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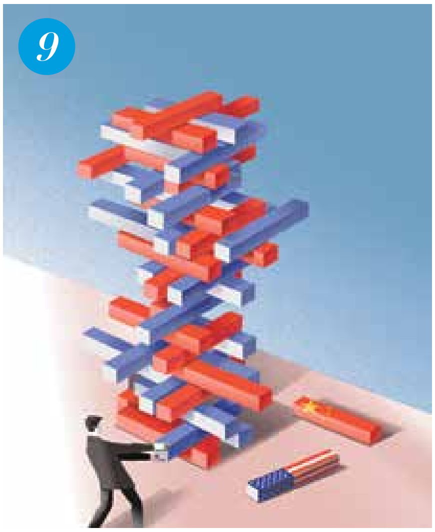
CHINA'S BAY AREA

Is the Pearl River Delta Greater Bay Area set to become the world's leading innovation hub?

- Why are Chinese consumers abandoning multinational brands?
- Is China on the verge of a business succession crisis?
- What's the real story behind China's growing ties with Eastern Europe?

Comment

Economy and Policy



Business Trends

Buying Chinese
Chinese consumers no longer perceive "Made in China" as a mark of shoddy quality

Coin Drop
Why China's cryptocurrency ban is not going to be reversed any time soon

Company

Downtime

Selling With Selfies
Why China's social media stars are the richest in the world

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Changing China

Let's play a quick game of word association. If you had to describe Chinese business in one word, which one would you pick? For a long time, most people outside China would have chosen words like "copycat" or "sweatshop," but these old labels are seriously misleading nowadays. China is rapidly transforming into an innovation and consumption-driven economy. In this issue, we'll try to give you a glimpse of this new China.

We begin by casting our eye over China's retail landscape, where the advance of big data technologies is leading to the creation of some fascinating new business models. CKGSB Professor Bingsheng Teng explains in "Data, Smart, Sharing: The Three Words That Define China's Business Future" (page 6).

We return to the shop floor later in the issue with "Buying Chinese" (page 41), which examines a quiet revolution taking place in the Chinese market: the increasing perception among Chinese consumers that domestic brands are superior to their global rivals.

However, Chinese companies still face many challenges, and in "Dropping the Baton?" (page 35) we look at a potentially serious one: the fact that more than half of China's millennial children of private company owners say they don't want to take over their parents' business.

For our cover story, we head south to the Pearl River Delta Greater Bay Area, where cities such as Shenzhen, Guangzhou and Donguan are transforming their economies by ramping up investment in innovation. Will it be possible for other Chinese cities to follow their lead? Find out in "Raising the Bar" (page 15).

We also have a trio of pieces offering a bird's-eye view of stories that have been dominating headlines in recent months. "High Stakes" (page 9) looks at the ongoing tensions between the United States and China, while "Tilting East" (page 23) shines a light on China's complex relationship with Central and Eastern Europe. In "Coin Drop" (page 45), we plunge into the world of cryptocurrency and ask what the likely impact will be of China's ban on bitcoin, ethereum and other digital currencies.

This issue's Downtime story, "Selling with Selfies" (page 62), gives us a whistle-stop tour of the colorful world of the *wanghong*, China's cash-flush social media stars. "The Daily Me" (page 57), meanwhile, chews over the business model of Bytedance, the Chinese app maker that wants to use artificial intelligence to change the way the world consumes content.

There are also some excellent interviews in this issue, including a conversation with Patrick Horgan, Regional Director of Northeast Asia for Rolls-Royce, about how the British manufacturer is adapting to a new era of Chinese growth (page 32). Yuval Ben-Sadeh, Director of the Israel Chamber of Commerce in China, argues that concerns about *Made in China 2025* are overblown (page 20). Peter Cappelli, George W. Taylor Professor of Management at The Wharton School, University of Pennsylvania, tells us what makes Chinese companies unique (page 28). And finally, Li Lode, Professor of Operations Management at CKGSB, reveals the secrets of China's most popular menswear brand, HLA (page 54).

In other words, there is plenty in this issue to think about and to discuss. As usual, if you have any comments or opinions to contribute, we would love to hear from you (*lzhou@ckgsb.edu.cn or ckgsb.knowledge@ckgsb.edu.cn*).

Yours Sincerely,

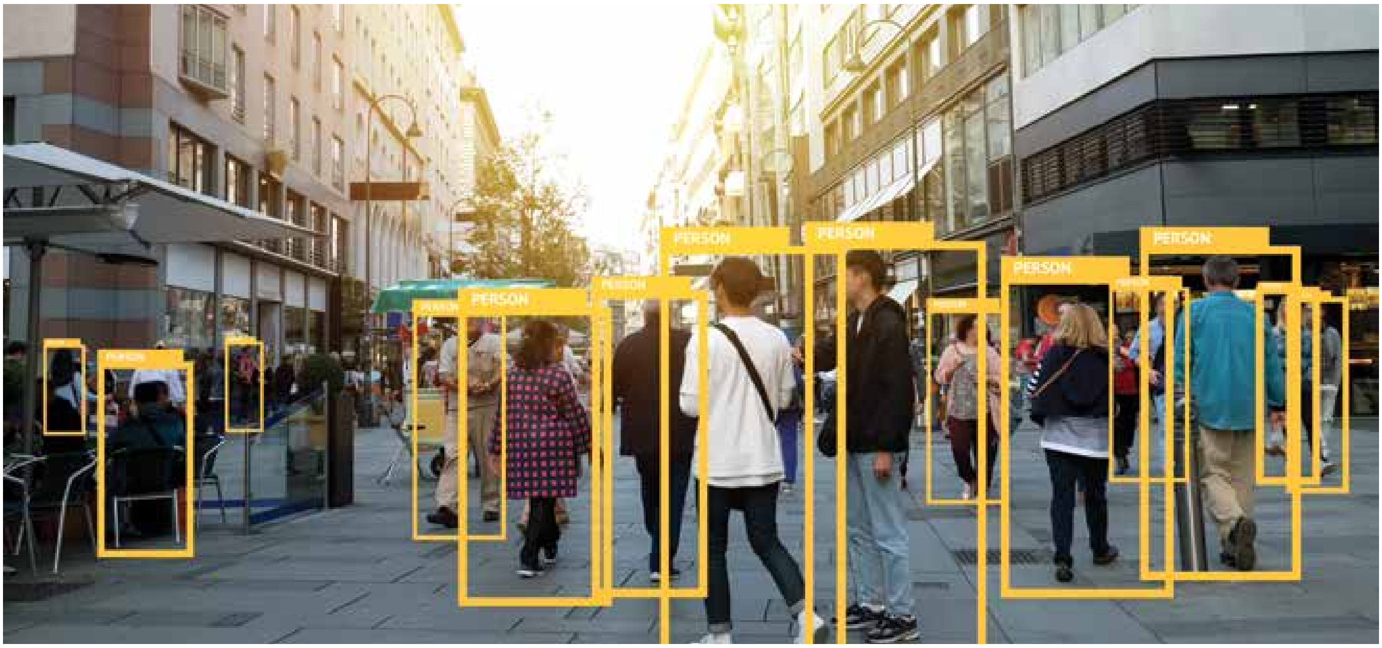
Zhou Li
Assistant Dean, CKGSB
Editor-in-Chief, *CKGSB Knowledge*

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

Data. Smart. Sharing.

The Three Words That Define China's Business Future

By Bingsheng Teng



Forget e-commerce. In today's China, the smartest businesses are moving the digital revolution into the offline world as the boundaries between online and offline become increasingly blurred.

The integration of information technology into our daily lives is allowing companies to apply advanced big data techniques to transform a range of industries previously considered relatively impervious to digital disruption. For businesses across nearly every sector, the key to future success now lies in three areas: data, smart systems and the sharing economy.

This phenomenon was clearly visible in 2017, with many companies applying these three concepts to achieve new efficiencies and upgrade their business models. This led to the emergence of some interesting new trends.

Rise of New Retail

Today's digital economy is no longer just about digitalizing traditional industries, but also about integrating more traditional business practices into digital industries. After years of rapid growth in the digital economy, some entrepreneurs believe that the online retail market is becoming saturated, and therefore are moving into the offline space.

An example of this trend is the rise of "new retail," a term first coined by the founder of e-commerce giant Alibaba, Jack Ma, who described it as the attempt to "integrate online, offline, logistics and data across a single value chain." The new retail phenomenon not only reflects consumers' increasing focus on quality, but also shows that the offline experience is becoming more and more important. However, offline retail is, almost by definition, a weak point for e-commerce companies.

Chinese smartphone brand Xiaomi initially found success through its "internet thinking" and "fan economy" strategy, which focused on creating a huge online community of users devoted to its brand. This almost purely online strategy allowed the company to generate huge buzz and sell its high-quality products at market-busting prices, but later Xiaomi found that the model was also limiting its ambitions to develop an ecosystem of connected devices and services around its flagship smartphone products. As a result, the company rapidly established a chain of physical outlets called Mi Home, which provides its customers with a better user experience.

E-commerce giant Alibaba has also been aggressive in pushing forward its new retail strategy, launching a multibillion dollar partnership with China's biggest home appliance retailer Suning, acquiring leading Chinese department store and luxury mall operator Intime Retail and opening a groundbreaking new chain of "digitalized" supermarkets called Hema Xiansheng in China's first-tier cities.

Alibaba's revamping of traditional retail is also spurring innovation in the e-commerce industry. One example of this is the sudden rise of "fresh malls" such as JD.com Home and Benlai, grocery store chains offering high-quality produce that allow customers to order online and have their order delivered to their home within two hours.

Tencent was initially slower to react, but has since entered the space by making a major investment in Super Species, the new retail unit of Yonghui Superstores, whose outlets combine high-end grocery shopping with an in-store dining experience, as well as offering fast online-to-offline delivery.

As smart technology is increasingly integrated into the way we produce and consume products, data has become a crucial resource for businesses. Many enterprises are now using big data, cloud computing and other technologies to transform themselves into digitalized businesses or even data companies. In the future, companies will increasingly use commercial platforms and interactive technologies such as data mining and forecasting to upgrade their business models.

In the new retail area, for example, Guo Xiao Mei has placed self-service grocery stores inside office buildings to bring its products even closer to its customers and scale up its business extremely quickly. By collecting data on all customers using its stores, companies like Guo Xiao Mei are able to develop a much more sophisticated understanding of the needs of its customers.

From Sharing to 'New Rental'

Another major trend in China, as elsewhere, is the huge growth of the sharing economy, a new form of business that uses internet platforms to activate idle social and economic resources. In the beginning, sharing-economy businesses focused on a "use without possession" or "share without cost" model, such as offering platforms for local residents to share household items. However, the concept is changing as the industry evolves. Didi Chuxing expanded the sharing-economy concept to ride-hailing, and then companies like ZBJ.com and Xiao Zhu introduced platforms for skill-sharing and short-term room rentals, respectively. These companies represented the "not free" stage of the sharing economy's development.

> **AI has become the absolute focus of many leading Chinese companies' research efforts**

People's understanding of the nature of the sharing economy shapes the way it develops. China's most famous contribution to the global sharing economy movement—the rise of dockless shared bike businesses like ofo and Mobike—shows this clearly. In fact, the shared bike business model has moved so far away from the concept of sharing and activating idle resources that it is sometimes referred to as "new rental." Whereas traditional sharing-economy businesses operated a peer-to-peer model, with the company only playing a matchmaking role, companies like ofo and Mobike directly own vast fleets of bicycles and rent them out to consumers using their apps.

Through this innovation to the sharing economy concept, ofo and Mobike have not only transformed the fortunes of China's bicycle manufacturers, they have also slowly built a social credit system for hundreds of millions of people, as they have been forced to develop sophisticated techniques for policing user behavior to protect their millions of bikes.

AI Going Mainstream

Over the past two years, artificial intelligence (AI) has become the absolute focus of many leading Chinese companies' research efforts. So far, most businesses have not yet found an effective way to integrate AI into their business models. But significant breakthroughs are being made in new technologies such as image recognition, speech recognition and deep learning, with several leading startups in the facial recognition area, including Sensetime, Face++ and Yitu, becoming unicorn companies valued at over $1 billion.

Autonomous driving has also become a hotspot for venture capital investment, mainly due to China's huge auto market and traffic-clogged road network. However, the advanced technology required to compete in this emerging industry means that the entry barriers are high.

As the AI business ecosystem develops, AI technology is gradually permeating every industry. Take health care as an example. IBM has developed a complete smart health care solution, which uses wearable devices to enable medical professionals to register, diagnose and provide adjuvant therapy to patients remotely.

Innovation in the era of smart business is characterized by non-linearity, disruption and discontinuity, and traditional enterprises should be open to artificial intelligence. Amazon overtook Walmart as the world's largest retailer by market capitalization in 2015, a clear sign of where the industry is heading. From online credit card payments to user reviews, e-books and the cloud, the US's greatest e-commerce company has embraced new technological advancements at every stage of its development. The era of smart business will not only be created by AI companies, but also by commercial enterprises willing to make bold use of the latest achievements in AI research.

Bingsheng Teng is Professor of Strategic Management and Assistant Dean for Asia and Europe at CKGSB

HIGH STAKES

The US and China are playing a risky game as they try to reset their economic relationship

By Dominic Morgan

Image by Lisa Ye

The US and China are negotiating to try to avert a trade war. But any deal may only mark the start of a new era of heightened tensions in the world's most important economic relationship

As Donald Trump signed the memorandum proposing the introduction of tariffs on $50 billion of Chinese imports on March 22, the president of the United States quipped: "This is the first of many."

The moment marked a dramatic escalation of tensions with China over trade, which have since risen even higher with China's threat of a tit-for-tat response and Trump's announcement that the US may consider an extra $100 billion worth of tariffs.

But for many observers, the signing of the memo also represented a deeper shift in the dynamics of the world's most important economic relationship.

In his *Sinocism* newsletter two days later, veteran US-China analyst Bill Bishop framed the Trump administration's move in historic terms: "The Trump administration… has now signaled officially that engagement is dead and we are in a 'New Era of US-China Relations,' in which there will be intensified competition if not outright conflict," he wrote.

This change in attitude could have implications far beyond even the prospect of a possible trade war. For decades, economic engagement has been the underlying foundation of the US's China policy. The doctrine holds that the more China is integrated into the global economy, the more it will open its markets and align policies with those of its liberal capitalist partners. It was the engagement doctrine that led to China being allowed to join the World Trade Organization in 2001 based on assurances of changes.

Many in the US and elsewhere have long criticized China for having changed too little to meet international norms on trade, investment and economic policy, and there are clear signs that the US policy elite is now moving to the view that the policy of engagement has not worked. In January, a White House report called China's WTO accession a mistake. The next month, the president branded China a rival that "challenge[s] our interests, our economy and our values" in his 2017 State of the Union address.

"China's integration into the global trading system hinged on its willingness to reciprocate on tariffs, but few people expected it to hold on to such extensive non-tariff barriers to trade and investment," Mark Williams, Chief Asia Economist at Capital Economics, tells *CKGSB Knowledge*. "Western governments have been lobbying unsuccessfully for China to open up its markets to Western firms for years."

Some US policymakers have concluded that power politics is the only way to convince China to implement the reforms they desire. "There are people in Washington who believe they can tighten the screws on China, and that China will bend to their will," says Williams.

It is this belief that seems to be behind the Trump administration's moves to place increasing restrictions on China's imports. "There is a grander strategy behind it," says Louis Kuijs, Head of Asia Economics at Oxford Economics. "There is a stance within the Trump administration: *we need*

> **There are people in Washington who believe they can tighten the screws on China, and that China will bend to their will**
>
> Mark Williams
> Chief Asia Economist
> Capital Economics

to be more forceful."

The administration appears to be using the threat of a trade war to force the Chinese government to meet two specific demands. The first is a reduction in the bilateral trade deficit with China, which rose to $375 billion in 2017, according to US government data.

"I've been speaking with the highest Chinese representatives, including the president, and I've asked them to reduce the trade deficit immediately by $100 billion," President Trump said after signing the memo on March 22.

The second demand is that China accelerates its market reforms by opening more industries to foreign competition, reducing import tariffs and abandoning rules that force multinationals operating in China to form joint ventures and transfer technology to local partners. Trump also alluded to this issue in his statement:

"The word that I want to use is reciprocal," he said. "When they charge 25% for a car to go in and we charge 2% for their car to come into the United States, that's not good."

China's response so far has been measured with President Xi Jinping's government keen not to escalate tensions. Some within the government remain confident that the president will eventually settle for a deal. "When two parties negotiate you have to bluff and Trump is a businessman," one adviser told the *Financial Times* in late-March.

But the hawkish turn in the US is undoubtedly steering US-China relations in a treacherous new direction. In the short term, there is a danger that the US will make demands that China is unwilling—or simply unable—to meet. And even if the two sides cut a deal in the coming weeks, it may only be a matter of time before the same issues cause tensions to rise once again.

Deflating the Deficit

One potential stumbling block is the US's trade deficit with China. Opinion is divided over how serious the demand for a $100 billion cut in the bilateral deficit really is. Some believe—and, given the "bluffing" comment, this may include people within the Chinese government—that the figure is merely a bargaining chip that may be traded in favor of more market opening from China.

But others are less certain. One analyst shares that a source close to the Trump administration calls the president deadly serious about reducing the trade deficit. "Trump really is a mercantilist kind of guy," he says. "He's a real hardliner when it comes to the current account."

Peter Navarro, Director of the White House National Trade Council, has called the US trade deficit a potential national security threat. If the president does see the bilateral trade balance in those terms, this has the potential to create an impasse in negotiations, since analysts almost universally predict that China's surplus with the US will expand even further in 2018 unless dramatic reforms are introduced. Ironically, the reason for this is the strength of the US economy and the Trump administration's tax-cutting agenda.

"Now that the US economy is warming up, we're seeing the hunger for imports is rising," says Kuijs. "In 2018, we're going to have further acceleration in domestic demand in the US because of the fiscal plans and the tax cut."

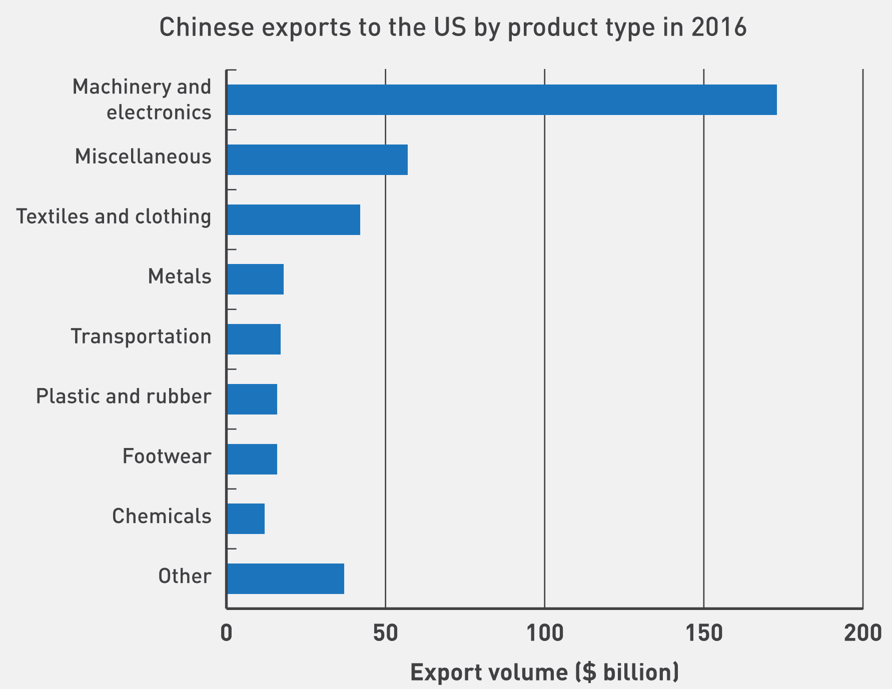
When it was passed in December, there were widespread fears in China that the US Tax Cuts and Jobs Act—which reduced the US corporate tax rate to 21%—would trigger an exodus of capital and manufacturers across the Pacific.

Maximilian Kaernfelt, a researcher at the Mercator Institute for China Studies, believes that US officials may have been hoping for the same. "I'm not saying that these tax cuts were specifically targeted at China, but I find it hard to believe that in the meeting no one said 'China' at one point," he says.

However, thanks partially to a one-off tax break for foreign businesses handed out by the Chinese government, that outflow appears unlikely to materialize, according to Shaun Rein, Managing Director of the China Market Research (CMR) Group.

Breaking Down "Made in China"

Electronics account for a large slice of Chinese exports to the US



Source: World Integrated Trade Solution, World Bank

"If companies think that there are still opportunities in China, they're going to keep that money here and grow," says Rein. "They're not going to go back to the US."

Instead, the US tax cuts look more likely simply to stimulate consumption, and therefore demand for imports.

Destined for Trade War?

So far, the US's approach to reducing the deficit has focused on slapping tariffs on Chinese imports, with $6 billion worth of goods already affected by new duties since the start of the year and a further $150 billion under consideration. But this approach is likely to prove painful in the short term and ineffective in the long term.

Even the proposed $150 billion worth of tariffs may not reduce the US's bilateral trade deficit by the stated target of $100 billion. In 2017, for example, the US's trade deficit with China rose over $30 billion year-on-year.

What's more, the real impact of the tariffs would be much smaller. For one thing, the tariffs will first go through a weeks-long consultation period where US industries will lobby intensely for them to be watered down or scrapped. "This means the tariffs are unlikely to be as heavy-handed as they might have been," Williams concluded in a note in late-March.

There are also other reasons to expect the impact to be relatively weak, according to Williams. "In many sectors there are few alternative suppliers that US buyers could switch to," he added. "Consumers may also not be deterred much by the resulting price rises."

Slapping tariffs on imports from China will also do nothing to solve the underlying causes of the US trade deficit. This means that any reduction of the US bilateral deficit with China is likely only to lead to an increase in the deficit with other countries, according to Kuijs.

"If you don't tackle a macroeconomic problem with macroeconomic instruments, then you'll see all kinds of second-round effects and evasions," he says. "There's a lot of that going on: Chinese companies setting up production in Malaysia or Vietnam, for example."

In reality, the tariffs announcements are likely intended to serve as a warning to China that the US was serious about renegotiating the bilateral relationship, rather than as a genuine solution to the trade deficit.

US Treasury Secretary Steven Mnuchin hinted strongly at this during a Fox News interview in late-March. "If they open up their markets, it is an enormous opportunity for US companies," said Mnuchin. "I am cautiously hopeful we can reach an agreement, but if not, we are proceeding with these tariffs."

Some believe that the US may have miscalculated the potential risks and rewards for the Chinese government of bowing to this threat. On the one hand, the tariffs give the US less leverage than some may think. Capital Economics calculates that the impact of the $50 billion round of tariffs on China's gross domestic product (GDP) would be only 0.1%, while the extra $100 billion of duties may raise this to 0.5% of GDP. This figure is "no longer a mere rounding error," according to Williams, but would hardly bring the Chinese economy to its knees.

On the other, China's leaders are under pressure not to be seen to cave in to US demands. "I think the two sides are a long way apart in terms of their perception of the US's ability to coerce China into changing its policies," says Williams. "In Beijing, the chances of that happening in any significant way are pretty close to zero."

When the Chinese government announced new duties on just $3 billion of US imported goods in late-March, Beijing received criticism on social media for its lack of action. Even Lou Jiwei, a former Chinese finance minister, pronounced the measure "relatively weak." It was in this context that China announced a potential tit-for-tat $50 billion round of tariffs on American imports a week later.

If the US tries to strong-arm China into making potentially humiliating concessions, China's leaders may feel they have no choice but to call the bluff, Williams calculates. "There's a risk of the two sides running into each other because neither is willing to swerve out of the way," he says.

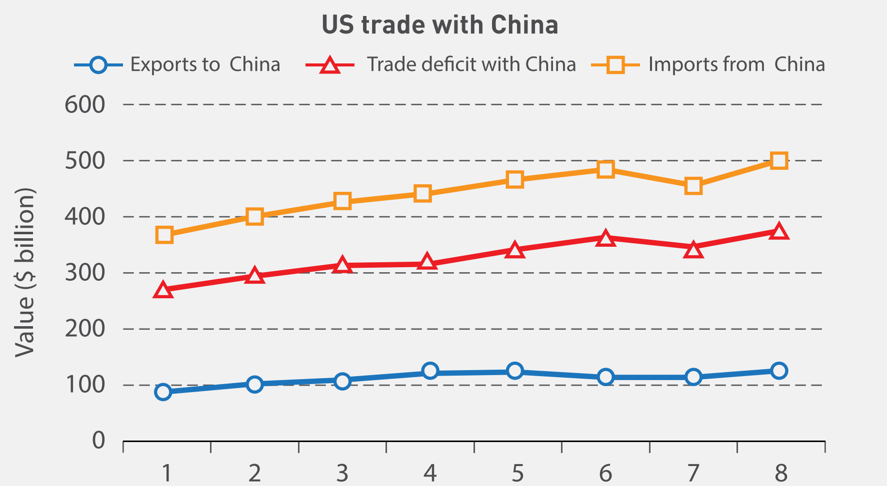
Saving Face

The easiest way to step back from the brink of a trade war would be for US and Chinese officials to agree a compromise deal, allowing both sides to claim victory to their respective domestic audiences. According to Stanley Chao, Managing Director of All In Consulting and author of *Selling to China*, this remains the most probable outcome.

"It's all posturing on both the US and

Maxing Out the Current Account

The US trade deficit with China continues to grow



Source: United States Census Bureau

China sides. China has too many social-economic issues to worry about: pollution, transportation, food quality, medical services," says Chao. "Eventually, both parties will meet and resolve the matter."

CMR's Rein believes that China will offer the US some concessions on market access to secure a truce. "In the end calmer, rational minds will prevail," he says. "There will be more opening, for sure, in financial services. I expect that there will be more opening in autos too."

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> Shaun Rein
> Managing Director
> China Market Research Group

According to *The Wall Street Journal*, relaxing restrictions on foreign firms and imports in the finance and auto industries was among the list of demands sent by White House officials to Chinese Vice President Liu He in a letter late-March. The list also included a request that China buy more US-made semiconductors in a bid to reduce the trade deficit.

There is a chance that China may agree to some of these asks because the government has been planning more opening in finance and autos for several years, according to Rein. "I think China will bow down and do it," he says. "It's not going to have a meaningful impact on the economy."

The question is whether the US would be satisfied with such a relatively limited deal, which would likely not get close to reducing the bilateral trade deficit by the stated target of $100 billion. China's total imports of US motor vehicles in 2017, for example, were just $10.6 billion, according to US government data.

As Williams points out, China would struggle to reduce the deficit through selective imports of American goods: "Soybeans are one of the major Chinese imports from the US. China's purchases account for a large share of the US crop. But they still amount to only $12 billion."

Neither will any deal include concessions from China in areas that it deems strategically important, Rein predicts. "The big issue is the internet and high-tech companies," he says. "You're not going to see opening there. But if you did, that's where you'd see a meaningful impact positively for American business."

The same applies for the Chinese government's practice of requiring multinationals operating in China to form joint ventures and share their intellectual property with local companies, a source of resentment among US firms, Williams forecasts.

"Those efforts are seen in Beijing as a key element of efforts to shift China's economy to high income status," Williams wrote in a March note. "Industrial upgrading is the core of the *Made in China 2025* program, which President Xi has put at the heart of his agenda."

If the Trump administration's aims are mainly political, it may choose to ignore these realities for now. But the issues will not go away.

Strategic Competitors

Even if the US decides to abandon its tactic of threatening a trade war to force China to open its markets, the "post-engagement" era of US policy toward China could be here to stay.

"There has been growing disillusionment with the results of economic engagement with China that goes well beyond the White House," says Williams. "There is now a growing consensus even in the business community, which has traditionally been a cheerleader for opening up to China, that this should not continue."

Ann Lee, author of *What the US Can Learn from China*, agrees that both Republicans and Democrats are now in favor of taking a tougher line with China. "I think that this has been building over the years," she says. "Trump merely gave voice to sentiments that were already there."

Even Senator Elizabeth Warren, one of Trump's fiercest critics, appears to agree with aspects of the president's tough approach:

"The whole policy [toward China] was misdirected," Warren told reporters during a trip to Beijing in April. "Now US policymakers are starting to look more aggressively at pushing China to open up the markets."

There is a new consensus forming in Washington, Williams says: "If China won't open up its markets, then Chinese firms should face more restrictions on their ability to invest in the US and Europe."

The US has become stricter in its oversight of proposed Chinese takeovers of American companies since the start of the year. It has blocked a string of deals, including the bid of Ant Financial, an Alibaba affiliate, to acquire MoneyGram and the buyout of semiconductor firm Xcerra by Chinese state-backed fund Hubei Xinyan.

A bill expanding the powers of the Committee on Foreign Investment in the United States (CFIUS), a government office that scrutinizes foreign acquisitions, is making its way through the US Congress. It has broad bipartisan support, according to *The Economist*.

If China does not change its strategic investment practices, the US may have no choice but to introduce extra protections. "Is China playing by the rules? Is China's economic system even compatible with our global system?" asks Kuijs from Oxford Economics. "I think these are legitimate questions to ask."

But there are also signs of a harder

> **It has nothing to do with playing fair; it has everything to do with the US wanting to be number one**
>
> Ann Lee
> Author
> *What the US Can Learn from China*

edge to the US's restrictions on investment, which has less to do with reciprocity and more to do with maintaining US dominance. In December, the US government branded China a "strategic competitor" for the first time in its annual national security strategy review, introducing a zero-sum element into US economic policymaking.

"These are things that if China dominates the world, it's bad for America," US Trade Representative Robert Lighthizer told a Senate committee in March.

The Treasury Department is currently working on a plan that would go far beyond the current restrictions, according to *Bloomberg*. It would use an obscure 1977 bill granting the president emergency powers in the event of an "unusual or extraordinary threat" to introduce a blanket ban on Chinese investment in certain strategic industries, such as 5G wireless networks and semiconductors.

"It has nothing to do with an even playing field; it has nothing to do with playing fair," comments Lee. "It has everything to do with the US wanting to be number one."

For China, the restrictions on investment could prove more damaging in the long run than a trade war, especially if the European Union also closed off its market. Acquiring foreign technology and know-how is crucial to China's efforts to upgrade its manufacturing sector—which currently powers 31% of the country's GDP—before it completely loses its cost advantages over developed economies.

Worryingly for China, sentiment also appears to be shifting in Europe. "Let me say once and for all, we are not naive free traders," said Jean-Claude Juncker, President of the European Commission, in his State of the Union speech last September. "Europe must always defend its strategic interests."

RAISING THE BAR

An "innovation race" is heating up among China's leading cities, particularly in the Pearl River Delta

By James Lord

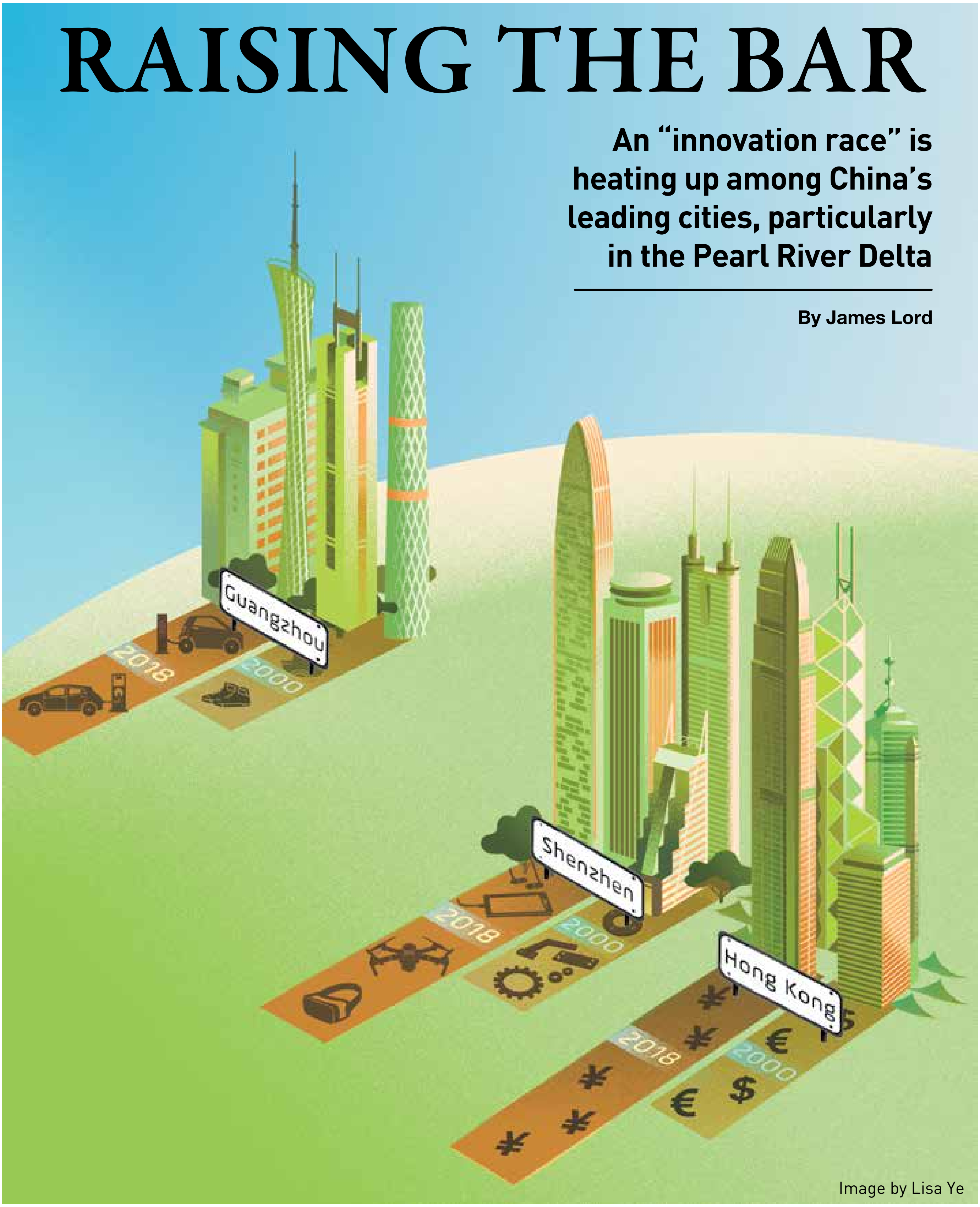


Image by Lisa Ye

Cities across China are pouring investment into research and development in a bid to transform themselves into world-class innovation hubs. But will the smaller players be able to compete with the likes of Shanghai and Shenzhen?

The news surprised no one, but when the Hong Kong government confirmed on March 1 that Shenzhen, the city next door, had overtaken the former British colony to become the largest city economy in south China, the shock still resonated strongly. After all, only 40 years ago, Shenzhen didn't exist.

Now, the startup city has a population of 15 million, more than double that of Hong Kong. The gross domestic product (GDP) of Shenzhen reached $355 billion in 2017, compared to Hong Kong's $340 billion. Many in Hong Kong saw the milestone as confirmation that their city was falling behind its dynamic rivals across the Chinese mainland border, and there have been urgent calls for action to keep up.

Hong Kong's Financial Secretary Paul Chan has unveiled sweeping reforms to the city's budget, including a 13.5% year-on-year increase in expenditure and a 500% rise in the amount of funding set aside for promoting innovation. For the traditionally laissez-faire Hong Kong government, the changes represent a striking shift in approach toward state interventionism. In his budget speech, Chan justified the switch in stark terms.

"To shine in the fierce innovation and technology race amidst keen competition, Hong Kong must optimize its resources by focusing on developing its areas of strength," he said.

In doing so, Hong Kong is tacitly paying tribute to the extraordinary success achieved by its neighbors in the Pearl River Delta. Formerly famous for cheap, low-end manufacturing, cities such as Shenzhen and Guangzhou have reinvented themselves over the past decade to become globally-competitive innovation hubs.

Shenzhen in particular is gaining a reputation as China's answer to Silicon Valley, home to a dynamic startup scene as well as world-leading tech companies including content and social media giant Tencent, telecommunications group Huawei and drone maker DJI. Together, Shenzhen-based companies accounted for over half the patents filed nationally in China in the first half of 2016.

According to Chen Xiangming, Director of the Center for Urban and Global Studies at Trinity College in Hartford, Connecticut, the key to Shenzhen's transformation has been aggressive promotion of high-tech industries.

"What Shenzhen has done is single-mindedly focus on doing one thing better than anybody else, and that's innovation," Chen tells *CKGSB Knowledge*. "It has very strong supportive policies for research and development."

Hong Kong is far from alone in attempting to learn from Shenzhen. As Chan suggested in his speech, cities across China are now aggressively promoting R&D in an attempt to shift their economies toward an innovation-led growth model.

"Senior government officials eventually figured out that [Shenzhen's] mysterious weapon is innovation," says Lin Jiang, Professor of Economics at Sun Yat-sen University. "The cities' competition might end up being based on innovation: how much they're expending on R&D."

For decades, the fierce competition among China's cities—which many consider a key force driving the country's fast economic growth—has focused mainly on large-scale fixed-asset investment. A shift toward competing on innovation is likely to have far-reaching consequences. Which cities will emerge as the winners and losers from this new struggle, however, is far from certain.

The Magic Solution

For cities on the Chinese mainland, the shift toward promoting high-tech industries is largely borne of necessity. As Jeongmin Seong, Senior Fellow at the McKinsey Global Institute, explains, the twin engines that have driven much of China's economic growth over the past decades—a huge demographic dividend and fixed asset investment on a vast scale—are gradually losing steam.

"China's working age population started declining in 2012," explains Seong. "Meanwhile, the return on [fixed asset] investment—the capital efficiency—is declining as China's economy matures. At the same time debt levels are rising. The debt-to-GDP ratio has been soaring, especially since the 2007 global financial crisis."

He adds, "So, China needs a new engine, which they believe is innovation."

China's top leaders have placed increasing emphasis on promoting high-tech industries in recent years. President Xi Jinping calling innovation "the primary force driving development" in his landmark address at the 19th National Congress of the Chinese Communist Party in October. As a result, municipal officials in almost every Chinese city are under pressure to promote innovation, according to Lin.

"The State Leader has stressed the all-importance of R&D, innovation and making China more creative," Lin says. "The lower-level governments have no choice but to follow what the State Leader said."

An additional factor driving Chinese cities to implement pro-innovation policies, Lin explains, is the tough competition for promotion that exists among Chinese government officials of the same rank: local officials are keen to impress their superiors by outdoing their peers.

These competitive pressures have been effective in driving officials to achieve fast economic growth in the past, and it may help accelerate China's emergence as a high-tech power. "Cities are competing. And that's a good competition, because innovation and competition go hand in hand," Seong says.

However, Lin argues that these political forces are also creating problems in some cities, because officials are too eager to achieve fast results. This is leading them to grasp for a simple, magic solution, which in many cases is pumping government money into research and development.

Governments across China have latched onto the fact that Shenzhen invests a whopping 4.7% of its GDP in R&D. This is an even higher percentage than world-leading high-tech powers Japan, Israel and South Korea, and far beyond the 0.7% of GDP that Hong Kong invests. Many cities have recently announced plans to raise their R&D to GDP ratio. Guangzhou has set a target of hitting a 2.7% ratio. Chengdu's figure has already leaped above 3%, while Beijing's has reached 5%. Carrie Lam, Hong Kong's Chief Executive, also plans to double the Special Administrative Region's ratio to 1.5% within five years.

> Shenzhen is different to Beijing and other cities like Shanghai because most of the R&D spending comes from private companies
>
> Guo Wanda
> Executive Vice President
> China Development Institute

"[City] government leaders believe that if they have the same [R&D ratio] figure as Shenzhen, they may achieve the same results. They sincerely believe that," says Lin. "But they ignore what the real situation is: Shenzhen's success is due to other economic factors."

A Long-term Project

As Guo Wanda, Executive Vice President of the China Development Institute, points out, Shenzhen's much-hyped 4.7% ratio is a symptom of success, rather than its cause.

"Shenzhen is different to Beijing and other cities like Shanghai because most of the R&D spending comes from private companies," says Guo. "More than 90% comes from enterprises, especially private companies."

This is not to say that the Shenzhen government has not played an important role in the city's emergence as a tech hub. Local officials have been laser-focused on promoting innovation since at least 2000, using a mix of regulations and incentives to move out low-end manufacturers and replace them with high-tech startups. Crucially, it has not let the state crowd out the private sector.

The government has played more of a facilitator role, creating the right environment and incentives to encourage companies to innovate, as well as fair competition and attractive R&D subsidies. The city also has stronger intellectual property and contract protections than elsewhere in China. This has given Shenzhen's private companies the security to invest big in innovation: more than 40% of DJI's employees work in R&D. At Huawei and Tencent, the figure is over 50%.

Creating this kind of innovation-friendly ecosystem takes time, Guo emphasizes. "[The Shenzhen government's] recent policies are not so important—it's more an accumulation of innovation," he says. "For example, Huawei was set up in the late 1980s."

For Professor Lin, this offers an important lesson for other Chinese cities about the importance of allowing the market to play the decisive role in driving the allocation of R&D resources.

"A high [R&D to GDP] ratio may not necessarily mean high economic efficiency," he warns. "For example, Guangzhou has an efficient market in comparison to Chengdu. If the Guangzhou government spends RMB 10 million, it may generate the equivalent of RMB 20 million in terms of the output of R&D in Chengdu."

If local governments simply pump money into state-run projects, there is a risk that they "may crowd out some private sector investment," says Lin. "Some companies may think, 'the government is spending money [on R&D], why should I continue to spend money? I can just be a free rider.'"

Ten Shenzhens

According to Chen from Trinity College, Shenzhen may be an unsuitable model for other cities to follow in other ways, too.

"I've heard people say, 'If China could create 10 Shenzhens, then China would be even more powerful,'" he says. "But that is an idealistic way of thinking. The circumstances, the coming-together that favored Shenzhen in such a unique way cannot be replicated elsewhere."

For starters, there is Shenzhen's status as a "miracle city" that was created by a stroke of a pen by former Chinese leader Deng Xiaoping in 1978. According to Chen, this not only ensured that the city government was "not polluted by the inefficiencies of the old centrally-planned economy"; it also helped create an open and diverse society in which 99.9% of the population is made up of migrants—the perfect breeding ground for an innovation hub.

"These arrivals were highly educated, highly entrepreneurial and highly risk-taking," says Chen. "They went to Shenzhen to seek out new opportunities."

Another advantage has been Shenzhen's proximity to Hong Kong, which sits just across the Sham Chun River. "The Shenzhen officials took advantage of Hong Kong's resources," explains Lin. "Hong Kong's financial circle wanted to help Shenzhen develop a high-tech center, because this is not a strength of Hong Kong."

There has also been a certain amount of serendipity behind Shenzhen's rise. In the 1990s, the city's strategy was to compete directly against Hong Kong's shipping and finance companies, according to Lin. But this plan was foiled by a deal struck between Hong Kong and Beijing soon after the city's return to China, which forbade Shenzhen from undercutting Hong Kong's core industries.

The upshot was that instead of seeking to attract banks, Shenzhen chose to focus on luring venture capital funds. More than 500 VC firms are now based in the city, and they have played a hugely important role in developing its innovation ecosystem.

"The venture capital funds not only provided Shenzhen's firms with capital; they also provided the entrepreneurship and supply chain management skills—the professional expertise that Shenzhen's business firms needed," says Lin.

Taking a Different Road

However, this does not mean that cities cannot succeed without the advantages enjoyed by Shenzhen. Chen points to the example of Guangzhou, just 140 kilometers northwest of Shenzhen.

As the provincial capital of Guangdong Province, Guangzhou has not been allowed Shenzhen's relative freedom from bureaucratic oversight; nor has it benefited from a mass influx of budding entrepreneurs. But the city has been able to leverage its elite universities and research institutes to support a number of emerging industries, such as biotechnology and new materials. This helped Guangzhou achieve GDP growth of 7% in 2017, not far off Shenzhen's 8.8%.

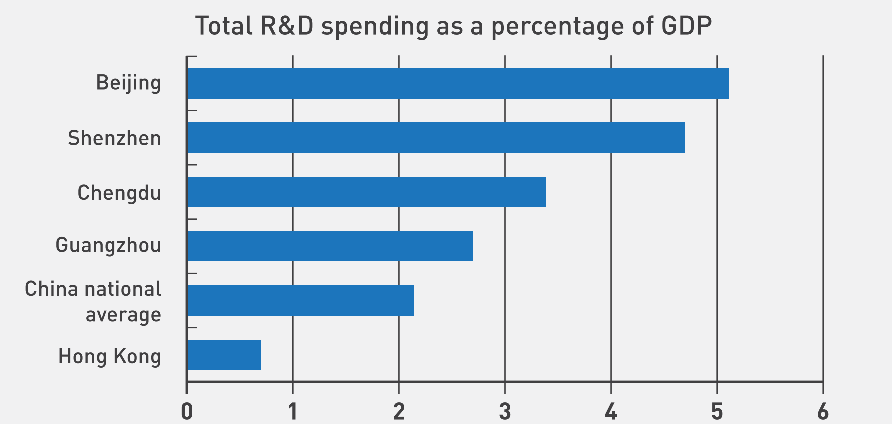
"Guangzhou's educational resources and research capacity have allowed it to do fairly well—not as well as Shenzhen, but certainly better than any of the other cities in Guangdong—in becoming more innovative and competitive," says Chen.

Smaller cities without the local talent pool provided by top-class universities, however, will often gain little from investing large government resources in R&D. "If you buy expensive R&D equipment and you

Guangzhou is a leading center for R&D in biotechnology, new materials and several other emerging industries

Raising the Ratio

Chinese cities are investing big chunks of their GDP in R&D



Source: South China Morning Post, Sun Yat-sen University, China Development Institute

don't know how to use it, then you will hit that R&D investment target, but… there will be waste," points out McKinsey's Seong.

Lin suspects that in some cases, local officials may simply be investing for political reasons. "How can they show they are responding to the top leaders' requirements [to promote innovation]? The only figure is the R&D ratio," he says.

Some analysts worry that in China's new era of innovation-led growth, less fashionable cities will find it even more difficult to compete with first-tier metropolises like Shenzhen and Shanghai, which tend to hoover up the best talent.

"When cities become big and become a magnet for talent, and also attract different groups of people like investors, entrepreneurs, marketing and manufacturing companies, there is a better chance for this city to become a big innovation hub," says Seong.

Hooking a Big Fish

Instead, smaller cities may need to try a different approach to jump-start their development. One possible option is the route taken by Hangzhou, the capital of Zhejiang Province on China's east coast. Not long ago, Hangzhou was known as a picturesque but run-of-the-mill Chinese city.

Today, it is famous as one of the country's leading centers of innovation, often placed just below Shenzhen on the pecking order of China's leading tech hubs. The rapid rise of Hangzhou can be explained in one word: Alibaba.

China's biggest tech company was originally based in Shanghai, but in the late-1990s Hangzhou was able to convince the company's chairman, Jack Ma, to relocate. The key attraction of moving out of Shanghai for Ma, explains Lin, was that his company would be a big fish in a small pond: the local government would go out of its way to make sure that the company was able to secure access to bank loans and other means of support.

"Hangzhou's officials made a good choice, because Hangzhou at that time had no more financial or technological resources than any other provincial city," says Lin. "Alibaba's arrival provided Hangzhou with good opportunities."

Over the past decade, an entire e-commerce ecosystem has developed around Alibaba in Hangzhou, which has also driven the development of related industries like cloud computing. Hangzhou also benefits from the fact that it is a quieter, pleasanter place to live than many Chinese megacities.

"Hangzhou is a clean city with beautiful scenery, a bit like the [San Francisco] Bay Area in the United States," says Lin.

Growing Together

Ultimately, however, China Development Institute's Guo believes that smaller cities should not look to beat tier-one tech hubs, but rather feed off their success. If towns are well-connected to a major city, for example, it is easier for them to attract high-level talent.

Seong seconds this point. "Cities can compete with each other, but they can also complement each other," he says.

The Chinese government aims to support this by connecting Beijing and Shanghai with the towns and cities surrounding them, as well as creating a Pearl River Delta Greater Bay Area. This will link together south China's major cities—including Hong Kong, Guangzhou and Shenzhen.

According to Guo, these projects could make a big difference to a lot of China's less fashionable cities. "Cities should be connected to each other," he says. "The central government should have an ambitious strategy about regional integration."

The Greater Bay Area could even offer a possible solution to Hong Kong's innovation woes. The city has struggled to promote innovation in part because it offshored its industrial base to the mainland during the 1990s and 2000s.

"The people in Hong Kong feel that they're playing catch-up in trying to redevelop their capacity to innovate," Chen says. "But it's difficult to do it because Hong Kong no longer has that strong manufacturing base—that foundation that Shenzhen has built up and is able to sustain."

However, new transport links such as the Guangzhou-Shenzhen-Hong Kong high-speed railway and the Hong Kong-Macau-Zhuhai Bridge are eroding the barriers between Hong Kong and its neighbors on the mainland. The new railway will run from central Hong Kong to Shenzhen's Futian business district in just 20 minutes.

With its deep reserves of talent and business know-how, Hong Kong may find a new role: not as a competitor to the PRD's other great cities, but as the nerve center of this emerging new mega-region, which looks set to become one of the centers of the global tech industry.

Straight Talk

Yuval Ben-Sadeh, Chairman of the Israel Chamber of Commerce in China and Founder of AST Clean Water Technologies, offers some home truths for foreign businesses operating in the Middle Kingdom

By Alex Wilson

Yuval Ben-Sadeh keeps things simple. For the Chairman of the Israel Chamber of Commerce in China (IsCham), business is business, rules are rules and everything else is just talk. Why waste time arguing about Chinese policy toward foreign businesses when you could be spending that time working out how you're going to adapt to it?

For Israeli companies, there is good reason to take this pragmatic approach. These are exciting times for the "Startup Nation," which has found opportunities galore in China's tech-hungry market.

When Ben-Sadeh first came to the Middle Kingdom to gauge the market potential for his company's water treatment systems in 1999, Israel's annual exports to China were in the tens of millions of dollars. This year, its exports are likely to surpass $10 billion.

In this interview with *CKGSB Knowledge*, he explains the key to success in China, and why there's no need to worry about the future.

Q: The Israel-China relationship is usually described as becoming closer and closer due to the countries' many shared interests. How does it feel to Israeli businesses on the ground in China?

A: First of all, it's challenging. It's a good feeling because we're quite welcome here, and this gives us a kind of advantage when it comes to the "landing." But then you immediately start to face the real business life in China, and you need to be prepared for it. If you learn [to deal with] it properly, it's a great place to be because there are a lot of shared interests, as you said, and shared ideas about the development requirements for both countries.

Q: What do you mean by the "real business life in China"?

A: It's mainly about a difference in cultures. Decision-making procedures in China are slower and longer, because it's a bigger country. I'm not criticizing it: I think it should be like this. But small Israeli companies that come here need to adapt to these procedures. This means a small private company needs to learn to think like a government-run company: they need to learn how to act and how to have patience with the decision-making process. If they adapt to it, it works well.

Q: Trade and investment flows between Israel and China have increased substantially in the last few years. What have been the main factors driving this?
A: It's very simple: mutual needs. Israel has a lot of ideas and development; China has a lot of needs. When the product meets the need, it's a match. A lot of China's needs are about its new era: it's less about heavy industry; it's more about sophisticated industries. Internet industries, artificial intelligence, internet applications, medical technologies… Israel has a lot of innovation-based businesses, so it's a good match. Plus, China has the money to invest, which it is willing to spend to promote the real needs of China.

Q: How many Israeli businesses are currently operating in China?
A: It's difficult to know because Israel is a very private market, so there is no real record, but it's several hundred companies. By Israeli standards, it's a huge amount.

Q: How much has this number increased over the last few years?
A: There hasn't been a big increase, but there has been a big change in the topics [of trade and investment]. Before, there were more agriculture companies or companies that wanted to buy from China. Now, it's more about high-tech companies coming into China. Before it was about [larger] companies, now it's about a lot of small companies, startups and individuals that are coming to China.

Q: What are the major obstacles to Israeli businesses in China?
A: You're talking from our side about small companies and private individuals that are coming to work in a very big system. But usually when you are talking about small companies, they need to get results in a relatively short period of time: after one year. In China, it might be after three years. You need to be prepared for it. But it's an obstacle because a lot of companies don't have the budget to act in this environment.

Q: How can businesses deal with this longer decision-making process?
A: Some can, some cannot. But you need to understand this reality. Some say, 'oh, I'll come and I'll register straightaway,' and we have to tell them, 'slowly, slowly. Calculate your steps.'

Q: What role does IsCham play in helping Israeli businesses deal with these issues?
A: Our main role is, first, helping them to do a proper matchmaking and, second, education. We give them information about how it works, about the regulation in China, about what to do and what not to do.

Israel has a lot of ideas and development; China has a lot of needs. When the product meets the need, it's a match

Q: In Israel, the perception of Chinese investment appears much more positive than in other markets such as Europe and the US. Why do you think this is?
A: I think it's like in all business: there are relations about power and influence, and about competition. If the US used to be the major investor in Israel and now there is a new player, China, obviously it raises issues. This is life.

Q: The Jerusalem Post *recently predicted that China would soon overtake the US as the largest investor in Israel. Do you agree?*
A: It's not about if I agree or disagree; it's about a situation that's happening all over the world. Because China has bigger needs than the US. It's very simple. It's all about needs.

Q: If China does supplant the US as the major investor in Israel, will that affect Israel's relationships with the two countries?
A: No, I still think the alliance with the US is based on different channels. I don't think there will be too many contradictions. There are a few, but not so many.

Q: Israel has already signaled it plans to be fully involved in the Belt and Road Initiative by working with China to develop a port in Eilat. What role will Israel play in BRI?
A: There is [already] a port in Eilat; they will enlarge it. I'm not sure if Israel will be fully involved because it's at the end of the "Road" [the 21st Maritime Silk Road linking East Asia, Africa and Europe]. But Israel has a lot of technologies that can contribute to this initiative, so it will be a good opportunity.

It will also have some limitations because the Belt and Road will cross from China to Israel, and in the middle there are some countries that don't exactly like us. It will be complicated for China and for Israel.

> Before it was very easy to sell imported products. But today, the Chinese perceive their products as better

Q: Tensions have been rising between the US and China regarding China's push to rival the US in strategic technologies like semiconductors. Do these tensions also affect Israel?

A: Again, I think only in a minor way. Mainly [this is because] there are some technologies that were developed mutually between the US and Israel, and obviously the US has a say about this.

Q: Officials from the European Union and US often express concern that their companies are forced to transfer technology to China in order to do business here. How does Israel perceive this issue?

A: They are not forced [to transfer technology]. China says, 'you want to work here; we want the technology. If you don't want to come here, no problem.' I don't understand why people have a problem [with that attitude]. If you want to come to work here, these are our needs. If you don't want to work here, fine.

Q: Other chambers of commerce in China have also raised fears that China is restricting market access for foreign businesses in certain industries as part of its Made in China 2025 *strategy. What is the Israel Chamber's view on this?*

A: At the end of the day, economic forces are stronger than anything else. Before, you used to send convoys and ships with goods from one place to another because only this place could produce them and the other could not. These days, it's different.

Manufacturing companies often operate facilities in Brazil, in Argentina, in the US. Why? Because it's not logical to send your goods across the world. The same goes for China: when the quality [of Chinese-made goods] keeps improving all the time, what's the logic of sending your products all the way from Israel to China?

By the way, several other countries are imposing import taxes in order to support their locally-made products: why can China not do the same?

[Made in China 2025] is an issue that you need to take into consideration, and you need to anticipate its effects. But generally, it's not logical to ship your products anyway.

Q: Some are concerned that Made in China 2025 *could make the playing field less level for foreign companies when they are competing for contracts against domestic firms in certain industries. What is your view?*

A: Who doesn't do it? Many other countries are doing this. So, why fear? I think it's logical and OK [for China to promote onshore manufacturing], and I think businesses need to prepare for this.

If I manufacture something here in China, or if I bring it from Europe to here, the second product is on the spot 30% more expensive. So, why would you buy it? Why would the Chinese government spend money on a project and pay 30% more? If the product is much better, fine. But if it's the same thing, why bother?

And by the way, what is President Trump doing now? Same thing. It's business logic, that's all.

Q: You have been running your own business—AST Clean Water Technologies—in China since 2009. How has your market changed over the past decade?

A: Before it was very easy to sell imported products. But today, the Chinese perceive their products as better, and the local products are excellent and even compete with us in other markets over the world. Now, there is a greater need for technology and know-how.

Q: Israel is often labeled the "Startup Nation." Why has Israel been so successful in promoting innovation and high-tech startups?

A: Because Israel acknowledges that the basis for development is always: invent yourself, become new. Be at the forefront of technology. And because, in terms of all these accelerators and incubators, Israel was already doing this 30 years ago. The government was already financing them.

Q: So, it's been very much a government-driven initiative?

A: Both: it's come from both sides. It's been the people who want to do it [set up new businesses], and the government understanding that it's important for our development. And based on this, it's grown. In Israel, there are about 2,800 startups registered every year. True, 90% don't last more than one year, but that's OK—this is the way with startups.

Q: How does China's startup ecosystem compare to Israel's today?

A: They are quite new to this, but they understand the need for it. They are pushing it quite hard, and they are learning and correcting all the time how to do it better. I think it will go on the right track. It will still take time: at the beginning, a lot of the incubators were lacking in technologies—the facilities existed but the technologies did not come. Now, things are changing and the projects are starting to come.

One of the things they're still in the process of understanding is: what are the incentives for the technology companies to come over? They are learning and improving, and it's starting to work.

TILTING EAST

Central and Eastern Europe faces a tough balancing act as it looks toward China for investment and growth

By Jens Kastner

Image by Cadie Can Long

China's growing ties with Central and Eastern Europe have raised concerns among some in the West. But the forces pushing the two sides together are much deeper and more complex than many realize

Hungarian Prime Minister Viktor Orban shocked officials across the European Union in late January when he told a business forum in Germany that the key to his country's future may be in Beijing, not Brussels.

"Central Europe has serious handicaps to overcome in terms of infrastructure; there is still a lot to be done in this area," Orban said. "If the European Union cannot provide financial support, we will turn to China."

For many, the Hungarian leader's ultimatum confirmed a fear that has been growing inside the European establishment over the last few years: that China is becoming an increasingly attractive alternative to the EU for the investment-hungry countries of Central and Eastern Europe (CEE). Since 2012, discussion of CEE's "turn to China" has centered on the China-Central and Eastern European Countries (CEEC) Summit, an annual meeting of officials and businesses from the Middle Kingdom and 16 CEE nations that is often called 16+1.

The stated mission of 16+1 is to make CEE a crucial component in the Belt and Road Initiative (BRI), China's ambitious vision for driving $1 trillion of infrastructure investment to better connect countries across Asia, Africa and Europe.

"16+1 came earlier than BRI, but it has already become supplementary to BRI, and both of them are strictly combined," Bogdan Goralczyk, the Polish representative of the newly-founded China-CEE Institute, tells *CKGSB Knowledge*.

The CEE bloc is integral to China's BRI plan: its members not only make up one-quarter of the countries along the Silk Road Economic Belt linking China and Europe, it also offers a useful route into the European Union.

"It has been obvious from the beginning that Chinese policy regarding CEE is of a strategic and long-term nature," observes Goralczyk.

This is why 16+1 provoked unease in Europe's traditional power centers, which see it as a strategic competitor to EU funding—and even a potential threat to European unity. "This sub-regional [16+1] approach is meeting a great deal of suspicion not only in Brussels but also in the capitals of many member states," a senior diplomat told the *Financial Times* in November.

In February, German Chancellor Angela Merkel confessed similar concerns when she told a news conference: "I see great value in EU members who participate in this initiative [16+1] also representing our common foreign policy toward China, because otherwise the EU would be allowing itself to be divided against itself."

The backlash appears to have been effective. In March, *Reuters* reported that Beijing is considering "paring back" 16+1 by making events more low-key, delaying this year's summit and perhaps even moving to a biennial format.

The news may be greeted as a victory by some in the West. But the demise of 16+1 will not end Chinese involvement in CEE. The forces pushing the two regions toward engagement are, and always have been, much deeper and more complex than many realize. And these forces are likely to become stronger.

A New Player in Europe

China's arrival as a major investor in CEE marked a historic shift for the region, which was traditionally dominated by its Western European neighbors and Russia. Before the turn of the century, the only time China had played a visible role in Eastern European affairs was during the 1950s, when the People's Republic helped prevent a possible Soviet invasion of Poland, according to the China-CEE Institute's Goralczyk.

However, Chinese involvement in CEE soon waned as Sino-Soviet relations became increasingly hostile during the 1960s. It was not until the early years of this century that the Chinese reappeared in the CEE, this time as an emerging global power and the world's fastest-growing market economy.

This return was driven more by hardheaded business interests of Chinese companies than any geopolitical interests of the Chinese government, says Agnes Szunomar, a senior economist at the Centre for Economic and Regional Studies of the Hungarian Academy of Sciences.

"Chinese companies like Hisense, Hua-

> **For all 16 CEE countries... Germany has substantially more leverage than China over them**
>
> Lucrezia Poggetti
> Research Associate
> Mercator Institute for China Studies

wei and ZTE entered for the same reasons Korean and Japanese companies entered a decade before them: it was market-, efficiency- and strategic asset-seeking, where the main point is access to the EU market," says Szunomar.

China's "go global" policy, launched in the run-up to its World Trade Organization accession in 2001, encouraged its businesses to become internationally competitive. Meanwhile, the accession of 10 CEE countries to the EU in 2004 made the region an attractive investment destination. Not only was it a market of 100 million consumers with excellent growth prospects; it also offered a combination of low-cost labor and frictionless trade with Western Europe.

Between 2009 and 2012, China-CEE trade jumped from $32 billion to $52 billion, according to data from the China-CEEC Institute. Chinese investment also grew quickly, particularly in the wake of the 2008 economic crisis when Chinese companies bought up large numbers of ailing European firms.

It was not until the second decade of the century that China's interest in CEE became more strategic, with then-Premier Wen Jiabao putting forward a 12-point plan for deepening China-CEE relations at the second China-CEE Business Forum in Warsaw, Poland, in 2012. Wen found a receptive audience, according to Szunomar, because many CEE countries had become disillusioned by the realities of EU membership.

"The new EU member states became disappointed with the EU… because they thought they could catch up to Western Europe faster," explains Szunomar. "So, now some CEE countries see China as a new potential ally."

Wen's speech led to the setting up of the annual 16+1 summit. It also inspired the creation of a special China-CEE secretariat in Beijing that coordinates a mixed architecture of financial cooperation, infrastructure projects, cultural and educational exchanges, and other economic and investment measures.

During the 2017 summit, Premier Li Keqiang, Wen's successor, announced the establishment of a China-CEEC Inter-Bank Association and a second phase of the China-CEEC Investment Cooperation Fund, which will provide the new Inter-Bank Association with $2.4 billion of funding via the China Development Bank.

The 16+1 project is an unambiguously Chinese-run affair: the secretariat answers directly to China's Ministry of Foreign Affairs in Beijing and all ranking officials are Chinese. European participation is limited to the "national coordinators" from each member country.

Phantom Menace

That 11 EU member states are also part of such a Chinese-led club has caused unease in Brussels, with many voicing concerns that Chinese influence in CEE could undermine any common European China policy. According to Lucrezia Poggetti, a research associate at the Berlin-based Mercator Institute for China Studies (MERICS), this concern has been increasing since mid-2016, when reports emerged that Hungary and Greece—both recipients of Chinese infrastructure investment, though the latter currently only has observer status at 16+1 summits—had watered down a joint EU statement criticizing China.

"It is difficult to say whether these countries changed their rhetoric to gain leverage in their negotiations with Brussels or to curry favor with Beijing in the hope to obtain investment," comments Poggetti. "Nonetheless, it raises concerns at the EU level and in Germany." Poggetti points out that there is little evidence to suggest that 16+1 is a realistic threat to Brussels' dominance in CEE, since China's financial leverage over the CEE countries is minimal. "This threat is mainly still a matter of perception," she says.

"The European Regional Development Fund and the European Social Fund poured into CEE far outweigh what China does in CEE," Poggetti continues. "And for all 16 CEE countries, access to the EU market and Germany in particular is economically vital, so Germany has substantially more leverage than China over them."

According to Szunomar, even in the Czech Republic, Hungary, Poland and Slovakia—the four CEE countries that have historically received most investment from East Asia—Europe accounts for 90% of foreign direct investment. The rest comes mainly from the US, South Korea and Japan, with China in fifth place.

"These statistics don't track back to the ultimate owner, so in reality Chinese investments are more significant," notes Szunomar. "Nevertheless, Japanese and Korean companies still have more investments in the [CEE] region as they arrived almost one and a half decades earlier."

A Shaky Platform

While Western Europeans worry about China's increasing influence in CEE, many in Eastern Europe have the opposite concern: 16+1 has so far failed to provide the surge in Chinese investment and trade that they had hoped for. To date, China's state-run banks have only signed off on $15 billion worth of deals for infrastructure-related projects in CEE, according to data collected by the *Financial Times* in cooperation with the Center for Strategic and International Studies (CSIS), a Washington-based think tank.

What's more, Szunomar points out that, "a lot of the [Chinese] investments were actually made before the establishment of the 16+1 cooperation."

Major projects undertaken include a bridge in Serbia, two roads in Macedonia and little else. There have been high-profile setbacks, such as the Macedonian Ministry of Transport and Communication's decision last year to block the completion of a Chinese-financed 57-kilometer, $460-million highway amid allegations of corruption and losses to the state budget of over $190 million.

According to Richard Turcsanyi, Director of the Strategic Policy Institute in Slovakia's Bratislava, many potential deals have fallen through because Chinese investors have been reluctant to offer good terms or comply with European procedures. "Many projects are based on unrealistic plans because China doesn't want to accept public tenders and comes up with loans that are more expensive than on the financial market," he says.

Growth in trade between China and CEE has slowed significantly since the founding of 16+1. After nearly doubling between 2008 and 2012, total trade grew by less than $7 billion over the next four years, reaching $58.7 billion in 2016.

Frustratingly for CEE countries, most of this extra trade is fueled by increasing Chinese imports, not exports to the Middle Kingdom. The 16 countries' trade deficit with China has continued to increase since 2012, with imports from China outnumbering exports twelvefold in 2016.

"The much hoped-for boost of exports to China has not materialized," says Turcsanyi. "CEE countries typically manufacture intermediate products for Germany, from where the final products are then shipped to China."

According to Szunomar, the underwhelming results are due to "insufficient knowledge of regulatory and business practice among Chinese companies," as well as "the small number of investment opportunities presented by CEE companies to Chinese investors."

Eleven of China's 16 CEE partners are also members of the European Union

Western Retreat

Given the low levels of Chinese investment in CEE up to this point, the importance attached to 16+1 from both sides of Europe—the Eastern Europeans hoping that China is the answer to their development needs, and the Western Europeans fearing the same—appears out of proportion.

According to Wang Yiwei, Director of the Center for EU Studies at Renmin University of China, the reason for this perhaps lies not so much in China's growing ambitions in Eastern Europe, but rather in the West's retreat from it.

"The US is becoming less interested in participating in European issues, and those leading countries in the EU, in many cases, can't even solve their own problems," says Wang. "This is why the CEEC is seeking opportunities from China."

Poland, for example, could lose its EU development funding—currently set at €80 billion ($98 billion)—once the next seven-year budget round begins in 2021 due to Brussels' plans to link access to the funds to countries' "judicial independence" and "solidarity." If Poland were to lose this EU support, it would be forced to look elsewhere for funding, according to Mercy A. Kuo, President of the Washington State China Relations Council, a US-based non-government agency.

"The EU structural funds for development will stop in 2020, and Poland needs to seek alternative investment vehicles to prolong its GDP growth," Kuo wrote in a recent article for *The Diplomat*. "Huge investments are still needed in infrastructure, especially train lines and the energy sector."

The Balkan nations' hopes of joining the EU, meanwhile, have receded, so they are searching for a new way forward. Gjorge Ivanov, the president of Macedonia, which has been a candidate for EU membership since 2005, has been frank about why his country needs to develop closer ties with China.

"As Europe is withdrawing—or rather not keeping its promises about making the Balkans part of the European Union—it's like a call from the EU to come and fill in that space," he told *The Telegraph* in November.

As Kuo points out, with the EU's budget set to shrink after Brexit, Europe will be in an even worse position to help CEE nations develop. For these countries, it will become even more necessary to attract increased investment from China.

Green Shoots

Fortunately for CEE, there are signs that this is finally happening with direct investment from Chinese companies appearing to be picking up. Poland saw a flurry of big deals in 2016, including the China Three Gorges Corporation's €289 million ($350 million) deal to take over Portuguese EDP Renovaveis' wind farms; China Everbright's acquisition of Polish waste and alternative fuel company Novago for $117 million; and NovoTek Pharmaceuticals' investment in insulin producer Bioton.

There were also greenfield investments by Suzhou Chunxing Precision Mechanical and Hongbo Opto-Electronics in plants to produce precision mechanics and street lights, respectively. According to Agnieszka McCaleb, a researcher at the Warsaw School of Economics' East Asian Research Unit, the turnaround has come from Chinese investors learning from past mistakes, such as COVEC's abortive project to build a highway connecting Warsaw with Germany before the Euro 2012 soccer championships.

"COVEC's failure delivered a significant blow to the reputation of the Chinese in Poland," says McCaleb. "But this has recovered as Chinese companies won bids and learned to work more closely with local subcontractors. Chinese direct investors also look for assets strategic for them in terms of technology, such as those related to waste management, renewable energy and the prevention of pollution."

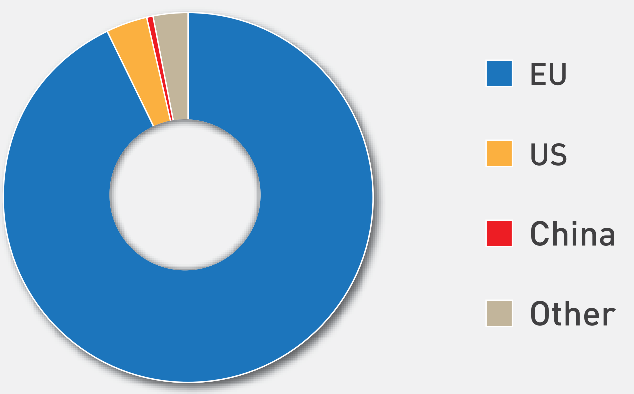
Eastern European companies are also learning to use 16+1 as a matchmaking platform to secure deals with Chinese buyers, according to Gabor Holch, a Hungarian consultant who advises EU companies operating in Asia. Holch notes that 16+1 is vital for helping connect small European and Chinese businesses that otherwise would never meet.

"One option for these two to come together is a government-funded delegation," he says. "The other option is Hungarian-Chinese trade fairs organized by a business chamber. And that is precisely where 16+1 comes in, as there are countless such activities organized under its umbrella."

Tipping the Scales?

EU investment in CEE vastly exceeds that of China

Sources of foreign direct investment in Poland in 2015



Source: National Bank of Poland, Ministry of Development, Polish Investment and Trade Agency

Winners and Losers

For Eastern European businesspeople like Holch, there is no reason that CEE economies should choose between the EU and China. "They need both markets and that need would also be applicable to the political realm," he says.

From Holch's perspective, 16+1 is helping companies from CEE do what their Western European neighbors have done before them: take full advantage of the Chinese market. According to the Hungarian, CEE companies are increasingly looking to team up to realize "production in China, such as the French do with their wine, but that can only be achieved with overarching government support through 16+1."

However, the question is whether those in Western Europe can be persuaded to see it that way. There are also signs that Western complaints about European unity mask more self-interested concerns. According to Michael Christides, Secretary General of the Organization of the Black Sea Economic Cooperation, this is visible in the attitudes of some in Brussels toward China's investments in ports in the western Balkans.

"[There are] fears the big ports of the north, like Rotterdam and Hamburg, could lose a lot of trade volume" because of competition from new southeastern facilities, Christides told a forum in Greece last year. "This is widely discussed in Brussels."

Though it will be painful for many in Europe to hear, Hungarian leader Orban is perhaps right to remind them that "it is now obvious that the world economy's center of gravity is shifting from West to East." Brussels can choose to embrace Beijing's presence in Eastern Europe, or resent it. But it cannot stop it.

In Search of the "China Way"

Peter Cappelli, George W. Taylor Professor of Management at The Wharton School, University of Pennsylvania, discusses the business practices of China's most successful private companies

By Dominic Morgan

China is now home to many of the world's largest and most dynamic private companies. But apart from a few exceptions like Alibaba's Jack Ma, little is known outside China about the intrepid entrepreneurs who built these business empires, often against astonishing odds.

Professor Peter Cappelli and his colleagues at The Wharton School, University of Pennsylvania, are trying to change that. Over the past few years, they have interviewed the leaders of China's biggest private companies, including Lenovo, Tsingtao, Geely and Vanke. Last year, they shared their findings in *Fortune Makers: The Leaders Creating China's Great Global Companies*.

Like the team's previous book, *The India Way*, which profiles India's top business leaders, *Fortune Makers* is an attempt to identify a set of attitudes and practices common to the target country's CEOs. But as Cappelli tells *CKGSB Knowledge*, outlining a "China way" was a surprisingly complex task.

Q: Fortune Makers *sets out to define a distinct Chinese business mentality. What are the unique features of the Chinese approach to business?*

A: One conclusion we reached was that China is not as neat a story as India. India has a clear model. The Chinese founders that we spoke to are in some ways not that different to the founding entrepreneurs of the United States a hundred years ago, in that they are the first movers in industries that have become very big. But there are attributes of who these people are that are distinct, because anyone who wanted to be a capitalist in a country that loathed capitalists was a pretty unusual person.

For a lot of Chinese founders, trying to make money was a way to establish personal security in a country where it wasn't obvious how you might do that. If you had lived through the Cultural Revolution, for example, everything that people thought led to success was suddenly tossed in the air. And if you lived through that, part of what motivates you is, "I don't want that to happen again."

> **Another quirk of Chinese companies is that the founder is still around. The founder can just say, 'you're all going to do this.' In US companies, power is more decentralized**

So, one part of the "China way" is that the people are very different, but the context is also different: China provided enormous opportunities in a way that India, for example, absolutely did not. India's government is a pain; the infrastructure is terrible. The joke in India is that the economy grows at night, while the government is asleep.

In China, a lot of the homogenizing effects of communism were actually perfect for helping entrepreneurs' activities flourish: standardization, a certain stamping out of diversity—in China a hundred years ago, you certainly would have seen more diversity in terms of clans, ethnicities, languages and so on—and a certain level of materialism.

So, part of the story is of people who were individualistic and strongly motivated to make money in a time where the opportunities to do that were extraordinary.

Q: What is unique about Chinese companies from an organizational or cultural perspective?

A: In terms of the way Chinese founders think, there are several things. One is that they think long term in a way you don't see in the West. Some of that is because they don't have short-term investor constraints.

Another part is that they're after market share, not for sophisticated strategy reasons, but because they believe—and they're probably right—that if you are a really big company you are much more secure in China than if you are a small company that generates tons of money, which would be the US model. I think that's partly why Chinese entrepreneurs are more willing to make much bigger investments, because of the more long-term orientation.

The emphasis on learning [inside Chinese companies] was also striking. And learning in a very traditional, academic way. Many companies require executives to write book reports and to spend time reading traditional academic works, going to training classes or bringing in experts. There's an openness, a recognition that we could really get better fast if we use these folks.

They can execute that because of the extraordinary top-down centralization of the "China way": all you need is the founder. That's another quirk of these companies, of course, that the founder is still around. The founder can just say, 'you're all going to do this.' In US companies, power is more decentralized.

The thing that was most positive that struck me came from the traditional Chinese "big boss" model: the loyalty to the individual leader. This ran both ways, as the CEOs were pretty loyal to those in their immediate circle. What that meant was, if you were willing to be a team player, if you made it to the inner circle, they cut you a great deal of slack. If you screw up, they're not going to fire you. But the requirement is, if you're in trouble, you don't try to hide it.

The advantage is that they don't need the elaborate control systems that you see in Western companies. If you compare it to a US company, they have all these layers of internal accounting to try to figure out what's going on and head off problems, because, frankly, they don't trust the people on the ground to act in the interests of the company.

Q: You mentioned that many of the Chinese founders you profiled came from the generation that grew up before capitalism was legitimized. How formative were these experiences, in your view?

A: I think they were fundamental. It's not like they had a complete reaction against communism either, that's not true. They embraced lots of it, and you can still see many manifestations of communist behavior in the way they do things. For example, you see people who make mistakes in these companies undergoing "re-education" where they're dressed down publicly and asked to write accounts of why something went wrong, and what you're going to do about it going forward.

I think most of these folks were at a formative age during the Cultural Revolution, and it's hard to believe that it wouldn't leave a mark on you.

Q: What could companies in the US learn from their Chinese counterparts?

A: Practically, I think American businesses could benefit from understanding how these companies operate, because you're competing against them. Chinese companies take a long-term view, they focus on market share and growth, they're willing to pay a price to get that and they're not always under pressure to meet quarterly goals—businesses need to understand that.

Sundar Pichai, CEO of Google. Unlike India, China has produced comparatively few CEOs of major global firms

I think there are weaknesses there, too. For example, Chinese companies are not good at developing talent and at managing complex organizations. They often struggle once they go abroad as they're not great at understanding and accommodating local cultures. They're also not yet developing a strong cohort of leaders. Some of that is due to the strong top-down model and some because, if you're not international, you don't have to give managers authority and autonomy in the way you do if you have subsidiaries in other countries.

Q: How exportable are Chinese business practices? Would they work as effectively in a Western-style market?

A: My gut feeling is that Chinese businesses will start struggling soon because most rely on people who are willing to follow orders. They've now got a big cultural divide within the country with the one-child family kids [born in the 1980s and 1990s], who are beginning to run things and populate the lower ranks of management in companies. I don't think the "just-do-it-because-I-said-so" stuff will go over so well with those folks.

The other thing I wonder about is that, in lots of companies worldwide, the great successes come from pushing authority down closer to the ground and front-line level: everybody is trying to do that. But they're not trying to do that in China. So, I'm not sure how well that style is going to work elsewhere.

If you look at the Indian companies, for example, there are a lot of Indian CEOs moving into jobs in companies around the world. I don't think I've ever seen that of a Chinese CEO. That's a pretty good marker of the nature of the challenge, I think.

Q: Could you elaborate on that? Why do you think it has been easier for Indian CEOs to transition to running companies abroad?

A: Well, I think Chinese companies don't operate like European or American companies do. The big challenge of working through people, which is the problem of corporations, in China is not a big deal. But in the rest of the world it is a big deal. Trying to develop commitment and engagement from your employees is a big challenge in most of the world; it has not been in China, though it may start to be pretty soon.

Q: As Chinese companies increasingly expand overseas, do you think the "China way" will influence the business cultures of other countries?

A: I don't think so. But I think that's a high bar, because even when Japanese car companies were operating in the US, American car companies weren't copying the Japanese companies.

I think that the things that are good about the Chinese companies are so unique to the Chinese context. Like the fact that they can take this long-term view and can move very quickly because they don't have all these internal systems: those can be real assets, but they don't translate elsewhere. A US subsidiary of a Chinese company is not going to be able to maneuver in the US any better than any other company. They're headquarter assets; they're not country assets.

Q: You alluded to the generation gap in China. How do you expect Chinese companies will adapt to the entry of an increasing number of "post-90s"?

A: I'd say with difficulty. We talk to senior people from these companies frequently because they come [to Wharton] for executive education, and they're puzzled about the behavior of employees, and particularly young people. Even with simple questions like, "we don't understand why people are quitting, why these young people are moving."

Part of that is because they don't have systems in place to answer those questions, but part of the reason they don't have those systems in place is because they don't understand why the questions should even exist. So, I think it's going to be difficult for them to handle.

Q: Do you think these societal changes will force Chinese companies to become more like global companies?

A: I do. And I think they already are. You know, they're borrowing so heavily from US consulting companies: they're basically setting everything up for them. So, I think they're not going to look like global companies. They're going to look like US companies.

And to some extent they do [already]. I mean, if you think about the workforce issues that I look at, they've got all the practices of US employers in human resources. They don't know how to execute them often, but they've got them. They have the pay systems with all the pay grades, and so on.

Q: What are the strengths and weaknesses of these younger generations in China, who were born after 1980?

A: Well, they're more global, and that's interesting if you're going to be a global company. The education standards have improved a lot, and there's more people going to college. I think so far that has not been very useful in China, because the supply of college graduates has vastly exceeded the demand. Some of that is because, compared to a lot of Western countries and Western companies, they don't have all these middle-management jobs. And they don't yet quite have the service culture that you see in the US.

These folks are interested in having, I think, more autonomy, and that's going to be useful if Chinese companies want to compete the way most companies find it necessary to compete, which is that people closer to the markets need to be tasked with making decisions, passing information along and things like that.

A US subsidiary of a Chinese company is not going to be able to maneuver in the US any better than any other company

Q: Is there a risk that these younger generations will be less dynamic than their predecessors?

A: For sure. In all developing countries, particularly ones that have developed as quickly as China has, the material rewards from working within the system have been astonishing: hundreds of millions of Chinese lifted out of poverty. You're not going to see anything like that again. The ones who got pulled out of poverty into the working class are not going to become middle-class in the next 20 years: that pace of change is impossible to sustain. So, they're not as hungry.

Q: What advice would you give Chinese companies struggling to adapt to this new reality?

A: They must get better at management. So far, in terms of what they have gotten better at, it's lots of aspects of business, particularly, of course, on the production side—in manufacturing, they're good and, in some places, world-class. But on other aspects, they're not [world-class], particularly around management.

They're going to have to start worrying about people behaving, especially because one legacy of communism is that a lot of these companies have not done an awful lot of firing people. And the government, of course, has been very concerned to make sure that they don't do lots of layoffs.

So, how are you going to manage when you're not good at management and you can't fire people? That's an interesting question, and there's not an obvious answer.

Planes, Trains and Automobiles

Patrick Horgan, Regional Director of Northeast Asia for Rolls-Royce, outlines how the legendary British industrial technology company aims to propel a new era of Chinese development

By Mei Xinlei

Few in the expat business community can rival Patrick Horgan's depth and range of experience in the Chinese market.

Since first coming to China as a volunteer in 1989, Horgan's career has spanned business, diplomacy and cultural relations. Since 2011, he has been Regional Director of Northeast Asia for Rolls-Royce. As he tells *CKGSB Knowledge* in this interview, he believes China's huge development ambitions make this an exciting time to be at the British manufacturing giant.

Q: China is expected to overtake the US as the world's largest civil aviation market by 2022. How big an opportunity is this for Rolls-Royce?

A: It's good news for us. In the civil aerospace market, China has come rapidly from a relatively low level. The growth through the 1990s and the last decade has been extremely strong. And yet, the total civil commercial fleet in China is about 2,800 aircraft or thereabouts, whereas in the US it's about 7,000 aircraft. When you compare the size and demographics of these two countries, it's easy to see that there is a lot of latent demand in China that is not yet being met.

That's why the forecasts are very consistent: whether you look at Boeing's numbers, or Airbus, COMAC or our own analysis, it all suggests [that China will acquire] in the region of 6,000 commercial aircraft over the next 20 years. That's a massive opportunity for many players in China, and obviously for the international air framers and engine providers as well.

Q: How will the emergence of China's state-owned aircraft manufacturer COMAC as a competitor to Boeing and Airbus impact Rolls-Royce?

A: COMAC is still a young company. Last year, they achieved the significant milestone of the first flight for the C919. This is a significant breakthrough: COMAC is creating civil airframes effectively from scratch. It's a massive undertaking, so this endeavor is something that you have to watch with admiration.

There are now two aircraft. There's the ARJ21 and the C919. The ARJ is in service; the C919 has had its first flight. But there is still some way to go before the C919 enters into commercial service. Our relationship with COMAC is focused on what comes after that, because we do not provide an engine for narrow-body aircraft at present.

Our focus and our sweet spot is very much in the wide-body twin-aisle aircraft market, as we produce some of the world's largest and most powerful civil large aero engines. COMAC has announced its plan to develop an aircraft, namely the CR929 in that segment. So, not surprisingly, we are engaged in close discussions with COMAC around that possibility.

Q: Rolls-Royce recently signed an agreement with Chinese rail group CRRC to partner on the Belt and Road Initiative (BRI). What type of projects will this partnership involve?

A: I think that's a very good question because when people talk about BRI it's often quite hard to conceptualize what is actually meant.

In the case of our business, Belt and Road is fundamentally about connectivity and infrastructure along both the terrestrial and the maritime routes connecting Europe and Asia. Whether you're talking about in the air through aviation or land and sea, these are all areas that are addressed by the products and services that Rolls-Royce provides.

So, there is a natural fit and we have concrete examples from across our businesses to demonstrate that. The example you're referring to, the relationship with CRRC, is the railway business. We have locomotive engines provided by MTU, part of Rolls-Royce Power Systems, and those engines are an excellent fit for diesel locomotives that are already in use on CRRC-led projects in BRI countries. We've sold about 500 locomotive engines through CRRC into other countries' markets.

Q: Many BRI projects are located in quite high-risk markets. How is Rolls-Royce assessing and managing those risks?

A: Clearly, there are very challenging aspects to investing in some of the countries that are covered by these Belt and Road routes, and that means that people will have to take a very responsible approach to assessing risk.

But perhaps that is also an argument for why it's important to have some initiatives that are led beyond the project-by-project, company-by-company approach, because in some cases the projects will simply not reach fruition if they don't have impetus from elsewhere.

Q: Many European businesses have reported that China's business environment has become more challenging in recent years. Has this also been the case for Rolls-Royce?

A: Well, I think that, whether the circumstances are difficult or not, the market's significance is unquestioned. It is conventionally the case for large multinationals that have a significant market in China that they may derive between 10 and 15% of their global revenue from this market. So, even in those circumstances where there are challenges, that doesn't negate the importance of the market, and for us that is very much the case.

> **There is always competition in the business world. We deal with that by being good at what we do**

We are a diversified group. We're perhaps best known for the aerospace business, but within the group we have a power systems business—that's gas and diesel engines for multiple applications—a marine business and a civil nuclear business. And for all of those businesses, China remains a very important and growing market.

Q: Regarding the figure you mentioned about 10-15% of revenue coming from China, is that also the case for Rolls-Royce?

A: Our group revenue in 2017 was £15.1 billion ($21.4 billion). Twelve percent of that revenue was generated from Greater China, and I would absolutely expect that to continue to be the case in the years ahead.

Q: Many of your key business segments are also a main focus of China's Made in China 2025 *strategy. How do you expect this policy to affect your operations in China?*

A: *Made in China 2025* is an industrial development strategy. It is natural and reasonable that all countries, particularly countries with bold development goals, should seek to have an ambitious industrial development strategy.

It is true that within that, there are areas highlighted that are exactly related to our areas of business, and you can take different attitudes to that. You can take an attitude that says, 'This looks like it is posing some kind of a competitive threat.' On the other hand, you can say, 'If China is directing its energy, its talent, its resources toward building capabilities and building a market in these segments, then that also implies opportunity for us.' And I think, of course, it is a combination of both of those things.

The reality is that there is always competition in the business world. We deal with that by being good at what we do, by constantly innovating. We invest £1.3 billion ($1.8 billion) annually in research and development. Whether or not there is an increased competitive threat emerging from domestic Chinese companies, we are well prepared to meet that threat.

Q: How effective do you think Made in China 2025 *will be in terms of helping Chinese companies in key industries become globally competitive?*

A: The industrial development strategy is aspirational, and there are clear priorities. For sure, China has abundant capability to try and address those areas. In reality, it would be strange if China was not successful in some areas and perhaps less successful in others.

I think the key thing here is to what extent market mechanisms will be at play. The issue that I hope will not occur is a repetition of some of the problems of the past, where if you have a state-mandated, state-directed approach to industrial development, you risk channeling a very large quantity of precious resources into areas where you don't necessarily have a viable, sustainable pay-back over time.

But I think it would be rash to second-guess. I think that there will be some areas where, without doubt, the *Made in China 2025* strategy will deliver for China.

Q: As one of the UK's most high-profile companies, to what extent has Brexit impacted your business? And how do you expect it to affect UK-China relations more generally in the future?

A: The relationship between the UK and China was important before Brexit and it's important after. And, if anything (of course, depending on how the final Brexit scenario plays out) the relationship with China is likely to become even more important over time. So, I don't think that Brexit is felt here as keenly as it is in some other parts of the world. After all, the issue seems somewhat remote when viewed from China.

It's also important to note that we are a multinational; we have large operations in the rest of Europe as well. So, while the UK-China relationship is significant and important for us in terms of the dynamics of our business, it's not the key consideration. China is a large unitary market and the importance of the European Union remains key.

> The relationship between the UK and China was important before Brexit and it's important after

Q: What role does China play in Rolls-Royce's global supply chain?

A: Actually, we started supply chain work in China very early on, going right back to the 1970s. It has grown particularly in recent years: we now do about $200-300 million annually in aerospace supply chain activity in China and we expect that to increase to approximately $500 million by about 2020.

I think what's really interesting and satisfying to see is the extent to which Chinese suppliers have been developing capability. Now, they are among the best suppliers that we have globally in terms of quality and delivery.

We also have a joint venture in aerospace supply chain that's been running for more than 20 years. The colleague who is now the general manager of that joint venture joined more than 17 years ago as the company's very first machinist. It's great when you see that kind of story.

Q: How is Rolls-Royce adapting to trends such as Industry 4.0 and the increasing prevalence of digital technology?

A: This clearly is an area of great significance for any industrial technology company. For a long time, we have been investing in acquiring digital capabilities. It's consistent with what we have tried to do throughout our history: actually pioneering these new kinds of initiatives.

Before people really started using the terminology around big data, Rolls-Royce was already doing big data: the gathering of digital information about the performance of our engines. Engine health monitoring, as it's called, is something that we've been doing for over 20 years now.

Gathering huge volumes of data has led to great advances in very concrete terms—advances in our predictive maintenance and the analytical capabilities to anticipate things that could go wrong with the performance of the engine. Similarly, because of these advances, we were also able to massively cut down the time and cost required for visual inspection of engines and help customers minimize disruptions to the operation of their fleets.

Q: What's next for Rolls-Royce in China?

A: Last year we established a new joint venture for our Power Systems business, and we will see the first engine coming out of that joint venture in April this year. That's MTU's highly successful Series 4000, a state-of-the-art diesel engine primarily for the Chinese off-highway market, in particular for power generation and oil & gas applications.

The other significant milestone in 2018 for us is the entry into service in China of the Airbus A350 aircraft with Rolls-Royce's Trent XWB engines. This is the world's most efficient gas-turbine civil large aero engine. It's a great plane with a great engine. If you fly, you'll notice how quiet it is. So, I'm really looking forward to seeing the A350 flying in China for our Chinese airline customers.

DROPPING THE BATON?

As a generation of Chinese entrepreneurs prepares to hand over the family business, many are discovering their children have other plans

By Allen Young

Image by Lisa Ye

Millions of Chinese family business owners are about to hit retirement age, but more than half their children say they're not interested in taking over. Is China facing a business succession crisis?

Last year, Xu Jia had a big decision to make. Her father, the founder of a successful high-tech materials company in Cixi, a town not far south of Shanghai, was getting ready to retire. He offered her his stake in the business.

In the end, the 23-year-old declined. "I don't want to do a job I'm not interested in," she says. "I don't think he was disappointed, but since he's not someone given to expressions of emotion, I'm not really sure."

Instead, Xu decided to continue her education in London, where she's working on a master's in Information and Experience Design at the Royal College of Art. After she finishes, she hopes to start her own business. "I've already found an office for my startup in London. I found a place and bought an apartment," she says.

Xu is far from alone. Winnie Peng, Associate Director of the Tanoto Center for Asian Family Business and Entrepreneurship Studies at Hong Kong University of Science and Technology, says China's young business heirs often have little interest in taking over the family firm.

"They're all well-educated, most of them have studied abroad, and they have outside opportunities," says Peng. "When they return to the family business they feel very bored."

Joseph Fan, Co-founder of the Centre for Economics and Finance at the Chinese University of Hong Kong (CUHK), has estimated that more than six in 10 children of Chinese founders are unwilling to inherit their parents' businesses. Even Wang Jianlin, the tycoon behind Chinese property behemoth Wanda Group, is reportedly planning to hand his business over to professional managers after he retires because his son, Sicong, is not interested in running the company.

With more than 3 million Chinese entrepreneurs set to retire within the next decade, according to Wu Xiaobo, one of China's leading business journalists, the effects on the Chinese economy could be far-reaching. Some analysts are even beginning to talk of a looming succession crisis.

"The first wave of Chinese entrepreneurs is now aged in their 70s and 80s, and they haven't given any thought to succession," says Patrick Trainor, Managing Director of Cornerstone Strategic Partners, a business advisory firm. "The heart of the issue is the one-child policy. No one foresaw that this would be a problem. But it exacerbates the difficulty of succession."

That policy, which took effect in 1978 and lasted until 2015, means that most Chinese millennials have no siblings. As a result, business owners hoping to hand the reins to their children often have only one option. If the younger generation refuses to assume leadership, the economic effects for the country could be far-reaching.

Yet reluctance among Chinese millennials to join their parents is not necessarily cause for alarm. In fact, by following their own path, they may be poised to drive growth in new areas.

Fear of Succession

Succession is a fraught issue in any family business anywhere in the world. Children and grandchildren don't always have a founder's talent for running a company, and the question of who will take over is often put off until it's too late to make adequate preparations.

A 2016 study by PwC found that 43% of family businesses surveyed from around the world had no succession plans in place. That same study found that as few as 12% of family companies survive to the third generation. Failure to last beyond three generations is so common, in fact, that it even has a name: Buddenbrooks syndrome, after Thomas Mann's 1901 novel about a merchant dynasty that ends in ruin.

In China, the issue of succession is especially pressing because as many as 90% of the country's 21.6 million private companies are family-run and a huge number of these were all founded within the same ten-year period, from the mid-1980s through to the mid-1990s. Fan from CUHK estimates that these family-run firms contribute more than half of China's gross domestic product (GDP).

Even the oldest of these businesses

were created after the economic reforms ushered in by Deng Xiaoping in the early 1980s. Having built their firms from scratch, many of the aging entrepreneurs are understandably reluctant to cede control. "That generation is incredibly tough and it's hard for them to give up what they've created," says Trainor.

According to a Credit Suisse report from 2017 that studied around 1,000 companies worldwide, family businesses in the Asia Pacific region (not including Japan) have an average age of 37, compared to 61 in the US and 82 in Europe. Over 50% of Asian family businesses are in the first generation, compared to around 15% in the US and Europe.

> The children of Chinese founders are mostly educated in the West, where the rules and the way they conduct business are quite different
>
> Bingsheng Teng
> Professor of Strategic Management
> CKGSB

In Asia generally, and in China in particular, leadership transitions are a new problem. "Succession is more of an issue in China than in Europe or other Western countries," notes Kevin Au, Director of the Centre for Family Business at CUHK. "In China, many family businesses are still run by the first generation. So, this challenge is quite new to many of them."

Generation Gap

Perhaps an even greater challenge is the generation gap between Chinese millennials and their parents, which is far wider than in the West. Thanks to three decades of dramatic economic growth, people under 30 in China have enjoyed opportunities that their parents never dreamed of—and they have the career expectations to match.

"They are mostly educated in the West, where the rules and the way they conduct business can be quite different," says Bingsheng Teng, Professor of Strategic Management at CKGSB. "Some have reverse cultural shock when they return to China."

Of course, not everyone studies abroad, but even those who don't tend to have a different outlook from their parents. As digital natives, they've grown up in a more global environment, so have a more varied sense of what a successful career means.

Trainor says that, in the past, "people would think that the way to the top is to continue their father's business, to get a traditional job or maybe join the army. Now, a lot of the younger generation look around on social media and say, 'Hey, that looks fun. I have my own ideas—I'd like to try that.'"

Zhang Bowei, 25, grew up in the city of Xining, high on the Tibetan Plateau in

Zong Qinghou (right), founder of Chinese beverage giant Wahaha, has made his daughter Fuli (left) chairman of the company

Wang Sicong, son of Chinese property magnate Wang Jianlin, has reportedly told his father he does not want to take over his company, Wanda Group

Qinghai Province. Shortly before he was born, his grandfather and father opened a business selling auto parts that grew to employ a handful of people. Their success allowed them to give Zhang opportunities to broaden his horizons and to study finance and accounting at the University of Sheffield.

Zhang's parents didn't ask him to take over the business—when his father retired last year, it went to his uncle—but they did hope he'd return to Xining, where they've already bought him three apartments.

Yet when Zhang moved back to China last year, he went to Shanghai, where he now works in finance. "Xining is a nice place, but it's very small," he says. For him, and for many in his generation with a global background, a cosmopolitan city on the coast holds far more appeal than a provincial capital in the interior. This preference could spell trouble for businesses located in more remote locations.

Rocky Transitions

Even when children do take over their parents' business, the transition doesn't always go smoothly. Second-generation company heads in China, as anywhere else, must establish their authority in the eyes of their employees—no mean feat, especially if they've spent the first part of their careers working in a different country or corporate environment.

The hierarchical nature of Chinese companies makes it especially difficult for younger leaders to find their footing because they're often overshadowed by an older generation that clings to power well past the retirement age, says Peng.

"Even if their son or daughter is 40 or 50 years old, the owner doesn't want to step down and dictates their behavior," she relates. "It's a hierarchical system, so you have to respect and follow your parents. You seldom have the courage to challenge them."

In her research, Peng has compared family business cultures in different national and cultural contexts, and she finds that Chinese firms struggle with transitions. By contrast, where there's a tradition of debate within the family, as in Jewish firms, the hierarchy is less rigid, and less debilitating.

Personal relationships pose another challenge. Though it's something of a truism, connections, or *guanxi,* are crucial to running a business in China. Adapting to the local business culture can be a huge challenge for many young people, who have often spent a lot of time overseas, CKGSB's Teng points out.

"These people don't have a network of classmates and friends who grew up with them, who can support them in a business sense," he says. "They often feel especially lonely when they are suddenly put into a leadership position, where they have to deal with so many stakeholders who are mainly strangers to them."

Crisis or Opportunity?

Still, it's not clear that all this adds up to a crisis. Despite a spate of recent articles forecasting the dire economic impacts of family businesses failing to find an heir, many experts offer a more optimistic perspective.

Peng is unequivocal: "I don't really think this is going to be a crisis for the country. It may be a crisis for the families involved, but not for the country."

In her view, the challenges that family businesses face are the same as the challenges faced by businesses of all types:

how to transform and upgrade, and how to respond to shortening business cycles and changing consumer demands. "Previously, in mainland China, we had a low-cost, low value-added business model. We need to change to a high-tech, high value-added model."

For his part, Au believes that even though some members of the younger generation may be unwilling to take over from their parents, that attitude is far from universal—many in fact appreciate their parents' sacrifices and want to continue the businesses they started.

"Particularly after the financial crisis of 2008, they see Asia as having more economic opportunities than the West," he says. "Many youngsters see coming back as an economic opportunity."

Going Their Own Way

It is worth looking at Chinese millennials' unwillingness to take over their parents' businesses from another perspective. For many, this reluctance is not due to a lack of entrepreneurial zeal: on the contrary, they are often impatient to strike out in their own direction.

In Trainor's view, children who are most like their entrepreneurial parents are the ones least likely to take over. "Does the younger generation really want to move into their parents' business? Or do they, like their parents 40 years ago, want to go their own way?" he asks. "The founders' generation were not the children of entrepreneurs. And now their children see them and think, 'We're just like you—we want to do our own thing.'"

Access to wealth built by their parents' business can help them achieve that goal. "For the second generation, they don't always need to be the managers [of the family business]; they can just be the owners," points out Au. "And they can use the family resources to develop their own careers."

Any economic effects of a troubled transition could, in theory at least, be offset by gains from the new enterprises they found. The rub is that not everyone with access to an international education may be eager to return to China.

Xu, the art student who's already drawing up plans for her business, is skeptical of returning home. "I've considered starting a business in China, but starting a business there is complicated: you have to have connections and deal with unfair competition," she says. "In the UK, the creative industry is very developed and is also developing quickly."

Carrying On

What happens to companies when the founders' children choose not to take over? Rather than shutting up shop, owners can sell the business or merge with a similar company in the field. Yet this may not always be possible: not only are many of China's entrepreneurs reluctant to sell to someone outside the family, but even those who are may find it difficult to locate a buyer.

> **Does the younger generation really want to move into their parents' business? Or do they, like their parents 40 years ago, want to go their own way?**
>
> Patrick Trainor
> Managing Director
> Cornerstone Strategic Partners

According to Trainor, businesspeople in China are seldom willing to pay for goodwill, the intangible value of a company's brand and reputation. They may also be put off by the fact that, given lax accounting standards, they can't be sure of what they're buying.

"Most buyers know that they can't trust audited statements and they don't want to buy into a company where there are skeletons," he says. "What you're going to see on the books is not a true reflection of what's going on in their company. It's slowly getting better, but it's not there yet."

Of course, when children opt not to continue a family business, their parents don't necessarily have to sell to outsiders—often they pass it on to a relative. This is what happened in Xu's case after she declined her father's offer.

"I have two cousins. Half a year ago my father gave the company shares to them," she says. "They both did undergraduate degrees in business or management, so maybe they're more interested." Such lateral transitions might mitigate any crisis on the horizon.

Another reason for optimism is that many of the first generation of entrepreneurs founded businesses in sunset industries like chemicals, textiles or low-cost manufacturing, which are capital-intensive and have limited prospects for the future. Children who pursue their own opportunities in finance, high-tech, or creative industries could ultimately contribute more to China's economy.

"The younger generation is heading into new areas in which they feel more comfortable and where they see better prospects," says Teng. "Although their success rate may not be high, as long as some of them carve out a niche for themselves, then I think it's a good thing for the economy."

A crisis in family business succession may turn out to be more of an opportunity than a threat, especially if it frees up talent for more productive purposes. In fact, that may be what Zhang's parents had in mind back in Xining.

"My dad said, 'This business is a dead end. You need to study hard and get a better job,'" he recalls.

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Buying Chinese

Why Chinese consumers are leaving multinational brands on the shelf

By Richard Whiddington

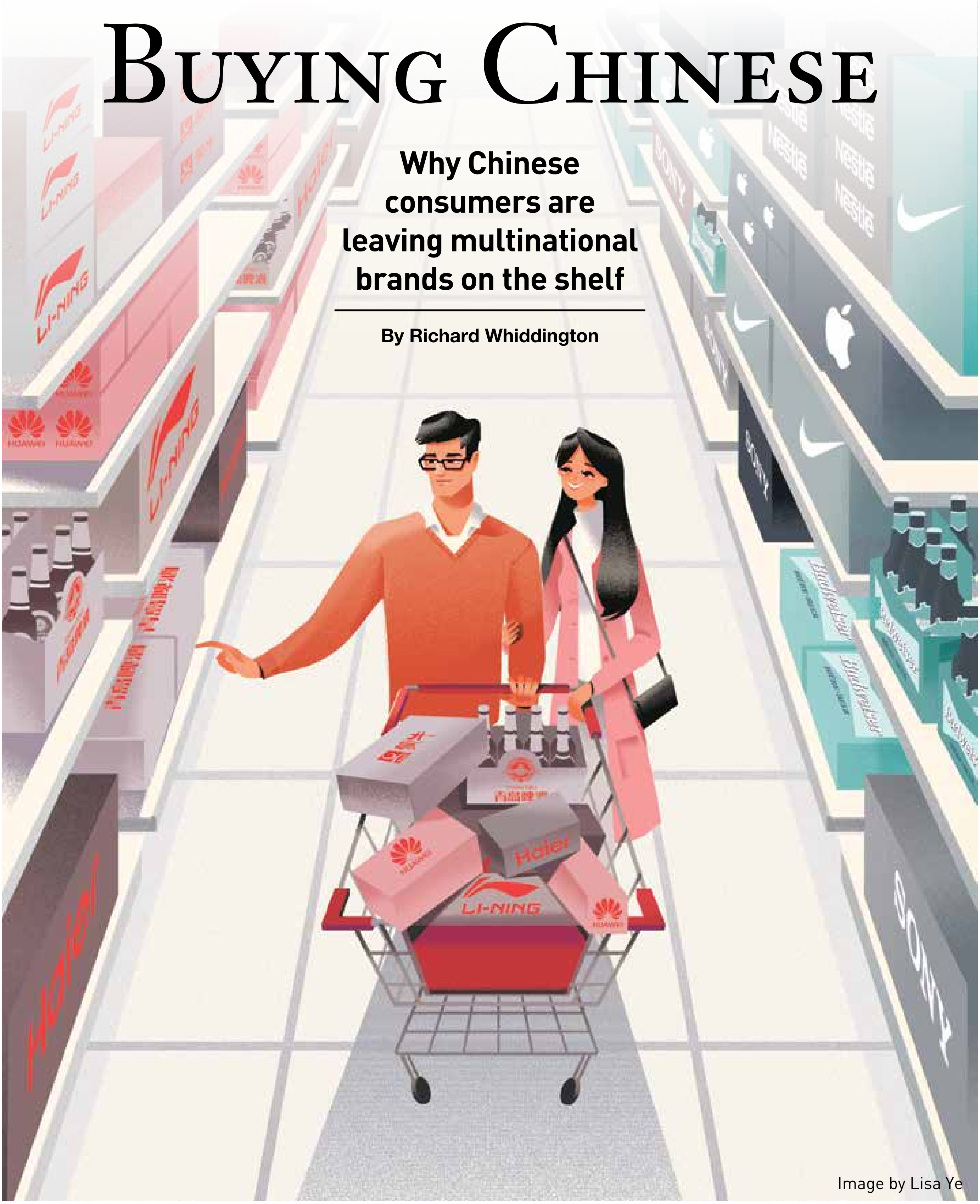


Image by Lisa Ye

Multinationals in China now face formidable competition from domestic brands in almost every sector. What can they do to regain the ascendancy?

In recent months, Beijing's vast subway system has been plastered with posters featuring a range of famous faces clutching sleek new smartphones, from NBA superstar Stephen Curry to a gaggle of FC Barcelona soccer players.

Five years ago, such A-list celebrities would likely have been promoting the latest Apple iPhone or Samsung Galaxy, but now the brands running these campaigns are all Chinese. Huawei, Oppo, Vivo and Xiaomi are now the country's top four smartphone makers by market share, according to Counterpoint Research.

Similar power shifts have taken place in sectors across the entire economy, as domestic brands increasingly outmaneuver their global competitors. The transformation has been so profound that the "brand power" of domestic companies among Chinese consumers overtook that of multinationals last year, according to the influential *BrandZ Top 100 Most Valuable Chinese Brands* report.

According to Mark Tanner, Managing Director of Shanghai-based marketing agency China Skinny, Chinese companies have been making enormous strides in recent years.

"Domestic brands have raised their standards and become contenders in the mid-premium segments: even the biggest of brands have been nimble and quick to adapt," Tanner explains to *CKGSB Knowledge*.

However, multinationals have so far failed to respond to this threat. "[Another surprise is] how slow and seemingly disconnected many foreign brands remain at adapting to China's dynamic market," says Tanner.

With real disposable income levels rising 8% year-on-year in China in 2017 and set to continue this fast growth, multinationals are at risk of being muscled out of the world's most exciting market unless they meet the challenge posed by China's flourishing domestic brands.

Remaking "Made in China"

A mere 15 years ago, the notion of mid-range Chinese-made goods being compared to foreign ones would have been laughable: domestic manufacturers were notorious for corner-cutting and producing shoddy goods. One Gallup Poll from 2004 indicated that 40% of Chinese consumers rated "Made in China" products as "poor/fair," while only 9% said the same about "Made in America" goods.

Horror stories were common place, from the ubiquity of electronic goods that broke after a single use to food-safety scandals, such as the poisoning of thousands of infants with melamine-contaminated milk in 2008. That scandal undermined consumer confidence in domestically-produced food products for years afterward.

But recently this perception has begun to change. Local companies have invested huge resources in upgrading standards and, just as importantly, communicating this to consumers.

"The quality of Chinese brands has improved in recent years and Chinese products are improving all the time," says Ji Fang, a Beijing resident. "Huawei is a good example."

The Chinese government has played a big role by driving domestic manufacturers to become internationally competitive. Premier Li Keqiang made raising the bar in China's consumer industries a key priority, telling a State Council meeting in 2016: "By improving the consumer goods sector, we will force the upgrading of equipment manufacturing. The manufacturing industry is the cornerstone for the country's entire industry."

Chinese companies have also been investing heavily in overseas manufacturers to acquire the world-class production know-how they need. Chinese outbound investment in manufacturing is rising faster than in any other sector, increasing by over $11 billion since 2015 to reach $31 billion. According to Zigor Aldama, a Shanghai-based reporter for Spain's *El Pais* who has been covering China since 1999, this investment is having a knock-on effect on consumers' perceptions of domestic brands.

"Chinese companies have greatly improved the quality and design of their products," says Aldama. "Increasing the country's innovation capabilities is also making it more interesting for the better educated youth and entrepreneurs. They feel China is more attractive and welcoming than the West."

Even China's dairy companies have bounced back. Top brands Mengniu and Yili have posted impressive gains in market share and profits by investing in offshore production facilities and developing new high-end products.

"[Dairy] brands trying to recover from the melamine scandal basically said, 'If we're going to survive this, we need to have our own premium brands that are actually more premium than even the foreign brands,'" says Benjamin Cavender, Principal at the China Market Research Group. "Chinese brands have a better sense of what Chinese consumers are worrying about."

The Importance of Selfies

Now that many Chinese companies are creating products on par quality-wise with those offered by foreign companies, their superior understanding of what consumers want is beginning to tell. This is most obvious in the smartphone market, where Huawei, Oppo and Vivo have all doubled their market share in the past five years. According to Cavender, the key to their success has been focusing on features that Chinese consumers care about.

"They [Chinese phone companies] do a good job on industrial design and quality: the phones look similar to a high-end Apple or Samsung phone," notes Cavender. "But they focus more on the idea that 'we know how you communicate with your friends, so we will design our phones to take the best selfies, the best food photos and really highlight those functionalities to the consumer.'"

Sun Hui, a young media worker from Hunan, a mountainous province in southern China, swapped her Samsung for a Huawei Honor last year. "Friends recommended the Honor," she says. "It's good-looking, a reasonable price and, of course, the camera is excellent."

Domestic brands' better knowledge of the local market also gives them a crucial advantage when it comes to advertising and selling their products online. According to Doreen Wang, Global Head of BrandZ for Millward Brown, many foreign brands struggle with digital in China. This is because they do not understand how best to use Chinese channels such as social media app WeChat and e-commerce platforms Taobao and Tmall.

"The restriction of Western internet companies' operation in China is limiting the growth of multinational brands who know best how to leverage the western digital channels to build brands outside of China," says Wang. "Local companies are more inclined and have the local knowledge to partner with local tech giants to communicate their products and services to local customers."

In a market where 57% of advertising spending went on digital in 2017, according to Group M, and e-commerce sales reached an estimated $1.1 trillion during the same year, the lumbering approach of foreign companies to online marketing is a huge weakness. However, Tanner believes there is an even greater challenge for foreign multinationals, as the differences in China's digital ecosystem run far deeper than simply which channels are most popular.

"Decision makers need to understand that China has a unique digital ecosystem: not only are the platforms different, but also the reliance and habits," says Tanner. "In most cases, Chinese consumers' engagement with digital is significantly more advanced."

Even companies in industries where brick-and-mortar retail remains effective need to pay attention to these trends, as cosmetics store chain Watsons found. The Hong Kong-based company was an early mover in the mainland market and now runs 3,000 physical outlets in China, but its recent success has come through a forward-thinking digital strategy.

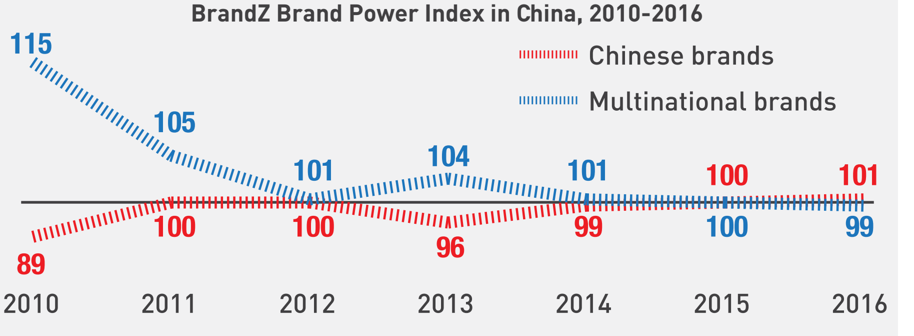
The Watsons app taps into the Chinese habit of touching up selfies by offering a virtual makeup service called Style Me, as well as featuring special discounts synched up with the company's social media feeds. More than 60 million people have now signed up for its loyalty subscription service through the app, and the company's e-commerce sales soared 47% in 2016.

"I use the Watsons app," says Lu Tao, a Shanghai resident. "WeChat promotions save me a lot of money and are a way for me to check up on good deals at a range of stores. It recently helped me save 20% on a face cream."

Tanner expects that global companies that fail to follow Watsons' example may soon begin to fall behind. "I see the biggest changes happening in the physical retail space, where the lines between online and offline will blur," he says. "We will see consumers increasingly setting trends rather than being led by foreign fads."

Reversing Fortunes

In China, domestic brands now outperform foreign ones



The BrandZ Brand Power Index assesses brands based on a combination of qualitative and quantitative methods, including financial data taken from Bloomberg and Kantar Worldpanel and interviews with tens of thousands of Chinese consumers.

Source: BrandZ, Kantar Millward Brown

Nation Matters

Foreign companies in China will not only have to get savvier about their marketing channels, there's also going to be more pressure on them to get the message right, too. In the past, such brands often enjoyed a prestige among Chinese consumers based simply on their status as a global brand. However, that is no longer automatically the case, particularly with regard to China's millennials, whose only memories are of a modern, confident China.

A 2016 report by McKinsey found that, if given the choice between a foreign and a Chinese brand of the same quality and price, 62% would pick the domestic one. This does not mean that the pendulum has swung toward domestic brands in every sector: another McKinsey survey found that 42% of respondents preferred or somewhat preferred foreign fashion accessories, while 19% said the same about foreign personal care products.

However, even in these areas multinationals find that there is little intrinsic advantage in being a global brand any more, as Chinese consumers are increasingly unable to perceive a difference between foreign and domestic products. According to McKinsey, 48% of Chinese consumers surveyed believed Yakult, a probiotic yogurt product from Japan, was Chinese and conversely 45% thought Meters/bonwe, a leading Chinese clothes brand, was foreign.

Many Chinese companies—particularly in fashion and apparel—are using these misperceptions to their advantage. Brands like Septwolves, Mo&Co and Peacebird not only adopt international-sounding names, but also project a modern, global lifestyle and boast of stores around the world. For its spring/summer 2017 collection, Peacebird hired British fashion photographer Josh Olins and a string of internationally famous models.

"Peacebird has done a good job of using international models and being more present on an international basis, not necessarily because they want to sell overseas, but because it gives the Chinese consumer the impression that they are as a brand more aware of international trends," says Cavender. "At the same time, they are focusing on localizing the product, so they have the best of both worlds."

Zhang Sai, a mid-20s fashion-conscious consumer from Anhui, an eastern province near Shanghai, sees Peacebird as a trendy alternative to brands such as H&M or Zara. "Peacebird is a successful Chinese brand and is more and more fashionable," she says. "It seems quite Western because they copy many foreign designs."

As Chinese consumers become more sophisticated and confident, even the most established brands will not be able to afford to be complacent, says Cavender.

"[Chinese] consumers… have a greater awareness of what brands *are*," he says. "[They] are much less likely to simply focus on big-name brands and instead focus on brands that reflect their image."

Instead of projecting a bland internationalism, foreign companies will need to focus on truly understanding Chinese customers. "Consumers are thinking, 'I want to be a more well-balanced self. How do I find products that fit me as an individual?'" observes Cavender. "Chinese companies have certainly done a better job of articulating how to provide that to the consumer."

> **Decision makers need to understand that China has a unique digital ecosystem... In most cases, Chinese consumers' engagement with digital is significantly more advanced**
>
> Mark Tanner
> Managing Director
> China Skinny

Another Door Opens

Though many foreign companies have struggled to adapt to these trends, these changes could open new possibilities. As the spending power of China's middle class rises, new spaces are opening up for mid-range brands offering quality, safety and value, according to Tanner.

"A few years ago, [mid-range products] struggled for traction as Chinese consumers were either price-sensitive and sought the cheapest products or wanted premium products, with those left in the middle not really pleasing anyone," he notes. "But as Chinese consumers have matured, they are trading up across almost all categories and demographics."

Though domestic companies are ready to fill this gap, foreign companies have decades of experience in the mid-range market and should aim to compete strongly in this segment. Brands at the luxury end of the market should also benefit. According to McKinsey, affluent Chinese consumers will spend as much as $147 million on luxury items by 2025—double the current level.

"There is still tremendous opportunity: consumers are increasingly wealthy and are going to be buying across an increasingly wide number of categories," says Cavender. "But to be successful, they [multinationals] are going to have to create memorable retail experiences, better understand consumers and be clear about what their messaging is.

"But the reality is they are going to face more and more competition from domestic firms that are already doing a really good job."

COIN DROP

China has banned borderless cryptocurrency like bitcoin, but it is a move it may come to regret

By Matthew Fulco

Image by Jose Luna

China's sudden move to curb trading and mining of cryptocurrency last September caught many people off-guard. Is there a chance of an equally unexpected comeback for digital currencies in China?

When the crackdown came, Jeff Chen was working at a small digital currency exchange in Shanghai. Up until that point last September, China had been by far the world's largest virtual currency market, accounting for 90% of global transactions. But then Beijing banned fundraising through initial coin offerings (ICOs) and shut down cryptocurrency exchanges.

"Investors and entrepreneurs went crazy," Chen, who now works as a business intelligence analyst at fintech firm ViewFinn, tells *CKGSB Knowledge*. "Speculators wanted their money back. It was a very frustrating time."

The clampdown has been effective. In the past six months, China's digital currency trading volume plummeted to just 1% of global transactions. And there appears little sign that the government will relent.

In a January memo, People's Bank of China (PBOC) Vice Governor Pan Gongsheng urged the government to ban centralized trading of digital currency and prevent individuals and businesses from providing related services. "Pseudo-financial innovations that have no relationship with the real economy should not be supported," he wrote.

Pan also pushed for measures to tamp down cryptocurrency mining—the electricity-intensive process by which digital money is created—suggesting that local governments make use of regulations pertaining to electricity prices, land use and environmental protection. Local governments should aim to facilitate "an orderly exit" for mining businesses, he said.

Beijing says that the crackdown on cryptocurrency is necessary to curb systemic financial risk. In September, China's National Internet Finance Association, an industry group, derided digital currencies as "tools for criminal activities of money laundering, drug deals, smuggling and illegal fundraising."

But a more sobering truth is that both the rise and fall of digital currencies like bitcoin in China were driven by deeper issues within the Chinese economy—especially the country's stalled financial liberalization—which the ban will do little to solve.

Virtual Money Talks

The digital currency business originally flourished in China because of its ideal market conditions. Ample power supply and space for large warehouse facilities made China's remote provinces attractive to crypto miners, who could easily procure mining equipment from domestic suppliers in Shenzhen.

Miners create new bitcoins by using software to confirm valid transactions, or blocks. They add new transactions to the blockchain every 10 minutes or so. The more transactions miners confirm, the more bitcoin they earn. Typically, miners receive 12.5 bitcoins for every block they create.

Mining hardware uses a huge amount of power. Research firm Digiconomist estimates that the global digital currency mining industry consumes 0.17% of the world's electricity, more than 161 individual nations.

To be profitable, miners need to be based where electricity prices are low. Local governments in some far-flung provinces proved happy to dole out generous electricity subsidies in exchange for a share of the profits. Governments in regions with abundant coal or hydropower were especially eager.

In Inner Mongolia, China's top coal-producing region, virtual currency mining companies partnered with the local government of the capital city, Ordos. The arrangement gave the firms access to electricity from China's State Grid for just four cents per kilowatt-hour—around a third of the typical charge for commercial users in Beijing—while the Ordos government received tax revenue from the mine's profits, *Tech In Asia* reported in August.

At the time of the crackdown, China mined about 75% of the world's bitcoins. But this is changing quickly as the electricity subsidies are phased out, according to ViewFinn's Chen. "Mining isn't so attractive here anymore," he says. "Costs skyrocket without cheap electricity."

"Since this will also impact the local officials who were getting kickbacks from the miners, it strikes me that this has as much to do with local corruption and the current state of central-local relations as it does the need to get bitcoin out of China," he adds.

Before regulators stepped in, China was also the world's largest market for trading digital currencies for similarly murky reasons, according to Lee Cheng-hwa, a senior analyst at the Market Intelligence & Consulting Institute (MIC), a Taipei-based research firm.

"Cryptocurrency became big because China's hot money did not have many investment targets and speculation prevailed," says Lee. "The other reason is that some people who wanted to bypass foreign exchange controls moved their money out of the country through cryptocurrency transactions."

China limits its citizens to overseas remittances of $50,000 a year, which isn't sufficient for large investments such as real estate. Some investors wanted to diversify their assets and found cryptocurrency an easy way to convert RMB to foreign currency. They simply bought bitcoin with their RMB and then sold the bitcoin for foreign currency.

An October report in *Quartz* points out that some Chinese investors were attracted to bitcoin's independence from the Chinese economy. Blockchain researchers have found that the virtual currency has almost no correlation to equity, debt or commodity asset classes. One unnamed bitcoin trader told *Quartz* that he liked how the Chinese government could not force down bitcoin's value by printing RMB.

However, the decentralization of cryptocurrency is precisely what bothers the Chinese authorities, who remain committed to capital controls. This was likely the main factor in Beijing's decision to move against digital currency trading and ICOs in September.

Not Too Big to Fail

The fall of digital currency in China has been abrupt. Market insiders initially thought that tighter official oversight signaled Beijing's intentions to regulate the market—not hobble it.

In September, Martin Chorzempa, a research fellow at the Washington DC-based Peterson Institute for International Economics, wrote on the institute's blog that the ICO ban was likely to be temporary. The ban "is necessary... to protect investors from fraud and maintain financial stability in the short term... and should not become permanent," he said.

Chinese finance experts supported that viewpoint. Hu Bing, a researcher at the state-backed Institute of Finance and Banking, suggested in a September interview on Chinese state broadcaster CCTV that the ban could be lifted once China had implemented a proper regulatory framework for cryptocurrency.

Six months on, however, virtual currency's prospects in China look bleaker. "From the government's perspective, digital currency introduces additional risk to the financial industry without solving problems in the marketplace," says Zennon Kapron, founder of Shanghai-based fintech consultancy KapronAsia. "It's different from mobile payments, which made transactions more efficient, or P2P lending, which has provided credit access to people who need it."

In most nations, restrictions on cryptocurrency exist primarily to prevent money laundering. While that problem concerns Beijing, the government's real focus is on maintaining control of the financial system.

"Bitcoin's anonymous internet transactions can perfectly bypass the central bank's foreign exchange defense line and make the policy of foreign exchange control ineffective," Cheng from MIC says. "It is unacceptable for the Chinese government to not know the amount of domestic funds being transferred overseas."

Initially, it appeared that other countries may follow Beijing's example in cracking down on cryptocurrency. The South Korean government also banned ICOs in September.

But as time passes, China's position is starting to look more and more isolated. In December, South Korea partially reversed its ban, announcing that it would likely permit institutional investors to participate in

Until last September, more bitcoin was mined in China than any other country

Top 10 companies with most blockchain patents, 2017

Rank	Company	Country	Global patents in 2017
1	Alibaba Group	China	43
2	Bank of America	US	33
3	People's Bank of China Digital Currency Research Institute	China	33
4	Nchain Holdings	Antigua and Barbuda	32
5	Beijing Ruizhuo Xitou	China	26
6	Mastercard	US	25
7	Jiangsu Tongfudun	China	23
8	China Banknote Printing and Minting Corporation	China	22
9	Shenzhen CloudMinds Inc	China	17
10	China United Network Communications	China	16

Source: Technode

Chinese enterprises dominated global blockchain research and development in 2017

cryptocurrency fundraising. *Chosun Ilbo*, a South Korean newspaper, reported in December that Seoul had formed a task force to develop an ICO regulatory framework.

Japan has also signaled greater openness toward digital currency. When hackers stole $460 million in 2014 from Mt. Gox, at the time the world's largest bitcoin exchange, the Japanese government did not try to stamp out virtual currency use. Instead, Tokyo developed a regulatory framework, including mandatory capital reserves for exchanges, separation of customer funds and know-your-customer (anti-money laundering) procedures. In April 2017, Japan legalized bitcoin as a form of payment. BTMs—ATMs that exchange fiat for bitcoin—have sprung up nationwide.

Meanwhile, China's clampdown on cryptocurrency doesn't appear to be having a major impact on the overall market. Hash rate and difficulty metrics directly related to energy consumption have increased steadily despite the crackdown, according to Chen, which suggests that the China ban has had little impact on the network.

Many of China's bitcoin miners now appear to be heading to Russia, wooed by greater openness to virtual currency and low electricity prices. The Russian government appears to be embracing this. Anatoly Aksakov, Chairman of State Duma's financial markets committee, said in December that Russia should "give people the opportunity to work legally with it [cryptocurrency], to protect them as much as possible." Russia reportedly plans to establish regulations for virtual currency trading, mining and ICOs by July.

Other Chinese mining companies are heading to developed economies. Bitmain, which operates China's top two bitcoin-mining collectives, has chosen Singapore for its regional headquarters. It has also set up mining operations in North America.

"Cryptocurrency is a global experiment and the bitcoin network is resilient by design," notes ViewFinn's Chen. "If mining stops in China, miners elsewhere will pick up the slack."

Backing the Blockchain

Beijing may be squelching cryptocurrency, but it is interested in the underlying blockchain technology. The transparency of blockchain technology creates a decentralized digital public record of transactions that is secure, anonymous, tamper-proof and unchangeable.

Making use of this technology, a government can control all activities in the financial field. Blockchain technology can also be used in nearly every other industry as well. In terms of blockchain spending size, banking, discrete and process manufacturing, professional services and retail will be the top five industries by 2021, says Xue Yu, Senior Analyst at research firm International Data Corporation (IDC) in Beijing.

For the China market, where counterfeit goods proliferate, blockchain technology has wide applications in supply-chain management. "Counterfeiting is a serious problem in China; it endangers consumer safety and erodes trademark owners' profitability," observes Dean Arnold, Managing Director of Shanghai-based intellectual property consultancy O2O Brand Protection. Blockchain technology could reduce counterfeiting by creating a secure and auditable record of a product's journey in the supply chain that we all could view, he says.

That could be a boon for Chinese farmers, who have struggled with food safety issues. Arnold takes the example of the dairy industry, which consumers have viewed suspiciously ever since thousands of infants were poisoned a decade ago with melamine-tainted milk powder.

"If blockchain allows people to see that the dairy supply chain is secure, that can help establish trust between the supply and demand sides," Arnold says. "It's good for dairy brands and it's good for consumers."

China's e-commerce giants are already implementing blockchain food-safety solutions. In March, JD.com announced that it would use blockchain to safeguard the integrity of its meat supply chain. When the system is launched later this spring, customers will be able to check how the meat was raised, butchered and transported.

Automation on the blockchain, widely referred to as "smart contracts," could also appeal to China. Beijing is investing big in artificial intelligence with the aim of becoming a global AI leader by 2030.

In the smart contracts segment, the

open-source blockchain Matrix is a rising star. Matrix's mining power can be used in big-data analytics thanks to its AI capabilities. Matrix is the exclusive blockchain and AI partner for Beijing's One Belt, One Road Research Center.

Cryptic Motives

To be sure, cryptocurrency is just one piece of the blockchain and Beijing doesn't need bitcoin to become a blockchain juggernaut. Yet the government's decision to clamp down on virtual currency illustrates a resurgent ambivalence about opening the financial system.

In the past few years, financial reform has stalled. As recently as 2012, industry experts foresaw a floating exchange rate and freely convertible capital account by 2020. That's no longer a realistic possibility.

Yu Yongding, Director of the Institute of World Economics and Politics at the Chinese Academy of Social Sciences, attributes stalled financial reform to concerns over capital flight. "If the government had not taken steps to slow, if not halt, the process of capital account liberalization in 2016, the results could have been truly devastating," he wrote in a February post on the World Finance website.

Instead, China intends to take advantage of the benefits of a digital currency while maintaining a strong grip on the financial system by launching its own sovereign digital currency.

A sovereign digital currency is different from a cryptocurrency like bitcoin in that the former must have the backing of a central bank, while the latter is decentralized by design. In October, Yao Qian, the PBOC's digital currency research chief, recommended that Beijing create its own virtual currency that could be used as cash and in digital wallets.

"A central bank digital currency (CBDC) provides an opportunity for a national government to build an ecosystem of banks that understands the potential of blockchain technology," says Carl Weger, Director of Asia Business Development for New York-based blockchain firm R3. "It also allows the government to give input into the standards that are being considered for cross-border CBDC transactions, which will begin this year."

According to Qian, China has successfully tested algorithms that would supply a digital fiat currency. Test transactions were conducted between the central bank and commercial banks. "Cryptocurrency is more auditable and traceable compared with banknotes, so it may help the central bank fight money laundering and financial fraud. It will also lower the cost of transactions," says IDC's Xue.

Along with Singapore and Russia, China is one of the largest economies experimenting with digital currency. Rogue states like North Korea, Iran and Venezuela are also mulling their own cryptocurrencies—primarily to evade international financial sanctions.

However, any digital currency is susceptible to hacking. It is not clear how Beijing would manage that risk. An October report in *Forbes* suggests that digital currency wallets would need deposit insurance or similar that could protect the funds being held from hackers.

> **It remains to be seen if Beijing someday will regret the crackdown**
>
> Isaac Mao
> Director
> Social Brain Foundation

Current defenses against digital-currency hacking are not sufficiently robust. In January, hackers stole $530 million from the Japanese cryptocurrency exchange Coincheck. Hackers steal from ICOs too. A December report by EY (formerly Ernst & Young) found that hackers pilfered 10% of the funds raised by 372 ICOs between 2015 and 2017, which works out to roughly $1.5 million a month.

With that in mind, Beijing's clampdown on digital currency also serves to protect investors, notes KapronAsia's Kapron. "The average Chinese retail investor is inexperienced," he says. "So, when a financial product fails, people get upset, and they complain to the government."

He points out that the government can easily phase out cryptocurrency now, given the small market size. Although China once had the largest virtual currency transaction volume, the number of people participating is estimated to be in the tens of millions, a fraction of the total Chinese population of 1.4 billion.

Yet in five years' time, the user base could be much larger. Market volatility would affect many more Chinese citizens. At that point, "there would be greater backlash" in the event of a market crash or government efforts to crack down on trading and mining, Kapron says.

Now that Chinese cryptocurrency trading volume is virtually nil, Japan is poised to fill the void. As of mid-January, Japanese yen account for more than 56% of bitcoin transactions. Japan is proving adept at incorporating digital currency into its economy, observes MIC's Cheng.

"Japan is leading in terms of adopting regulations for cryptocurrencies so that they can be used legally in the exchange of financial services and payments," he says.

In an October post on the Asia Society's ChinaFile, Chinese entrepreneur and blogger Isaac Mao mused about what might have been for cryptocurrency in China. "It remains to be seen if Beijing someday will regret the crackdown [on virtual currency] for having undermined the potential to lead the world in this sector," he said.

CKGSB Business Conditions Index

China Hits a Crossroads

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

The Chinese economy continued to perform strongly during February, according to our second CKGSB Business Conditions Index (BCI) survey of the year. However, the government will soon be forced to make some tough decisions over monetary policy if China is to sustain this strong economic performance.

Key Findings

- The BCI rose to 59.5 in February, showing firms are feeling optimistic about the next six months
- Executives' confidence is rising regarding all four major sub-indices: profits, sales, financing and inventory levels
- But the high consumer price index suggests that inflation could be a significant economic risk

Respondents reported feeling more bullish regarding all four major sub-indices in February, though the scores for financing (42.3) and inventory (43.5) remain well below the baseline threshold of 50. SMEs' access to loans is a long-term issue in the Chinese economy.

Another potential cause for concern is the consumer price index, which rose to 67.8 in our February survey. This suggests that the Chinese government will need to be aware of the risk of inflation over the course of this year.

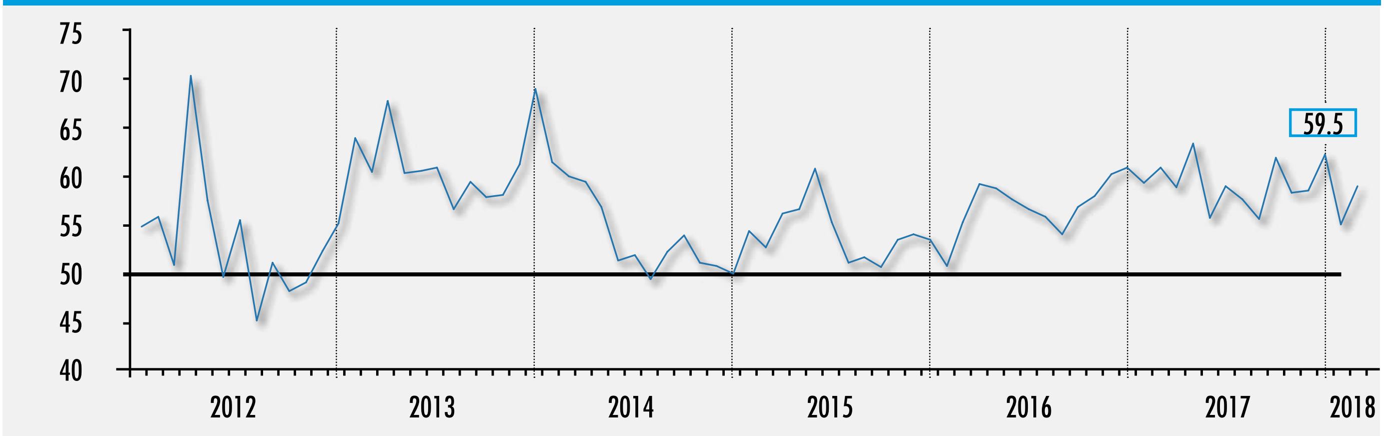
The scores for investment, recruitment and labor costs all stayed well above 50 in February, as has been the case in all previous editions of the BCI survey.

What is the CKGSB Business Conditions Index?

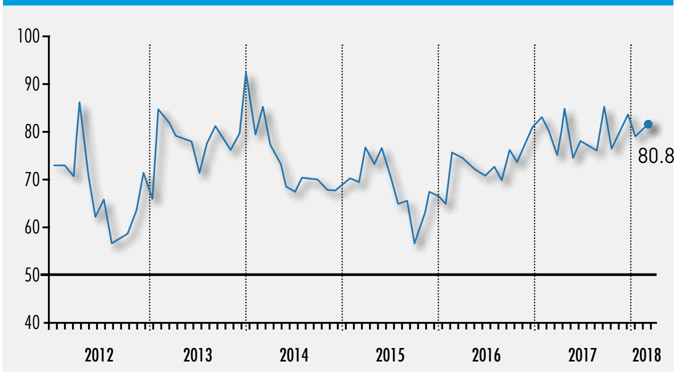
Each month, CKGSB conducts a survey of senior executives at both consumer and industrial companies in China. The list is skewed toward privately-owned SMEs, and so provides a snapshot of sentiment among China's most efficient businesses. Respondents state whether they expect a range of indices to rise or fall over the next six months.

CKGSB Business Conditions Index

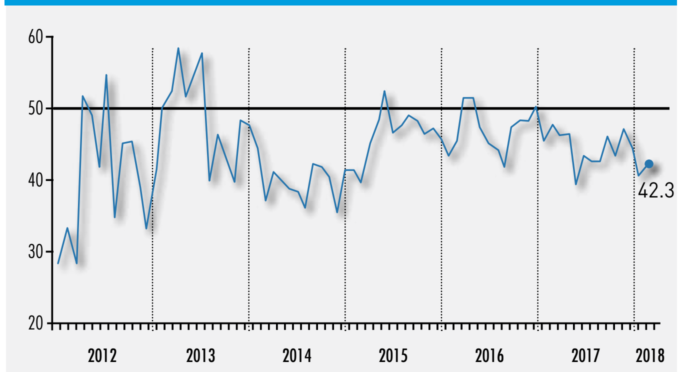
Chinese businesses' confidence is on the rise



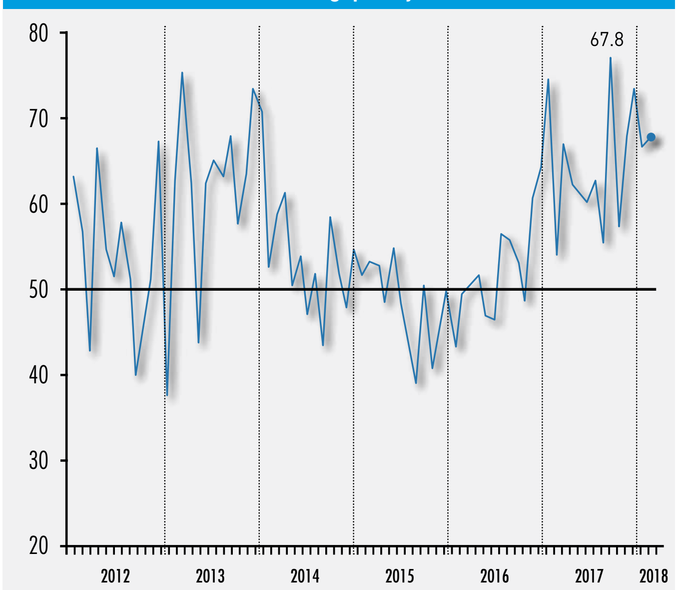
Corporate Sales Index
Confidence that sales will rise remains high



Corporate Financing Index
SMEs' access to financing is a long-term problem



Consumer Prices Index
Prices are rising quickly in China



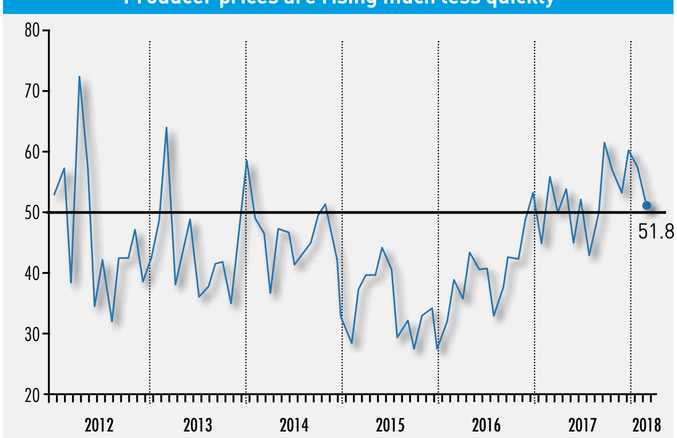
Conclusion

Given the continued rise in prices, we believe that the risk of further inflation should not be underestimated, and further relaxation of China's monetary policy could be a bad idea. Maintaining a balanced and stable economy is likely to be far more conducive to business operations and economic development.

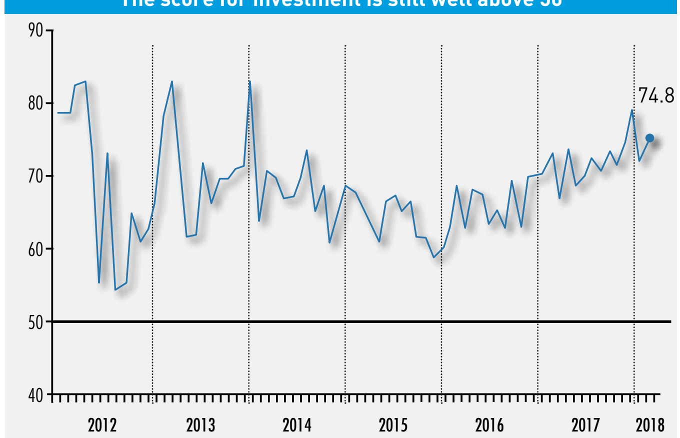
If the US Federal Reserve continues to raise interest rates, this could also cause a headache for Chinese policy makers. China can respond by either raising interest rates, allowing the market to play a greater role in setting the RMB exchange rate, or by further strengthening capital controls. All three of these options have their own dangers.

We expect the government will decide to pursue an approach that combines stricter capital controls with hikes in interest rates. This may not be the best option, but it may be the most realistic and harmless one.

Producer Prices Index
Producer prices are rising much less quickly



Investment Index
The score for investment is still well above 50



CKGSB Business Sentiment Index

Turning the Corner

The BSI is directed by Gan Jie, Professor of Finance at the Cheung Kong Graduate School of Business

The outlook for China's industrial economy looks brighter than it has in several years, the CKGSB Business Sentiment Index report for the final quarter of 2017 suggests.

The continued overcapacity and weak investment in China's industrial economy meant that the Business Sentiment Index remained in negative territory in the fourth quarter, with a score of 48. But there were clear signs that the sector's structural problems are improving. We expect this improvement to continue in 2018.

Key Findings

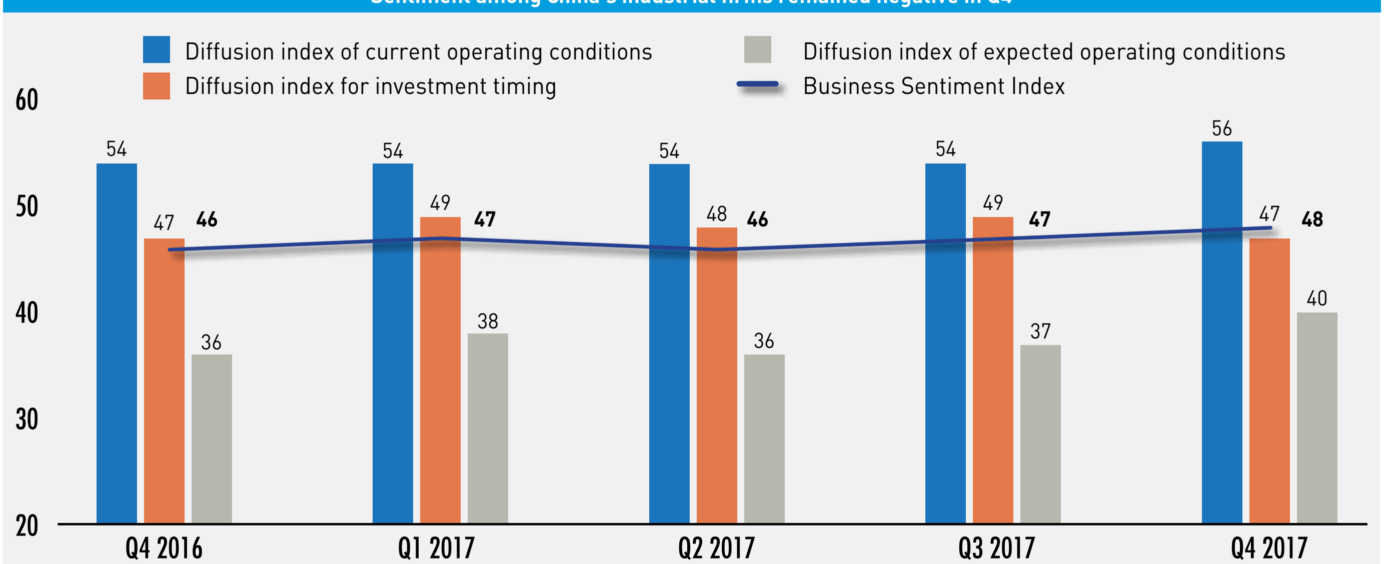
- Production rose by quite a significant amount in Q4 2017, and the rise was driven mainly by private firms. This is an important change, as private industrial firms have struggled in recent years
- Firms are significantly more optimistic about the economic outlook than a year earlier, suggesting that they expect the upturn of 2017 to continue
- Overcapacity and rising costs are still keeping firms' profit margins low. Though the structural issues are being mitigated, they are still far from solved

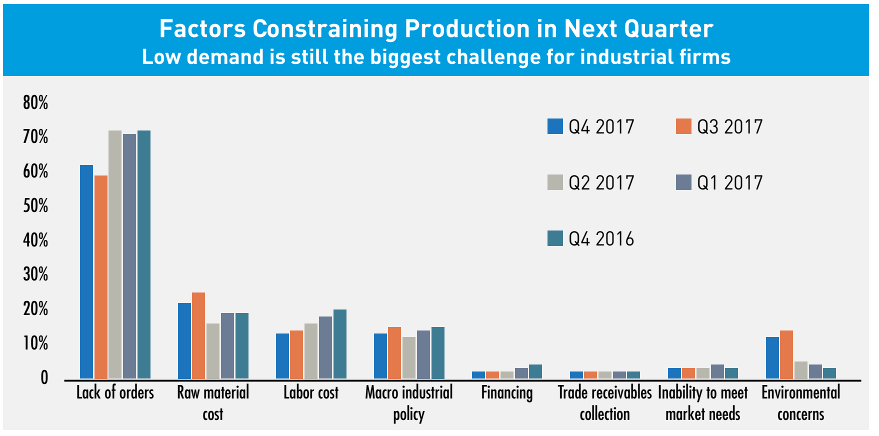
What is the CKGSB Business Sentiment Index?

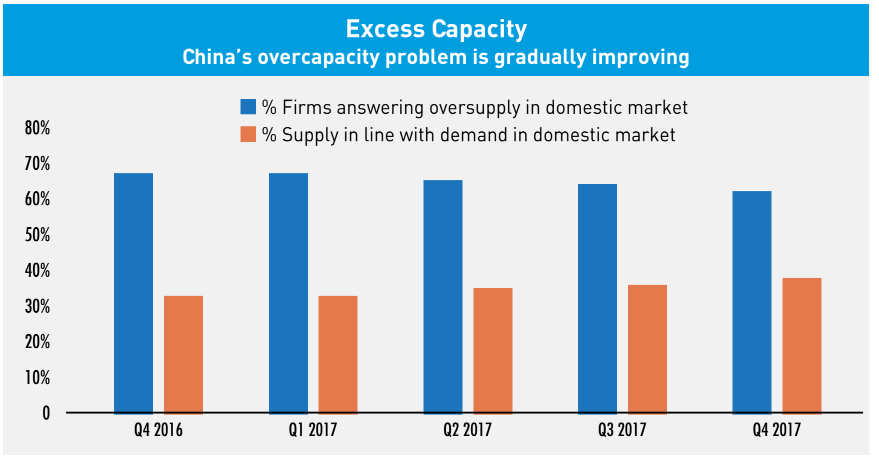
The Business Sentiment Index estimates the operating conditions in China's industrial economy. It is based on CKGSB's quarterly survey of around 2,000 Chinese industrial firms. The survey sample is weighted by industry, region and company size to fully reflect China's industrial economy.

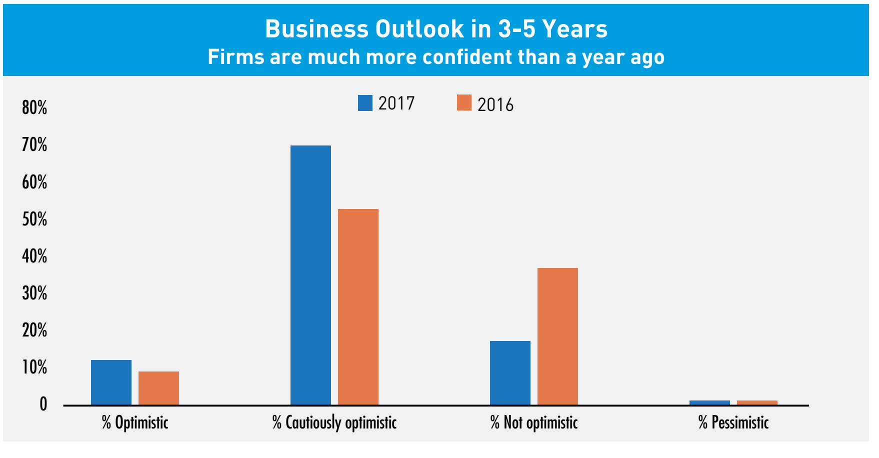
Business Sentiment Index

Sentiment among China's industrial firms remained negative in Q4









Analysis

For the industrial firms surveyed, lack of demand remains by far the largest roadblock for expansion, followed by rising costs. More than 60% of the firms surveyed said they lacked orders, while 22% and 13% of firms said that raw material and labor costs were a problem, respectively.

Interestingly, concerns over environmental regulations are now almost as great a concern as inflation, indicating that the government's crackdown on pollution is having a significant impact. It is also worth noting that only 2-3% of firms said that financing was a restraining factor, indicating once again that access to financing is not a major problem affecting the industrial economy.

The lack of demand is likely due to the continued overcapacity plaguing China's industrial economy, which remains very high by international standards. However, there was a marked increase in the number of firms that had suspended production in Q4, indicating that the excess capacity is starting to be eliminated. This is supported by the fact that the number of firms with a capacity utilization rate above 90% rose to 54% in Q4, compared to 42% during the first half of the year.

Firms are also significantly more optimistic about their prospects than this time last year. Only 18% of firms said they did not feel optimistic.

Conclusion

- The operating conditions of China's industrial firms, particularly private firms, improved markedly in 2017
- The biggest challenges facing firms remain overcapacity and rising costs
- Given the government's commitment to dealing with these issues, we remain confident about the outlook for the industrial economy

Changing Clothes in China

Li Lode, Professor of Operations Management at CKGSB, examines China's most successful menswear brand: HLA

By Mei Xinlei

Over the past five years, the business model of China's clothing industry has been unraveling. For decades, China's vast apparel industry competed mainly on price. But with labor, land and raw materials costs rising, environmental regulations tightening and competition becoming ever fiercer, even many of China's best-known brands have struggled.

There has been one glaring exception: HLA. The Jiangsu Province-based menswear label has grown stronger and stronger even as competitors shuttered hundreds of outlets.

In this interview, Li Lode, Professor of Operations Management at CKGSB and Professor Emeritus at Yale University, explains how HLA's extraordinary success has been made possible by smart strategic decisions.

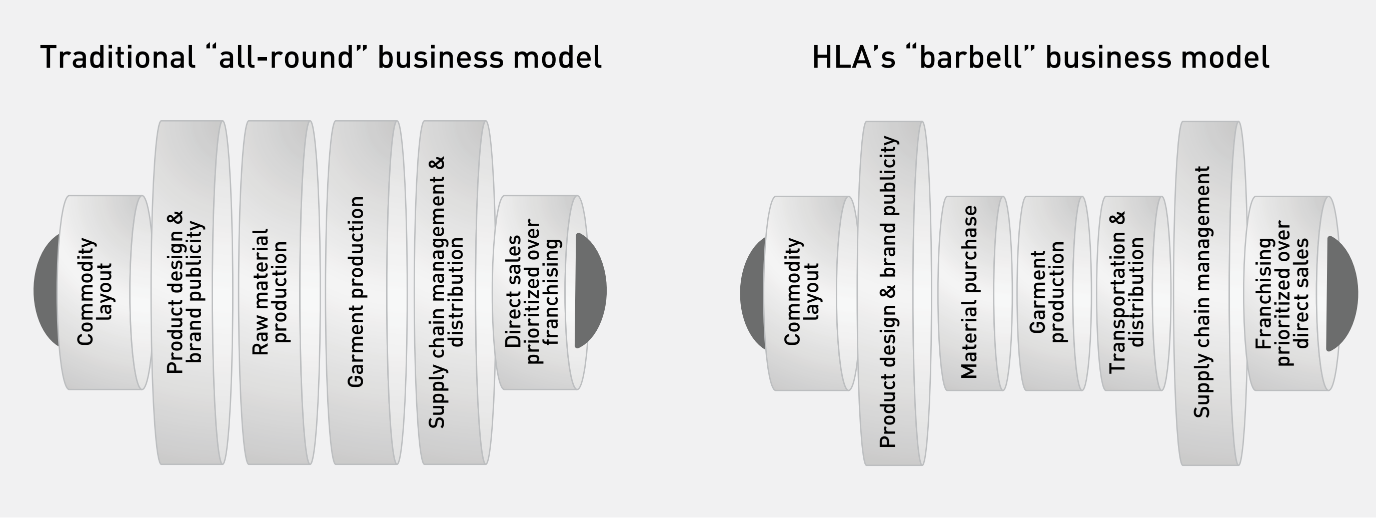
Q: What inspired you to study HLA? What's special about this company?

A: Since its founding in 2002, HLA has grown from a small local factory in a third-tier Chinese city to the country's leading menswear brand. Within eight years, the company had opened stores in all 31 provinces, autonomous regions and municipalities on the Chinese mainland, from Tibet to Hainan.

What's more, the company was able to sustain this success. From 2012 to 2016, its annual retail sales and net profits grew at a compound rate of 59% and 30% respectively. This allowed the company to become the largest apparel company listed on Shanghai's A-share market.

Seeing this rapid growth, I was intrigued by questions such as: how HLA has continuously solved the problems encountered during its development? How has it innovated and improved its business model, and what universally applicable lessons can we learn?

What I found is that HLA's success has been based on a certain mindset. In short, it does not regard itself as a standalone enterprise, but as a partner in a supply chain. As a result, it has focused on creating a win-win environment for all the members of this supply chain. This allows it to take full advantage of the skills and resources of



HLA's lean business model resembles that of a sharing-economy company

all the businesses within its supply chain, often making significant cost savings as a result, to achieve rapid growth. Many traditional manufacturing companies could learn from this strategy.

Q: How did HLA develop from a tiny township enterprise to a successful clothing company?

A: HLA's success was built on the business model innovations it adopted early on. HLA was originally founded as the Third Woolen Mill Factory, a collective run by its local township.

As the company tried to upgrade its business during the 1990s, it encountered a problem. On the one hand, when it tried to retail its own branded clothes, it found that it would have to compete directly with its former retail clients. On the other, when serving as an agent to other clothing brands, it faced tough competition from outlets like supermarkets and shopping malls.

Zhou Jianping, Chairman of HLA, sought to break out of this vicious circle. After visiting clothing brands in Japan in 2002, he decided to position HLA in a segment where the competition was less fierce: affordable menswear with a variety of designs and trendy lines.

He adopted the self-service retail chain model used by many of Japan's most popular brands, and aimed to create a "one-stop shop" retail chain experience for menswear in China.

Q: In China, competition in the apparel market is so fierce that many brands have closed their brick-and-mortar stores. How has HLA bucked this trend?

A: The driving force behind HLA's rapid growth has been its innovative business model. Instead of following the "all-round" model favored by many competitors, in which they manage the whole production and sales process from raw materials to design, manufacturing, distribution and store management, HLA has developed an "asset-light" or "barbell-style" model.

Under this model, the company focuses on two critical stages in the process. First, it concentrates on brand building; second, it maintains firm control over its supply chain and store management.

Apart from this, the company leaves material purchasing, garment production and distribution to its suppliers, and expands its store network rapidly through an innovative "quasi-direct sales" model. This means that the franchisees delegate the operation and management of their stores to HLA, while sharing the stores' profits with HLA in the manner of a financial investor.

Q: What are the advantages of this "asset-light" model?

A: HLA's lean business model is in some ways like that used by sharing-economy businesses such as Uber. The model allows HLA to design incentives to encourage its franchisees and suppliers to expand rapidly. At the same time, the company benefits from being able to specialize and focus its energies on a narrow set of critical tasks.

One feature of this kind of fast-fashion company is that it has many product lines that change rapidly. By outsourcing materials purchasing, production and some design functions to suppliers, HLA can concentrate on what the company is good at, such as supply chain management, store management and brand building, allowing it to raise the value of its products and achieve efficiency savings.

Q: How does HLA's "sharing-economy" model benefit its suppliers and consumers?

A: All of HLA's 200 suppliers are garment factories located in the southern part of Jiangsu Province. These small- and medium-sized manufacturers lack the scale or brand power to secure big orders when operating independently.

HLA effectively operates like a "platform" in the supply chain—in a similar way to a sharing-economy platform like Uber.

Through HLA's unified information and logistics platform, these hundreds of suppliers can integrate their production capacities to meet the needs of the market across the country.

It also allows them to achieve economies of scale when procuring raw materials. For example, since 2012 HLA has been reforming its procurement practices to help major suppliers join together to collectively negotiate with upstream raw materials suppliers. This allows HLA's suppliers to get materials at discount prices, reducing the production costs both for them and for HLA.

Q: What other differences are there in the way HLA deals with its suppliers compared to traditional manufacturers?

A: Usually, domestic clothing brands have a simpler "commissioned processing" relationship with suppliers, in which suppliers earn a 5% to 8% processing fee.

However, HLA gives its suppliers a gross margin of an amazing 30-40%. What is the reason behind this? HLA's suppliers actually wear many hats: in addition to manufacturing, they also take on responsibility for product design, and bear the inventory costs as well as the risk of product returns.

Q: The suppliers provide the product design?

A: To be more precise, the product design is a joint process. Amazingly, despite the huge number of designs launched by HLA each year, the company only has around 150 designers at its headquarters.

HLA's central design team controls the core planning for new lines and developing proposals, while the rest of the non-core design processes are outsourced to the suppliers. This allows HLA to leverage the suppliers' 1,000-2,000 local designers. Usually, HLA selects 100 designs from almost 1,000 samples, and then gives the orders to the suppliers.

Q: The toughest part of this for the suppliers is that they must bear the risk for product returns. Why do the suppliers accept this arrangement?

A: At the moment, 20-30% of HLA's products are classified as "buy-out items," while the rest are sold on a consignment sale basis. The procurement contract HLA agrees with its suppliers states that HLA can return "unmarketable goods"—this is usually defined as goods that remained unsold after two seasons—to the supplier. However, some of these "unmarketable goods" are then repurchased by HLA for use in its sister brand Hieiika, formerly known as *Baiyibaishun*.

The suppliers can afford this because of the super-high 30-40% gross profit margins. If their dynamic sales rate remains stable at around 70-80%, their operating conditions are benign. If the sales rate is even higher, they will also receive bigger orders from HLA.

Q: Regarding HLA's sales channels, what are the advantages of its "quasi-direct sales" model?

A: HLA's approach to opening stores has been a big factor in its expansion. The three major foreign clothing brands in China—Uniqlo, H&M and Zara—all use a direct sales model, which gives

Amazingly, despite the huge number of designs launched by HLA each year, the company only has around 150 designers

them strong control over their terminal sales channels. However, the financial burden this imposes also restricts the speed at which they can expand.

Most domestic menswear brands typically use a more hierarchic agent system. Under this model, the brands do not have to open new stores themselves as they use their agents' existing sales channels. This allows them to expand quickly. However, as the franchisees own the stores, they have a strong say in how the stores are run. So, when the brands disagree with their franchisees, it is difficult for them to exert control over their stores, and this often harms the brands' interests.

Unlike these other business models, HLA's "quasi-direct sales" model lets its franchisees play the role of a financial investor. They are responsible for paying relevant costs, but do not play an active role in store management. This has helped HLA achieve rapid expansion by leveraging its franchisees' capital while keeping control of its sales terminals.

Even in the second half of 2015, when the clothing market was sluggish, HLA still managed to open many flagship stores in prime areas of major cities. Lichen Zhou, HLA's Vice Chairman, said: "It's hard to secure these locations when the market is good, so now is a good time to get these places."

Q: How has HLA convinced its franchisees to give up control of the stores and merely play this financial investor-style role?

A: HLA has designed an attractive commission system. The company offers its franchisees a high commission rate of up to 35%. After paying for rent, utilities, staff wages, tax and other expenses, the franchisee takes the remaining amount as profit.

Meanwhile, under HLA's franchise model, franchisees do not have to pay a franchise fee, bear the risk for overstocking or play an active role in store management, so the commission is very attractive.

The Daily Me

Chinese app maker Bytedance is using artificial intelligence to change the way the world consumes content

By Wynne Wang

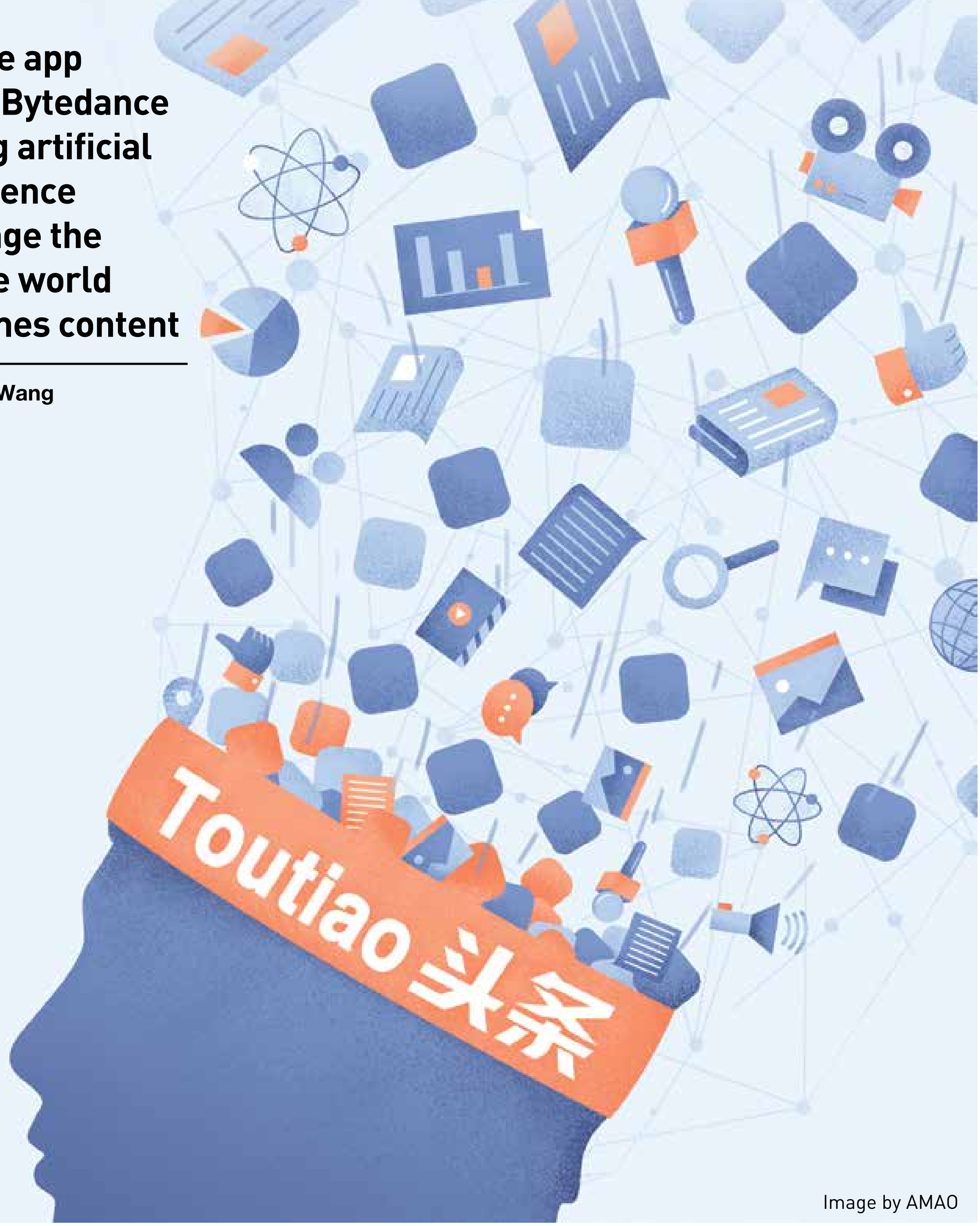


Image by AMAO

Chinese software startup Bytedance has hooked hundreds of millions of smartphone users on its content apps. Now, the Beijing-based company is looking to take on the big beasts of Silicon Valley in the global market

Few people outside China will have heard of Bytedance, the Beijing-based software startup that creates fiendishly addictive content apps using world-leading artificial intelligence technology, but that may be about to change.

More than 200 million people in China—or over one in four of the country's mobile users—use Bytedance's products every day, and now the company has ambitions to hook the rest of the world on its apps too.

Bytedance has been raising investor cash at ever higher valuations over the past year. In 2017, the company's valuation hit an estimated $20 billion, and sources in the Chinese private equity industry told *CKGSB Knowledge* that the tech firm might now be valued as high as $40 billion.

The app maker has been using this investor cash to buy up seemingly any content provider with a global presence that it can get it hands on. In November, it acquired Musical.ly, the Chinese lip-synching app popular among US teens, for an estimated $800 million, as well as global news aggregator News Republic. It has also bought out Flipagram, the music-focused video platform, invested $25 million in Indian content app Dailyhunt, and even made an unlikely bid to acquire Reddit, according to *The Information*.

According to Liu Zhen, Bytedance's Senior Vice President, these moves were just the start. "We will continue to aggressively grow, by acquisition or expanding into new markets," she told reporters late last year in Beijing, adding that the company aims to generate half of its revenue outside China within five years.

Bytedance's strategy is to add value to these acquisitions by integrating its sophisticated artificial intelligence technology—which the company claims can figure out a user's tastes to a high level of accuracy in just 24 hours—into their existing products.

If Bytedance is going to realize this ambition, it will need to overcome some ferocious competition from the big beasts of the tech world, both American and Chinese. But anyone familiar with the company's rise would be hesitant to write it off too soon.

BuzzFeed with Brains

There has been a huge amount of hype surrounding Bytedance over the past year, but the company is no overnight success: it has had to work hard to earn its unicorn status, especially by the standards of China's turbocharged tech scene.

The Toutiao app was first launched in 2012, just when mobile was beginning to take off in China. "Toutiao was born during the golden age when China's number of mobile users was growing fast," a private equity investor, who preferred not to be named while commenting on Bytedance, tells *CKGSB Knowledge*. "It built up its user scale and technology advantages when there was no proper competitor."

Offering users a continuous stream of mainly lowbrow, clickbait-style content, the app initially found success among regular folk in China's smaller towns, to whom the company was able to advertise cheaply. Toutiao acquired its first million users during its debut year while spending only RMB 1 million ($160,000), according to social media consultancy WalktheChat.

The Toutiao app synchs up content from thousands of other providers, offering users a kind of one-stop shop for online media. When users open the app, they are presented with a never-ending feed of headlines. Toutiao then tracks the users' behavior and uses its powerful algorithms to learn what type of content they prefer.

This combination of addictive content and personalization has proved hugely effective. Toutiao now has around 700 million registered accounts, and these users have an extremely high level of engagement. More than 120 million people use Toutiao every day—a similar level to Twitter's estimated total global daily active users. What's more, these users browse the app for an average of 74 minutes per day, even longer than users typically spend on Tencent's "do-everything" app WeChat.

In other words, for around one in six Chinese mobile users, Toutiao is their dominant, or even only way of accessing the news. This is case for Hayden Chen, a mother in her thirties from Shanghai, who says she reads articles on Toutiao for around an hour every day. "I want to read news and opinion on education issues," Chen says. "What Toutiao recommends to me is good enough, so there's no need to look for information from any other sources."

To reach this stage, Toutiao has taken a lot of traffic—and, allegedly, content—from traditional media organizations and other online publishers, the company fought numerous lawsuits over copyright infringement during its early years, but it is now so big that most websites are willing to work with it.

"Toutiao stole content from other media during its first years," says a senior executive at a rival online media firm, who spoke on condition of anonymity. "But now it is paying the media decent money, acting like a pioneer in copyright protection."

Bytedance now pays its content partners based on the number of views their content receives. Because traffic on Toutiao is so huge, this often becomes an important revenue stream for other companies.

"More people read your stories and you get money for it," says a reporter whose website has been working with Toutiao for two years. "And don't forget they would publish your stories anyway. The choice is between Toutiao paying you as the court orders, or based on a contract you both agreed."

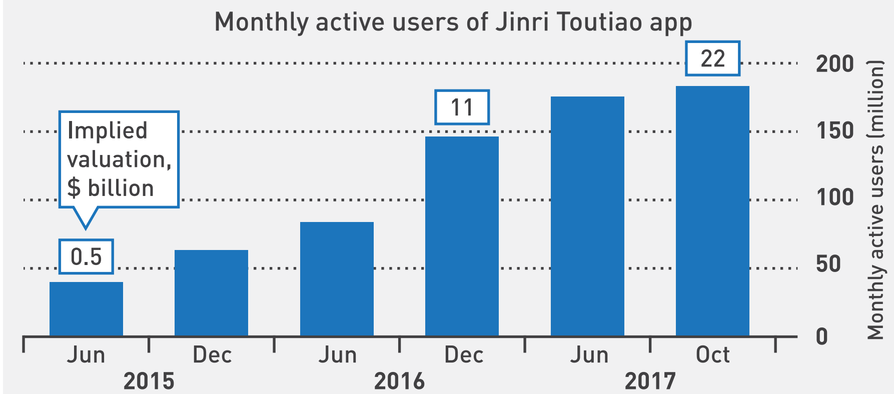
The company is able to offer such good rates because—in addition to attracting large amounts of investor capital—Toutiao functions extremely well as an advertising platform. Bytedance generated revenues of RMB 16 billion ($2.5 billion) in 2017, most of which came from display advertising, and Vice President Liu has predicted that this will rise to RMB 50 billion in 2018.

"Toutiao is really good at attracting advertisers thanks to its huge traffic," says the online media executive. "Its strategy of saying the advertisements can always go to the right targets also works well."

Bytedance claims that its AI technology is so good at personalizing users' feeds that ads function almost as content on its platforms, earning higher click rates than ads on other websites. Hayden agrees that she genuinely finds her Toutiao ads useful. "The advertisements the app shows are mainly targeting me or my kid, so I would occasionally open one or two links," she says.

Headline Numbers

Bytedance's user base and valuation have skyrocketed since 2015



Source: QuestMobile, Economist

Beating the BAT

Online content is a fast-moving, fickle industry, and even BuzzFeed has found life challenging recently. But, for now at least, there appears little chance of a challenger emerging to dethrone Toutiao.

"Everyone wants to become Jinri Toutiao, but no one has been very successful at copying it so far," says the online media executive. "The way it works sounds pretty straightforward. But when you try to do it yourself, you find that, firstly, you don't have the scale of content and, secondly, your recommendations are not as smart."

It is Bytedance's lead in AI that gives it this security, and the company is willing to do whatever it takes to get the best talent. The company offers jaw-dropping salaries to top AI researchers, sometimes offering pay rises of 50% to poach them from their rivals, *Bloomberg* reported in September.

Inevitably, this has brought Bytedance into direct competition with China's big three tech giants—Baidu, Alibaba and Tencent, often collectively referred to as BAT—and it is these three companies that pose the greatest threat to Bytedance's future development.

"Toutiao's market performance is very strong. " says Xue Yu, a senior analyst at market intelligence firm IDC China. "Its major challenge will come from direct competition from BAT and other tech giants."

Tencent is Bytedance's most direct competitor among the BAT, as Toutiao is battling Tencent News for control of China's news apps market. Tencent News was the dominant player before the emergence of Toutiao and is a more traditional news app, curated by a team of editors rather than by algorithms.

"Tencent had the number one news app before Toutiao appeared," says the reporter. "But facing Toutiao, Tencent suddenly seemed like a traditional media company."

Competition between the two apps is finely balanced. They currently have similar daily active user rates, though Toutiao's is rising while Tencent's is slightly declining. Though Toutiao's AI-powered system gives it an edge, Tencent has the formidable advantage of being able to drive traffic to its news app via WeChat.

It is also a war that is proving costly. The two sides have been trading lawsuits for allegedly republishing each other's content without permission, and they are also looking to outbid each other to sign deals with the best content providers. Bytedance recently announced it will spend RMB 1 billion ($160 million) to support short video makers. Shortly after, Tencent pledged to pay RMB 1.2 billion to original content producers, according to *China Business News*.

However, Bytedance's true enemy among the BAT is Baidu, famous mainly for its search engine, according to the short video maker.

"Baidu is the one that hates Toutiao the most among BAT," he says. "Baidu heavily relies on advertising revenue and it's being taken away by Toutiao."

In late-January, Bytedance sued Baidu, alleging that the company's search engine was directing users who searched for Toutiao to Baidu's own media platform. The next month, a Chinese journalist also claimed that Baidu has an "anti-Toutiao department," though Baidu has since launched libel proceedings disputing the report.

"Bytedance is so strong in its own areas that everyone is taking it as a rival," says the PE investor. However, the company's most immediate problems are not related to business, but politics.

Fake News with Chinese Characteristics

Much like Facebook in the US, Toutiao is receiving pushback over its AI-driven newsfeeds in China, though the reaction obviously reflects China's dramatically different political system.

In December, the Beijing Internet Information Office accused Toutiao of "spreading pornographic and vulgar information" and forced Bytedance to shut down several sections of Toutiao for over 24 hours.

In response, Toutiao suspended the accounts of more than 1,100 bloggers that it said had been publishing "low-quality content." It also replaced Toutiao's "Society" section with a new section called "New Era," which republishes a lot of content from state media.

Many users have reported that their feeds are now topped with reports on speeches by government leaders and that there has been a marked decrease in the amount of clickbait content, which has been an important part of Toutiao's success.

"Some people are joking that Toutiao has run out of low-quality content because it has banned so many bloggers," says the online media executive. "There is such a huge demand for it and production is heavily lagging behind."

To avoid a repeat of the shutdown, Bytedance has set up a content review center in Tianjin, a northern city near Beijing. The center already has a team of over 4,000 editors, and the company plans to increase this number to 10,000, according to Chinese news portal *The Paper*.

However, even this has not appeased the authorities. On April 10, Toutiao was banned from app stores in China for three weeks, along with three other leading news apps, for publishing inappropriate content.

Dancing to a New Tune

Bytedance is attempting to hedge against political risk by reducing its dependence on Toutiao. In particular, it is moving aggressively into the short video space, which has boomed in China in recent years. The Chinese internet video market is expected to grow by 36% annually through 2021, according to IDC China.

The company has launched several short-video apps covering different markets, and so far they have performed very well. Its three most popular video apps—Douyin, Xigua and Huoshan—all had more than 20 million daily active users in January, and were among the top five most popular short-video apps during the Chinese New Year holiday, statistics from data company Jiguang show.

> **I think it's a very dangerous move for Bytedance to focus on English written media**
>
> Elliot Zaagman
> China tech industry consultant

Douyin, a music video-sharing platform targeting under-24s living in China's major cities, could develop into an especially valuable product for Bytedance.

"We now consider Douyin as the next WeChat that is emerging," says an internet marketing manager, who declined to be named. "It is going to grow much bigger."

Though there are signs that even China's video market will not be safe for Bytedance. In early April, Huoshan also came under pressure from government censors, forcing the company to announce on its social media feed that it will "suspend updates to the 'video' channel and only recommend content with positive energy."

Luckily for Bytedance, its video apps are making inroads in markets outside China. Douyin's overseas version, Tik Tok, is now available in markets including Southeast Asia, Japan and Korea, and has appeared above YouTube and Instagram on the Apple AppStore in some other countries.

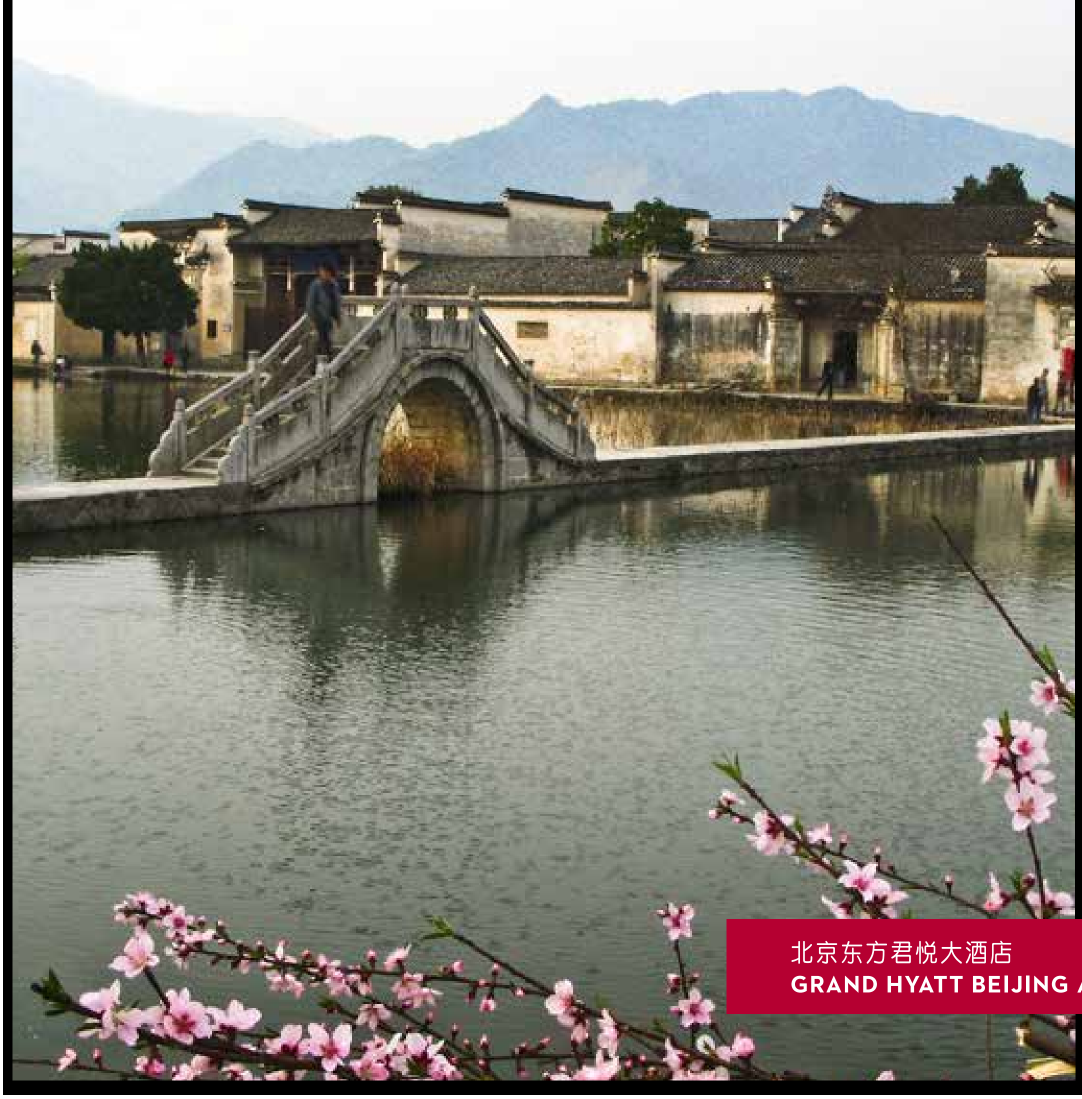
"China's internet users only constitute one-fifth of global users. If we don't go for products that can achieve scale abroad, one-fifth cannot compete with the remaining four-fifths. Going abroad is a must," Zhang Yiming, Bytedance's CEO, said in 2016.

The company claims that its AI technology is essentially language-independent, and so there is no barrier to its apps achieving the same high performance outside of China. But crossing the cultural divide may be a greater challenge, especially in Western countries.

TopBuzz, which launched in 2015, has already been accused of repeatedly pushing fake news in the English-language media. According to Elliot Zaagman, a consultant who advises Chinese companies on overseas expansion, Bytedance would be wise to avoid trying to recreate Toutiao's success in the West.

"I think it's a very dangerous move for them to focus on English written media," says Zaagman. "Especially when there are economic tensions arising between the US and China."

"The more they can go into areas that are more light-hearted—Musical.ly would be a good example—the better chance they have of being successful in the West."



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- 2017 Forbes Travel Guide Four - Star Award 《Forbes Travel Guide》
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Selling With Selfies

In China, online celebrities now earn even more than A-list movie stars. But is the livestreaming bubble about to pop?

By Helen Roxburgh

Image by Yang Illustration

From early morning until she turns in for the night, Melilim Fu is online. Armed with four smartphones, the 27-year-old spends most of her day posting furiously to her social media feeds: livestreams, beauty tips, video tutorials, photos, articles and anything else that will appeal to her followers.

With her striking blue hair, quirky style and bubbly, outspoken manner, Melilim is one of China's most successful online celebrities, or *wanghong*. She is an idol to her hundreds of thousands of fans, and a darling of brands looking to piggyback on her huge audience.

"In 2017, I was in the top four beauty influencers in China, but that doesn't matter to me—how to care for my fans is most important," she tells *CKGSB Knowledge*. "I tell them we don't only have one standard for beauty and everybody has a lot of different options."

Forming connections with fans, clients and brands keeps her extremely busy, but it is also extremely lucrative. China's top *wanghong* are now in the same category as movie stars and A-list celebrities; in fact, the online celebrity economy by some calculations is worth more than the country's domestic film industry. Data company CBNData estimated that the online celebrity economy was worth RMB 58 billion ($9.2 billion) in 2016, while the domestic film industry brought in RMB 45.7 billion in revenues in the same year. Superstar fashion influencer Zhang Dayi reportedly earned over RMB 20 million ($3.2 million) during a recent two-hour livestreaming event.

For many young Chinese, online stardom is the ultimate dream. A survey by qq.com, one of China's most popular news portals, last year found more than half of respondents born after 1995 aspired to make a living through online broadcasting. Another study by China University Media Union found 42% of college students want to become *wanghong* after graduating.

According to Jonathan Sullivan, Director of the China Policy Institute at the University of Nottingham, the rise of *wanghong* culture is fueled by the quirks of China's media landscape, where the government exerts strict control over mainstream channels.

"The avenues for regular people to become celebrities are essentially limited to the internet," says Sullivan. "Reality TV is not an avenue to fame in China—despite a few reality shows, the ecology is not there, and the mediasphere that celebrity needs to breathe is too constricted."

Online stars are also able to connect with young Chinese in a way that the TV and movie industries often fail to do. "I think there is enormous appetite for something distinct from the 'ideotainment' [ideological entertainment] and dry fare that dominates mainstream media," adds Sullivan. "An online persona doing something different to the norm can catch fire in a space where information flows are quite concentrated."

Turning Clicks Into Cash

In China, the most profitable types of internet celebrityhood are the fashionistas and beauty experts that broadcast through social media platform Weibo and Alibaba's online marketplace Taobao. Somewhere between brand ambassadors and content providers, they have emerged as a significant force in China's online retail ecosystem.

With a vast potential audience of 750 million internet users, many of these social media stars have established huge followings. Their ability to promote an aspirational lifestyle while fostering a sense of authenticity also makes them ideal partners for brands, who refer to them as Key Opinion Leaders, or KOLs.

The power of KOL marketing was evident recently when Givenchy partnered with leading *wanghong* Gogoboi for the launch of their Duetto handbag collection. After Gogoboi posted about Duetto to his 7 million Weibo followers and set up his own WeChat boutique platform featuring the range, the bags sold out within 72 hours.

Many brands will pay big money for this kind of influence. A typical fee for one Weibo post is RMB 500 ($79) per 1,000 views, meaning a popular post from a successful KOL can bring in hundreds of thousands of RMB, according to Elijah Whaley, Chief Marketing Officer of influencer agency Parklu, who is also the business partner of Melilim Fu. Once a KOL has around 1.5 million followers, upward of $50,000 per post is common.

According to Jeremy Webb, Vice President at Ogilvy China, brands in China are more willing to pay KOLs than elsewhere because digital marketing is more challenging here.

"As a marketer, I'd say the reason why KOLs earn so much money is because there aren't many alternatives," says Webb. "In the West, advertising tools on Facebook and the like are so much stronger… In China they were crap for so long, which means if you're a brand or a marketer and you wanted to get your message out there, there was no way to achieve it except through so-called KOLs."

KOL marketing has become so big in China that even niche stars can command large fees. One example is Zhang Yumi, a diminutive young woman who found online

> The avenues for regular people to become celebrities are essentially limited to the internet in China
>
> Jonathan Sullivan
> Director, China Policy Institute
> University of Nottingham

fame for her ability to eat gigantic amounts of food. Videos of her devouring four kilograms of rice or eight bowls of rice noodles in one sitting have gone viral on Weibo, winning her over 4 million followers. She is now regularly offered six-figure sums by companies to feature their products in her next challenge, Zhang told the *South China Morning Post*.

Astrology blogger Tong Dao Da Shu, meanwhile, is said to charge about RMB 300,000 ($47,500) per WeChat post.

Selling Out

The real value of the top *wanghong* is that they are able to form a true emotional connection with their followers, who often think of them almost as friends rather than idols. Stars such as Melilim invest significant amounts of time interacting directly with fans.

"I wanted to make girls feel pretty who don't look like what Chinese think is pretty," says Melilim, who often discusses personal issues with her fans, such as boyfriend problems or failing tests. "I want to help girls with dark skin or eccentric tastes to feel beautiful and confident."

Melilim Fu is one of the top beauty influencers in China

Some *wanghong* monetize their fans' devotion directly by tapping their followers for tips. This is easier to do in China because social media apps like WeChat have in-built digital payment services, which allow users to send each other cash gifts with one swipe. For successful stars with millions of fans, earning $15,000 or more from cash gifts in one broadcast is routine.

But when *wanghong* begin to take money from brands they face a tricky balancing act of pleasing their corporate partners without losing their integrity in the eyes of their fans.

"KOLs need to be true and genuine to their fans. In the case of a KOL, you're very concerned about the audience, and the brand in some ways comes second," says Parklu's Whaley. "This is probably the most complex form of marketing today because you have human factors on both ends."

Striking the right balance is becoming even more challenging as the *wanghong* economy becomes ever more professionalized. Talent agencies scour the internet to snap up and train budding *wanghong*, while big businesses have even set up online celebrity "incubators." Tech giant Alibaba, for example, has invested RMB 300 million ($47.5 million) in a center run by venture capital firm Ruhan E-commerce, which grooms young stars with the help of a team of designers, buyers, photographers and assistants.

"Melilim is the only significant KOL that I know of that is completely unsigned and completely home-grown," points out Whaley. "And the only reason we were able to do that is because of good connections at the companies and platforms."

The platforms Whaley refers to are the social media and livestreaming sites that host the *wanghong*'s content. Experts confide that the biggest stars all have connections at these platforms that help push their profiles to prominent positions on homepages and search results.

"If you know the person picking out the featured content on the front page of the video platform, then you have a distinct advantage," says Whaley.

Growing Scrutiny

With influence over so many millions of fans, concerns are rising about the power *wanghong* exert. Beijing is keeping an eye on the craze and has already cracked down on livestreaming channels at various points, including a recent ban on "sexy banana e ating."

Several negative press reports, including from state-owned *Beijing News* last year, exposed the long hours, poor pay and unfair contracts that many aspiring *wanghong* get trapped in, presenting the industry as a seemingly get-rich-quick solution. The Beijing News article featured the plight of 19-year-old Er Xuan, a livestreaming host who was portrayed as one of many Chinese girls who dreamed too big.

> **KOLs need to be true and genuine to their fans. You're very concerned about the audience, and the brand in some ways comes second**
>
> Elijah Whaley
> Chief Marketing Officer
> Parklu

Er Xuan told reporters that she had signed a contract with a local *wanghong* training agency in May, and since then had been forced to work exhausting hours as a presenter on livestreaming platform Huya for just RMB 5,000 ($790) per month. "Yesterday, I was online from 3 p.m. till 5 a.m.," she said. "The day before was even longer: I live-streamed till 6 a.m. or 7 a.m."

Studies have also suggested that social media can have a negative impact, with online crazes such as the "A4 waist" challenges putting pressure on women to conform to a particular body image. While these trends have had varying levels of support and derision, some experts have flagged a worrying trend toward beauty ideals.

Others have expressed concerns over the so-called "big stomach" *wanghong* like Zhang Yumi, with some worrying that this is encouraging eating disorders or that the stars force themselves to throw up after broadcasts. However, Sullivan does not expect the backlash to dampen the enthusiasm of young Chinese for the *wanghong* lifestyle.

"The previous reticence to solicit notoriety via viral images, video and streaming is gone for large numbers of young people," he says. "This is a really significant change: traditional and socialist values despise showing off, or drawing attention to oneself.

"Given the popularity of *wanghong*, I see this trend continuing with millennials increasingly embracing online performance themselves and being willing to support others doing so. I think *wanghong* fits the mood developing in Chinese youth—and the government is going to exert controls to ensure that it develops in a 'politically correct' manner."

An Online Bubble?

Other experts warn that the *wanghong* industry could be a short-lived phenomenon, as KOLs are increasingly struggling to provide value to brands. According to a survey by China Tech Insights, 41.7% of respondents reported a dislike or disgust of internet celebrities, while 51.1% reported a neutral feeling toward them.

"*Wanghong* are usually not considered to be an influential factor to change people's viewpoints and favorability toward a brand," says Alina Ma, Associate Director of Lifestyle at Mintel, a global market research company, who has researched the phenomenon. "Consumers may spend more time getting to know a brand better if they like a *wanghong*… but [*wanghong*] do not have enough power to drive the majority of consumers to the path of purchasing a brand."

"I think there will be a bit of a bubble bursting, because to me these KOLs are not K, have no O and are not L in any way," adds Webb.

There are worrying signs for KOLs that they are already going out of fashion in China's fast-moving online world. The number of monthly active users on Chinese livestreaming sites, for example, fell significantly during the first half of 2017, from 104 million in January to 91 million in June, according to TechNode.

"I don't think people really care so much about online celebrities promoting products these days," says Shanghai-based entrepreneur Sun Yongqiang. "You know they're just saying they like something because they've been sponsored. I think the whole *wanghong* thing is a bit stupid, to be frank."

Savvy KOLs are therefore branching into new platforms and media or looking to launch their own brands. Melilim Fu already had a successful career as a professional makeup artist before launching her online brand, and she has ambitious plans now for her own self-branded beauty products.

"My life is all about creativity, meeting people and beauty: all the things I love," she says. "If I could change anything it would be the overwhelming pressure to keep up… Social media never turns off."

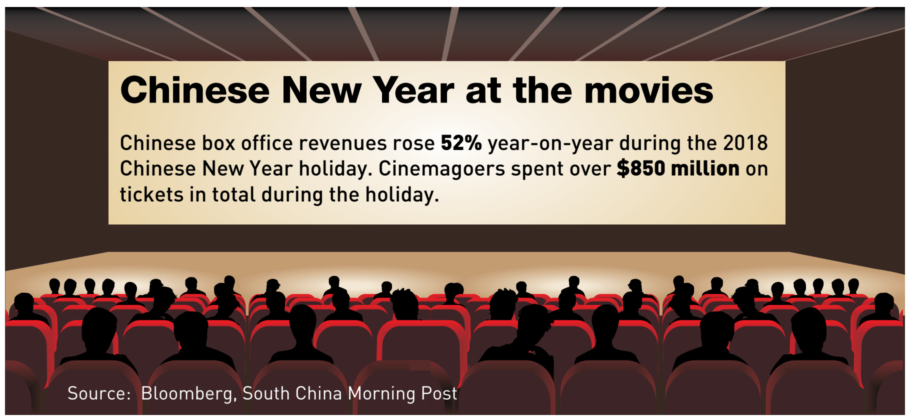
data CHINA data

The stats you need to know

US stores embrace Alipay and WeChat

More than **170,000** US outlets have adopted Chinese mobile payment systems Alipay and WeChat Pay in the past two years in a bid to attract Chinese tourists. Over **3 million** Chinese visited the US in 2017, spending **$33 billion**.

Source: Reuters, ECNS



Chinese New Year at the movies

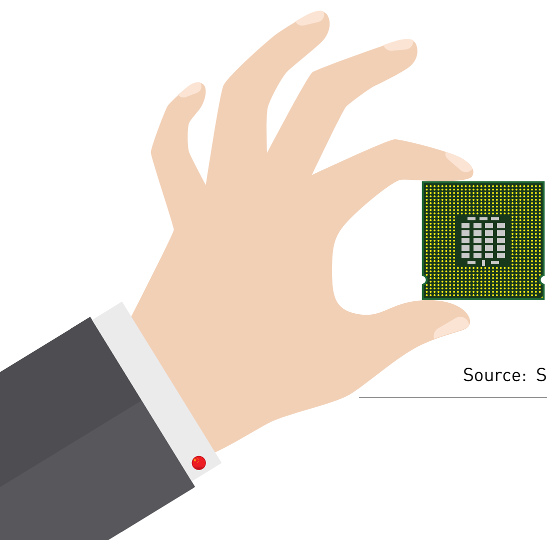
Chinese box office revenues rose **52%** year-on-year during the 2018 Chinese New Year holiday. Cinemagoers spent over **$850 million** on tickets in total during the holiday.

Source: Bloomberg, South China Morning Post

Topping the science table

China has overtaken the US as the world's top publisher of scientific papers. Chinese scientists publish **18.6%** of the world's research papers, while their American colleagues account for **17.9%**. However, China has also retracted more papers for fake peer reviews than any nation since 2012.

Source: Nature, New York Times

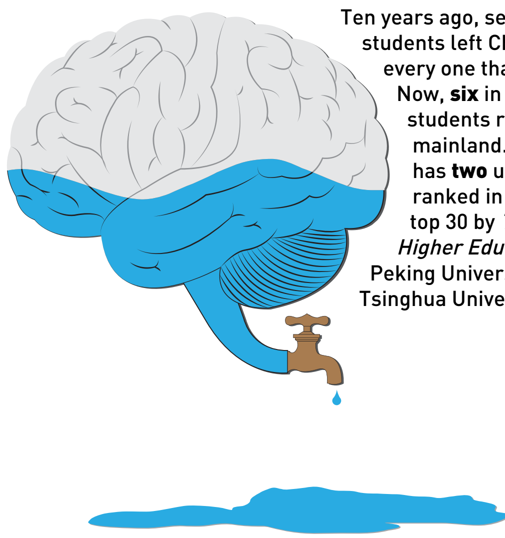


Chinese chips

The Chinese government is raising **$31 billion** to boost China's domestic semiconductor industry. China currently imports **$200 billion** worth of semiconductors each year.

Source: South China Morning Post

Brain drain fades away



Ten years ago, seven students left China for every one that returned. Now, **six** in every seven students return to the mainland. China now has **two** universities ranked in the world's top 30 by *Times Higher Education*: Peking University and Tsinghua University.

Source: Inside Higher Ed, Times Higher Education

Coal comeback

China's annual coal consumption increased for the first time in four years in 2017, rising **0.4%** year-on-year. This was largely due to last year's fast economic growth, with total power demand up **6%** year-on-year.

Source: Caixin

Transfer tax bomb

Soccer clubs from the Chinese Super League spent less than **$200 million** on new players during this winter's off-season, compared to **$500 million** last year. The reason for the drop is a new **100%** tax on big-money transfers.

Source: Financial Times, China.org.cn

Robots on the road

Two Chinese auto makers received approval to road test driverless cars in Shanghai in March, three months after Beijing allowed similar tests.

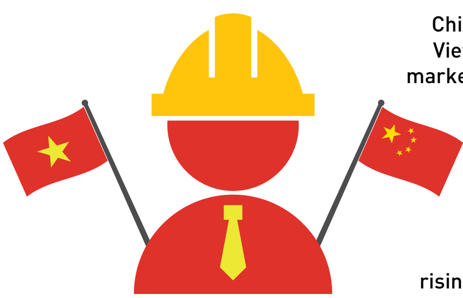
Source: Caixin Global

Billionaire boom

China minted **210** new dollar billionaires in 2017 to take its total to **819**. That's **40%** more than the US. Pony Ma, founder of Chinese tech giant Tencent, is China's richest man with **$47 billion** estimated total assets.

Source: People's Daily, Hurun Report

Made in Vietnam

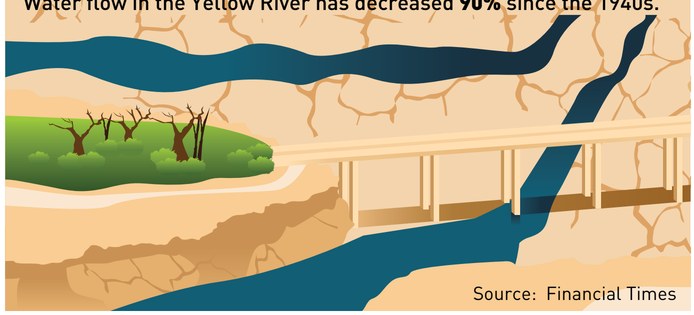


China overtook the US as Vietnam's biggest export market in January. Vietnam exported **$3.7 billion** worth of goods to China that month, up **106%** year-on-year. Exports of smartphones and other electronics are rising particularly quickly.

Source: People's Daily

Rivers running low

In the past 25 years, more than **28,000** of China's rivers have dried up as the country's water resources become more and more stretched. Water flow in the Yellow River has decreased **90%** since the 1940s.



Source: Financial Times

Industry 4.0

How China Plans To Revamp The World's Largest Manufacturing Industry

The integration of smart technology into factories is creating a "fourth industrial revolution" in the West as firms automate processes and use big data analysis to become more efficient. The two countries driving this revolution are the US and Germany. But the approaches they are taking differ sharply.

- Germany's Industry 4.0 strategy is a government-driven plan
- The aim is evolution, helping manufacturers integrate smart tech into their businesses
- Focuses on small- and medium-sized manufacturers
- Target is increasing German industry's competitiveness

- The US's Industrial Internet Consortium is a private initiative set up by leading firms such as GE, AT&T, Cisco and Intel
- The aim is revolution, helping tech companies develop groundbreaking new digital applications
- Focus is much wider: any field where smart tech can improve efficiency
- Global focus: plan is to entrench global leadership of American tech industry

Why China is embracing Industry 4.0

China is embracing Germany's more focused, state-led model. It aims to use Industry 4.0 to upgrade its manufacturing sector, which is rapidly losing its competitive advantages.

Rising Costs

Costs are rising fast for Chinese businesses. Rent, labor and raw materials costs rose **9.7%**, **6.8%** and **7.8%** respectively last year

Low Productivity

China's manufacturing productivity is only **one-fifth** of that of developed countries

Lack of Technology

In Germany, there are around **20** workers to every robot. In China, there are roughly **10,000**

Industry 4.0 will help China overcome these challenges. Digital transformation will help Chinese manufacturers increase productivity by **30%** and reduce operational costs by **20%**, according to the Ministry of Industry and Information Technology.

Source: McKinsey, South China Morning Post, BCG, Daxue Consulting, Global Times, MAPI Foundation

China's plan for Industry 4.0

Implementing Industry 4.0 will require huge investment, since China still lags behind the US and Germany in digital infrastructure and experience. The *Made in China 2025* and *Internet Plus* strategies set out ambitious goals to overcome this.

Investment

800 government funds valued at **$325 billion** will support *Made in China 2025*

Robotics

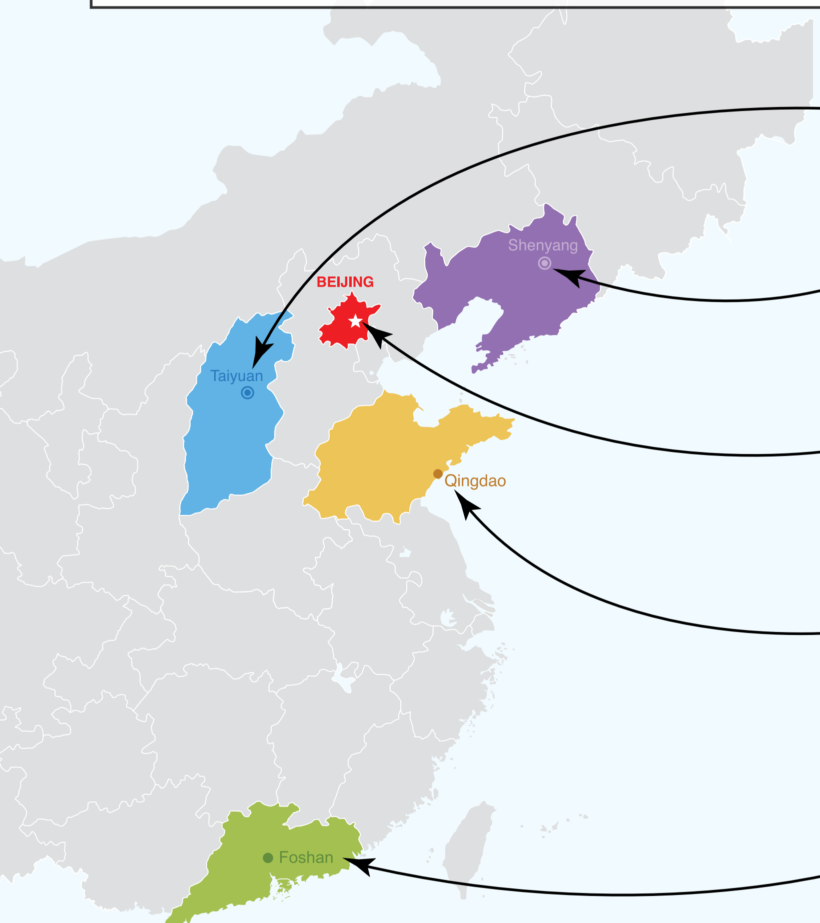
China is predicted to account for **half** of Asia-Pacific's total spending on robotics by 2020 at **$59.4 billion**

Industrial Internet

China will roll out industrial internet infrastructure covering every region within **20** years

Learning from Germany

China is also tapping the expertise of German companies to accelerate its transition to Industry 4.0. This assistance will be crucial: only **9%** of Chinese companies have designated teams working on Industry 4.0, compared to over **one-third** of German manufacturers, according to McKinsey.



Siemens Industry 4.0 Center
Siemens has opened a research center to help local companies implement Industry 4.0 practices in Taiyuan

Sino-German High-end Equipment Manufacturing Park
Foreign firms have invested $123 billion in this Industry 4.0 demonstration park, including BMW Brilliance

Joint Declaration on Industry 4.0 Cooperation
The Chinese and German governments signed an agreement to deepen cooperation on *Industry 4.0* and *Made in China 2025* in 2015

Sino-German Eco-park
Siemens has also partnered with Chinese white goods giant Haier and five state R&D center on smart manufacturing research in Qingdao

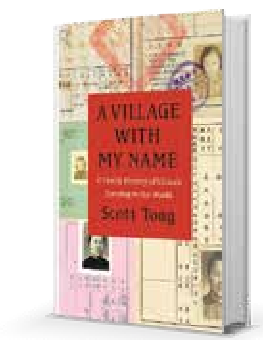
Sino-German Industrial Service Zone
Leading German firms including Allianz and robotics manufacturer Kuka, recently acquired by Chinese appliance makers Midea, have opened operations in southern manufacturing hub Foshan

Source: China Daily, Global Times, McKinsey, Daxue Consulting, South China Morning Post, US Chamber of Commerce

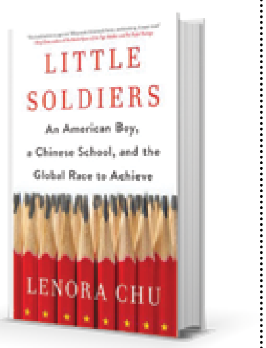
Reading the Real China

Jeremy Goldkorn recommends the best books for shattering your preconceptions about China

Jeremy Goldkorn founded Danwei.org, a website about Chinese media in 2003. It grew into a research firm that was acquired by the Financial Times *in 2013. He is now Editor-in-Chief of SupChina.com and co-host of the well-known Sinica Podcast. Originally from Johannesburg, South Africa, he lived in Beijing from 1995 to 2015 before moving with his family to Nashville in the United States.*

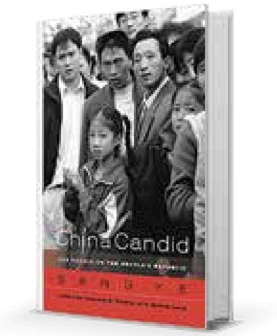


A Village With My Name
by Scott Tong

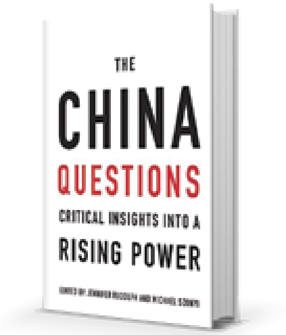


Little Soldiers
by Leonora Chu

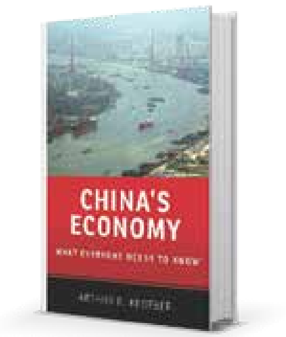
If I had to recommend a single book for someone new to China, it would be **China Candid**. It is a collection of oral histories by the Chinese journalist Sang Ye, who has spent decades talking to people all over China, and whose positions are as different as a government cadre, an unrepentant former Red Guard and a prostitute.



Another great book for learning about China is **The China Questions**. Edited by Jennifer Rudolph and Michael Szonyi, it is a series of essays by scholars at the Fairbank Center for Chinese Studies at Harvard University, each of which answers a question about Chinese society, politics, history or culture. Right now, I would say it's the best contemporary introduction to everything you need to know about China.



For a general introduction to the Chinese economy, I'd recommend **China's Economy: What Everyone Needs to Know**. Arthur Kroeber is someone who does not have a vested interest in promoting a positive story about China, but is a cool-headed optimist. Even if you do not agree with all his views, he is a clear thinker about what is going on in China's economy.



Any foreigner planning a business, cultural or social venture in China should read Jonathan Spence's **To Change China**, a history of Western businesspeople, missionaries, bureaucrats and Cold War ideologues, who thought they could come to China and change it. Short version: they all failed.