to a significant hit to its share price.

Internationally, and somewhat out of the company's control, there is also the issue of how China is viewed by the rest of the world. The perception of China, particularly in the West is a hindrance for businesses across a wide range of sectors and for tourism it affects interest in travel and business collaboration opportunities.

It remains unclear as to how and when demand, capacity and the previous intensity of travel to and from China will return to pre-pandemic levels. And for Trip.com Group and the entirety of the Chinese market, 2023 has been a year of learning, working to understand new behaviors, trends and attitudes and working out how to cater to them properly in 2024.

But with what is likely to be the worst of times behind them, and numbers slowly rising again, thanks to innovative strategies and a dynamic business approach, the company looks set to take off.

"They have to drive demand, and although that can be tricky, I think we're going to see some kind of acquisition or global move that puts them in a stronger position," says Bowerman. "What that will be is hard to say, but what we have seen in the past is that Trip have always met their challenges head on."

CKGSB BUSINESS CONDITIONS INDEX

Hot or Not?

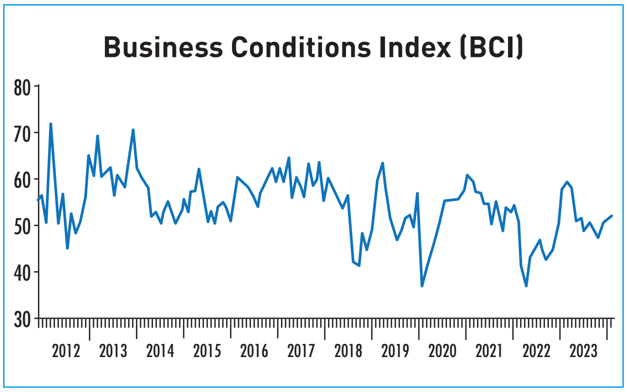
CKGSB's Business Conditions Index, reflecting confidence levels in China business, shows a not yet significant rebound

The BCI is directed by Li Wei, Professor of Economics at the Cheung Kong Graduate School of Business

The CKGSB Business Conditions Index (BCI) registered 51.6 in February, a slight rise from January's total of 51.1, which does not yet indicate a significant rebound. Further developments will need close observation.

Introduction

The CKGSB Business Conditions Index (CKBCI) is a set of forward-looking diffusion indicators. The index takes 50 as its threshold, so a value above 50 means that the variable that the index measures is expected to increase, while a value below 50 means that the variable is expected to fall. The CKGSB BCI uses the same methodology as the PMI index.

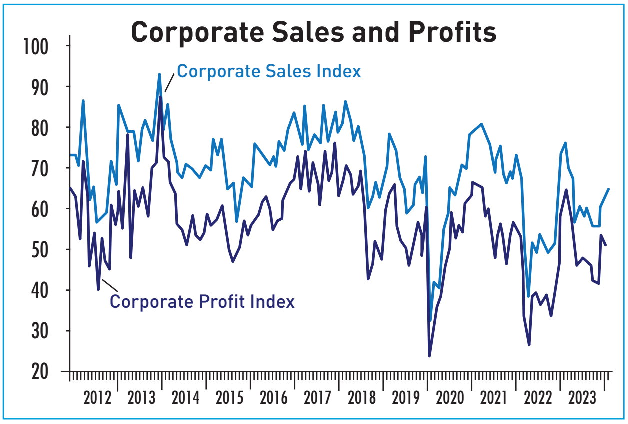


Key Findings

- Profit expectations displayed a weak show of confidence, falling to just above the 50 mark
- High cost predictions mean companies see rising expenses in the next six months, which could be an indicator of the economy heating up
- The Investment and Recruitment indices rose slightly, but after significant slides in recent months

Analysis

The CKGSB BCI comprises four sub-indices: sales, profit, financing environment and inventory. Three measure prospects

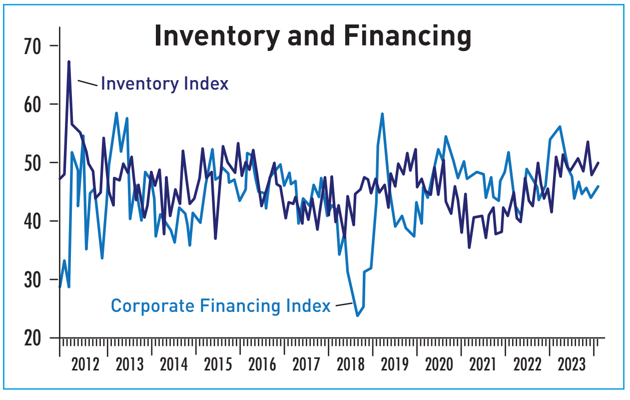


and one, the corporate financing index, measures the current state of affairs. In February 2024, they performed as follows:

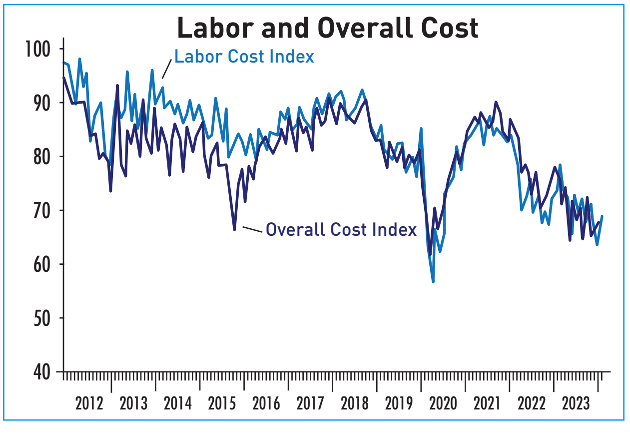
Three of the four subindices rose and one fell this month. The corporate sales index rose from 60.9 to 64.1, while the corporate profit index slid from 52.7 to 50.2. This means profit expectations stayed above the 50.0 mark, albeit in a relatively weak show of confidence.

Corporate financing prospects rose slightly from 44.3 to 45.6. The index for inventory stayed below 50.0, at 49.1 up from January's 47.9.

Important to note is that, unlike for sales, profit and financing, when it comes to the subindex measuring inventory, a falling index means overcapacity. While for the first three sub-indices, a rise means that the situation is improving, and a fall, deteriorating, for inventory a fall suggests stocks may be gathering dust in the warehouse.

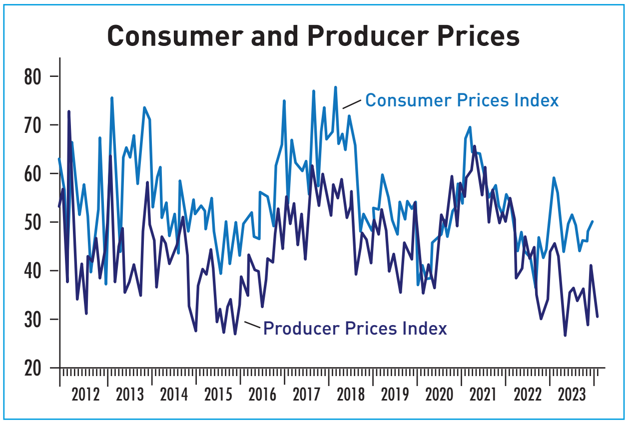


Aside from the main BCI, we also forecast costs, prices, investment and recruitment demand over the next six months.

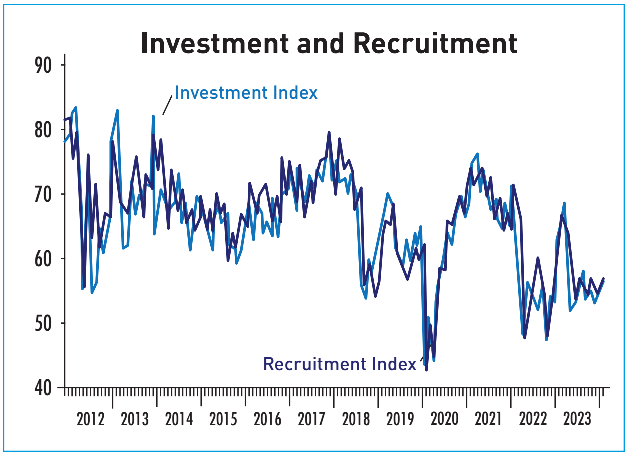


This month, the prognosis for labor costs rose from 64.0 to 68.3. The overall costs index rose slightly from 66.4 to 67.5. These high-cost predictions mean most companies anticipate rising expenses in the next half year. Although high labor and overall costs increase pressure on companies' bottom lines, they do not necessarily mean a deterioration of business conditions in China over the next six months. It could instead mean the economy is heating up, and companies are feeling the push to spend as demand recovers. When unit costs of production or sales rise, this may mean demand has grown. Companies feel the impact of cost hikes, but improved sales mitigate this.

The consumer price index rose marginally this month, from 49.4 to 49.5. The producer price index headed back into unfavorable grounds, dropping from 40.2 to 30.8, showing the pressure continuing to be faced by primary goods producers.



We now turn to investment and recruitment. These indices have both been at the more confident end of the scale since the BCI began. In the past few months, they have slid significantly. Since the Chinese economy is largely investment-driven, and investment has a strong link with job recruitment, their trajectory is important to follow. In other words, these two indicators look at plans for expansion in China's business world. The index for investment rose slightly from 55.5 to 56.4; the index for employment rose from 55.7 to 57.1.



Conclusion

There is a lukewarm feeling towards the economy in these indices. While there are some signs that the economy may be warming up, there are still plenty of causes for concern.

CKGSB CASE STUDY

Banking on Data

MYBank has used the digitalization process to innovate on and revolutionize supply chain finance

By Song Zhongzhi, Associate Professor of Finance, Shanghai Jiao Tong University;
Li Mengjun, Senior Researcher, Case Center, Cheung Kong Graduate School of Business

China's private sector, which primarily comprises micro-, small- and medium-sized enterprises (MSMEs), is the backbone of the Chinese economy. It contributes more than 50% of tax revenue, more than 60% of GDP, more than 70% of technological innovations, more than 80% of urban employment and more than 90% of market entities in China. MSMEs play a pivotal role in driving economic growth, but with conventional commercial banks in China tending to be risk-averse, MSMEs often face difficulties obtaining cheap financing due to a lack of credit and collateral.

In the past, MSMEs often relied heavily for credit on "core enterprises," that is key players in the supply chain, which coordinate and drive the flow of goods, service and payments. Typically large-scale buyers and manufacturers, they have enormous power stemming from their ability to set payment terms and conditions for their suppliers.

To address the challenge of providing credit to MSMEs, MYbank, an Alibaba-backed digital bank in China, launched a finance system named the "Goose System."

Money talks

MYbank was established by Ant Group in June 2015 and from the outset has positioned itself as a digital financing institution serving MSMEs and individuals with limited access to bank financing. MYbank operates without brick-and-mortar branches, instead aiming to be a technology-based online bank.

MSMEs often require quick and flexible access to low-interest loans. However, their sometimes limited collateral, sparse credit records and incomplete financial reports may make them less appealing to traditional lenders, even for relatively small loan amounts.

In its early days, MYbank mainly served e-commerce sellers on Taobao and Tmall. By leveraging transaction data accumulated on these e-commerce platforms, the company developed a unique big-data automated loan processing system that was referred to as "310," since it granted loans within three minutes and disbursed them in one second with zero human intervention. Since 2017, MYbank has expanded its online lending to serving offline businesses using a QR code-based payment system, through which it has achieved solid cashflow and has served businesses in sectors including retail, catering, clothing, logistics, construction and manufacturing.

At present, MYbank has three major business units, providing finance services for MSMEs, rural communities and supply chains respectively. As of the end of 2022, MYbank had served more than 50 million small- and micro-level customers. For 80% of its clients, MYbank has been their first business loan provider.

Branching out

In 2016, Alibaba announced that it would be focusing on "new retail" and "new finance." Backed by Alibaba's affiliate firm Ant Financial, MYbank responded by launching "self-factoring" for Tmall brand owners, a service that allowed Tmall sellers to receive early payments for invoices that had yet to be paid. MYbank subsequently extended its services to offering loans to eligible distributors and companies operating within the Alibaba-supported supply chains of the Cainiao logistics and Freshippo retail services.

In 2018, MYbank made the move to operate beyond Alibaba's e-commerce ecosystem. There were several reasons behind this decision. Firstly, MYbank has a mission to empower as many MSMEs as possible across society, by providing them with convenient and affordable financial services. Second, many core enterprises, or large corporations such as Mengniu (a dairy company) and Liby (a detergent manufacturer), reached out to MYbank to provide supply chain financial services for their downstream and upstream MSME partners.

Third, through its operation within the confines of Alibaba, MYbank accumulated large volumes of data, an understanding of risk management and experience in granting credit and offering interest rate concessions, all based on the dynamic needs of merchants. This knowledge and experience was available to extend to a broader set of customers beyond Alibaba.

> As well as offering loans to distributors, MYbank's Goose System also addresses the difficulties of fund management through its "cloud fund" offering

The Goose System

MYbank recognized that the methods used by conventional banks to assess the risk of default were not appropriate for MSME borrowers and that it needed to find a new way to evaluate applications for credit. Therefore, MYbank developed an integrated digital supply chain finance solution, the "Goose System," in collaboration with tech teams from Alibaba Cloud and DingTalk, an Alibaba communication platform.

The Goose System is essentially a digital transaction monitoring platform, centered on core enterprises but covering businesses along the entire supply chain.

Alibaba serves companies large and small, generating abundant data. With access to the data MYbank can assess how well these companies are performing. Thus, similar to how it analyzes QR code payments to assess small businesses, MYbank has access to a reliable information source to verify a borrower's credit level when both parties to a transaction are using the Goose System. Based on the data acquired, MYbank offers a range of cloud debt products covering different stages of supply chain finance for businesses of varying sizes.

The Goose System requires no collateral and runs without human intervention. It can span the entire supply chain and now extends across China. Currently, more than 500 large brands, or core enterprises, including Haier (home appliances), Huawei (electronics), Mengniu (dairy) and Want Want (food and beverage), have adopted the system. MSMEs, and in particular those that are their distributors, now have an alternative basis for their "credit rating," i.e., their transaction data with these core companies, making them eligible for credit loans. Thanks to the Goose System, MSMEs face a much lower barrier than they had previously confronted when accessing supply chain finance. Almost 80% of core enterprises' downstream distributors and brick-and-mortar stores now have access to business loans. With its large data pool, the Goose System has been able to analyze combined transaction data across different supply chains that had previously been assumed to be irrelevant to one another and in doing so has been able to more clearly map out various markets and industries. The more data MYbank can acquire, the better its chances of creating a novel and successful method of risk management, something that cannot be matched by a traditional bank.

The approval rate of business loans for MSMEs through Goose is currently over 80%. It has particularly benefitted China's under-developed regions, with nearly half the SMEs using MYbank's procurement loan services being located in central and western China. The Goose System and its digital credit have also alleviated the need for core enterprises to vouch for their distributors, thereby minimizing their exposure to financial risk.

Take that to the bank

Mengniu provides an example of how MYbank can work in the real world. The Chinese dairy giant has almost 20,000 distributors in China, many of whom have previously experienced difficulty securing loans. As early as 2009, Mengniu started trying to address this, but loans were only provided to the largest distributors — those with sales exceeding ¥10 million ($1.5 million) — leaving the remaining 70% of distributors without access to credit.

In 2018, MYbank began providing exclusive procurement loan services to Mengniu's downstream small- and medium-sized distributors. Since partnering with MYbank, the approval rate of business loans for these distributors has risen to 80%, 58% of them coming from the under-developed central and western regions of China. According to Mengniu's supply chain financing platform, distributors using MYbank's digital financial services in 2020 saw a 22% YoY growth in sales volume, compared with only 10% for those who did not use MYbank.

As well as offering loans to distributors, MYbank's Goose System also addresses the difficulties of fund management through its "cloud fund" offering. MYbank provides firms with a complete set of online payment and fund management tools, including cash registers, account distribution, purchase payment collection and so on. Having these various functions under one single system simplifies account reconciliation, reduces costs, ensures compliance and ultimately improves efficiency of enterprise fund management.

In 2021, Happy Sweet Potato, a Chinese tea chain with nearly 2,000 franchise stores nationwide, combined its business and funds management systems using MYbank's Goose System. The system has allowed Happy Sweet Potato to accurately identify the source of payments in its offline stores and to automatically record accounts in the system, thereby enabling headquarters to immediately dispatch goods as soon as a franchise store has paid for them. Financial efficiency has increased by 30% compared with the earlier set-up, in which accounts were cross-checked across multiple systems.

Cash strapped

MYBank has, however, faced challenges with the Goose System.

Challenge 1: Understanding the subtleties of different businesses

To date, MYbank has served 500 core enterprises in nearly 20 industries. It takes time to build up an understanding of each industry, its underlying structure and any idiosyncrasies. Similarly, there may be regional differences, local policies and seasonal changes to be taken into account. MYbank needs to be sufficiently flexible to be able to adapt to these different situations, rather than taking a "one size fits all" approach.

Challenge 2: Obstacles associated with core enterprise customers

Another set of major challenges for MYbank is the technological barriers that eventuate from core enterprises that are not yet digitally advanced. While MYbank has been in contact with more than 1,000 core enterprises, over 80% of them lack the required digital capacity to access the Goose System. Of concern, many appear to be lacking the motivation to digitalize, since doing so will require a high level of upfront investment, with the benefits not immediately apparent.

If core enterprises are not digitalized, the quality data required for accurate risk assessment will not be available to MYbank, stymieing the opportunity for loan issuance. To overcome these barriers, MYbank is working closely with Ant Financial to try to encourage core enterprises to reach an adequate level of digitalization.

Another issue is that some core enterprises have requested commissions from the finance that MYbank has provided to their suppliers and distributors. MYbank has been reluctant to enter into these kinds of transactions, since it will inevitably involve transferring the cost burden onto the small- and micro-sized enterprises, increasing the financial pressure on them at a time when regulatory departments have been encouraging financial institutions to provide credit to MSMEs at lower interest rates.

Challenge 3: Promoting MYbank

While the model may be highly functional, MYbank has been lacking a dedicated sales force to promote its services. By contrast, most of MYbank's conventional commercial bank competitors have a large network of branches, numerous client managers and an established presence in the industry.

Ever since it was established, MYbank has acknowledged that it would not compete head-on with traditional financial institutions. Instead, MYbank has set out to collaborate with these banks, to share and co-develop the market, offering them improved operational efficiency through MYbank technology.

Conventional banks certainly have the advantage when it comes to managing people, while the digital-driven MYbank excels at processing data. Any cooperation between the two is win-win: banks are able to make more deals and MYbank earns a commission fee for each loan.

> The approval rate of business loans for MSMEs through Goose is currently over 80%

A bank you can bank on

The COVID-19 pandemic accelerated demand for contactless financial services, providing a clear advantage to online banks. Data and information have been key to the development of finance for those smaller supply chain enterprises that were not being well served by the traditional financial institutions. However, there are considerable risks in data acquisition and use. MYbank will need to ensure that data security is tight, in order to minimize the risks to its business operations and to ensure compliance with regulatory authorities.

The MYbank 2022 Sustainability Report clearly outlines its positioning, as "an explorer of internet banking and a practitioner of inclusive finance." MYbank has worked to solve the problems associated with microfinance through the use of technology, assisting MSMEs by providing efficient and convenient financial services. Further, it has taken an open and cooperative partnership approach in its dealings with traditional banks, local governments, tax bureaus and financing guarantee companies.

Rather than focusing solely on economic returns, MYbank has prioritized the social value generated through its businesses. MYbank needs to continue to ensure that it takes the necessary safeguards to minimize the various market, credit and operational risks it faces, while improving profitability and ensuring healthy development in the long run through championing innovative approaches to fintech.

WHAT'S ON THE MENU?

China's F&B industry is booming, with creative new products and services springing up, catering to broadening tastes

By Lu Zhao

The combination of new and old is a driving force behind parts of China's F&B innovation

Grabbing a coffee on the way to work is the norm for workers across the world and a trend increasingly catching on in China. But in coffee shops around the country, people are lining up not just for the standard fix of Americanos and Lattes, but also for new-fangled experimental drinks.

In September 2023, Luckin' Coffee and Moutai teamed up to create an unusual *baijiu*-flavored latte. The brand collaboration, bringing together the new—coffee in China—and the old—*baijiu*, which has always been China's number one selling liquor—is one of many examples of the new experimental trends sweeping across in the country's food and beverage (F&B) industry.

This tipsy cup of joe had Chinese social media up in a storm. "Can we drive a car after drinking the Moutai coffee?" was the number one subject on Chinese social network Weibo that month.

Chinese consumers are up for culinary experimentation—and F&B brands are happy to go the extra mile for them. The vast diversity of F&B offerings growing throughout the country continually surprises even Chinese consumers themselves as they stumble upon obscure regional foods and new culinary trends hyped on social media daily.

While Chinese food generally enjoys global recognition, the remarkable dynamism of China's domestic F&B industry often goes unnoticed outside the country. From budget-friendly street fare to multiple Michelin-starred dining experiences, the Chinese F&B industry is an ecosystem unlike any other worldwide.

"F&B demands [in China] are diversifying, opening up opportunities for a wider range of brands," says Allison Malmsten, public research director at Daxue Consulting specializing in China's food trends.

A Thriving Market

China is the world's largest food market by revenue, having surpassed the US in 2011 and undergoing robust growth ever since. By 2023, it generated $1,493 billion and is projected to grow by around 8% annually in the coming years. The F&B landscape comprises 2 million full-service catering businesses and a bar industry projected to hit a ¥1.6 trillion ($219.3 million) market size by the end of 2023.

Chinese consumers exhibit an ever-growing willingness to spend on F&B, although the recent pandemic created a sizeable bump in the road. According to a Rakuten Insights survey from December 2022, approximately 30% of respondents in China typically spent between ¥51 and ¥100 ($7-14) per person on dinner when dining out—the equivalent of an entire day's income when compared with the average per capita disposal income of households.

This of course, comes after the COVID-19 pandemic which had a notable impact on consumer spending, evidenced in part by the 16.6% decline in China's total catering revenue in 2020. As the economy continues to grapple with recovery, Chinese residents are still somewhat cautious on spending, which has led to a shift in F&B tastes.

"Consumers now care more about cost-effective products," says Rio Liu, co-founder and Asia sales director for Shanghai-based Peddlers Gin Company. "Higher-end F&Bs are more challenging to run."

The pandemic spurred rapid industry evolution and the introduction of novel F&B business models. Online food delivery, already a mainstay in China, surged, while pre-made meals are gaining traction among food establishments and consumers. Although concerns over the food safety and health benefits of pre-made meals persist among some skeptics.

"When it comes to pre-made foods, people link it to plastic packaging, excessive additives in their perception," says Yaling Jiang, founder of research and strategy consultancy ApertureChina and newsletter *Following the Yuan*. "There's so much pushback against it from the consumers that it requires manufacturers to be ultra-transparent with steps such as raw ingredients, preparation, processing, packaging and reheating."

Internationally, China plays a pivotal

role in both importing and exporting agricultural products. It leads in producing various goods like rice, meat and corn, but the country increasingly depends on imports such as soybeans and dairy products.

"Changing diet patterns have also driven up China's imports of edible oils, sugar, meat and processed foods," said Zongyuan Zoe Liu, the Maurice R. Greenberg Fellow for China Studies at the Council on Foreign Relations, in a January 2023 paper.

Emerging Trends

Despite the limitations of the pandemic, several new food and beverage trends have mushroomed across China in recent years. Small-scale Chinese fusion bistros, for instance, combining Chinese and Western cuisines with high-end drinks, have gained traction among young Chinese diners for their intimate, modern and often social media-worthy atmosphere.

"From the Western-style bistro in Shanghai in the early years to the rapidly growing modern Chinese bistro, Chinese consumers still enjoy the social entertainment scene of eating and drinking together," says Liu. And, according to Liu, with heightened competitiveness in the industry, venues are compelled to offer distinct experiences and competitive prices.

For instance, Ber2 Bistro in Zhengzhou, a city renowned for its historical significance as one of China's ancient capitals, blends French fine dining with the distinctive flavors of local Henan cuisine. Among their signature dishes is the yellow croaker cooked with clams in spicy soup, a traditional hot pepper soup originating from the region.

A diner shared their experience on the restaurant's Dianping page, China's equivalent to Yelp, stating, "This dish is a captivating fusion with unique Henan notes, and the spicy soup evokes nostalgic flavors reminiscent of my childhood."

Purchasing a specialty coffee in the provincial capital of Hunan, Changsha, for example, can cost less than $1. But despite such low prices, cafes, bars and other drinking establishments in China have seen an annual revenue increase of 16.4% to $9 billion over the past five years, including a notable 20.1% surge in 2023 alone.

Despite the traditional dominance of tea in the Chinese beverage market, China has emerged as one of the fastest-growing coffee markets globally, with an increasing number of coffee shops across the country. Shanghai is now home to the most coffee shops of any city in the world.

"There are a growing number of coffee aficionados that are looking for more sophistication. This drives coffee shops to explore and craft unique tastes, simultaneously educating consumers to appreciate higher quality coffee," says Hao Yang, a financial professional in Shanghai and coffee as well as cocktail enthusiast. "It feels the same for alcoholic drinks as well."

The trend of infusing Chinese elements and promoting health consciousness in coffee culture has also flourished throughout China. In Foshan, situated in the central Guangdong province, a coffee shop named Wuwei specializes in crafting "Chinese coffee" that incorporates traditional Chinese medicine ingredients like dried citrus peel and female ginseng. These additions are believed to offer health benefits, catering to the preferences of young professionals who seek the energizing effects of caffeine while also prioritizing their well-being to combat work-related burnouts.

Part of a healthy diet, plant-based drinks like soy, almond and multigrain products have long been embraced in China thanks to the country's Buddhist traditions. But recent years have seen the rise of oat and coconut drinks among young consumers, mostly influenced by the entry into the market of Western brands and tastes. Brands such as Oatly have helped drive not only the popularity of their own products, but also the coffee industry as a whole, and there have been other cases, too.

Luckin' Coffee's success with its raw coconut latte basically helped the company turn around after it had a financial scandal. "It sold 300 million orders in two years after launching in 2021," says Jiang. "As a result FreeNow, a supplier of Luckin's coconut drinks has also become a consumer-facing business.

Molecular mixology and innovative cocktails have also garnered significant popularity, catering to consumers seeking novel taste experiences, and shifting away from traditional liquors like *baijiu*. Imported spirits, low-alcohol drinks and other innovative options have flooded the marketplace and there are bars across the country offering both high-end foreign and domestic wines.

Even Chinese tea is undergoing a rebranding, with young tea manufacturers innovating new flavors, products, store decor and marketing strategies, catering to diverse consumer preferences.

Consider Reverse, a dual-functioning establishment in Chengdu, known for its daytime operation as a teahouse and transformation into a bar by night, reflecting the city's rich traditional teahouse culture. Bartender Guo Bing shared insights with RADII in 2022, expressing his passion for crafting tea-infused cocktails. "I really love making cocktails, but I've also always loved drinking tea. So it was natural for me [to mix tea and alcohol]," he said. "Tea has plenty of interesting aromas and fragrances that are just amazing to experiment with, and they make for great cocktails. The main challenge is ensuring that their bitter notes are not over-extracted when making tea-infused liquor."

These F&B trends are also observable in less developed Chinese cities, but to a more limited extent. Yang noted that while smaller cities may lack the purchasing power for fine dining experiences compared to tier-1 cities, night markets and street stalls thrive more in these areas. Big cities like Shanghai and Shenzhen have banned street vendors for decades and only eased the restrictions on hawking recently to boost the economy after the pandemic.

Social Media Eats First

The changing trends in the Chinese F&B industry are largely driven by and targeted at the younger generation of consumers, known for their willingness to spend on experiences. The desire for internationalized food experiences and the ease of access through delivery apps like Ele.me and Meituan facilitate these trends.

However, the primary driver behind the popularity of many F&B establishments is social media. According to Liu, approximately 70% of Gen Z's spending on F&B was originally intended for the production of social media posts. "This has led to many innovations that need to be more about 'looks good,' rather than just product quality," says Liu.

The driving force behind this are the many key opinion leaders (KOLs) that wield significant influence in shaping F&B trends, with consumers trusting their recommendations over brand endorsements.

According to Chanmama, a social media ecommerce data analysis platform, KOL Shikele (是可乐) emerged as the leader on Douyin's food sales charts in May of 2023. Throughout the month, she hosted 24 livestreams, amassing a collective increase of 214,000 fans and achieving daily sales ranging between ¥2.5 million to ¥5 million ($350,000 to $700,000). Now with over 3 million fans on Douyin, Shikele sells an array of food items, ranging from fruits to dim sum.

Social media platforms such as Douyin, Xiaohongshu, Bilibili, Weibo or even food documentaries have amplified the exposure of catering services, contributing to their visibility and popularity. "Even if a store does not have food delivery service or even tastes average, as long as it can increase its online exposure, it can gain consumer attention for a period of time," says Yang.

Cheers Burger, an internet-famous burger takeaway joint in Shanghai, gained widespread attention well before its official opening in October last year. Its distinctive vintage industrial architectural style continues to lure numerous KOLs and regular customers, drawing them to take photographs in front of the shop.

"There is definitely a rising demand for F&B content on social media," says Stephanie Cheung, director of Vermilion Asia, which oversees Xiaohongshu accounts for numerous F&B brands. "KFC set a record with nearly 3,000 posts on Xiaohongshu among F&B brands in a 90-day period in late 2023, while investing approximately ¥7.7 million ($1 million) in these efforts."

Bakery brand Bakehouse in Hong Kong, which has opened five stores within five years, has been a great example of what social media can produce. According to Cheung, "Xiaohongshu catapulted the brand to prominence, making it a top destination for mainland tourists visiting Hong Kong." The store sells over 900 egg tarts daily, with peak times seeing sales of 300 in just 15 minutes.

Old and new: Chinese F&B is melding together traditional and modern influences

Brands are actively pursuing strategies to maintain relevance on social media and to engage younger consumers. One popular approach involves forging collaborations with other, often seemingly unlikely, brands. For instance, Kweichow Moutai the top *baijiu* brand, and one half the liquor-latte collaboration with Luckin', also joined hands with Mengniu Dairy in May 2023 to launch its flagship ice cream store. These campaigns are designed to bring Moutai to the attention of younger generations, as the typical *baijiu* consumer is getting older and customer numbers are dropping.

Luckin' Coffee, meanwhile, experienced material shortages for the product due to unprecedented demand for the initial batches of the products.

"It is a smart, and potentially successful, way to increase popularity and visibility," says Yang. "In China, most young people believe Moutai is a consumer product that belongs to the previous generation. But these crossovers are bringing Moutai closer to young people and increase the potential for Moutai consumption in the future."

Malmsten also sees co-branding and IP collaborations as effective tools for F&B brands to generate excitement in China.

"On the streets of Shanghai we can easily find coffee flavors like orange juice coffee, cucumber latte, rose latte, osmanthus latte, and of course, the recent baijiu coffee," she says. "This open and experimental attitude towards food and drink creates opportunities for brands to be creative in the industry, allowing them to stand out with lower risk of backlash, compared to Western countries."

Tradition endures

Despite the appearance of new trends, traditional Chinese food continues to dominate the country's culinary scene.

"Although in cities or regions with limited exposure to foreign cuisine, the initial introduction of international dishes might capture a segment of the market, the majority tend to favor traditional Chinese food," says Yang. "Moreover, traditional Chinese cuisine has evolved by incorporating new flavors and enhancing service quality, which has garnered favor among younger demographics."

Encouraged by documentaries, food vlogs and social media, authentic regional cuisines have gained popularity across China. Dishes like 'Stilted Beef' from Leshan and Kaili sour fish soup from Guizhou, once limited to their respective regions, are now found across the country.

Chinese culinary influence has also extended beyond China and Asia, with brands like hotpot chain Haidilao and milk tea shop HeyTea expanding overseas.

"I see more 'going abroad' examples in beverage and hotpot, which have lower barriers to understanding for audiences abroad," says Jiang. "Having had a stable reputation in China, they have no problem attracting the initial audience who are Chinese diaspora. And locals will follow suit through the core audience."

But Jiang also pointed out that while Chinese food has gained recognition abroad, successful international operations hinge on the quality of service, products and overall experience. HeyTea's franchise in London faced a backlash due to supply issues, highlighting the challenges faced by brands expanding globally.

Regional cuisines also encounter hurdles in their global expansion. Chinese culinary representation abroad primarily revolves around Cantonese and Sichuanese cuisines. The former owes its prevalence to historical migration, while the latter has gained popularity abroad thanks to its tantalizing flavors.

While some may argue that popular Chinese chains abroad, such as P.F. Chang's and Panda Express, are "inauthentic," there are many who see these changes as adaptations necessary for localization.

"Food evolves with time and location, it's unfair to ask it not to change," says Jiang. "Also, from a product perspective, the likes of P.F. Chang's Panda Express serve the local audience, not visitors from China, so it's unfair to call it inauthentic."

"This is normal," agrees Liu. "All commercial products in foreign countries need an adjusted strategy. KFC sells Chinese food in China, but not in America."

Trends and Beyond

While the continued changes of the F&B industry as a whole are indisputable, the transient nature of social media-driven trends challenges businesses to constantly innovate and remain relevant. Restaurants must invest in food quality and service excellence to sustain long-term popularity amidst ever-changing trends. Restaurants vie to maintain an online presence and remain relevant by frequently updating menus and decor or through new and unique collaborations.

"Dining is no longer just about eating," says Cheung. "It now intertwines with the subjects that resonate with and captivate younger audiences, and there will certainly be a continued increase in catering's investment in marketing and collaborations with KOLs."

Additionally, as in any country, social media platforms have an impact on China's diet culture through the dissemination of health-related information, accurate or otherwise. Chinese celebrities such as actors Qin Hao and Yin Zheng have promoted various diets on social media, and this phenomenon has resulted in a diversification of F&B demands, opening up opportunities for a wider range of brands.

"With an abundance of information there are more and more diverging ideas of what is 'healthy,'" says Malmsten. "For example, there is a consumer tribe that eats a 'steak diet' where steak is the focal food of all meals, meanwhile there is an increasing number of vegetarian consumers."

The influence of Western cuisines high in fat have also resulted in a growing number of health concerns for China's citizens. "Obesity rates in our country are on a concerning rise," said Zhang Zhongtao, deputy director of Beijing Friendship Hospital, during a conference held earlier this year in Beijing. "More than 50% of adults are overweight or obese, with the proportion of obese individuals increasing at a higher rate than those overweight."

The burgeoning demand for healthy, affordable and enjoyable dining experiences has intensified competition within the catering industry, posing challenges and talent shortages. "There are definitely challenges for latecomers to the market that lack adequate capital support to stand out in the competitive landscape," says Yang.

Moreover, the shortage of talented chefs, attributed to social status perceptions, presents a significant industry hurdle. "Chef isn't a highly respected profession and there are historical reasons behind it," says Jiang. "The educational barrier isn't high, and in the 1970s and 1980s, kids learned to become a chef not because they loved it, but because you got fed."

And, according to Jiang, of those who are entering the industry now, a growing number of educated young Chinese are focusing on the Western food industry rather than traditional Chinese cuisine, reflecting a broader trend in the evolving landscape of China's F&B industry.

Full plates

Overall, China's F&B industry continues to evolve rapidly, driven by younger consumer preferences for unique experiences, healthy options and convenience. Despite economic fluctuations, Cheung shares, the country's catering revenue is expected to grow steadily at least through 2026 when it is estimated to reach about ¥8.165 billion ($54 million).

China's F&B industry, once rooted in centuries-old traditions, is now undergoing swift changes reflective of modern influences and a growing internationalization.

"China represents a huge market that never fails to attract individuals eager to engage in competition," says Yang. "The country's catering industry will continue to seek inspiration globally, embracing diverse raw materials, food processing techniques and production methods. Chinese consumers ardently look for innovative dining experiences, thus compelling China's F&B industry to undergo continual evolution and adaptability."

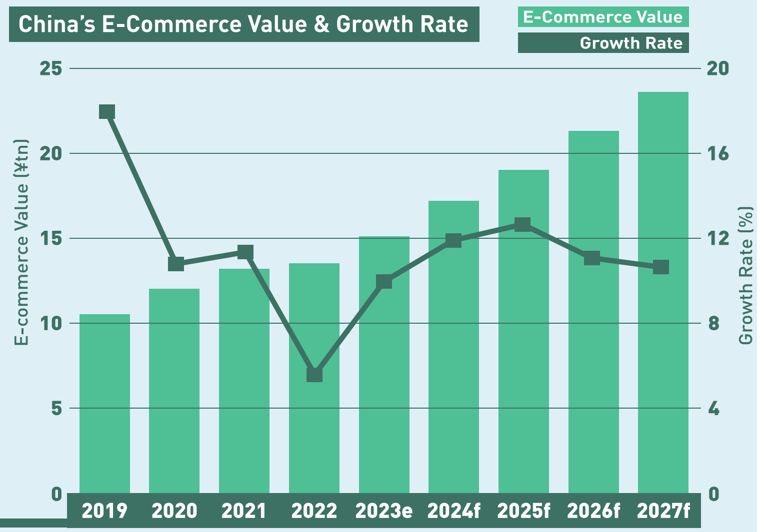
DIGITAL DELIVERY

China's e-commerce industry is world-leading in many ways, with almost 50% of worldwide e-commerce transactions taking place within the country's borders. The country is also a driver of innovation within the industry, and companies are rapidly adopting and refining product and logistical options to make it easier and more convenient than ever for consumers.

Value For Money

The e-commerce industry is still growing rapidly thanks to widespread mobile phone adoption, 5G adoption and evolving consumer behavior. By the end of 2024, the market is expected to be worth a remarkable $3 trillion, up from around $2.1 trillion in 2021.

The range of products availble to Chinese consumers online is huge, with apparel and electronics often being the most popular, followed by personal care products, home furnishings and groceries. But there are also growing markets for items such as luxury goods and health supplements.



"e" refers to "estimated", "f" refers to "forecast"

The Big Guns

Although there are a vast number of e-commerce platforms in China, the majority of purchases are concentrated on a much smaller number of apps. In 2022, Alibaba's Taobao and Tmall held a 50% market share, followed by JD.com on 15% and Pinduoduo at around 13%.

Alibaba
The largest e-commerce company by merchandise volume, mostly sold through Taobao and Tmall

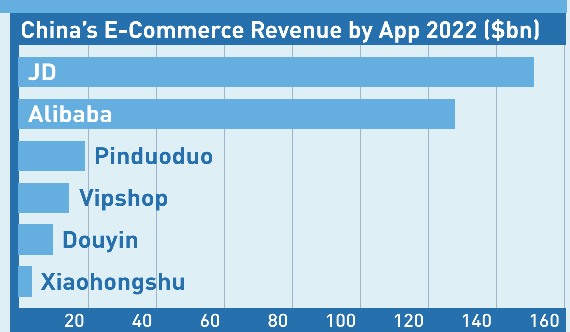
JD.com
While far behind Alibaba in volume, JD is the largest e-commerce platform by revenue

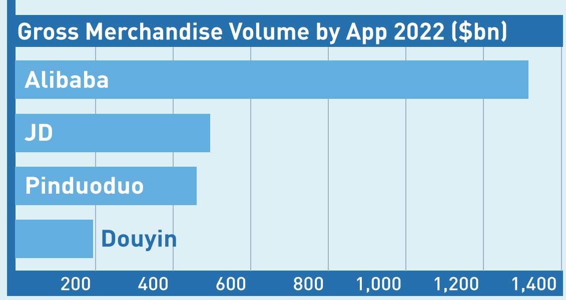
Pinduoduo
Increased the amount of direct-to-customer e-commerce in recent years through group purchases

Douyin 抖音
Tiktok's Chinese sister app which makes sales through a live commerce platform

Xiahongshu 小红书
'China's Instagram' which also offers sales through live commerce streams

Vipshop 唯品会
A discount and flash deal platform





Consumer Collective

The sheer number of consumers in the China market is key to the country's e-commerce industry expansion. Over two-thirds of the population are now online shoppers.

In the first half of 2023, 82% of all internet users in the country purchased something online.

Special Holidays

E-commerce in China is also the originator of a number of special holidays, during which brands offer massive discounts to attract customers. In 2009, Alibaba created the 'Singles Day' event held on November 11th or 11/11. During the week-long sales brands on the platform can generate up to 80% of their annual revenue.

Other holidays include Valentine's Day, Chinese New Year sales and the 18th June Mid-Year Shopping Festival.

Sharing is Caring

The integration of social media and livestreaming into the purchase process, through platforms such as WeChat, Douyin and Xiaohongshu, has given birth to a new form of e-commerce. China is at the forefront of the 'Social Commerce' phenomenon, which has transformed how consumers discover, evaluate and purchase products.

Livestreaming e-commerce buyers in China

2022 - 360 million

2025 Prediction - 415 million

On average, consumers watch 3-5 livestreams per week/100 minutes per week

Singles Day streams can reach 250 million views

Straight to the Door

Parcel Deliveries in 2023

China	120 billion
USA	21.2 billion
India	88.8 million

100 the annual average number of deliveries per person in China

Going Global

Chinese e-commerce firms are not just limited to the country's borders. There have also been a number of success stories with big names taking their expertise abroad.

Tencent 腾讯
Shopee
Lazada
AliExpress
ByteDance
TEMU
Ooma
SHEIN
MISSGUIDED

Sources: GlobalData Banking and Payments Intelligence Center; trade.gov; examinechina.com; SCMP; Ecommerce China Agency

data CHINA data

The stats you need to know

Macro

Rising Ratios

China's debt-to-GDP ratio climbed to a new record high in 2023 despite a slower pace of borrowing, reflecting the economy's weakening growth, according to a report from a state-backed think tank. The macro leverage ratio, which measures total outstanding non-financial debt as a share of nominal GDP, rose to **287.8%** in 2023, **13.5** percentage points higher than in 2022.

Source: *Caixin*

Beijing Bonds

The Beijing municipal government is experimenting with a program to repay its special-purpose bonds early to save on interest charges. The city government said that it has saved more than **70%** on interest costs through early repayment of special-purpose bonds in 2023, paying one bond nearly **17** years before its maturity date.

Source: *Nikkei Asia*

Toppling Trade

China's exports posted the first full-year decline since 2016 as global demand faltered and prices fell, hurting a major pillar of growth for the world's second-biggest economy. The country sold **$3.38 trillion** worth of goods to the rest of the world last year, a **4.6%** drop from the record a year earlier.

Source: *SCMP*

Business

Accruing Crew

British Airways plans to double the number of Chinese cabin crew for its flights between China and the UK as it sees strong demand for premium leisure travel. The UK's flagship carrier, which currently has **50** China-based cabin crew in its ranks, will add another **50** local-language staff. The recruitment drive will make China British Airways' second-largest international cabin crew base after India.

Source: *Caixin*

Setting Sail

BYD's first chartered cargo ship set sail in January as the carmaker ramps up exports of its electric vehicles. The *BYD Explorer* No. 1, capable of carrying **7,000 cars**, was bound for Europe. The ship is managed by Zodiac Maritime and is being rented to BYD.

Source: *Caixin*

BYD

Unsold Property

Embattled Chinese property developer Country Garden Holdings' contracted sales in 2023 plunged to less than half the previous year's level, with a sharp dip in December underscoring the dire situation facing the company. Contracted sales are the company's main source of revenue but the figure for December dipped almost **70%** year-on-year.

Source: *Nikkei Asia*

Generating Jobs

According to the country's Ministry of Human Resources and Social Security, China created **12.44 million** new urban jobs in 2023. China had set a goal to create around **12 million** urban jobs in 2023. The job creation goal for 2024 is expected to be unveiled at the opening of the annual parliamentary meeting in March.

Source: *Reuters*

Technology

One return, please

Chinese Android handset maker OnePlus has returned to Germany's smartphone market after a nearly **18-month** hiatus, after sister firm Oppo and Finnish telecommunications giant Nokia reached a global 5G patent cross-licensing deal to end a protracted legal dispute across **12 countries**. Shenzhen-based OnePlus reintroduced **6** smartphone models to the world's **4th-largest** economy.

Source: *SCMP*

Up in the air

Xpeng Aeroht will start taking orders for its flying car late this year, according to the subsidiary of Chinese electric vehicle maker Xpeng Motors, and deliveries to start in late 2025. The vehicle will first be sold in China for more than **¥1 million** (**$140,000**), with buyers able to fly the vehicles in designated trial areas first.

Source: *Nikkei Asia*

Selfie Sales

Chinese selfie apps giant Meitu said new image-and-video-editing tools powered by artificial intelligence (AI) helped the company triple its profits in 2023, in stark contrast to how many other firms have struggled to monetize the technology. Hong Kong-listed Meitu estimated net profit last year to be between **¥330 million** and **¥370 million** (**$46.36-$51.98 million**), up more than **200%** from 2022.

Source: *SCMP*

Revenue Record

Video-sharing platform TikTok has generated **$10 billion** from user spending, becoming the first non-gaming app to hit the milestone. The seven-year-old infotech brand is on track to see its revenue reach **$14.6 billion** in 2024, making it the highest earning mobile app ever.

Source: *Caixin*

Consumer

Going for Gold

Chinese investors and households have been buying gold as a refuge from local property and stock market mayhem, helping to support record prices for the haven asset. Chinese demand helped push the price of gold to record highs and kept it above **$2,000 per troy ounce** throughout 2023.

Source: *Financial Times*

Top-up Travel

China recorded over **1.72 million** inbound and outbound trips per day during the three-day December new year's holiday—similar to levels last seen before the pandemic in 2019—spurring hopes that a travel recovery could boost the sputtering economy.
The figures were up almost sixfold from the previous year's levels and exceeded forecasts.

Source: *Caixin*

Border Buster

JD.com's logistics unit has launched a new cross-border express delivery service for consumers to North American and European markets, as the Chinese e-commerce giant seeks overseas growth to offset weak demand at home. Individuals residing in Shenzhen and Guangzhou can now ship parcels to an initial group of **23 countries**, including the US, Canada and Mexico as well as the UK, France, Germany, Italy and Spain.

Source: *SCMP*

BOOKSHELF

Unpacking Ideas

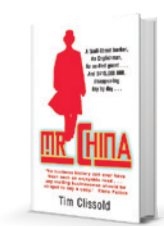
Former Director of Communications and Publications at the American Chamber of Commerce in Shanghai, Ian Driscoll, discusses widening perspectives on business in Asia and a deepening understanding of China

Born in Singapore to peripatetic parents, Ian Driscoll later lived in Hong Kong for eight years, Beijing in the late 1990s, and then in Shanghai from 2012-2024. A former journalist, his last China role was a director of communications and publications at the American Chamber of Commerce in Shanghai. Two years ago, he, his family and a Shanghainese friend drove 3,500 kilometres around Gansu and Qinghai.

What would be your number one book recommendation for someone looking to learn more about business in China?

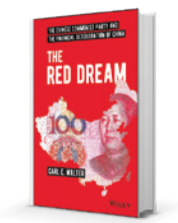
Business in China changes so swiftly that there's no catch-all. But a good primer would be Barry Naughton's *Growing Out of the Plan*, which explains the forces behind opening and reform but also the survival of state-owned enterprises. James Mann's *Beijing Jeep* should be obligatory reading for foreign business executives working in China. And for foreigners fresh to the country, *Myself a Mandarin* by Austin Coates, is an affectionate but revealing insight into the Chinese mind. It's old, but it's certainly not outdated.

What book on business in China have you re-read the most?



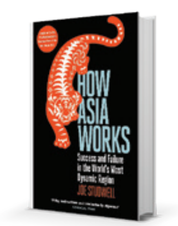
The book's popularity has turned it into a cliché—which my endorsement may further cement—but Tim Clissold's *Mr. China: A Memoir* is a cautionary yet outrageously funny tale of how Western hubris and cultural misunderstanding turned a deep-pocketed China-focused private equity fund into a penurious one. Briton Clissold's account of how he and American investor Jack Perkowski burned their way through $400 million—generously aided by sketchy local businessmen and enigmatic cadres—is instructive and uproarious. The author's self-deprecation helps. Unputdownable.

Which China business book are you reading currently?



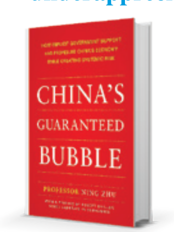
Most recently, I read veteran China banker Carl Walter's *Red Dream*, a deep dive into the inner workings and questionable data of China's financial system, particularly local government financing. *Red Dream* isn't for the faint-hearted, but the revelations would give any central banker night terrors. Walter and many others have long warned of the dangers lurking in China's financial system, yet only now are policymakers paying attention. The concluding chapters mull what lies ahead for China, with Walter offering wisdom on how the country might avoid Japan-like stagnation. If it's not too late.

What book totally changed your perspective on a certain topic?



Joe Studwell's How *Asia Works* didn't change my perspective, but it widened my eyes to why some Asian countries have modernized and others not. Studwell shows how land reform and the surplus cash it created helped to finance export capacity and industrial manufacturing expertise in countries like Japan and Korea, an approach China mimicked. Underpinning their success were supportive state policy, huge investment and the erection of barriers to entry. Western nations chaffed at the latter, but the model worked. The book is also indispensable for anyone seeking to understand why Indonesia, Malaysia, the Philippines and Thailand remain relative economic backwaters.

Which China business book do you think is the most underappreciated?



I doubt it's underappreciated, but the next China book on my list is Zhu Ning's *The Guaranteed Bubble*, penned in 2015. The book was a harbinger of the causes of China's current economic malaise: implicit guarantees in the financial sector, overcapacity, misallocation of resources, and so on. With demographic decline and an underfunded state pension plan now layered on top, Zhu sounded a warning bell long before many of his peers.

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Chinese Brands Meeting the Needs of Global Tastes

- Need for Speed: How SHEIN Became a Global Online Fashion Retailer
- The Cream of the Crop: Yili's Ambitions to Build a Global Dairy Company

Western Brands Finding Success in China

- Milking It for All It's Worth: Oatly's China Market Entry Strategy
- Fast Food, Fast Success: KFC's Digitalization Strategy in China

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