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A Balancing Act

With a slowing economy and mounting debts, as well as Belt and Road Initiative renegotiations and a brewing trade war to contend with, China has in recent months been engaged in a balancing act of great delicacy. It has also become evident that China is now integrated into the global economy so much that any tremors here are felt all over the world.

In this issue of *CKGSB Knowledge*, we analyze several of the challenges that China is facing, led with our cover story looking at the prospects for the country to move to another level of prosperity. China has grown at an unprecedented rate over the past few decades, but with the country's economic growth now slowing down, **"Aiming for the Top"** (page 27) explores the possibility of China getting stuck in the so-called Middle-Income Trap and whether it will ever be able to join the ranks of high-income countries.

One of Beijing's key responses to slowing growth has been the introduction of fiscal policies including wide-ranging tax cuts aimed at encouraging more private-sector investment. **"China's Tax Dilemma"** (page 11) examines how China's is now facing the decision of whether to prioritize growth or control the country's mounting debts.

"Small is Good" (page 19) looks at how many of China's fast-growing smaller cities are climbing up the city-tier system faster than was anticipated. How sustainable is this growth and which industries can benefit from it the most?

While China is now well integrated economically into the world, two of our stories look at how that arrangement is playing out. **"Stretched to Breaking Point"** (page 7) analyzes how growing disputes are making the World Trade Organization increasingly dysfunctional and asks if it will lead to a complete overhaul. **"E-commerce Law and Order"** (page 35) looks at China's new e-commerce law and whether it will be able to create order from chaos by rigorously enforcing rules targeting intellectual property infringement in the world's largest online marketplace.

Next, we examine the question of why the Chinese public has to a large extent lost confidence in drugs made in China in **"Climate of Mistrust"** (page 43), and consider the significance of trust for both domestic and international pharmaceutical companies.

US-China trade negotiations have also highlighted how China's agriculture sector appears to be preparing the ground for a major



policy shift on genetically modified crops. **"Seeds of Change"** (page 47), explores why there is such a resistance to this change and what it could mean for the industry as a whole.

We also have stories that zoom in on the profitability of two industries. **"Co-working Capital"** (page 51), looks at the massive investments that have flowed into China's shared co-working space market, while **"Hungry for Profits"** (page 62), explores the real price of the booming food delivery industry.

We feature four fascinating interviews in this issue. Jane Sun, CEO of Ctrip, explains how China's online travel giant is pushing into new markets and gives her insight on how countries can better attract China's free-spending tourists (page 24). Simon MacKinnon, Chairman of Xeros China, explains how foreign companies

can take advantage of China's fast-growing environmental sector (page 40).

Arnold Ma, CEO of Europe's first Anglo-Chinese digital marketing agency Qumin, walks us through some of the most prominent digital marketing trends in China that Western companies should be aware of (page 16). Michele Wucker, author of the top English-language bestseller in China, *The Gray Rhino*, teaches us how to be prepared for obvious threats that we may fail to recognize (page 32).

This issue presents plenty to think about and discuss. 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/>

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STRETCHED TO BREAKING POINT

Growing disputes are making the World Trade Organization increasingly dysfunctional. Will it lead to a complete overhaul?

By Jens Kastner

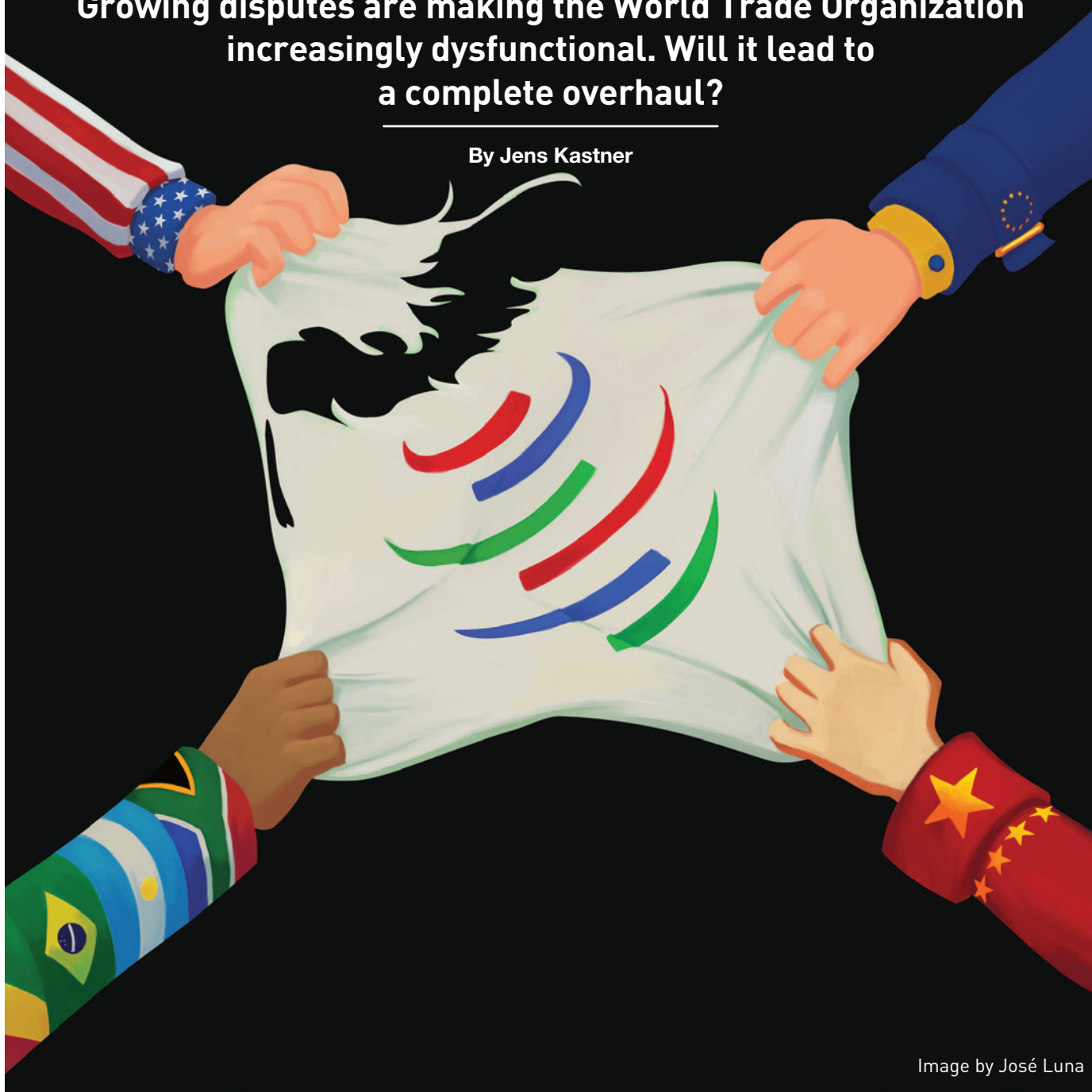


Image by José Luna

The World Trade Organization has been the primary global trading system for decades, but there are increasing signs that in its current form, it no longer fits the purpose

Late last year, China's Vice Commerce Minister Wang Shouwen, criticized the World Trade Organization (WTO), saying its very existence is threatened by serious issues. The US President Donald Trump agreed with him, albeit for different reasons. "If they don't shape up," he threatened, "I would withdraw from the WTO."

The WTO is nothing less than the world's primary trading system, comprised of 164 member-economies scattered across five continents. It is obviously in the interests of the world that it works effectively.

Struggling to accommodate so much diversity, the WTO has in recent years been facing an escalating standoff mainly between its three most powerful members: China, the European Union and the United States.

"Some countries are in reality just hoping to uphold their monopoly status and restrict other member states' development," said Wang when speaking on the WTO last year. "The WTO should prioritize key issues that threaten the institution's existence."

The stakes are especially high for economies such as China, Germany, Japan and South Korea that rely heavily on their exports reaching the world's major consumer markets with low or no import tariffs. Although these countries have been doubling down on their efforts to save the WTO, it is far from certain that the system will survive.

"The WTO is in a precarious situation, and it has probably never been this destabilized and under such tensions since it was founded in 1995," says Sebastien Jean, director of CEPPI, a French center for research on the world economy.

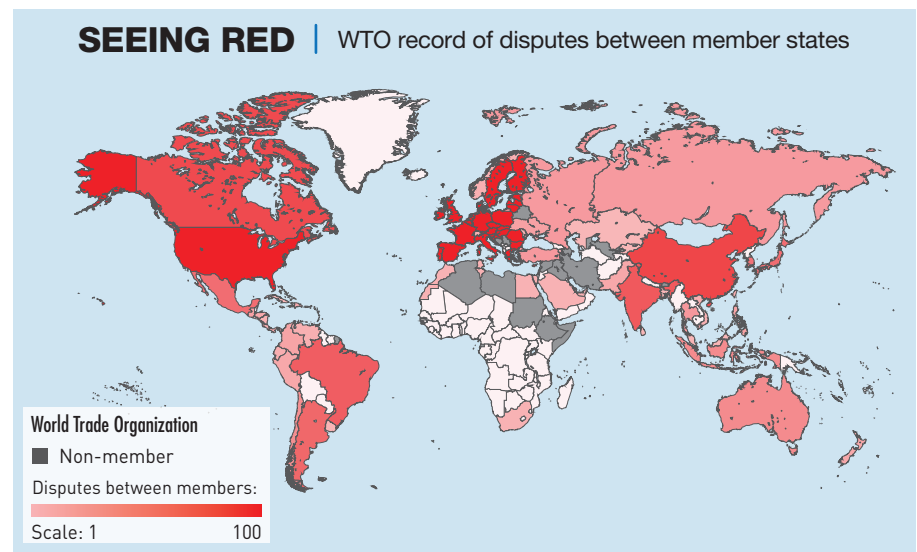
"It has a lot to do with US-China frictions, but it goes beyond those and will not end even if the US and China would find an agreement in the near future."

Jean explains that the main underlying problem is that today's world is not what it was when the WTO was crafted. Global trade is much more multipolar now than it was then, and Asia has moved from the periphery of the world's economic activity to its epicenter.

An unsatisfying status quo

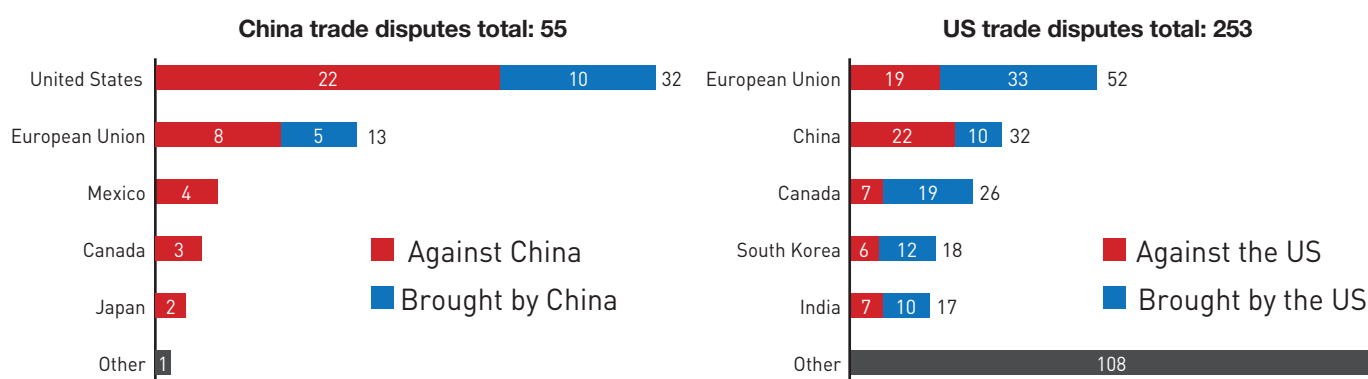
The WTO replaced the old General Agreement on Tariffs and Trade system (GATT), which covered only explicit barriers to manufactured goods at the border, mainly import tariffs and quotas, with liberalization in services and agriculture being much shallower than under the WTO.

China joined the WTO in 2002, thereby leveling the world's playing field for its export goods, catapulting the country to first place in global export rankings. The WTO is currently the only international organization dealing with the regulation of trade between participating nations by



Source: World Trade Organization

TROUBLES IN TRADE | The number of unresolved China and US trade disputes with WTO members as of 2018*



* Since 1995, over 500 disputes have been brought to the WTO and over 350 rulings have been issued.

Source: World Trade Organization

providing a framework for negotiating trade agreements and a dispute resolution process.

Meanwhile, the US trade deficit with China grew from \$83 billion in 2001 (the year before China joined the WTO) to \$166.3 billion in 2008 (during the Global Financial Crisis which accelerated the rise of China relative to G-7 nations) and to \$566 billion in 2017 (the first year of Trump's presidency). The US reportedly lost 3.4 million jobs to China from that time to 2017, with losses happening in every US state.

"The Trump administration's trade experts noted that the WTO had no provisions for dealing with many of the reasons for the trade deficit, many of those relating to China's domestic policies, such as market intervention to support state-owned enterprises and the continuation of discriminatory barriers against imports," says John F. Copper, a professor emeritus of international studies at the US's Rhodes College.

"Thus, President Trump concluded that the WTO was unable to solve the problem, and he had to rely on other means, namely tariffs to fix the problem."

Besides the trade deficit, the US alleges the existence of a Chinese campaign to steal American intellectual property and force technology transfers from US companies.

To force China to address these issues to the US's liking, the US has as of May 10 imposed 25% tariffs on \$250 billion of Chinese goods. It justifies this by citing the WTO's security exception clause, which

China says violates the WTO rules as Chinese goods should not be categorized as a security threat.

China also says that the US violates the WTO's most favored nation provision that stipulates that WTO members apply the same tariff treatment to all other WTO members. Nevertheless, arguably the most devastating shot the US fired at the WTO did not occur in the Trump presidency but under his predecessor Barack Obama in 2016.

Since that year, the US has been failing to fill vacant seats at the WTO Appellate Body, the body for settlements of disputes between members. By September 2018, the normally seven-strong Appellate Body had only three judges left, the number required to hear each appeal, and the Appellate Body would fully fail to function by December 2019, when two judges are scheduled to leave.

"The US says the WTO's Appellate Body has developed into an international court that not only reviews the legal reasoning of the first instance of the WTO dispute settlement process but also sets new law," says Axel Berger, a senior researcher at the German Development Institute.

"The US is also at unease with the WTO allowing its members to define themselves as developing countries, saying that China has been exploiting this loophole."

China, for its part, argues that the WTO and all trading nations are now challenged by unilateralism and trade protectionism.

Pointing at China's own misgivings vis-à-vis the WTO, China's Vice Minister

of Commerce, Wang Shouwen, said reform should rectify the long-term severe distortion of international agricultural trade caused by excessive agricultural subsidies in developed member countries.

China as well as India have criticized the subsidies that the EU and the US give to farmers, arguing that they lead to increased export production and artificially low prices, which in turn hurt the farming sectors in developing countries.

Wang furthermore argued that reform should relieve the severe impacts on the normal international trade order imposed by the abuse of trade remedies, especially the "surrogate country approach" in anti-dumping investigations.

The "surrogate country approach" allows WTO members to determine whether China is exporting products below market value by comparing their prices with prices and costs in a third country and levy high tariffs against China in anti-dumping investigations. China says it is unfair that the "third country" used for comparison is often a developed market economy where production costs are higher than in China.

"China's economic miracle made good use of the WTO, and it wants the WTO to survive, given that it provides the stability and predictability China's export sector needs," says Jean, the director of CEPPII. "On the other hand, China wants to be treated fairly, and there is that Chinese perception that China has been opening its markets much more under the WTO than India, for example."

The cost of its unraveling

Most observers prescribe to the notion that the consequences of an unraveling of the WTO would be unilateralism, economic nationalism and trade wars that are largely unconstrained.

The world's smaller economies have much to fear if the Trump administration achieves its goal of turning the WTO back into a GATT-like regime, where member states have a veto right should the dispute settlement committee rule against their interests.

This somewhat resembles ASEAN where disputing members can resort to any among a number of fora for settlement of disputes at any stage, so that in fact the ASEAN Appellate Body has never sorted out a dispute until the end.

"A return to GATT would mean the power of the strongman would replace the power of the law," says Berger.

"And, as the G-20 [a group of 20 important economies] becomes the main format of moving the WTO reform debate forward, smaller countries would no longer be involved in this debate. We need to ensure effective outreach processes of the G-20 to ensure that the interests of developing countries in particular are taken on board."

Similarly, although Trump has said he would like to see the WTO replaced with many bilateral agreements between countries, it would be an undesirable outcome for smaller countries, as they would almost certainly be on the short end of the stick should they negotiate bilaterally with an economy that is far bigger.

"A network of bilaterals would not only be unfair but also so terribly complex that it would not be an option for the world level," says Jean.

Ming Du, a professor and WTO expert at the UK's Surrey University School of Law, believes that the US dropping out of the WTO and even more so an end to the WTO would certainly mean serious economic worries for China. This is indicated by the effects that US tariffs are already having on Chinese goods.

China's economy grew at its slowest recorded pace in 28 years in 2018, amid



A network of bilaterals would not only be unfair but also so terribly complex that it would not be an option for the world level

a standoff with the US as its largest trade partner.

Du explains, "of course, China cannot accept such an outcome, and it therefore strives to form alliances to gather support for the WTO in order to improve the system's efficiency."

No quick fix

In November, the EU together with Australia, Canada, China, Iceland, India, Korea, Mexico, New Zealand, Norway, Singapore and Switzerland unveiled a proposal for concrete changes to overcome the current deadlock in the WTO Appellate Body, including new rules for outgoing judges.

Meanwhile, Trump has been calling for a "comprehensive agreement on a large range of issues" between the US and China to resolve their current trade conflict. Under a bilateral US-China free trade agreement (FTA), the two countries could create an entirely separate dispute settlement system to uphold the deal.

As WTO rules allow its members to have such FTAs that provide broad discretion to improvise on how to enforce any disputes, a US-China FTA would not necessarily mean the US drops out of WTO.

However, casting doubts on the prospects for such a comprehensive US-China agreement, Cui Tiankai, the Chinese ambassador to the US, in February said that while certain commitments such as purchases of US goods could be realized by China in a short time frame, structural reforms to China's economic and trade policies being pushed by the US "could take years to enact," as they would have to go through China's legislative process.

A way out for the WTO might be that

like-minded members will get together more often for specific issues.

An early example was Canada in October inviting 13 WTO members but not the US and China to a closed-door session on reforming the WTO's dispute settlement system, improving the efficiency and effectiveness of the WTO monitoring function and modernizing trade rules.

Another example came in January when 48 WTO members, including China, the EU and the US, in January launched discussions on a digital trade accord that would reduce cross-border hurdles to e-commerce.

China, which for years has restricted use of the internet inside its borders, until the last minute resisted joining the talks. By contrast, the US has been keen on getting discussions on e-commerce going.

While some observers said the talks on a digital trade accord shows that the WTO is still alive, others see the challenges for it to survive are still daunting.

"It is much easier to destroy than re-establish the multilateral trading system that provides predictability for businesses, the governments and other stakeholders and reduces the costs of addressing trade disputes," says Heng Wang, a WTO expert and professor at Australia's University of New South Wales.

The problems seen in the WTO may also be reflective of an underlying breakdown of the deeper global trading systems and economic arrangements.

"But pitifully, the WTO reform is probably more about the gap between major economies on the major legal issues than technical aspects," says Wang, "it is not easy to find promising proposals for reform or modernization of the WTO on the table." ■

CHINA'S TAX DILEMMA

China is now facing the challenge of prioritizing efforts to stimulate growth or control the country's mounting debt

By Colin Peebles Christensen

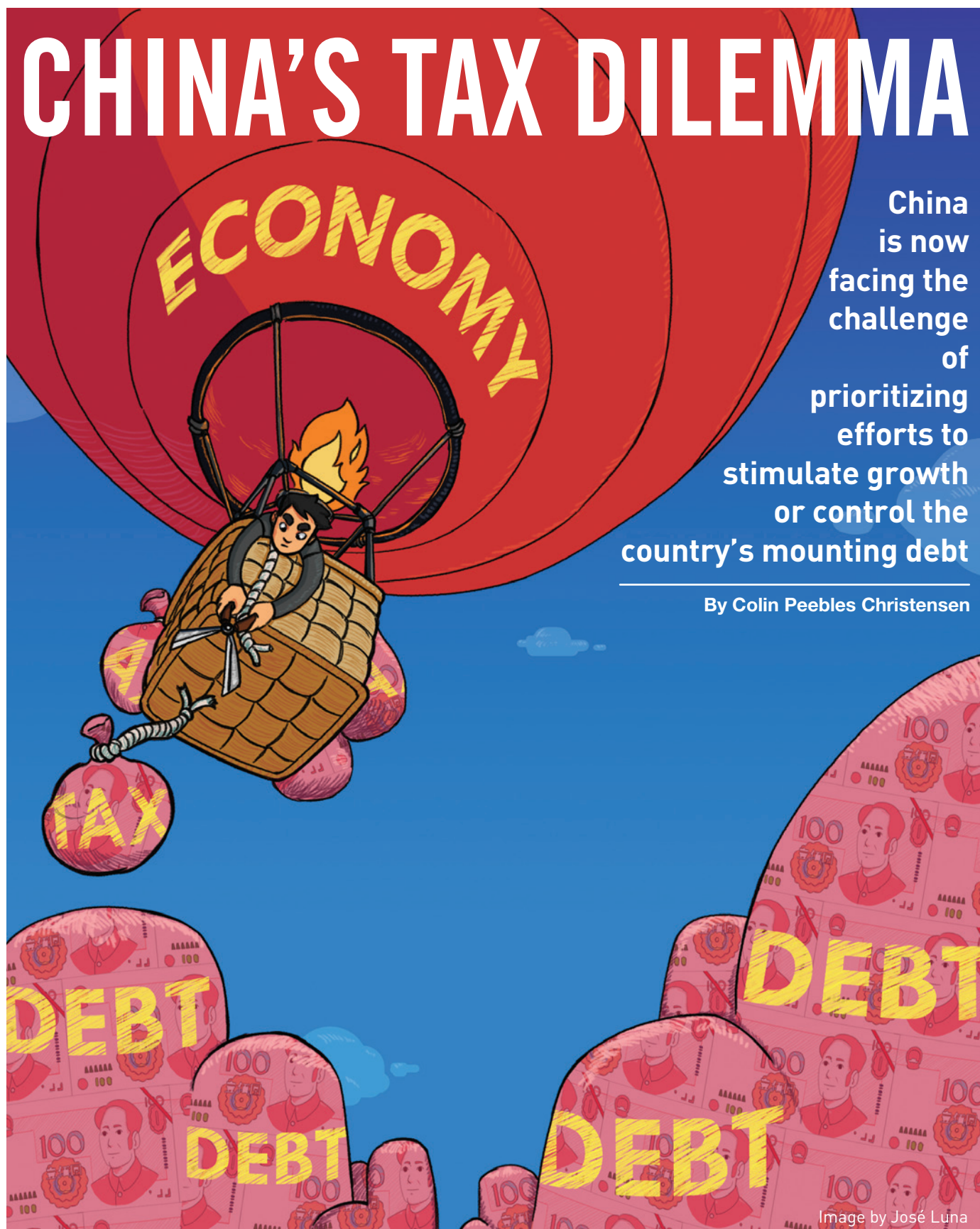


Image by José Luna

Faced with a slowing economy, the Chinese government is this time looking to boost growth through tax cuts rather than stimulus spending

China's economy seems to be slowing faster than the government would like, and US trade war tariffs are just one of the issues weighing down overall growth and threatening hopes for a choreographed and gradual deceleration. The last time this happened in 2008, Beijing responded with massive stimulus spending, thereby creating a debt mountain. This time, what should the economic planners do?

At the annual National People's Congress in March, Premier Li Keqiang downgraded China's 2019 gross domestic product (GDP) growth target to between 6.0 and 6.5%, warning of a "grave and more complicated environment." At 6.6%, last year's economic growth rate was already the lowest since 1990.

Instead of another strong stimulus to boost growth, this time Beijing is instead turning to "proactive fiscal policies" to encourage private-sector spending, with wide-ranging tax cuts, the largest overhaul of the individual income tax system seen in four decades, and tax breaks for a wide range of private companies.

"Fiscal room for the Chinese government has been pretty limited currently, if we look at the debt-to-GDP ratio, taking both official debt and contingent debt into account," says Zhennan Li, China economist at Goldman Sachs. "This is one major reason for the government to take a finer approach to stimulate the economy this time."

Though they may remedy some of China's problems regarding growth, the tax cuts run the risk of resulting in even wider deficits. This would erode the government's future ability to deal with the debt overhang and other pressing issues such as social security outlays.

China's fiscal deficit-to-GDP target of 2.8% for 2019, up from 2.6% in 2018, is not large by global standards, but actual government spending has overshoot the target every year since 2015. The country's economic system also harbors additional hidden risks, the most obvious perhaps being the lack of diversification within key areas of the economy, and a top-loaded fiscal structure in which most revenues flow into central government coffers while

most of the expenditures are shouldered by the local government.

Still, government revenues increased by 6.2% last year, reaching RMB 18.3 trillion (\$2.69 trillion), and China's tax revenue as a percentage of GDP, often viewed as a yardstick for development, has increased steadily over the last two decades from 9.8% in 1995 to 20.1% in 2015. China is currently positioned below the OECD average of 34% and stands between other developed Asian economies such as Singapore (13%) and South Korea (27%).

In 2008, during a national tax conference, then Vice Premier Li Keqiang told taxation officers to strictly enforce corporate income tax laws to boost revenues due to concerns at the time that taxation income might fail to match expenditures. In the decade since, China's GDP growth has slowed to single digits, while the total debt load, mostly on local governments and state-owned enterprises, has increased to somewhere between 240-300% of GDP. This leaves little room for monetary stimulus. As a result, Li Keqiang, now Premier, is turning to fiscal levers instead, and the Chinese authorities are increasingly choosing changes to tax policy as a way to grease the wheels of economic growth. But critics fear that without structural reforms, tax cuts run the risk of providing only temporary relief.

The sources

China instituted sweeping changes to the Individual Income Tax (IIT) Law, which took effect from January 1 this year. They are aimed at reducing the tax burden for lower- and middle-income groups and thereby boosting private-sector spending. The law also revises the rules for foreign residents, reduces and streamlines tax categories, and introduces new tax reporting and anti-avoidance measures. More significantly, the law raises income thresholds and offers a string of new tax deductions for household welfare spending.

"To relieve burdens on low earners, the 3%, 10% and 20% brackets are widened, and the 25% bracket is narrowed," says Melody Liu, tax manager at KPMG. "So relief is being directed at the bottom of the

income distribution.”

The personal deduction threshold has been raised from RMB 3,500 (\$513) to 5,000 per month, while new deductions cover expenditure on education, serious medical treatment, housing mortgage interest and rentals, and support for the elderly, said Liu. These complement existing exemptions for social security contributions, such as pension, medical and unemployment insurance, as well as housing fund contributions.

“The general policy behind it has been to try and alleviate the tax burden on the middle class,” says Paul Dwyer, director and head of international tax and transfer pricing at Dezan Shira & Associates. “It would certainly benefit those people that historically have not been earning a significant amount of money, in order to provide them with extra liquidity and more disposable income.”

By cutting taxes, however, the government is also giving up a large chunk of tax revenue. Income tax brought in RMB 1.39 trillion last year—around 7.6% of total tax revenue. This makes it the fourth largest source of tax revenue, after domestic VAT (with a 34% share), corporate income tax (19%) and value-added tax on imported goods and consumption tax (9%). Together, the four slices make up nearly 70% of the national tax pie.

In parallel with the IIT reform, new corporate tax laws are providing more flexible treatment for certain sectors and smaller-scale companies. In addition, the National People's Congress in March unveiled further VAT cuts—with the standard rate dropping from 16% to 13%.

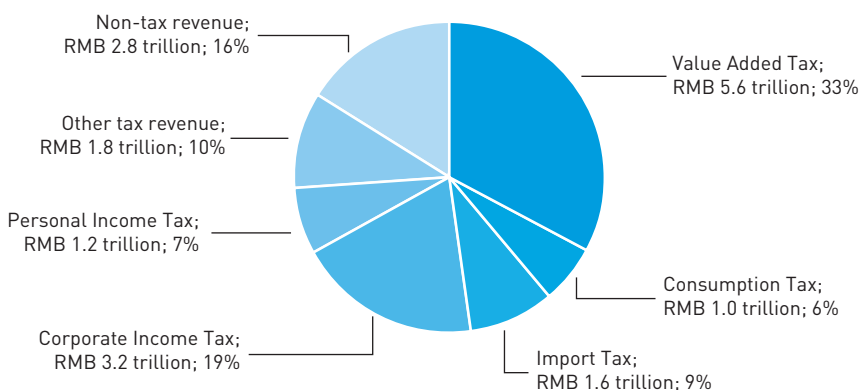
Overall, taxes, levies and fees will be slashed by nearly RMB 2 trillion, a figure which significantly beats the expectations of most analysts of RMB 1.3 trillion before the cuts were announced. The result has been the very clear signaling that the government has an even stronger commitment to tax cuts than first anticipated—and perhaps a greater necessity—to shore up the economy.

The mountain

The continuing slowdown in the growth of

RUNDOWN OF REVENUE

A breakdown of China's general fiscal revenue of 2017



Source: CEIC, UBS

the economy is causing pain. Debt levels, meanwhile, look likely to rise again, after two years of decline. New loans jumped to RMB 3.23 trillion in January, well above estimates, and shadow financing increased for the first time in 11 months.

“The Chinese government has been pretty conservative with their official fiscal targets—always below or equal to 3%,” says Goldman Sachs economist Li. “So even with more tax cuts, they may have to cut back spending to meet their official fiscal deficit target.”

Beijing hopes to offset some of the impact of lower taxes by widening the tax base and plugging loopholes. New IIT anti-avoidance rules aim to tackle evasion and underreporting—which involves fighting offshore tax havens and artificial tax-motivated contracts.

At the same time, a broad institutional reshuffle last year transferred social security and corporate tax responsibilities from the Ministry of Human Resources and Social Security to the State Administration for Taxation, in an effort to improve tax collection. With stricter enforcement, China has also lowered social insurance premiums across the country—notoriously high by global standards.

“The expansion of tax brackets and new deductions should lower revenues, but at the same time the anti-avoidance rules might raise further revenue,” says Shanghai-based Lewis Lu, head of tax at KPMG China.

Exporters, small businesses and high-tech sectors—who constitute the backbone of the high-growth parts of the economy—will benefit from tax rebates and other

The Chinese government has been pretty conservative with their official fiscal targets—always below or equal to 3% [of GDP]



Zhennan Li
China Economist
Goldman Sachs

We think corporate tax cuts are the preferred tool for China at the moment



Michelle Lam
Greater China economist
Société Générale

advantages. New preferential corporate income tax rates of 5% and 10%—compared to the standard 25%—affect SMEs with annual profits of less than 1 million and 3 million RMB respectively and will last until 2021. The VAT exemption threshold for small enterprises has been increased to RMB 100,000 per month.

A crucial piece of China's taxation puzzle long term is property tax, which basically does not exist in China today. The government trialed individual property tax in Shanghai and Chongqing in 2011, but had to abandon the effort due to massive opposition from property owners, which risked a sharp fall in property prices. Local governments across China currently depend heavily on land sales and property translations to fund local utilities and infrastructure, and a key target for the government is shifting to a property tax arrangement, providing stable income for local governments.

The central government hinted at the National People's Congress session in March this year that another effort would be made to implement property taxes, but psychologically it is hard for Chinese owners to accept for a number of reasons, one being that they don't actually own the leasehold of their apartments and other properties—all property in China is leasehold from the state, typically for 70 years.

The official goal is to insert the thin edge of a tax wedge into the situation. Ying Zhongqing, deputy director of the financial

and economic affairs committee at the National People's Congress, said that if the central government implements a property tax, it would, as with income tax, have a minimum tax-free threshold to protect the interests of average home owners.

"Whoever has a larger house will pay more taxes, and whoever lives in the major cities, or in central areas in a city will pay more taxes," Ying told the *21st Century Business Herald*, adding that the tax-free threshold could be set at 40 to 60 square meters per person.

For now, provinces and municipalities across China have instead announced reductions of up to 50% in local taxes, including resource tax, stamp duty, and urban land use tax for small enterprises—an estimated total fee reduction of RMB 200 billion, according to Lu.

A thousand cuts

Stimulus measures are not being actively implemented, but some analysts believe tax cuts alone may not be enough to spur growth.

"During cyclical weakness as we are seeing now for the Chinese economy, impacts of tax cuts could be pretty limited, as firms may not have a strong incentive to increase investment, even with improvement in profitability, and households may not have a strong motive to spend more even with increases in disposable income," says Goldman Sach's Li.

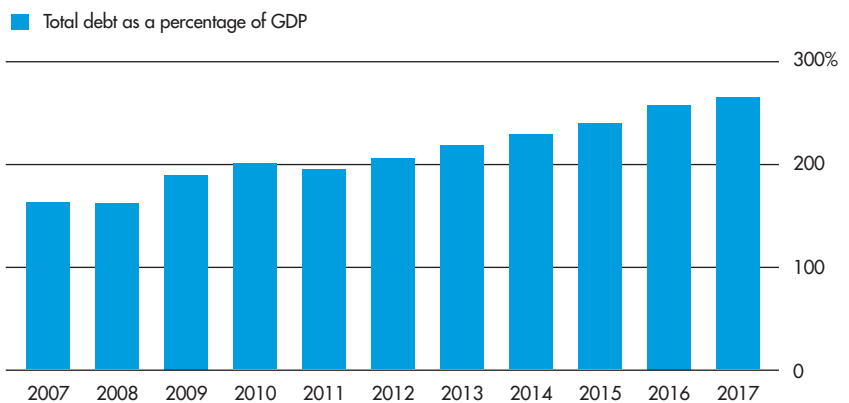
Michelle Lam, Greater China economist at Société Générale, estimates that the impact of the RMB 2 trillion tax cuts will be an improvement in GDP growth in the range of 0.7 to 0.8%. "However, a caveat is that the government is likely to cut spending to balance the books, so the ultimate impact may not be as big."

A key focus of the tax reforms is to correct some of China's dire wealth inequalities—a potential future stress test for the government. However, KPMG's Lu points out that as China's income tax revenue accounts for only 7% of its total tax revenue, taxation plays only a limited role in adjusting income distribution. In addition, without proper implementation of inheritance tax, the new reforms may have a limited impact on wealth distribution.

Still, the increases in disposable

ON THE TREADMILL

Experts say that a major stimulus program would require a reacceleration of credit growth



Source: Bloomberg Intelligence



Chinese Premier Li Keqiang downgrades China's 2019 GDP growth target at the annual National People's Congress in March

incomes and new welfare deductions could potentially lift living standards and life quality for lower income earners across the country.

Catch-22

The key winners of the tax reforms are actually exporters, high-tech manufactures, small, medium and micro-sized enterprises—along with the venture capital firms that fund high-tech startups. At the same time, the central government says it will increase transfers of payments to local authorities, making up for the revenue gaps caused by reduced tax income at the local level. State-owned enterprises (SOEs), on the other hand, appear to have drawn the short straw, as private sector tax reductions will in effect be funded by state-sector profits.

Unfortunately for the authorities, the contradiction between maintaining growth and controlling debt is unlikely to go away. Increased investment spending would require a re-acceleration of debt growth, and tax cuts will inevitably increase the public deficit and further add to debt in the long run. Still, fiscal policy steps are seen as experts as the best option for short-term growth.

“We think corporate tax cuts are the preferred tool for China at the moment,” says Lam. “Infrastructure investment is the quickest way to stimulate the economy, but it is not the most efficient way to make use of resources and it could add on the debt burden of local government and financial vehicles, with the latter under the government’s pressure to deleverage. In contrast, tax cuts work more slowly to reflate the economy, but the savings return to the private sector who can make investment decisions based on risks and returns—this encourages a more efficient allocation of capital.”

“If the growth rate of fiscal revenue is not far away from GDP growth, the government will face no pressure for further cuts, because local government can also issue bond or leverage by the local government financing vehicles,” says Yue Su, China Economist at the Economist Intelligence Unit (EIU). “However, there’s a risk that local government has been leveraged too much in the off-balance-sheet. If this ratio is moving up quickly, then it might leave limit room for further tax cuts.”

However, Li argues that the

government has notably strengthened fiscal discipline as well as improved the balance sheets regarding government borrowing. “Overall, we think these underlying changes can make the debt costs of stimulus smaller,” he says.

The new tax policies have the added benefits of helping to streamline tax collection, incentivizing tax reporting and possibly contributing to some extent to a fairer wealth distribution. Tax breaks for startups, SMEs and high-tech ventures could spur growth and private entrepreneurship without sacrificing long-term sustainability.

Nevertheless, sooner or later, a wide range of experts say, China likely has to consider larger structural reforms—with a redesign of fiscal relations between central and local governments, a deepening of supply-side reform, improved support for SMEs and possibly addressing issues such as the inequality of power between state and private capital.

“Reducing financing cost for private enterprises cannot be done overnight, because banks are concerned about the non-performing loan ratio,” Su says. “Tax cuts are the measure that the government can do in the short term.”

The Secrets of Successful Digital Marketing in China

Arnold Ma, CEO of Europe's first Anglo-Chinese digital marketing agency Qumin, explains how Chinese culture should always be at the center of China marketing strategies.

China's private consumption is expected to increase from \$4.4 trillion to \$9.7 trillion by 2030. With older people becoming increasingly familiar with technology and the rise in popularity of the short-video content, having an effective digital marketing strategy for the Chinese market has never been more important.

China is already the single largest market for many multinational corporations being one of the world's largest unified economic spaces. However, with fierce domestic competition, many foreign entrants are left scratching their heads on how to keep up with China's ever-changing digital sphere.

Arnold Ma is a leading specialist in digital marketing, a technology enthusiast and entrepreneur. He has unique insight and experience from creating China marketing strategies for some of the biggest brands in the United Kingdom.

In this interview, he walks us through the most common challenges that Western firms face when creating digital marketing strategies in China and shares his unique East-West perspective on how businesses can succeed in the world's second-largest economy.

Q. What inspired you to launch Qumin and what made you feel that there was a growing need for a company such as yours?

A. I've always loved technology; my earliest memory was coming

over to the United Kingdom in 1996 and discovering the personal computer. Later, at university, I developed a love for advertising and marketing. Throughout all of my time in the UK, however, I always missed China. I missed the culture, the people, and mostly

the food. I said to myself that when I graduated, I would find a job that allowed me to work on something China-related. And as China was finally gaining a greater presence on the global stage, I was proud. I was proud because China was closed for a long time to the rest of the world, and it was finally opening up.

Unfortunately, as hard as I tried, I couldn't find a job that related to China and that I could confidently use my skill set in tech and creativity. So after initially working in various marketing roles but still feeling unfulfilled, I decided to form Qumin, with a mission to "Open the world to China." I then met my co-founders Tom Nixon and Yan Peng, and together, we built a business and created jobs that we wanted, but did not exist.

Qumin was started to help global brands understand Chinese culture and engage with Chinese people. Over the years we've helped the UK's largest tech company, SkyScanner, successfully enter China and then helping them—as the largest British tech exit to this day—sell to Ctrip. We've worked with brands such as Sony, Manchester United, Häagen-Dazs, Wrigley, the British Library and Kering.

However, more recently, as Chinese brands start to globalize,



and as China continues to open up to the world, we are also helping Chinese brands such as ByteDance—now the world’s largest tech startup having surpassed Uber—to understand and engage with Western culture and people. We also continue to work with amazing, innovative Chinese companies such as Geely Automotive and China Mobile.

We found that our understanding of both Chinese and British culture works both ways, and so we work on connecting brands with audiences in a meaningful way.

Q. Why does the Chinese market require a different marketing strategy than, for example, the European or American market?

A. In answering question, most would immediately start talking about platforms and technology, and indeed, that is something that we need to be aware of. However, with all the focus on platforms and technologies in China, we completely overlook the people, why technology leapfrogs in China, as well as why and how service design integrates into people’s daily lives so rapidly.

Fundamentally, Chinese people are very different and the country’s socioeconomic changes against the backdrop of traditional values plays a huge part in all of the fantastic innovations we are seeing today.

Q. What are the most important instruments for digital marketing in China?

A. People, always the people. A close second is the product knowledge of the platforms people use. And finally, having the right knowledge and experience to overlay technology on top of the campaign to achieve hyper-personalization at scale. But it must start with the people. Hyper-personalization or Customer Relationship Management (CRM)-driven digital marketing will only work with real cultural insight. Go back to the age-old advertising principles and focus on creating stories that make people feel like they come from within their own communities and subcultures, rather than superficial content created with an outsider’s view.

A strong CRM strategy will work better in China than anywhere else in the world because of the oligopolistic nature of the large digital web of services – you rarely need multi-channel attribution.

Q. How much more of an influence do you expect digital marketing to have on consumers’ habits over the next few years?

A. The line between “digital marketing” and just “marketing” is more blurred in China than anywhere else. For example, WeChat’s product ecosystem is the only one in the world where marketers can attribute offline purchases (WeChat Pay) to online engagement (WeChat). This opens up a whole array of CRM and personalization opportunities. For the audience that is inside this ecosystem—or web of services provided by WeChat and its brands—it means even more relevant and service design-driven digital products and platforms. We are already seeing this with the

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likes of Little Red Book, initially a niche user generated content-review platform, which is now branching into e-commerce – but in the traditional sense – it’s a new type of customer to customer e-commerce that WeChat stores has popularized.

Q. What are some of the most common challenges that Western companies have faced when it comes to marketing themselves and their products in China?

A. We see a lot of amazing, strong Western companies launching in China, then hiring a Chinese managing director with a background in sales and distribution, someone that has connections that get them into stores. Western companies feel like they must do this in order to succeed in China, as that is how Chinese companies have succeeded domestically.

In the process of “localizing,” these Western companies and brands overlook what made them so successful in the first place: their brand strategy or product design, as well as their insight-driven, long term approach to marketing and customer-centric business. The biggest mistake is opting for a Chinese approach in sales and distribution. The reason Chinese companies succeeded in the past with a distribution-led, product-led, presence-led approach is because China was closed to the world for so long. Competition and consumer choice were limited, but consumers’ behavior and expectations are changing quickly, as with all things in Asia. That type of functional marketing worked in the past, but will not work in the future.

Brands entering China need to realize that what they think is their weakness, insight-driven creativity and brand focus, is in fact their strength. China is no longer closed, it’s now open, filled with the world’s most fickle and mature consumers.

On the flip side however, brands must not get sucked into thinking creativity has to be irreverent or be led by provocative ideas—this is a western concept that only works well in certain cultures. Do not go down the irreverent route until you confidently understand Chinese people and their subcultures from a native



Qumin successfully launched Skyscanner in China

perspective. Leverage “why you do what you do,” but do not “copy and paste” your western strategy into China.

Q. Do you see Chinese brands struggling with the same difficulties when marketing themselves in Western countries, or are the typical challenges that they face different?

A. Chinese brands also need to learn how to build a deeper level of connection with their audiences. We see the exact opposite with innovative and successful Chinese brands that are globalizing. Chinese companies have the tendency to rely on what made them successful in China with a sales and distribution led strategy, and thus marketing efforts that focus on short-term exposure rather than long-term brand building work. There isn't a one size fits all strategy, but the best Chinese brands we've worked with have always been the ones that are humble and flexible, working to understand Western people and their culture, the marketing industry, ways of working and how to articulate their proposition in a completely different way to how they have done so in China.

Q. What are some of the most prominent digital marketing trends in China that Western companies should be aware of right now?

A. Social Selling is going to be big over the next three years. If you want your organization to be ahead of the curve, think about how to create a strategy that fosters brand loyalty among micro-sellers that have curated products among their private networks. In the next few years, true social selling or micro e-commerce will be the biggest change in the digital landscape of China.

Q. We've seen several blunders in the marketing strategies of Western big-name brands in China lately, how can companies effectively repair their reputation in the Chinese market once damage has been done?

A. One word, respect. While it is important to retain a creative approach to marketing, brands should not try and force a particular

message in their China strategy. If you've already made a mistake, don't fret, Chinese consumers are quick to pick up on mistakes, but are also very quick to move on. Go back to the basics and ensure that your next campaign resonates on a local level.

Dolce & Gabbana's recent *faux pas* gained a lot of traction in their media lately. Previously they had conquered the hearts of many fashion fans and customers by focusing on their Italian roots and authentic story-telling, combined with an unfiltered satirical, irreverent voice from their founders, which has proven to be a great recipe for Europe, the United States and beyond, but it really backfired in China. Whilst there is nothing wrong with their brand strategy per se, unfortunately D&G missed the mark when assuming that their usual satirical and rebellious approach would have the same positive effect when parodying the Chinese culture.

Apple's recent Chinese New Year advertisement however is a perfect example of how to build a meaningful connection with Chinese customers. Filial piety as a central value in Chinese culture is a concept that many westerners often find difficult to comprehend, but when used in their advertising campaign, found that it pulled on the heartstrings of Chinese people. The polar opposite of D&G's execution, Apple's creativity was local, humble and very different to their global or Western approach of experimental creative thinking.


Q. What tips do you have for those who are looking to stay updated on digital marketing trends in China?

A. It's actually very difficult to do this from a Western perspective. My personal method is to simply go to China often and talk to people, which sounds simple, but really works. If you are serious about your China strategy, then make a quarterly trip to China. Every trip will provide you with new knowledge, new insights and expand your thinking. If you cannot afford that luxury, then follow China conversations on LinkedIn. We at Qumin (myself and Tom Nixon) also regularly share our thoughts and start discussions on LinkedIn to stimulate the creation of new ideas and strategies.

Q. What kind of an impact do you think Qumin has had?

A. It's always difficult to talk about your own impact firsthand, we don't work with many brands, but those that we do work with we build long-term relationships with. We want to ensure our focus is not too diluted. And we are most proud when we make a real difference to the brands we work with.

Take Skyscanner again for example, we launched them in China and were there for every step of their China growth, including changing their proposition, brand and even acquisition and integration with a local Chinese product—we couldn't have been happier when they exited to a Chinese tech giant!

We were the first Chinese digital creative agency outside of China, with a mission to “Open the world to China.” We wanted to create a new kind of working result that the world has never seen before – work that's not Chinese and not Western, but something completely different. We will leave it to our clients and consumers to judge whether we've achieved that so far. 

SMALL IS GOOD

China's smaller cities are growing faster than anticipated
and there are big business opportunities

By Mable-Ann Chang



Life in China's big cities is getting tougher for many people, and growth in many third- and fourth-tier cities is now outstripping that of the top-tier cities. Will this trend provide support for the country's slowing economy?

China last year recorded its slowest economic growth in 28 years, but for leading e-commerce player Pinduoduo, it was boom times. Business was up 234% for the year thanks to a largely ignored market—China's vast rural regions and smaller towns and smaller cities, termed “non-first tier cities.”

Pinduoduo is an online shopping platform that allows users to participate in group shopping deals, which have become a very hot area in China's online economy. “More players are looking at lower-tier cities and they're also trying to mimic what Pinduoduo is currently doing,” said the company's CEO Huang Zheng. “The greater emphasis given to the lower-tier cities by our peers is also helping awaken the underlying demand for consumption that has been dormant in these cities.”

His peers include Alibaba, China's biggest e-commerce player, which is also tapping into the potential of smaller cities. In an earnings call in March, the company said that more than 70% of the increase in its annual active users came from these low-profile regions.

China has a population of over 1.3 billion, and well over half of them live in urban areas outside of first-tier cities. Tier-one cities such as Beijing, Shanghai and Shenzhen are the most-developed and the largest of the cities across China with populations between 15 and 25 million. But lower-tier cities make up 50.3% of China's population. More than 100 cities in China have a population of more than

1 million, and most of them are unknown outside of the country.

Many of these “smaller” cities are in fact still massive by most international standards. Lanzhou in Northwest China, for example, is considered a lower-tier city by Morgan Stanley's standards, but still has a population of 3.7 million.

Despite the popularity of the city-tier system, the Chinese government does not have official criteria on how the classification of a city in a specific tier is determined. Cities are loosely classified based on various factors such as their GDP, population size, and level of infrastructure, with four tiers making up the city-tier system overall.

After decades of playing second fiddle to the first-tier cities near the coast, numerous smaller cities are now beginning to thrive, and in many ways they offer better opportunities for business growth than the mature metropolises do.

“In our big picture now, these so-called lower-tier cities, they will be basically the major driver of growth in China in the next 10 to 15 years,” said Robin Xing, Chief China Economist at Morgan Stanley in an interview with CNBC in March.

According to Morgan Stanley, consumption in China's smaller cities is expected to triple between 2017 and 2030, due to population growth in those cities, favorable government policies on offer to enterprises that set up there, a rise in household incomes, and higher consumer spending.



According to Morgan Stanley, consumption in China's smaller cities is expected to triple between 2017 and 2030

China's "new first-tiers"

The rise in population in lower tier cities is being fueled by two factors, movement from rural areas as well as people migrating from first tier cities.

According to United Nations estimates, more than 160 million people in China are expected to move from rural to urban areas over the next 15 years, with three-quarters of them going not to the major coastal cities, but to lower-tier cities inland. Many of them would probably still opt to move to the first-tier megacities if they could, but because of high living costs and inflexible household registration policies, an increasing number are choosing smaller cities instead, especially cities close to the richer first-tier ones.

"One of the things we've seen over the last three to four years is a trend of reverse migration, with people who had moved to first-tier cities to start their careers now moving to smaller cities to help companies establish regional offices," says James MacDonald, Senior Director of Research in China at Savills.

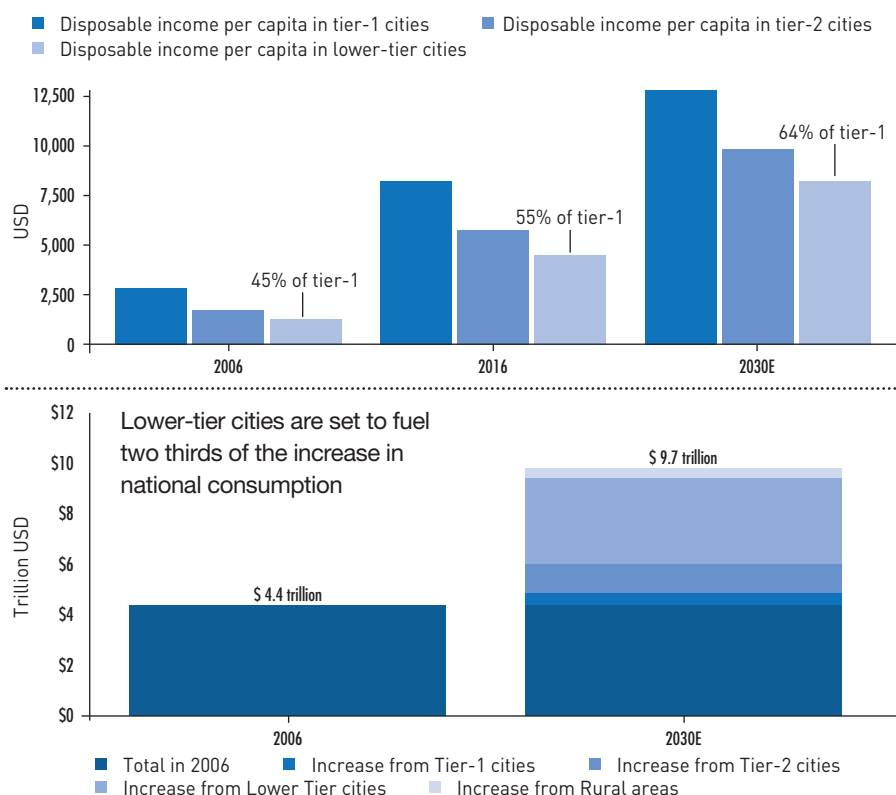
Lower-tier cities have been seeing a large amount of growth and development in recent years, driven chiefly by central government subsidies, advantageous government policies and improved infrastructure. They offer higher standards of living, rising income and opportunities brought on by enterprises moving parts of their operations inland, and more flexible handling of the household registration policy—known as *hukou* in Chinese.

Under the *hukou* system, every Chinese person is registered according to their family's place of birth and this impacts on many elements of a person's life, including health, education and welfare services, as well as the right to live in and buy property elsewhere. It has historically been used by the government as a method of population management and it can be very difficult for people to change their *hukou* from a smaller city to a larger one, or from a rural to an urban area.

In practice, this means that migrant workers from inland areas who have been living in major cities such as Shenzhen and Shanghai may not be entitled to

CATCHING UP

Smaller cities are likely to continue closing the gap with larger cities



Source: National Bureau of Statistics, Morgan Stanley Research

public welfare services there—healthcare, unemployment benefits and education for their children—despite having worked and lived there for years or even decades.

To mitigate these difficulties and to encourage migrants to move to China's smaller cities, China's state planner in April directed local governments to lift *hukou* restrictions for second- and third-tier cities, making basic services in these cities accessible for newcomers.

Cities in Jiangsu Province such as Nanjing, Suzhou and Wuxi—all within an hour's high-speed train ride from Shanghai—now report higher GDP per capita than China's first-tier cities, each more than \$18,000. But property prices in these cities are much more affordable than in first-tier cities.

"Most of our first time [home] buyers are from outside of Wuxi," says Lucy Chen, an estate agent at Zhongshan Real Estate Group in Wuxi. "They're moving to Wuxi for employment opportunities and a better

education for the children." Wuxi makes more sense than Shanghai for a number of reasons, including housing prices. "I'd say an apartment in central Shanghai is easily triple the price of an apartment in Wuxi," says Chen.

Many young people are also choosing to remain in their smaller hometowns instead of moving to the nation's megacities. "Some of my friends stayed in Yiyang because both they and their parents think that finding a stable job and remaining closer to home is ideal," says Zoe Sun, a 23-year-old originally from Yiyang, a fourth-tier city in Hunan Province. "New companies and factories have recently opened up in Yiyang, providing more opportunities for employment. There are also plans for a high-speed railway station to be built there in the future."

Ming Lu, an Economics Professor at Shanghai Jiao Tong University explains that there are two forces at play, both of which are driving migrants back to smaller cities.



Haikou, a city in Hainan Province, is considered a third-tier city in China

“The movement of people is driven by policy,” says Lu. “The central government is doing two things, one, controlling the population growth of large cities like Beijing and Shanghai using the *hukou* system and restricting land supply, and two, heavily subsidizing the hometowns of these potential migrants.”

“The first encourages migrant workers who may have been interested in, or already are living in China’s first-tier cities to move to smaller cities,” says Lu. “The second involves the ‘pulling’ of these migrants back to their hometowns or to other smaller cities.”

“Central government has been investing heavily in the infrastructural and real estate development of these smaller cities, subsidizing industries such as agriculture in the hopes of drawing the masses.”

The winners

Those that benefit from these trends are the residents of smaller cities as well as companies that have taken advantage of the opportunities that smaller cities have come to provide.

In the past, many enterprises focused their business on first- and second-tier cities, but third- and fourth-tier cities are now also emerging as pillars of consumption. Much like Pinduoduo, other enterprises

have also caught onto the potential for growth in smaller cities, with many Fortune 500 companies having opted to transfer parts of their operations to China’s inland cities. With lower costs, local government incentives, housing subsidies and a growing number of consumers in those areas, it appears to be a natural choice.

Last year saw both DHL and Lufthansa Cargo move portions of their operations to the city of Chengdu, while China’s top tech companies—Tencent, Alibaba and Baidu—have sought partnerships in inland cities to develop their AI initiatives, citing the benefits of lower tax and cheaper labor.

“Some companies are looking at first-tier cities and thinking that they are too expensive to hire employees at the salaries they’re able to offer and that smaller cities could give these employees a more reasonable standard of living for the salary they can provide,” says MacDonald.

Many small business owners also prefer setting up shop in smaller cities. “The pace of life in smaller cities is relatively slow while the quality of life offered here is quite high,” says Wu Kai, a small business owner in third-tier Rui’an in Zhejiang Province. “For entrepreneurs, third- and fourth-tier cities offer lower costs and a less competitive environment.”

Lower living costs in smaller cities

allow their residents to have a greater amount of disposable income, which increases consumption rates. The rising level of income in lower-tier cities also means a change in consumption habits, with certain sectors seeing huge growth, particularly luxury goods, entertainment and tourism.

Those living in lower-tier cities also tend to have less debt, especially when it comes to home loans, allowing them to spend more. Official data showed that growth in sales of consumer goods last year eased back to 2.7% in Beijing and 7.9% in Shanghai, but generally less developed provinces such as Shaanxi, Yunnan and Anhui saw a growth of 10% or higher.

“Consumers in smaller cities now spend about 70 to 75% of their annual disposable income,” said Frank Hu, Strategic Development General Manager, at Five Star, a Chinese investment firm. “This is compared with 60 to 65% in tier-one and two cities.”

The China Tourism Academy revealed in 2017 that interest in trips abroad in lower-tiered cities was increasing dramatically, while travel company TripAdvisor said that interest in Chinese travel to Thailand is now driven by second-tier cities as opposed to the expected first-tier ones.

Running risks

Despite the optimistic outlook that lower-tier cities may provide, there are still some key risks that need to be taken into consideration, including possible policy curbs on household leverage build-up, a housing market correction, the accumulation of local municipal debt, risks of private investment falling and a rise in US-China trade frictions.

MacDonald points out that “Smaller cities may have higher growth rates, but the actual additional value contributed to the Chinese economy is still heavily weighted toward the bigger cities, because they’re working from a larger base. So even though the bigger cities only report a 5-6% growth, they contribute more to the national economy than the 7-8% growth of a smaller city.”

The effect that the current national economic downturn may have on investment into smaller cities, particularly in infrastructural development and industry

subsidies, could be huge as many of these smaller cities still rely heavily on funding from the central government.

To keep up with expectations, smaller cities also have to adapt to the demands of its newcomers. Common issues raised have been a lack of entrepreneurship support, still too few opportunities for employment and the need for higher salaries, particularly for recent graduates. As Lu highlights, “Without jobs, people cannot move.”

There are two schools of thought on how the growth of smaller cities is going to play out. One is that consumption in inland areas may act as a buffer against the economic slowdown that China is experiencing. The other is that the growth of lower-tiered cities is to some extent artificial and therefore not necessarily sustainable. But regardless of how it plays out, the massive consumption potential of lower-tier cities could mean bright prospects for a range of consumer-focused industries, with implications for

the overall Chinese economy and global investors.

“Of course, more than a decade ago no one would have thought that the speed of development would be so fast,” says Wu.

Others, however, say it is unlikely that stronger growth in smaller cities can meaningfully offset a nationwide slowdown.

“I do not have a very optimistic forecast for the growth of lower-tiered cities in the future, because if you look at the economic growth pattern of those smaller cities, you will see that their growth is mainly driven by very heavy investment,” says Lu.

“Many of their financial resources are transferred from the central government, and their local financial vehicles. They’re taking out bonds and loans from the bank, but the return on those investments are actually very low. So, I don’t think the high growth in the past driven by investments can be sustained into the future.”

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The Sky's the Limit

Jane Sun, CEO of Ctrip, explains how China's online travel giant is pushing into new markets and gives her insight on how countries can attract China's lucrative tourism market

By Dominic Morgan

Online travel giant Ctrip is one of the great by-your-bootstraps success stories of China's technology sector.

Much like its more famous rival—Jack Ma's e-commerce juggernaut Alibaba Group—Ctrip has effectively built its market from the ground up.

When the Shanghai-based firm was founded in 1999, only 0.7% of China's population had internet access and vacations remained an unthinkable extravagance for most people.

Yet Ctrip has surfed the wave of China's growth miracle for 20 years, and today remains the country's dominant online travel player with a 60% market share. Last year, 135 million Chinese tourists made bookings through Ctrip's platforms.

This is all the more impressive considering that the Chinese travel market has attracted a number of formidable players, from US travel industry leader Expedia to domestic tech behemoths Alibaba and Meituan-Dianping.

But none of these new entrants have slowed Ctrip's rise. The NASDAQ-listed firm is now the world's second-largest internet travel agent in gross merchandise value terms. In March, its market capitalization rose above \$24 billion.

Ctrip is also expanding into the international market, buying up British flight comparison site Skyscanner and US startup Trip.com, among others.

One of the chief architects of Ctrip's success has been Jane Sun. After starting her career in Silicon Valley, the Shanghai native returned to China and joined the company as its chief financial officer in 2005.

In 2015, she became the firm's co-president, and in late 2016 she took over as Ctrip's chief executive, becoming one of China's few female tech CEOs.

Under her watch, Ctrip has continued to defy a wider economic slowdown in China, posting nearly 20% revenue growth in the final quarter of 2018.

Revenues from Skyscanner and Trip.com have more than

doubled in the past year. The company is also making a big push into China's smaller cities and rural areas by opening up thousands of brick and mortar stores. In this interview, Sun explains how Ctrip has managed to maintain its edge and what it plans to focus on next.



Q. Ctrip has outperformed expectations over the past year. To what do you attribute this strong performance?

A. No matter whether there is an upturn or downturn in the market, we always keep up our investment in our technology, services and products. Globally we have around 10,000 technical employees. We make sure that our backbone is very strong—that's very important.

The second thing is the product. During any upgrades to our app, the 60 products we offer will all be upgraded simultaneously. So, no matter whether you are looking for a winter skiing trip, a summer diving trip, hiking, weddings, photography or anything else, you can find it on Ctrip. We're the only company that can launch so many products in

a global space.

The third thing is our excellent customer service. We provide a 24-hour, seven-days-a-week service. If a customer suffers any kind of crisis—the tsunami in Japan, the Nepal earthquake—our team is always behind them to support them. That gives our customers peace of mind when they travel with us.

Q. In recent months, there has been a lot of discussion of how the trade war with the United States may be leading to a "consumption downgrade" in China. To what extent has Ctrip felt the impact of this?

A. I think there are a couple of things to say on this. First, we target business and high-end travelers, and that segment in relative terms has been very resilient. Second, I personally feel that international travel brings people together. It eliminates misunderstandings and promotes peace. So, in the global environment we have now, travel is becoming even more important.

Q. How do you expect China's outbound tourism market to develop over the next couple of years?

A. I think outbound is still going to be the leading force for China's travel industry—it is still growing very fast.

We also need to work with the government to promote inbound tourism into China. We are talking with different officials to see whether we can improve things, such as making visa application processes much easier. Instead of having to fly to London, Houston or New York to get a Chinese visa, perhaps travelers could apply online. Offering more direct flights is also important. Can we get more airports in China to host international flights? Also, can we make cities like Shanghai as convenient for foreign friends as Hong Kong or Singapore? All these things need to be addressed, and then inbound tourism also has good potential.

Q. How much potential for growth is there in China's inbound tourism market? Although the outbound market has grown rapidly in recent years, the inbound market has stayed relatively flat.

A. Yes, the outbound market is now around six or seven times larger than the inbound market. So, I think there is a lot of potential. If you look at the ease of visa applications, China has a lot of room to improve. In terms of museums, the US probably has 10 times more than China. In China, the museums are nearly all government supported. We should have more private art galleries. On high-speed rail, China is well developed, but on airports we are way behind the US. So, there should be a lot of upsides for the inbound business.

Q. What advice would you give countries aiming to attract more Chinese visitors?

A. Visa applications are also very important for attracting Chinese tourists. Chinese travelers tend to book very last minute. If it takes a month to apply for a visa, customers will automatically have to look somewhere else. Lots of countries are now offering visa-free travel to Chinese tourists, and that makes a big difference. Direct flights are also very important.

In Italy, we run something called the Welcome China program to help make Chinese visitors' experience more convenient. Rome airport has Chinese signs and Chinese-speaking staff, and airports in Finland and Russia are also following their lead. Through our Chinese Preferred Hotel program, we are also working with hotels to optimize their service for Chinese guests. We recommend that they offer some hot teas and slippers—just small things that help customers feel more comfortable.

The Italian government in particular has been very supportive. I went there and we signed more than 30 agreements with the Rome municipal government, train stations, museums, etc. They are very keen to work with us.

Q. China's online travel market is extremely competitive, and Ctrip competes directly against several very large technology companies. How have you been able to maintain your lead?

A. Every year, there are several new players coming into the



Ctrip's global headquarters in Shanghai

market to work with us or compete against us. The way we see it, when you run with fast runners, your team becomes stronger.

The other companies, their focus is not necessarily on travel. Whereas for Ctrip, our 38,000 people—our engineers, technical team, product team—focus on nothing else except travel. That is why we can provide the best product and services to our customers. We monitor what our competitors are doing, but our strategy is always to focus on our customers.

Q. Ctrip has made a big push into offline travel retail recently, opening up thousands of brick-and-mortar stores. Why are you pursuing this strategy?

A. The rollout of China's high-speed rail network has given us the opportunity to reach more third- and fourth-tier cities, and these cities have the potential and appetite to grow. So, we have started opening up our stores near these new high-speed rail stations.

Unlike in Beijing and Shanghai, a lot of people in these smaller cities may not know what Ctrip is. In these remote areas, having an official store in the center of the city or in popular malls really helps our brand. It also allows us to add a human touch to our service, and to cater to a wider demographic, as many people in China may still not be so comfortable booking their trips through an app. That's why we feel that it's a good supplement channel for us.



When you run with fast runners, your team becomes stronger

Q. How do you see your offline retail business developing compared to your online channels?

A. The potential is quite big, particularly for complex, big-ticket items. For people in Shanghai, they are so used to making a reservation online. They are willing to transfer money without seeing a physical person because Ctrip's brand is very strong. But for big-ticket items—if people are going to Japan, Korea or Thailand—many people want to see someone in a store.

Q. Ctrip has made several overseas acquisitions in recent years, including the \$1.7 billion deal for Skyscanner in 2016. What have these international deals brought to your business?

A. Skyscanner has a very strong team. Their model is price comparison, a meta-search engine for air tickets. Before we made the investment, they would redirect web traffic from their site to airlines and online travel agencies. The user experience was not maximized. So, after we made the investment, we inserted our direct booking system onto their website, so that customers could make bookings right away on their site. This enhanced the user experience and the conversion rate also increased.

Q. What plans does Ctrip have for further expansion into the international market?

A. I believe it's important for us to focus on our organic growth. If we are growing organically very well, then people will be attracted to us. With the Skyscanner deal, for example, there were many other parties that were interested in them. The reason Skyscanner came to us was that they saw how strong our execution is, how much we can achieve. That's why we made a very good "1+1=10" type of investment.

Q. More than half of Ctrip's staff members are female, which is quite unique in the technology sector. How has the company achieved this?

A. If you look at the numbers, more than 50% of Ctrip employees are female. More than 40% of our middle managers are female, and about one-third of executives are women.

There are a few things that we have done that are very supportive for our female staff. For example, when an employee is pregnant, we provide them with free taxis. When their baby is born, we give them RMB 800 (\$120) as a welcome gift and RMB 3,000 as an education fee. When new mothers return to the office, we provide nursing rooms and we offer flexible working hours.

Now, we are starting to hire more and more masters and PhD students from overseas. Some of them struggle to decide whether to focus on work or family. So, if they choose to have their eggs frozen, the company will pay for it. That's a very progressive policy and Ctrip is the first company in China and one of the first in the world to offer it, after a few tech giants in Silicon Valley.

Q. You are one of the few female CEOs at a major technology company. How does having a woman in the top job help improve gender equality in the workplace?

A. Ctrip has always been a progressive company. But as a female CEO, I understand that being a working mother is very challenging. For example, one time we had an executive working meeting off-site. One female executive had recently had a baby, and I knew that she was breastfeeding her child. I am also a working mother and had breastfed my children, so I told her to bring along her kids so that she could continue feeding her baby. If I hadn't had this experience and if she had been shy, her milk ducts would have started to retract quite quickly. And if she had a guilty feeling, that because of her work her baby could not get her milk, eventually she may have left the company.

But because I am a working mother, it was easy for me to support her, and these kinds of small issues can be addressed on the spot. That's one reason why our female leaders are very dedicated to our company.

Q. What are Ctrip's top priorities for 2019 and beyond in terms of your strategic development?

A. If you look at our history, our growth has been driven by two main factors: expanding our product offering and expanding our regional coverage.

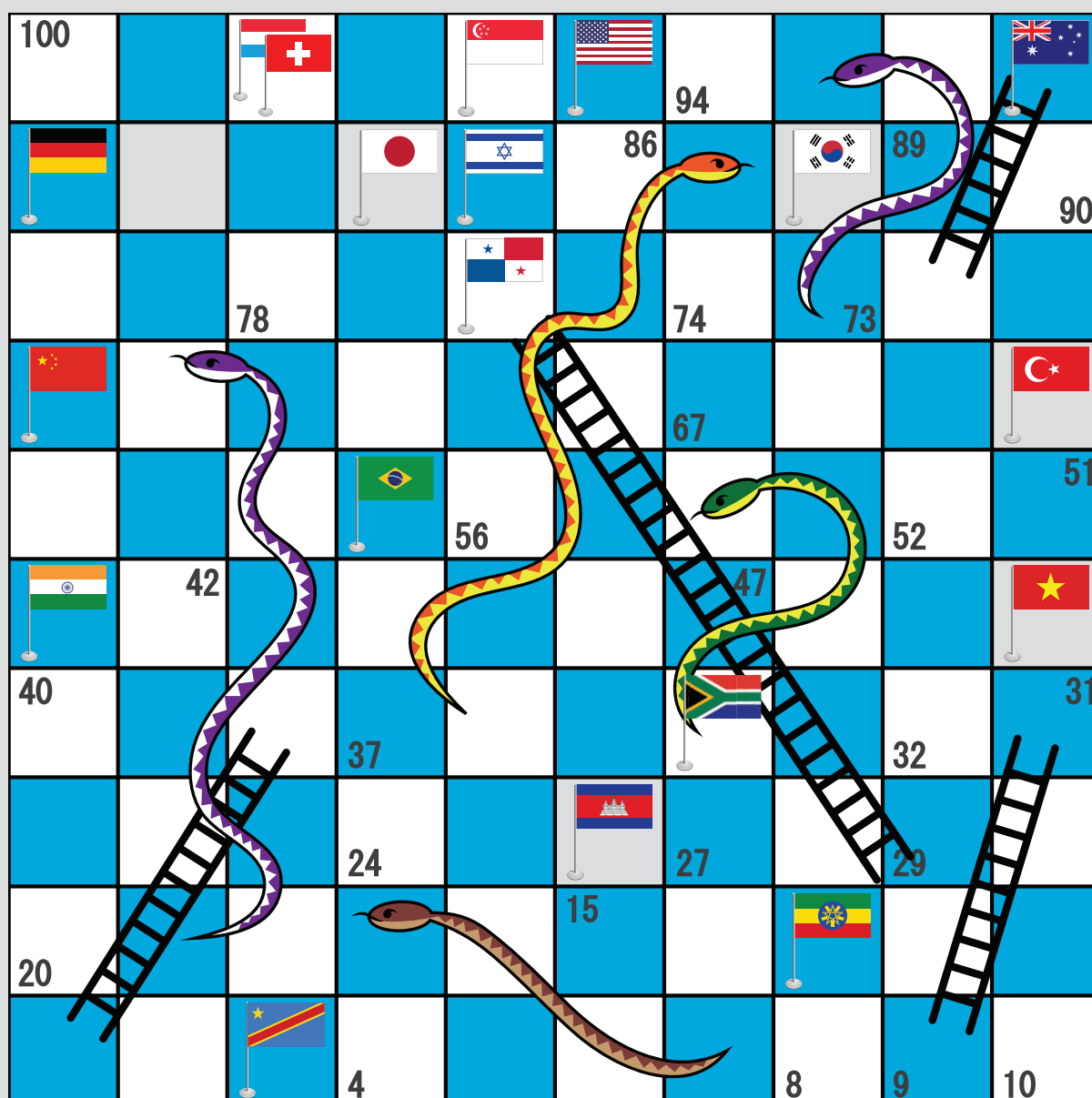
In product expansion, we started with hotels and then added air tickets, package tours, corporate travel, etc. Now, we have more than 60 products. Going forward, whatever our customers want, we need to be able to offer it, whether it is weddings, photography or diving schemes. We need to have it on our platform.

The second is regional expansion. Before, we only handled Chinese people traveling within China. Later, we started to help Chinese tourists travel within Greater China, and then the rest of the world. Now, we also handle foreign people traveling to China, and increasingly tourists traveling from Hong Kong to London, or Tokyo to Paris. So, it is an exciting time and there are a lot of things that we can do.

AIMING FOR THE TOP

Since 1960, only 15 countries have escaped the so-called “middle-income trap” to join the ranks of high-income economies. Can China beat the odds?

By Colin Shek



China's economy has grown at an unprecedented rate for decades, but now faces a whole new challenge: the middle-income trap

At a meeting of world leaders near Beijing in November 2014, Chinese President Xi Jinping gave a speech that referenced an obscure theory of economic development. “This year we have...discussed ways of leaping over the middle-income trap,” he told the audience, which included US and Russian Presidents Barack Obama and Vladimir Putin, as well as Japanese Prime Minister Shinzo Abe. Hours later, on the same day, Xi brought it up again over dinner with the other heads of state. “Major new topics such as leaping over the middle-income trap ... have been added to our agenda,” he told them.

First coined by two World Bank experts in 2007, the middle-income trap phenomenon—the existence of which is disputed by some economists—describes how growth in developing countries tends to stagnate when gross national income (GNI) per capita rises above a certain level, as higher wages push up production costs. Countries can become “stuck in the middle” as they struggle to compete with low-income newcomers where labor costs are still low, and advanced high-income economies with strong innovation.

The World Bank's latest designation for high-income status is GNI per capita of at least \$12,056. Brazil, who went through a period of spectacular growth before experiencing economic stagnation and eventual contraction, seems to have fallen into the middle-income trap, where its per capita GNI has leveled off at around \$10,000. The Philippines, the first country in Southeast Asia to begin industrializing in the early 1950s, has languished as a lower middle-income economy for more than half a century. In Mexico, GNI per capita has fluctuated in a narrow band between \$8,000 and 9,700 for the past 25 years.

“Middle-income countries are not doing nearly as well under globalized markets as either richer or poorer countries,” says Linda Glawe, a researcher at Germany's Fern Universität in Hagen and co-author of a recent paper about China and the middle-income trap.

In recent years, the middle-income trap has been increasingly discussed in the context of China, which used to make up

much of the world's poor, but now accounts for a growing chunk of its middle class. Since initiating market reforms in 1978, China has averaged gross domestic product (GDP) growth of nearly 10% per year—the fastest sustained expansion by any major economy in history—and lifted hundreds of millions of people out of poverty. China today accounts for the world's second-largest share of global GDP after the United States, and in 2017 had a per capita GNI of \$8,690—putting it squarely within the World Bank's bracket for an upper middle-income economy.

The question is whether or not that is as good as it is going to get, as there is a view that China's climb up the ladder of prosperity could be stalling. Instead of continuing to rise to high-income status, the country is in danger of becoming the biggest, most high-profile victim of the middle-income trap.

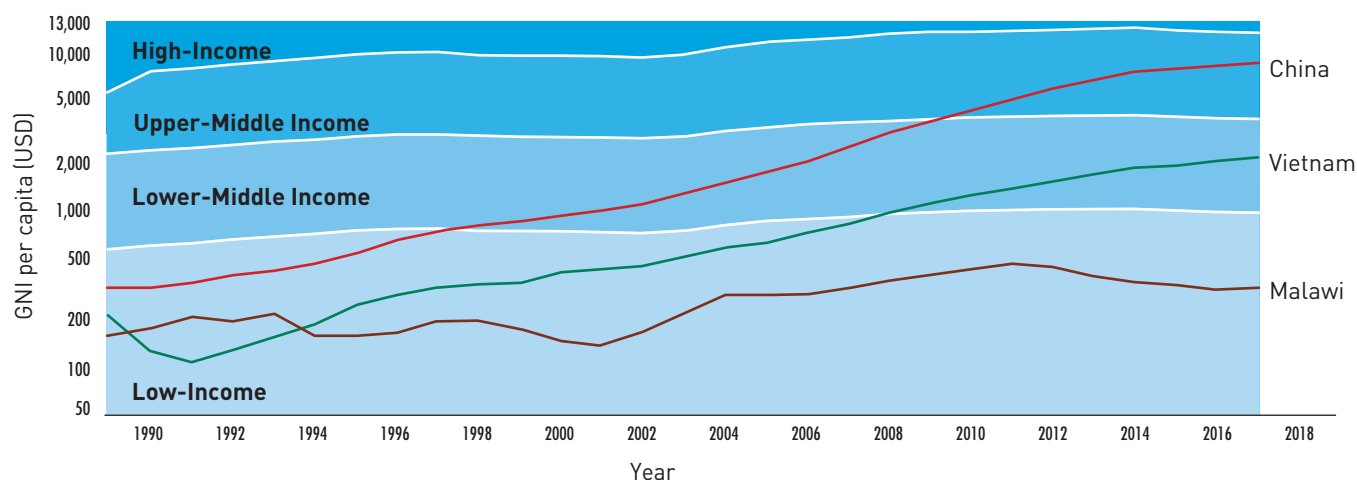
“In the long run, it's hard to say. The possibility that China can get out of the middle-income trap in the short term or next 10-20 years is there, but relatively low,” says Yikai Wang, assistant professor at the University of Oslo's Department of Economics.

In Beijing, China's top leaders are said to be relatively upbeat about avoiding the potential “trap” and believe they have bigger issues to address, according to Wang Yong, deputy director of the Center of New Structural Economics at Peking University. “They are quite optimistic about moving out of the middle-income trap. Things are different after the global financial crisis occurred, when China's leadership was really worried. But now, although China's growth rate has slowed down, I think the top leadership has more ambitious goals than just avoiding the trap.”

Making the leap

Although many countries in recent decades have emerged from poverty to enter the middle-income category, very few have made the additional leap to high-income status. In 2012, the World Bank found that only 15 out of 101 middle-income economies in 1960 had achieved developed status by 2010. Five were from East Asia—

IN THE MIDDLE | China is ranked by the World Bank as an upper-middle income country



Source: World Bank

Hong Kong, Japan, Singapore, South Korea and Taiwan. And while escaping the middle-income category is difficult, it is not impossible, with countries like Panama, Argentina and Croatia rising to join the ranks of high-income countries in 2018.

While many of these growth stories, particularly those in East Asia, offer relevant lessons for the Chinese mainland, China's growth story is unique. It underwent rapid economic expansion from a low base starting in 1978. In the year that China's late paramount leader Deng Xiaoping launched the reforms that kick-started growth, it was very poor with a per capita GDP just 1.5% of the US. The low starting point and the size of China's population were key factors in making the growth spurt unprecedented in its length.

Since then, in many ways China has followed a similar development path and growth trajectory to its northeast Asian neighbors, but it is not guaranteed to repeat the transformation they achieved. "If you compare China to these East Asian success stories, when they were at a similar development stage as China was in 2010, there are mixed results," says Glawe. She points to three factors that will determine China's ability to avoid the middle-income trap: human capital, export structure and productivity.

Investment in human capital is critical, as there is a strong correlation between quality education and economic

performance—a quality education system can stimulate creativity and in turn fuel innovation. But despite a huge cultural premium placed on academic achievement in China, human capital and education are areas where the country surprisingly trails its successful Asian rivals.

While less than one-tenth of China's population had completed secondary education in 1980, this reached a peak of 27.5% in 2000. In the following decade, however, the share declined, to 26.9% in 2005 and 22.9% in 2010—leaving China, by this measure, behind various Latin American and East Asian middle-income countries.

China fares better in export mix and productivity, the two other factors considered vital for overcoming the middle-income trap. Researchers consider

the structure of a country's exports—including export diversification and product quality upgrading—as an important trigger to escape the middle-income trap, as specializing in certain, more sophisticated products over others can generate higher growth rates.

"China's export sophistication level is higher than what would be expected of its economic development," says Glawe. "However, I think in the future, it's important to have a stronger focus on the export upgrading instead of further diversifying the Chinese export basket."

China remains fundamentally a poor country, with per capita GDP and GNI still very small compared to developed economies. But this also means there is plenty of room for growth in productivity, according to Wang. "Unless China

If China fails to catch up with the speed of integration in the global economy, the consequences will be severe

Yikai Wang
Department of Economics
University of Oslo



experiences some kind of chaos, war or something dramatic, I am confident economic growth will be quite steady. It will not be as high as before, but 4-5% is still very feasible for the foreseeable future. I think the government is also quite determined to achieve that,” he says.

Made in China

Chinese leaders have realized the need to nurture new methods of maintaining economic momentum, as the investment and exports that the economy has relied heavily upon in the past decade are beginning to reach their limits. The country has picked all the low-hanging fruit for advancing its technology, such as simple transfers of technology from importing machinery, and the initial phases of economic reform by marketization. To reach a high-income status, the country will have to cultivate new growth sources associated with innovation and technological progress, and accelerate industrial restructuring instead.

China has made some strides here, although it continues to lag behind more developed economies. Its expenditure on research and development (R&D) represented less than 1% of its GDP in 2000, but by 2016 it had more than doubled to 2.11%. While this was a notable improvement, China still trailed the likes of South Korea (4.24%), Japan (3.15%) and the US (2.74%).

China has fared better in the number of international patent applications filed—another common barometer of

innovation—with 48,900 filed in 2017, second only to the US and nearly double the 25,544 filed in 2014. Of the top 10 global patent applicants in 2017, three were Chinese—Huawei, ZTE and display panel maker BOE Technology.

In recent years, the government has also stepped up its industrial restructuring efforts. Beijing’s bold high-tech industrial development push, dubbed “Made in China 2025,” aims to promote so-called ‘intensive manufacturing’ and fundamentally transform China’s manufacturing sector from being a global giant in volume and output, to a leading manufacturing power in quality and tech prowess.

This will be a departure from its growth experience over the past 40 years, which Wang says has been largely reliant on imitation. He highlights that doubts still remain over China’s ability to innovate. “China’s really good at reverse engineering, copy and paste. Imitation will become more and more challenging for China. So how can China switch from the previous investment-based growth mode to this innovation-based growth mode? It requires a fundamental change in China’s institutions and the whole system.”

As Beijing gropes for a new growth model, it needs to contend with demographic headwinds from an aging population. China’s working-age population has edged down since peaking in 2011 and the United Nations has forecast this decline to accelerate in coming decades. This demographic change will act as a drag on

both overall economic growth and the pace of per capita GNI gains, as it pushes down the labor force participation rate. There are signs this is already happening, as China’s employed population shrank year-on-year in 2018 for the first time on record—something that only happened in China’s neighbors after they had already reached high income levels.

“China already has a very old population relative to its current state of economic development,” says Glawe. “Compared with India, China is the complete opposite. India will profit a lot from their demographic dividend, but this is one of the opportunities that will not apply to China anymore and could put additional pressure on China regarding the middle-income trap.”

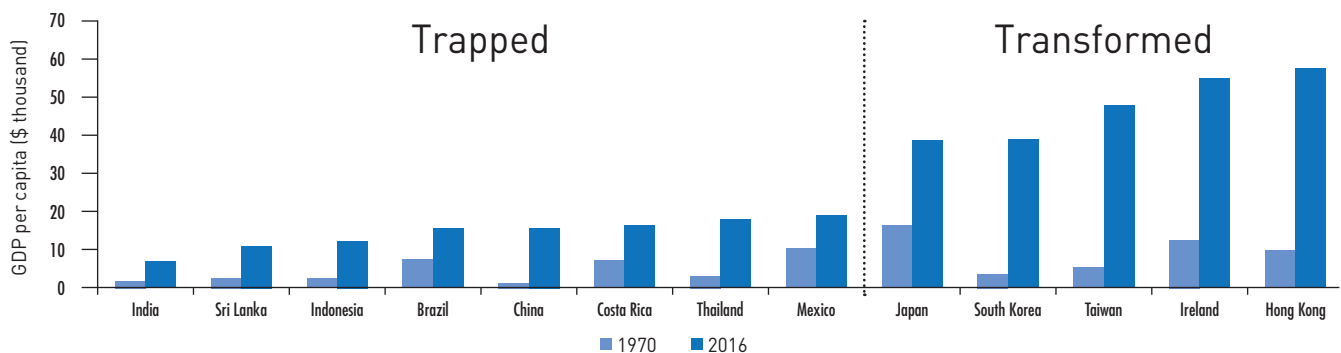
While China’s leadership has acknowledged the existence of the middle-income trap, in some ways the current trajectory of policymaking is viewed by researchers as being more likely to hinder rather than help efforts to reach high-income status.

Nearly all countries that transitioned to high-income levels underwent liberalization as they became richer. Economic liberalization was also a key driver behind China’s rapid growth from the 1980s to the 2000s, but has largely stalled during the past decade.

More recently, the government has appeared to be intent on retaining control over large swaths of the economy. “State intervention is already harming

AVOIDING THE TRAP | Economies that have reached high-income status

Gross domestic product per capita, constant prices of 2015



Source: Macrobond, Rabobank



High-tech zones, such as the Shenzhen High-tech Industrial Park in Guangdong Province, highlight how China is moving from export-led growth to new growth sources associated with innovation and domestic consumption

productivity and is likely to be a growing constraint. It becomes harder for state planners to allocate resources effectively as a country gets richer,” says Chang Liu, China Economist at Capital Economics.

Reforms have made progress in some areas, the most obvious being the opening-up of China’s financial sector. But in some other crucial areas, things appear to have moved backward, according to Liu. “It is no coincidence that a few commodity-rich economies aside, the countries that successfully reached high income status all relied on the free market to allocate resources to a degree that China seems reluctant to embrace,” says Liu.

Decisions at the top

The jury is still out on whether Beijing will succeed in lifting China out of the middle-income trap, but domestic policy officials and experts have expressed confidence that it can. In April 2018, Justin Lin, the World Bank’s former Chief Economist, said that China was on track to ascend to high-income status by 2025. Wang has a similarly optimistic view, predicting that China would enter the World Bank’s high-

income bracket of \$12,000 no later than 2025-2027. “I’m quite confident China will exceed that threshold value, so it will escape the middle-income trap,” he says.

Other experts are more conservative in their outlook, citing structural headwinds that look set to become an increasing drag on China’s growth. “Over the next two decades, we expect China’s per capita GDP to increase by 70%—far less than the fivefold increase over the past 20 years,” says Liu. “Given that the US economy is likely to perform relatively well over this period, China will remain much poorer than the US in 20 years. That said, it would probably just reach high-income status by the World Bank’s standards.”

“I would think it’s going to take a very long time. It’s hard to guess, but I would think [by] 2050. I think there are a lot of problems that China needs to solve first, so it will be more difficult than what Japan or Korea went through,” says Yikai Wang from the University of Oslo.

With this year’s GDP growth target revised down again to 6.0-6.5%, Beijing has acknowledged that China’s stellar run of economic outperformance is

becoming increasingly difficult to sustain. Slowing growth is now firmly established as China’s new normal. This presents a problem as robust growth needs to be maintained if China is to continue gaining ground on developed economies and move toward high-income status as an economy.

On Beijing’s current trajectory, and barring a major shift in the reform agenda, a combination of weaker investment, population aging and continued state intervention, it looks possible that China could stall in the middle-income area, which could have significant implications.

“If China... fails to catch up with the speed of integration in the global economy, the consequences will be severe, both for China and the global economy, says Yikai Wang. “If China’s trade and integration with the global market fails to keep improving and catching up with the needs of the technology and production changes in the global economy, then China will not be able to provide the manufacturing goods and services as it is doing now. Output and innovations in other countries and companies may not be able to grow as they are doing now.”

The Future Depends on Your Risk Attitude

Michele Wucker, policy analyst, CEO and founder of business strategy and development company Gray Rhino & Company, and author of the top English-language best seller in China, *The Gray Rhino*, teaches us how to be prepared for the significant threats that we may fail to recognize

By Liu Sha

Standing right next to the “black swan,” a popular term which refers to improbable and unforeseeable events, is the “gray rhino,” an expression coined by Michele Wucker to describe highly probable threats that have a potentially high impact yet are often ignored.

Why do leaders and decision makers so often fail to address obvious dangers before they spiral out of control? That is the topic of Wucker’s book, *The Gray Rhino*, which is essential reading for managers, investors, planners, policy makers and anyone else who wants to understand how to avoid getting trampled in an increasingly changing world.

In this interview, Wucker discusses how to avoid “gray rhinos” in both our professional and personal lives, how people should train themselves to recognize risks and do “small but right things,” and what entrepreneurs can do to protect themselves from “gray rhino” events such as the US-China trade war.

Q. The gray rhino theory tells people to avoid obvious risks, but some people feel the need to take risks in the hope of making a breakthrough in innovation. How do we balance these two ideas?

A. There are two kinds of risks. There are positive risks and negative risks. The first involves people doing things that no one else has ever done before and therefore creating something new. That’s the risk that you want to promote. What you don’t want is the second kind of risk, the one that’s taken without adequate consideration.

Such as when people see markets going up, they often decide to borrow money to invest in more shares and push the market up further, when in actual fact they don’t really understanding what’s

going on at all. That’s something that we’ve been seeing in the United States. In the last 10 years, the markets went way up because of cheap money and a lot of gullible people being pulled in at a time when the smart money and institutional money were starting to pull out.

Q. How do you differentiate between healthy risks and bad ones?

A. The problem with evaluating risk is that the answer is not necessarily obvious at first. But some of the questions to ask are: am I trying to create something new? Have I thought about the possible scenarios that could happen? Have I come up with ideas of what I would do in each of those scenarios? If you see a stock market that has gone up by 300% and it has been going almost straight up for 18 months in a row, and you know the interest rates are about to turn, does it really make sense to borrow money to buy more stocks? On the other hand, there are a lot of entrepreneurs who are all about taking risks, but not all of those risks necessarily pay out. You have to realize that some failures are steps on a path toward success. So, it’s very difficult because you may take a risk thinking you have a decent chance at success. And you may be wrong. But that doesn’t necessarily mean that it was a bad risk to take.





Michele Wucker speaking at a CKGSB event in Beijing in January

Q. There is general consensus on many of the bad risks in the world, such as water shortages and global warming, but some people choose not to worry about them because they're not seen as immediate risks. Why do people usually wait for leaders and policy makers to enforce a change before making a change themselves?

A. I created the gray rhino as a metaphor in the hopes of getting people to focus on those long-term risks. Of course, many people think that those risks are centuries away and that they're not close enough to see and therefore they don't have to worry about them.

Policy is about affecting the behavior of many people. We shouldn't wait for policies to change before we do the right thing. In Chicago, for example, a new tax on plastic bags was introduced. It didn't really affect me because I already carried re-useable bags when I went to the grocery store. But why should we wait for a bag tax before we do the right thing? Realizing that you can make changes ahead of time is very important.

One person can have a much bigger impact than you think. A snowstorm is made up of lots of snowflakes, after all. One of the reasons I think people don't always do the right thing is because they don't feel like they have the power to change anything. When you think about the fact that it takes hundreds or thousands or in many cases millions of people to curb gas emissions, it shouldn't diminish you, it should encourage you. You have the potential to join your power with the power of so many other people.

Q. Besides the big issues, what are some other typical gray rhinos that we come across in our daily lives that we should be aware of, and how can we prepare for them?

A. I think there's a connection between how we handle challenges in our personal lives, at work or in our communities. You always hear about people who are workaholics, who are absolutely on top of everything at work and try to avoid any form of a crisis,

but their personal lives are a mess. I don't think you can separate the two. Those small things that you avoid in your personal life, like making that doctor's appointment or changing the oil in your car, will end up taking over and affecting the work life that you so carefully constructed.

Therefore, I think it's very important for people to look at gray rhinos in a holistic way. By changing some of your personal habits, you can improve your ability to handle gray rhinos at work as well. It's a skill, a muscle that needs to be exercised, to recognize a risk and know how to deal with it. The more you start working on your personal life, by recognizing the things you need to deal with, the sooner that skill will transfer over into your job.

Q. How can entrepreneurs better prepare themselves for gray rhinos?

A. In general, I think the first thing entrepreneurs should do is to come up with possible scenarios of what may happen in the future, based on the present. What is the worst-case scenario for your business if the trade war drags on? What is the best case and medium case? What are your strategies for each of them? It's important to visualize your strategies ahead of time and to assess whether or not you have the right resources to manage the worst-case scenario. Just by facing up to the possibility will help you be better prepared. That way you're not making decisions in panic-mode or at the end when you don't have a lot of options available to you. A further step is to consider whether any opportunities could present themselves in the scenarios you thought of and how you could make use of those opportunities.

Q. Based on your experience in handling gray rhinos, what is your prediction on the US-China trade war?

A. The trade war is a very big gray rhino. It's both a political issue and an economic issue. There has been a lot of concern

over the global economy being close to the end of a business cycle, and starting a trade war accelerates that growth cycle. It increases the risk of an economic recession.

There is a lot at stake for the US. There has been a great deal of tension over growing inequality in recent years, seeing as most of the country's monetary expansion went into stock markets and not into jobs and wages. There's a lot of tension over jobs that have been lost to automation, and it's the oldest political trick in the book to blame that on immigrants and on other countries.

With that being said, many countries have also felt that China's trade policies are more suitable for how China used to be in the past, where it was a developing country, and not the world's second largest economy. And as China's economy has grown and gained more economic power, the US is now tapping into some of their resentment of that and the perception of China as more of an economic threat.


I think there are areas that would be very much in China's interest to address. For example, strengthening intellectual property protection as China develops more and more intellectual property of its own, is very much in its own interest. It is also in China's interest in terms of smart power to open up a conversation about countries that are still developing, how their growth in technology might be used to help countries that don't yet have the power to develop the technology themselves. And then in terms of access for foreign investment, I think China has already recognized that it is in its own interest to bring in more investment.

So, I think it's more a matter of China identifying the areas in which it already has its own interests. There is still this perception internationally that China's walk doesn't yet match its talk. China could really dramatically change the situation by making some moves that are already in its own interest, but doing so in a way that portrays them as proactive rather than reactive.

Q. Well-known Chinese economist Xu Xiaonian suggested that the Chinese economy is facing several sharp-horned gray rhinos—the trade war, and also low productivity and mounting internal debt. Based on your observations of China, what do you think of Xu's comment?

A. I think increasing productivity is a very good focus to have. Questions arise as we start using more artificial intelligence and automation, but in some cases you can actually dramatically enhance human capabilities if these advancements are used responsibly, particularly if there is a focus on investing in human capital.

It's very important for countries to look at the resources that they are putting into building their human capital, as well as financial and physical capital. In the US, for example, we have the problem that there are much bigger incentives to put financial capital into secondary securities markets where they're not necessarily going into productive activity. Obviously, China's economic strategy is very different. But I think in any economy,




It's important to visualize your strategies ahead of time and to assess whether or not you have the right resources to manage the worst-case scenario.

no matter how well it's performing, it's important to ask yourself over time, what are the things we're incentivizing and the things that we're not? And are we really putting priority on the things that we need to do?

The other part of that question involves how markets can help allocate capital. How the government can provide a proper policy environment is a difficult question that I know China has been wrestling with over the years. How do you incentivize the things that are important without burdening the market and slowing down the things that the market can do well?

The other risk is debt. China has done a very good job in identifying the financial risks at stake and has taken some steps to deal with those risks. It's very difficult to slowly let the air out of asset bubbles instead of letting them pop. But I think China has very much done the right thing in starting its attempt to do that. We need to make it easier to restructure debts that aren't doing what they ought to be. And realize high risk borrowing pays higher interest rates because they're higher risk.

Things like that are much easier to do if done in an orderly way. Just look at the difference between Argentina's collapse in 2001, which was completely chaotic, and Greece in 2012 when they restructured. Obviously it wasn't easy, but it was done in a much more orderly way. And so that amount for foresight in making difficult decisions can really make a difference in the way it's managed.

The sooner and more strategically those decisions are made, allows time for a more gradual approach, instead of having to clean things up after a crisis. 

E-COMMERCE LAW & ORDER

**Can China's new
e-commerce law tame
the world's largest
and most-disorderly
online retail market?**

By Matthew Fulco



Image by José Luna

China has introduced a new e-commerce law to tackle counterfeit goods and tax evasion, but how effective will the law be in better regulating the massive online consumer space?

Adidas's Yeezy sneakers designed by rapper Kanye West have been among the world's best-selling footwear since they were released in 2015, and a pair of Yeezy Boost 350 V2s retails for up to \$1,000 on most e-commerce sites. But on Alibaba's Taobao site, the world's largest online marketplace, vendors offer the same pair of sneakers for as little as RMB 300 (\$45).

That sounds too good to be true, and it is. They are counterfeits.

Chinese consumers aren't fooled either. "Chinese consumers are among the savviest in the world when it comes to detecting fake goods—they've had a lot of exposure," says Dean Arnold, managing director of Shanghai-based consultancy O2O Brand Protection. "They buy fake fashion items when they want the brand, but at a fraction of the real price."

China's e-commerce titans have robust takedown systems in place, but ultimately the burden has been on the authentic brands to report the offending listings. The brands lack the manpower to catch most of the counterfeiters, and also the legal machinery to counter the counterfeiting, which is not confined to Taobao—it is a feature of just about all Chinese online market platforms. WeChat, as a Chinese multi-purpose messaging and social media app that is often compared to WhatsApp, is also regularly used as a sales platform for counterfeit products.

"Selling inferior-quality products is the most pronounced illegal practice found

on WeChat stores and live-streaming platforms," Piao Xiaolin, a senior official at China's Consumer Association, told Xinhua in a January interview.

This could all change dramatically with China's new e-commerce law, which holds the e-commerce platform operators jointly liable with the individual sellers for infringements. Effective January 1 this year, the new law applies to e-commerce marketplaces like Taobao, WeChat, as well as any websites where goods are sold. For instance, if a fake Hermès bag was being sold on Taobao, under the new law both Taobao and the seller are liable and both could be punished.

The e-commerce law, which has been promulgated but not yet put into effect, stipulates that platform operators may be fined up to RMB 2 million (\$291,000) for instance of intellectual property infringement.

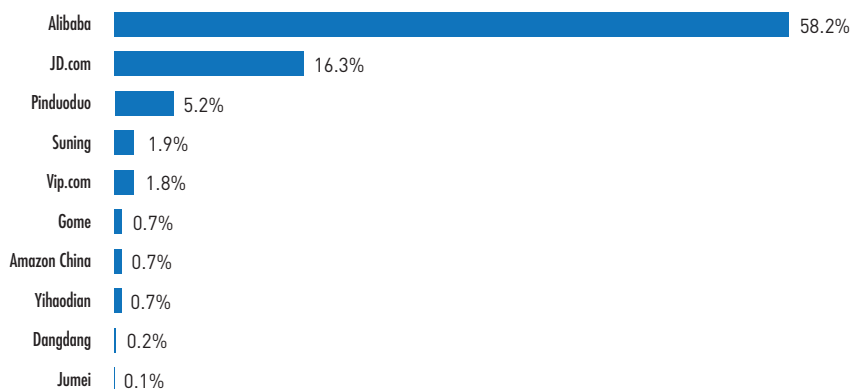
The law also requires online sellers to obtain business licenses and pay taxes. For small overseas purchasing agents—more commonly known as *daigou* sellers in China—who import goods into the country through gray-market channels, the new law could spell trouble: for many their business model is only profitable because they don't pay any taxes.

"The government doesn't want to walk away from the tax revenue anymore," says Ben Cavender, a director at the Shanghai-based China Market Research Group (CMR).

A WIDE MARGIN

Alibaba continues to lead retail e-commerce sales in China

Top 10 e-commerce retailers in China as of June 2018, by sales share



Source: eMarketer, Statista

SHOPPERS' PARADISE | The top channels for e-commerce channels in China, broken down by category of sales

B2C STANDALONE eSHOP	B2C PLATFORMS	B2C ONLINE MULTIBRAND RETAILERS	B2C PRIVATE SALES SHOPPING CLUBS	C2C MARKET PLACES
  	    	     	   	  

Source: web2asia

The e-commerce law comes as Beijing moves to assert greater control over the world's largest online shopping markets, which were valued at \$1.1 trillion in 2018, according to research firm Forrester. Forrester reckons online sales in China will grow at an 8.5% clip to reach \$1.8 trillion in 2022, compared to the US e-commerce market, valued in 2018 at \$713 billion.

Li Jiao, a counsel in the Amsterdam office of law firm Buren, describes the e-commerce law as a mini-constitution for China's e-commerce regulatory system, establishing ground rules to ensure that the industry develops stably. Addressing criticism that the law lacks specificity, she says that China's State Council is expected to enact further practical enforcement guidelines in due course.

"Chinese law usually establishes a concept first and then a framework by which the law is enforced," she says. "The direction is clear: The industry will be subject to the same regulatory requirements as offline retail."

The long arm of the law

The e-commerce law will arguably affect platform operators the most. The burden falls on them to keep the marketplaces on the straight and narrow. That in itself is a reasonable goal, but the sheer number of fake goods on sale in China makes

combating the counterfeit trade a tough task.

Counterfeits appear just about anywhere that goods are sold online in China. The largest platforms have the most fakes, but they're also best positioned to address the problem. They have deep pockets and advanced analytics capabilities. Alibaba, with a market capitalization of \$442 billion, can afford to spend a bit of cash on anti-counterfeiting. So can Tencent (the owner of WeChat), which is valued at \$418 billion.

The Chinese government is also concerned about fake products that affect human health because they pose real dangers to consumer safety.

In March 2017, as his company faced an onslaught of criticism about fake goods on its

platforms, Alibaba founder Jack Ma called on China to get tough on counterfeiting. "We need to fight counterfeits the same way we fight drunk driving," he said on his blog. "For example, if the penalty for even one fake product manufactured or sold was a seven-day prison sentence, the world would look very different, both in terms of intellectual property (IP) enforcement and food and drug safety, as well as our ability to foster innovation."

It isn't clear if the e-commerce law as it has been promulgated is what Ma had in mind, but it certainly places the onus on operators to police their platforms more aggressively. "They will have to put their money where their mouths are," says

Chinese consumers are among the savviest in the world when it comes to detecting fake goods—they've had a lot of exposure



Dean Arnold
Managing Director
020



Chinese workers sort out piles of parcels, most of which are from Singles Day online shopping (11/11), at a distribution center in Chengdu, Sichuan Province

Arnold of O2O Brand Protection. “The big operators are fully capable of proactively removing infringing listings, but until now they’ve never had financial reason to do so.”

The *Daigou* purchasing agents face a grimmer situation. Indeed, the e-commerce law strikes at the heart of their business model: private imports that can be sold at competitive prices only because they evade duties. In a February report, China’s state-run *Global Times* newspaper reported that Japanese duty-free retailers’ revenue fell over the Lunar New Year holiday in tandem with fewer purchases by Chinese customers. Retailers in Japan had been accustomed to *daigou*-powered shopping sprees.

Japanese brands have become so popular in China that thousands of Chinese residents in Japan are believed to be working as *daigou* merchants, Japan’s *Nikkei Asian Review* reported in March. But this era could be drawing to a close now that they are being forced to compete on a more level playing field with licensed importers.

Bigger *daigou* merchants are likely to register as companies, pay taxes and become legitimate businesses, while smaller ones will probably close shop, says CMR’s Cavender. “The lady who sells a small volume of merchandise through her WeChat group isn’t going to want to deal

with the complicated paperwork and accept low margins.”

With that in mind, Chinese consumers may end up paying higher prices for imported goods in high demand, like luxury goods and nutrition supplements, he says. With fewer gray-market options, “it will be harder to get a good deal,” he says.

By the same token, Beijing is mindful of ensuring fair competition in the e-commerce market, notes Mark Tan, a partner at Taylor Wessing in Shanghai. “The law addresses the complaints of licensed importers—that *daigou* merchants have an unfair advantage because they don’t play by the rules,” he says.

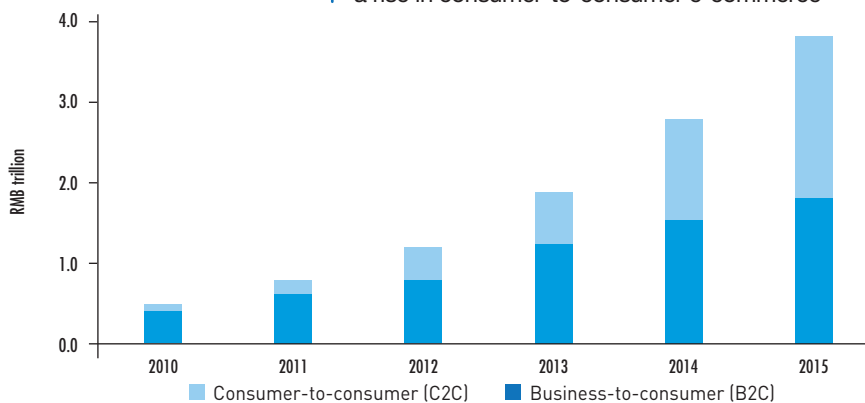
Another group of operators affected

by the law are overseas sellers without a physical presence in China. Before the law was enacted, they could sell goods to Chinese consumers from overseas without registering as a business in China or paying taxes there. Those days are apparently over.

The e-commerce law applies to all e-commerce business activities within China’s borders, therefore including the sale of products on a Chinese e-commerce platform by a foreign business, even if they do not have a Chinese entity. According to the American Chamber of Commerce, even the sale of products on a foreign website by a foreign entity to a consumer in China will likely also be considered to have occurred

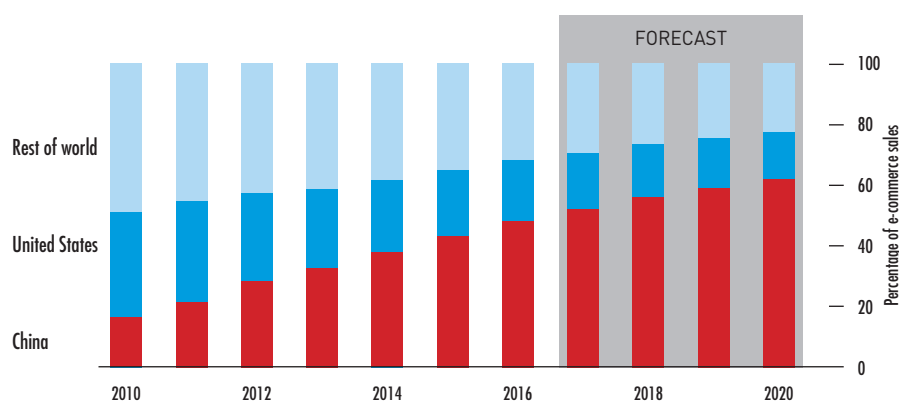
THE RISE OF C2C

Online shopping in China between 2010-2015 saw a rise in consumer-to-consumer e-commerce



Source: KPMG, China E-commerce & O2O Summary Report

E-COMMERCE DOMINANCE | Retail e-commerce sales worldwide



Source: eMarketer, The Economist

within China and therefore subject to the e-commerce law.

International law firm Harris Bricken highlights that it may be challenging for foreign companies, especially smaller businesses, to comply with these requirements. Already, some foreign stores that used to ship their products directly to China for their online sales have rather opted to open shops on large Chinese e-commerce platforms through a Chinese distributor or subsidiary. Others have pulled out of the Chinese market entirely.

There could also be a significant impact on the cross-border delivery model, says Taylor Wessing's Tan. "The law gives Chinese authorities regulatory oversight over vendors outside of China selling to Chinese consumers," he says. Those who fail to comply with the law could be subject to punitive measures, such as having their goods detained or their website blocked in China.

"Operating onshore [in China] will become more expensive, but will be necessary to mitigate risk," he says.

The devil is in the implementation

E-commerce industry stakeholders are watching carefully to see how Beijing enforces the law. While they agree that Beijing intends for the law to create a more orderly e-commerce environment, it is unclear how effectively the law will be implemented.

"It's a question of manpower and

political will," says Matthew Dresden, a partner and China expert at international law firm Harris Bricken. "We'll see if it has teeth."

For effective intellectual property protection, however, implementation at the local level is crucial. For instance, China's big tech companies have been cooperating with local law enforcement for years and Alibaba regularly helps local authorities track counterfeiters by providing evidence of their illicit online activity. The e-commerce giant "has a very good takedown and verification system—it's comprehensive," says Buren's Li.

But under the new law, the onus is on Chinese authorities to punish the offenders, and they have tendency to sometimes look the other way. For instance, in August 2017 authorities in Shaanxi Province apprehended counterfeiters infringing on the trademark of China's Tsingtao Beer. Since the bogus beer were only valued at RMB 30,000 (\$4,340), authorities decided it wasn't worth their trouble to charge the suspects with a crime. Instead, they just made them empty all the bottles. In fact, they didn't even confiscate the bottles, apparently suggesting they could be redeemed for cash at a glass recycling center.

"They [the suspects] could make much more money by refilling the bottles with more fake beer," says O2O Brand Protection's Arnold. He notes that fake goods sometimes make important

contributions to local economies in China, and for that reason, authorities may be loath to put counterfeiters out of business.

Cases that do reach the courts face challenges of their own. "There are a huge number of cases involving counterfeiting, while China has a limited number of judges with deep knowledge of IP protection," says Li. "It will take time for the judiciary to develop broader expertise in this area."

One area where Chinese authorities are clearly enforcing the e-commerce law is the inspection of goods brought by individuals into China from overseas. It is precisely such strict custom checks that are discouraging *daigou* merchants from bringing goods into the country that could be construed as intended for commercial sale.

"*Daigou* [merchants] will have to be more careful about what they bring into China," says CMR's Cavender.

What the law will have the most trouble changing is entrenched Chinese consumer behavior. The interest in fake goods and in cheap parallel imports won't disappear overnight, even if they become harder to find online.

One Chinese consumer, an experienced Shanghai-based financial services professional, told *CKGSB Knowledge* that she buys high-quality fake designer handbags that she uses outside of Shanghai—where she isn't surrounded by her colleagues and friends. She uses the authentic handbags for work and social functions in Shanghai.

"A fake is 1/10 the price of a real one, and I can use the money I save to buy other things I want," she says.

Some Chinese consumers don't care if goods are fake or not, and they certainly don't care if products they buy came to China legally with import duties paid, says Li. "They may not see trademark infringement as inherently wrong, or a reason to not buy a product. It's related to education."

If the law were to make the purchase of fake goods a crime, there would see a sharp decrease in demand for counterfeit and parallel import goods, "but the law doesn't work that way," she says.

Cleaning Up China

Simon MacKinnon, Chairman of Xeros China, explains how foreign companies can take advantage of China's fast-growing environmental sector

The Chinese government has set high “green” targets for China, revealing how environmental protection has become a major growth industry in recent years. Government officials talk of building an “ecological civilization,” and planners estimate that this transition toward becoming a more environmentally-sustainable society could require a whopping \$19 trillion of investment.

Gaining a foothold in this fast-growing sector can be a challenge for foreign firms, but for those with the right products and mindset, China's environmental sector still offers massive opportunities, according to Simon MacKinnon, head of China for environmental technology firm Xeros Technology Group.

MacKinnon has more understanding than most of what it takes to succeed. He has spent over 20 years working on environmental projects in China, in fields as diverse as automotive emissions control, water treatment, solid waste processing and soil remediation and “can't remember a time when there was such opportunity in the environmental sector.”

In this interview, he discusses what these experiences have taught him and what foreign firms need to do to thrive in the Chinese market.

Q. How has China's environmental sector changed over the past 20 years?

A. It has changed dramatically. It has grown at a tremendous rate, for both foreign and Chinese companies alike. Most importantly, the Chinese government has made environmental protection one of its top priorities. Two decades ago, the focus was on economic growth and the environment was low on the list of national priorities. Today, “building an ecological civilization” is top of the priority list. We saw it at the 19th National Party Congress

in 2017 and we saw it again at the “Two Sessions” meetings in March.

Having been involved in five or six different areas of the environmental sector, from auto emissions control, to power station emissions control, municipal waste issues, water quality issues and water reduction, I see openings for commercial solutions in all of these areas. If you have environmental products, services or technologies, if you want Chinese partners to work with or if you are looking for investors, China is a great place to be now.

Q. In your experience, how do foreign firms need to adapt to succeed in China?

A. There are three key items:

The first is alignment with China's priorities. This is not so different to the rest of the world: the environmental sector is a regulation-driven industry par excellence, so you better know what the goals and the rules are, what the incentives are by region and by city, who the industry players are and what is available for foreign firms to invest in and what is not. The key is working with the grain, not against it.

The second is strategy. A smart strategy is always the key to market success in China: deciding what you're going to do, what you're not going to do, and being really brutal in that and understanding your strengths and weaknesses. You have to be clear that you've got no right to be a player in China, you've got to earn orders and trust from customers just like in every other country in the world.

The third is timing. There are some sectors where the timing is ripe; there are others where it is really competitive now; and there are some that are just too hard because there are too many players and some very strong local players, as well as maybe some



protections and special incentives for domestic firms.

A related point on timing is that you can't look for a quick win. China is a market that requires a long-term commitment. As Bill Gates once said, 'we all overestimate what we can do in a year, but underestimate what we can do in a decade.' That has proved to be the case with all my environmental projects in China: it is more like a steady run than a sprint. The rewards will be there if you can commit the time and the resources.

Q. The government plays a particularly extensive role in the environmental sector. How does dealing with the Chinese government compare to dealing with governments in other markets?

A. All governments work for their country's national interest. My Chinese colleagues and I don't buy the argument that the Chinese government is mystical or different. Today, there is a lot of experience and capability in the ministries, provinces and city governments.

So, I would advise thinking about what your company does elsewhere in the world. Are you actually any good at dealing with government and government-controlled companies? You have to be very honest with yourself about this. If you do not have a lot of government customers or experience, you need to think seriously about whether spending time, resources and capital on entering China is worthwhile.

Some companies have it in their DNA when it comes to dealing with governments. I've worked with Siemens on projects in the past, and they are very good at dealing with governments. This helps them when it comes to working with the Chinese government and state-owned enterprises. Other companies hire the best people they can find to lead or fill gaps in their teams in entering China market and in working with government.

Q. What are the common mistakes that foreign companies make in China?

A. A common mistake is treating the Chinese government the same as you would treat the government in your home country. Every government is different; each one deserves respect. You have to develop relationships; you have to understand their priorities and the pressures they are under. These days, Chinese government organizations have KPIs—they are being assessed for their bonuses and promotions, and you'd better know what they are and how you can align with their organization and what they are trying to achieve. It's not rocket science: many companies do that very well in other parts of the world. Sometimes I say to people, 'it's different, but it's the same.' You've just got to do it in a Chinese context.

To do that you need to have talented and senior Chinese on your team, just as to win in the USA a Chinese company needs to have senior Americans on its team. If you look at many of the big foreign company success stories in China—such as Honeywell, General Motors and Volkswagen—they've all got very senior Chinese leaders who are empowered. These Chinese leaders

know the culture of the foreign organization, and they are also very well attuned to the market and to what China, the SOEs and their partners are trying to achieve.

I'm also a big advocate for foreign companies holding board meetings in China. It is one of the most effective ways to help your company's directors understand the opportunities and the challenges of doing business here, as many will have never been to China. Try to get them out of comfortable five-star hotels in Shanghai or Beijing and visit third- or fourth-tier cities. Look at your board and then talk to your CEO or managing director and say, 'if this market is important, then this year, out of your seven or eight board meetings, if you're doing one in Asia, can you do one in Beijing or Shanghai?' Then, you have the opportunity to discuss a lot of issues.

Arm them with questions, challenge them, and help get your team up to speed on the real issues in China. The Chinese government wants to see commitment from foreign companies. If you're going to succeed, these people need to be exposed to China.

Q. Your first major environmental project in China was a deal to build a water treatment plant in Shanghai. How did this deal come about?

A. This was during my time working at P&O, the British shipping and services conglomerate, which at the time owned Bovis Construction, a leading construction management firm.

By the mid-1990s, Shanghai was growing fast thanks to the opening-up policies announced by Deng Xiaoping, and the city's infrastructure was struggling to cope with this growth. At the same time, difficult as it is to believe now, China was also short of foreign exchange. This meant Shanghai was looking for both world-class technology to help expand its water treatment capacity and also for funding for projects.

As a result, Bovis Construction in partnership with Thames Water [in the UK] was able to negotiate a deal to build a water

**The rewards will
be there if you
can commit the
time and the
resources**



treatment plant in Shanghai as a build-operate-transfer, or “BOT,” project, in a joint venture with Shanghai Water Company. We secured innovative funding for the project in the form of offshore limited non-recourse financing, one of the first China projects to succeed in doing this.

BOT infrastructure projects were already fairly common in the UK and other markets, but it was a pioneering project in China at the time. There were few regulations to cover this type of project, so that meant the negotiations were very long and interesting, to say the least. Shanghai wanted to sign the deal; we wanted to sign the deal. It was then a matter of what could be approved.

Q. You have also helped one of China’s major building materials firms, Huaxin Cement, transition into waste management. How did this come about?

A. I joined the board of Huaxin, a Shanghai A-share-listed company, in 2015. At that time, Huaxin’s CEO Li Yueqing, who is one of the leaders in the cement industry in China and a visionary, saw that in other countries many cement makers get involved in adjacent areas. He is also passionate about the environment. Cement plants are dirty, and Huaxin has some of the leading technology in the industry. We have as our largest shareholder Lafarge, of Switzerland, and we have been able to benefit from their technology support.

What Huaxin has done is respond to one of China’s priority tasks in the environmental sector: waste management. As approximately 1% of China’s population moves into cities every year—that’s around 80-100 million people over the past decade—the challenge of disposing of municipal solid waste has become enormous. The landfills have filled up.

So, Huaxin was the first cement maker, and still the leading cement maker, in working with Chinese cities to take their waste and then completely process and recycle it in our kilns. It’s a total solution—it’s a win for the cities and for the environment in terms of closing down landfills, and it’s a win for Huaxin as it helps us reduce costs. It’s a beautiful example of business and government working together, and China’s now increasingly using cement companies and power companies to solve this problem of municipal waste.

Q. Why are local governments willing to pay Huaxin to process waste rather than putting it in a landfill?

A. First of all, it’s common practice. Worldwide, governments pay so-called tipping fees for recyclers and waste processors to take that waste off their hands. Second, landfills around the world are pretty tough places. They have a tendency as things decompose to release gas, which sometimes leads to explosions—they’re not safe places. Far worse, many of them leach poisonous chemicals into the ground and into the water supply. In China, as elsewhere, with the huge volume of waste, you don’t want to live anywhere near these places. And they increasingly take up land.

So, if you can avoid all these problems by paying someone who has the technology and certified means of disposing of the



In all my 35 years in China I can’t remember a time when there was such opportunity in the environmental sector

waste, it is far better for the government, which is sensitive to the needs of its inhabitants, to use this kind of solution and close the landfills, just as we have been doing in Europe and the US. And make sure we’re not using more agricultural land for this purpose.

Q. Where do you see foreign companies finding the most opportunities in China’s environmental sector over the next five years?

A. I’m an optimist and a realist. As an optimist, in all my 35 years in China I can’t remember a time when there was such opportunity in the environmental sector. Across air, water, waste, soil, plastics, sustainability and more, in sub-sector after sub-sector China has challenges and now has policy priorities where it is looking for solutions. The government knows that some of those solutions will come from overseas partners and technology providers. China is developing a lot of its own technology, but there are many opportunities for foreign companies. China wants experience and it wants the best from around the world.

As a realist, of course there are challenges. Lots of them. There are market access challenges. There are incentives for Chinese companies. There is cheap money for your competitors. There is an enormous amount of Chinese government money going into R&D. Everyone is aware of “Made in China 2025” or whatever replaces it. Execution is challenging. Government will favor local suppliers just as they do in other countries. So, you have to be realistic about the competition.

However, if you do your research, you have the right people on the team and you have a strategy that learns from others and is well aligned with China’s objectives, you can succeed in China’s environmental sector.

CLIMATE OF MISTRUST

China's latest vaccine scandal is the latest in a long series of fake and substandard drug scandals. Has the public lost all confidence in drugs made in China?

By Timothy Ang

After a stream of scandals and medical incidents, the Chinese public appears to be losing faith in drugs made in China. What are the implications for domestic and international pharmaceutical companies?

In January 2019, thousands of protesters marched the streets of Jinhu County, in China's eastern Jiangsu Province, to voice outrage about something that has become all too familiar: another vaccine scandal.

According to the local government report, "only 145" children between the ages of three months and four years had been given expired oral polio vaccines under the state inoculation program. The news broke when one mother wrote online that her child's dose was three weeks out of date, which was quickly corroborated by other nearby parents.

This time, the protests got ugly. A viral video of the county Communist Party head being mobbed to calls of "Beat him! Beat him!" seemed to capture the fury of the parents. The scandal sparked a nationwide probe and 17 officials were punished for their negligence.

Just months earlier, the country was rocked by news of a much larger incident involving over half a million doses of substandard vaccines for rabies, diphtheria, tetanus and whooping cough. The ensuing investigation revealed that the pharmaceutical firm responsible, Changchun Changsheng, had falsified its production data to hide the fact it was using expired ingredients and illegal production procedures in order to cut costs.

"This vaccine case has broken the moral bottom line," said Premier Li Keqiang before opening the inquiry. Changchun was fined RMB 3.4 billion (\$510 million) and stripped of all pharmaceutical licenses.

"The main impact of the string of scandals has been to pressure the leadership into recognizing the sensitivity of quality healthcare as a political issue," said George Baeder, senior vice president at clinical contract research firm dMed Global in Shanghai. "It's clear now that this can no longer be ignored or dealt with in an ad hoc crisis manner."

The challenge before the government is clear: restore confidence in the system or risk jeopardizing the growth of China's \$130 billion healthcare industry.

Trust deficit

When a company makes a PR fumble, such

as Samsung's infamous exploding phone of 2017, it can cost millions of dollars to resolve their tainted image. The incident caused Samsung's global market share in premium phones sales to plummet from 35% to just 17%. Similar blunders can cause companies to close the door on a large chunk of business.

For China, the scale of the challenge is enormous. The government has to convince the world's most populous nation that it is willing and able to overhaul the entire health regulatory infrastructure. This means re-examining all parts of the domestic healthcare machine, from supply chains and research to imports and hospitals.

China's pharma market was worth \$123 billion in 2017, according to consultancy L. E. K., making it the world's second largest by sales behind the United States. This is expected to jump to \$160 billion in the next five years as the Chinese population ages and gets wealthier, aided by a steep increase in nationwide R&D spending as part of Beijing's "Made in China 2025" industrial development policy.

China is also emerging as a powerful exporter of pharmaceutical ingredients to other markets, especially the US. Besides traditional plant-based products, domestic manufacturers are stepping up their production of generic drugs—those for which original patents have expired, such as paracetamol—to sell overseas, connecting China with the global pharma market and its standards.

But so far, a combination of size, corruption, and cultural attitudes toward healthcare have long dragged down regulatory standards for end products, scarring the reputation of Chinese goods among patients and consumers.

China is still getting to grips with how to effectively marry regulation with what was for decades an industry in which production was entirely state-controlled. The first central regulatory body, and all accompanying legislation, was set up only in 1998, just over 20 years ago.

"The previous government manufacturer, the State Pharmaceutical Administration, was concerned with output rather than quality," said George Baeder.

“It had limited control over individual plants which were under the influence of provincial governments.”

Since then, an explosion of pharmaceutical oversight departments has often led to clumsy delegation of responsibilities. Before the landmark government reshuffle in spring of last year, the lack of clarity on the remits of the National Health and Family Planning Commission (NHFPC), the Ministry of Agriculture (MoA), the General Administration of Quality Supervision, Inspection and Quarantine (GAQSIQ), and the Food and Drug Administration (CFDA) inevitably created regulatory loopholes for players in the giant sector. With an estimated 6,000 pharma manufacturing sites throughout the country, the auditing requirements are staggering.

China has one of the most under-resourced healthcare systems in the world, both on the regulatory side and in terms of medical provision. In 2017, the CFDA reported around 300 internal reviewers, while the United States Food and Drug Administration (FDA) had an estimated 2,000. There have also been reports of high-level corruption in the past, typified by the execution of former chief of the State Food & Drug Administration (SFDA) in 2007, for accepting \$850,000 in kickbacks.

Despite steady annual increases in expenditure, the total healthcare spend in China only amounts to 3% of the world total and that is to look after 22% of the global population, according to China CITIC data. Similar to Canada, almost the entire Chinese population is covered by state-run health insurance. But since the coverage doesn't extend to many essential services, people still have to pay a large share of medical expenses from their own pockets.

An explosive account by the Chief Executive of iKang Guobin Healthcare Group late last year shone the light on how this may have allowed scandalous behaviour to creep into China's \$10 billion medical examination industry. Speaking at the Chinese Enterprise Leaders Summit, Zhang Ligang reported that nurses were posing as doctors to draw blood for a screening, and then fabricating results to

avoid doing the work.

“Trust really is the underlying problem,” said Dr. Scott Wheelwright, founder and principal consultant of Complya Asia. “In many respects, China has an even closer eye on its drug market than other countries, but this is an industry-wide problem, particularly for economies at an earlier stage of development.”

This endless stream of drug and medical scandals has eroded Chinese public trust to the extent that many patients now look elsewhere for healthcare-related products, placing greater faith in the systems of Australia, Hong Kong, or Japan.

“I always ask my friends or relatives to bring back huge bags of tablets and syrups when they go on holiday, and if we need it, more important medicines,” said Zhi Juan, a former health sector worker and mother of two. “Chinese companies just want money, I know it. And the government is involved, too.”

Restoring confidence

Despite the ongoing stream of scandalous headlines, there are signs to suggest that China is working hard to right the situation and not just react to problems as they arise but take a more structured approach.

The goal of significantly improving the regulation of medical products was included in the latest five-year plan (2016-2020) which stated that China will by revise, or formulate, around 3,050 national

drug standards and 500 medical device standards during the period. Two years later, the CFDA compounded these goals by publishing the pivotal “Guidance of Further Strengthening Food and Drug Standard Work,” which has since led to a series of national drug standards being drafted.

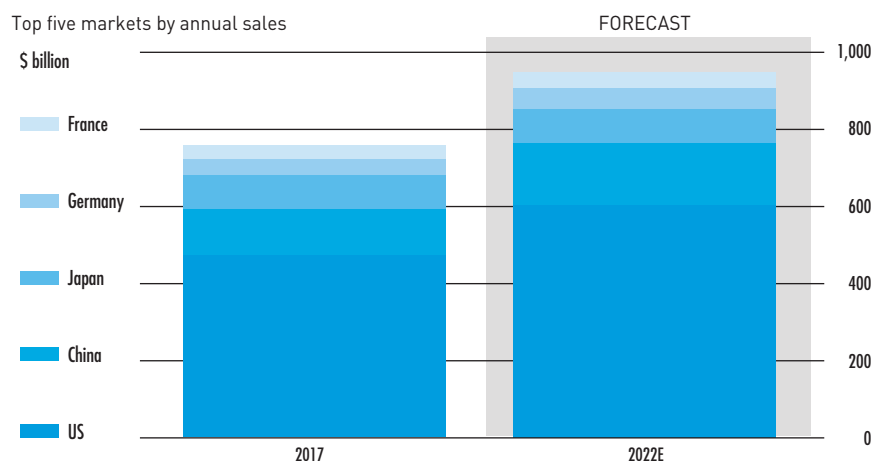
Streamlining has also helped to address the redundancy of functions among regulatory bodies. The National Medical Products Administration (NMPA), the successor to the SFDA, was elevated to ministerial-level status in 2013, after already taking on greater duties five years earlier in the wake of the nationwide dairy product crisis. Following the 2018 government reshuffle, the administration now only supervises the safety of drugs, medical devices and cosmetics.

“In 2018 China underwent significant institutional reform,” said Yilia Ye, senior editor at regulatory consultancy ChemLinked. “The administrative optimization of establishing an office exclusively for drug oversight will certainly lead to a more stringent supervision of pharma safety.”

China's increasing engagement with the global healthcare market, both as an exporter and as an importer, has also been a driving force behind regulatory reform. Plagued with approval waiting times of up to 40 months for new drugs and a chronic shortage of high-quality generics

SECOND-LARGEST MARKET

China is the world's second-largest pharmaceutical market



Source: *Financial Times*, LEK Consulting

the issue even became a box office hit last summer with the film “Dying to Survive” highlighting how difficult it is to get certain drugs in China already approved elsewhere in the world. China has invested billions of dollars in new staffing and rolled out new rules to cut the backlog of imported drugs waiting for the green light.

At the end of 2017, there were over 800 reviewers employed processing applications, with more hiring planned for 2018, however, approval times have since more than halved, from an average of 18.5 months in 2016 to just 8.6 months in 2017. In December, Astrazeneca’s roxadustat became the first foreign-made drug to gain approval in China before doing so in the US.

In June, China was admitted to the International Council for Harmonisation of Technical Requirements for Pharmaceuticals for Human Use, requiring Beijing’s central pharma watchdog to adhere to the council’s safety guidelines. As of 2017, overseas manufacturers no longer have to repeat clinical trials within China before getting drugs to market.

“As ICH guidelines become China’s standard, China is increasingly willing to accept global clinical data in support of local product registrations, with priority for products that serve Chinese patients’ unmet medical needs,” said Lingshi Tan, director of the Drug Information Association in the US.

“Staffing the NMPA will take a decade to create the talent pool to act as regulators or to provide the right quality systems within pharma manufacturing operations,”

says George Baeder. “Training people who really know how to create and implement ‘good manufacturing practice’ systems within companies is no quick fix.”

Wider implications

The stakes are high for the Chinese authorities to get their act together. Not only is biopharma a priority industry for Beijing’s development goals, but with public trust damaged, there is the risk of a large-scale consumer backlash.

Over 50,000 children were affected by the widespread use of melamine—a resin—to falsify nutrient contents in infant milk formula. The public perception of domestic brands plummeted, creating a demand for trustworthy products which foreign firms were able to take advantage of and soak up market share. The scandal had such a deep impact that many parents today still think of it when choosing their children’s food.

“I didn’t have children in 2008, but I remember my friends and older relatives getting very frustrated and concerned about the news,” said Yi Hua, a young mother in Shanghai. “Now I have my own child, and because I can afford it, I basically only buy imported goods of this kind. Why risk it going Chinese?”

Foreign drugs bear a similar stamp of approval. China’s *daigou* market, for example, in which armies of (usually) young women travel abroad to buy coveted foreign-brand products and then sell them back home via social media, may be worth up to RMB 50 billion (\$7.6 billion), according to Bain Capital estimates. Many more travel out of China every year to

places like the US and South Korea as ‘health tourists.’

Chronic suspicion of China’s pharma industry is a huge burden for domestic firms, but they have been making progress in establishing themselves both at home and on the world stage, particularly those in the private sector. According to Dr. Scott Wheelwright, China’s homegrown firms are quickly realizing that “winners don’t cheat.”

“Businesses, and indeed the government, are recognizing the threat that this bad reputation will have on the Chinese market,” said Wheelwright. “In the US, for example, which had its own string of issues 25 years ago, honesty and professionalism has replaced tighter government control because CEOs know they’ll lose clients if they don’t provide a reliable service.”

China’s blossoming drug export industry is already testing the capacity of foreign oversight committees, such as the FDA in Washington, to effectively review all the Chinese ingredients entering its ports. *The Financial Times* has reported that somewhere around 40% of US drugs contain Chinese-made ingredients, meaning any slip in confidence could force customers to other suppliers vying for business, such as India.

For the multinationals, however, their enthusiasm has yet to be dampened. Foreign drug makers still make up the top five largest companies in China by market share, and they appear to remain bullish on China as a source of future growth, given that it still doesn’t account for a large portion of existing sales.

“They’re investing in ways that they haven’t before,” said Wheelwright. “Firms like Eli Lilly and Pfizer, for example, are now producing drug substance [the active pharmaceutical ingredient] in China, not just drug product [the finished good such as a tablet or syrup], which shows that they’re taking the market more seriously.”

And rightly so. China has already made it clear that it aspires to become a global pharmaceutical powerhouse, both as a consumer base and innovation hub. But before it prepares to conquer overseas markets, China must first convince its own citizens that its drugs are safe.

I always ask my friends or relatives to bring back huge bags of tablets and syrups when they go on holiday



Zhi Juan
Former health sector worker
and mother of two

SEEDS OF DOUBT

Is China finally ready to give the green light to genetically modified crops?

By Dominic Morgan

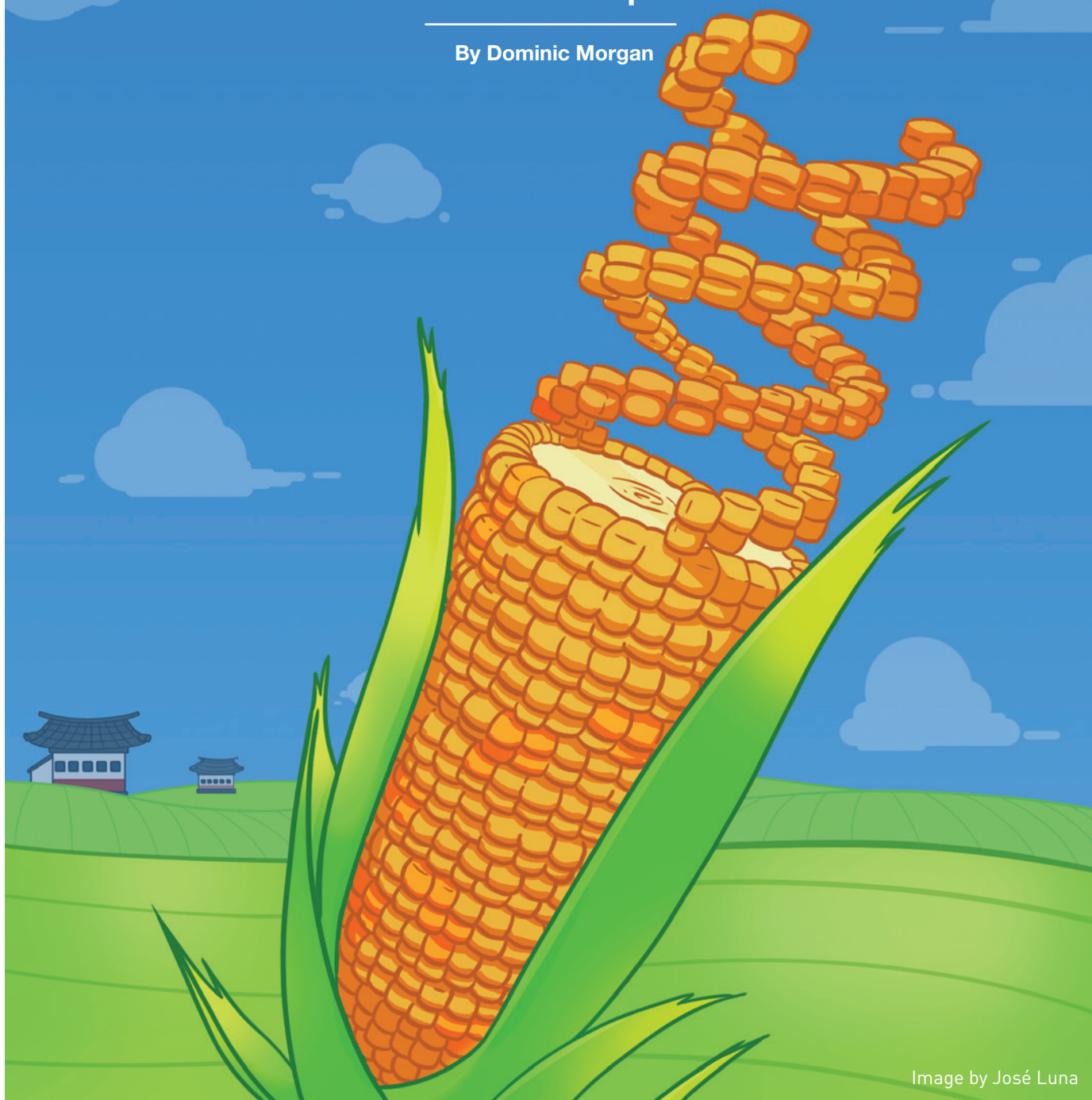


Image by José Luna

China has approved five new varieties of genetically modified crops for import, highlighting the huge impact Chinese GMO restrictions have on the global agricultural sector. Is Beijing planning to relax its near-total ban on GMO?

As China and the United States tried to hammer out a deal to end the trade war through the winter and into spring, an unexpected issue arose as a key focus of negotiations: genetically modified crops.

Agricultural products have long been the backbone of America's agricultural exports. In 2017, the US shipped \$13 billion of grain to China and almost all of these products were grown from genetically modified seeds.

But Chinese policy toward genetically modified organisms (GMO) is much more cautious than the US, creating a continuous source of tension between the two sides.

"The GMO issue has become a hotly debated one in China, perhaps the most contested science-related debate," says Cong Cao, a professor at the University of Nottingham Ningbo China and author of *GMO China*. "Given the state of public sentiment right now, the government is understandably being cautious."

Commercial planting of transgenic crops in China is almost entirely illegal, with the exception of some strains of cotton, papaya, tomato and tobacco.

Beijing has approved imports of more than 20 types of GMO crops, which has allowed the US to emerge as a key agricultural supplier. But in recent years the government has become increasingly reluctant to grant further licenses.

The regulatory panel that decides on new import permits used to meet a minimum of three times per year, but over the past five years this has fallen to two, or sometimes just one.

This has created a problem for global agricultural technology firms, and the farmers who use their products, because China has become such an important market. Before the start of the trade war, around 60% of US soybean exports went to China each year.

It is almost impossible for global agricultural technology firms to commercialize new products until they have been approved for import by Chinese regulators.

In 2018, Swiss agtech firm Syngenta, now owned by ChemChina, was forced to

pay US farmers \$1.5 billion in compensation after prematurely commercializing a pest-resistant strain of corn, which led to the grain being rejected by Chinese customs.

The agtech firms argue that the slowdown in Chinese approvals has impacted innovation in GMO across the world, since firms are unwilling to invest in developing new varieties unless there is a clear path to commercialization. DowDuPont estimates that it takes 10 years and \$250 million to bring a new seed product to market.

Growers have also suffered because the new seeds awaiting sign-off from Beijing would allow them to increase yields. As time passes, older GMO crops, such as Monsanto's widely used Roundup Ready products, are becoming less effective as weeds develop a resistance to the company's Roundup weed killer, also known as glyphosate. Agtech companies have created products with different mixes of pesticides to get around this problem—using 2,4-D and other chemicals—but Beijing has only approved a few of these new products. As a result, American farmers are largely unwilling to use them, meaning that agtech companies are losing large amounts of money.

The agtech industry body CropLife International estimated last year that the regulatory slowdown in China had cost the US economy \$7 billion since 2013.

Which brings us back to the "trade war" between China and the US.

US negotiators have been pushing China to relax restrictions on GMO. They appeared to score an early victory on this front in January, when the Ministry of Agriculture and Rural Affairs announced it had cleared five varieties of GMO crops for import, including transgenic strains of canola, corn and soybeans.

These were the first approvals granted in more than 18 months. What's more, the varieties given the green light included DowDuPont's Enlist soybeans—a product analysts consider to have a large market potential but which had been stuck in China's approval pipeline since 2014.

"This move looks like a signal from China's regulators that they are willing to

play ball on trade,” says Even Pay, Lead Agriculture Analyst at Beijing-based consultancy China Policy.

But US negotiators are continuing to push for further concessions. In April, one American trade official told Reuters that China’s GMO policy remained a “big issue” preventing the two sides from reaching a deal.

According to Pay, the US side is likely to have three main goals concerning GMOs in any trade negotiations. The first is an assurance that China will accelerate its approval process.

A second, more ambitious ask is the creation of a system of mutual recognition for new GMO varieties, which would mean that any seed approved by the US would automatically be eligible for export to China.

The third demand, which is the concession the US dreams of securing, is that Beijing legalizes the cultivation of genetically modified staple crops inside China. This would give American agtech firms access to sell their transgenic seeds and other GMO products in China’s vast agricultural sector, which produces around a quarter of the world’s corn and nearly 30% of its rice.

“If China were to grant approval for domestic GMO grain cultivation, it would be the fruition of more than two decades of investment by the world’s top agricultural

biotechnology firms,” says Loren Puette, CEO of agriculture market consultancy China Ag. “It would greatly benefit the global agtech industry.”

How far China is willing to go on GMO policy remains to be seen. Beijing’s top priority will be avoiding any perception that it is caving to US pressure on this issue, as Chinese public opposition to GMO is intense.

But a move to relax bans on growing transgenic grains is not out of the question. In fact, there are tentative signs that Beijing is already sowing the seeds for such a policy shift.

A plot against China?

Far from being GMO-skeptic, the Chinese government has long had ambitions to lead the world in transgenic crop research. China is home to 22% of the global population but has just 8% of the world’s arable land, and so the government has been keen to promote any technology capable of boosting yields.

In 1992, China became the first country to legalize commercial planting of a GMO—a virus-resistant tobacco plant.

Since then, the government has invested billions in GMO research and development. In the *13th Five-year Plan for Science and Technology*, released in 2016, GMO crop research was one of 13 strategic technologies singled out for priority promotion.

The same year, the government laid out a three-stage roadmap for legalizing the commercial use of GMO seeds. The first to be approved would be non-food crops like cotton, then would come crops mainly used for animal feed, such as corn, and then finally regulators would move on to staple foods like rice.

There is strong support inside several government departments, especially the agriculture and science and technology ministries, for allowing cultivation of more GMO crops, according to Cao.

“The government has already invested so much money into research in this area—it has an incentive to push for commercialization,” says Cao.

Yet progress towards this goal has stalled in recent years. Beijing appears unwilling to legalize domestic cultivation of GMO grain until domestic seed firms emerge capable of challenging the global agtech giants.

“Chinese-owned companies would have to profit directly from domestic GMO cultivation [for the government to consider a policy change],” says Loren Puette, CEO of agriculture market consultancy China Ag.

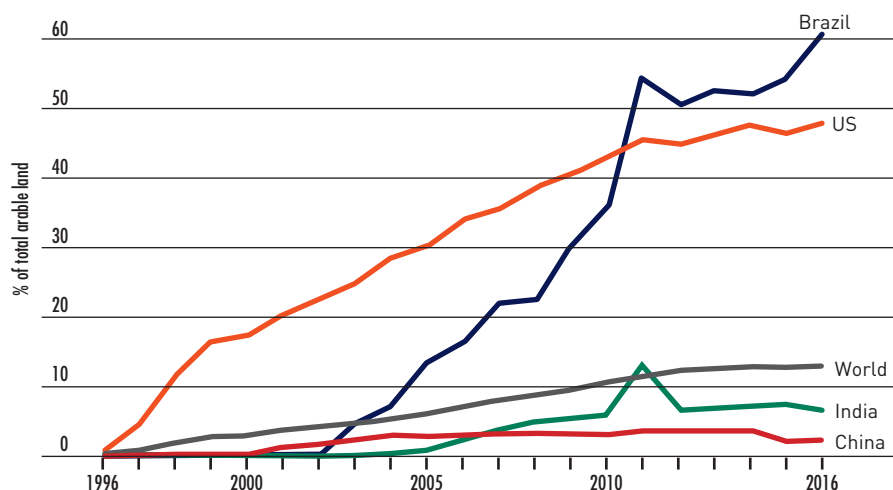
The government launched a crackdown on false information about the health risks of GMO in 2015, but it has been unable to stem the flood of online rumors. In December, officials were forced to deny that the agriculture ministry has a secret non-GMO food supply for its cafeteria.

According to Kai Cui, a professor at Shanghai Jiao Tong University, who conducted a GMO survey published in *Nature*, the strength of public opposition has made the government reluctant to move forward with commercializing GM grain.

“Only 18% of the Chinese population thinks GMO crops are safe to eat, 21% lower than the figure in the US,” says Kai. “And people’s reasons for opposing GMO are also different.

“In China, people worry that GMO might change their genes, and also impact the safety of their food. There are widespread conspiracy theories claiming that people in the US don’t eat GMO food, and the US just exports all its GMO crops to China.”

LAGGING BEHIND | Area planted with GM Crops



Source: *The Economist*, International Service for the Acquisition of Agri-Biotech Applications

Point of no return

But China may be reaching the point where the government perceives a policy change less of a risk than maintaining the status quo.

For one thing, it is becoming increasingly clear that the restrictions on GMO have done little to deter farmers from seeking out transgenic seeds to boost their profits.

The exact size of China's black market for GMO seeds is unknown, but evidence suggests that it is very large indeed. Caches of illicit seeds have been uncovered across the northern provinces, from Xinjiang in the west to Heilongjiang in the east.

A 2016 Greenpeace investigation in northeastern Liaoning province found that 93% of corn samples collected tested positive for GMO contamination.

Officials have launched several high-profile crackdowns on GMO, locking up seed distributors and farmers and burning their crops to the ground. But more incidents keep emerging.

In August 2016, for example, the local government in Jingbian, a rural county in northwestern Shaanxi province, announced it had completed an inspection of the entire region and destroyed all illicit crops. But court documents uncovered by *Caixin* revealed that officials uncovered dozens of metric tons of GMO corn seeds during the following months.

The continual seed scandals put the government in an awkward position. First, the images of officials burning fields of GMO crops undermine the government's message that GMO is safe. Second, the fact that GMO are being grown illicitly means that consumers have no idea whether the food they are consuming is GMO or not.

And third, the existence of the black market sharpens the trade tensions with Washington, since US companies are missing out on large amounts of revenue.

An investigation led by Wang Deyuan of the China National Rice Research Institute found that most of the GMO corn planted in China is derived from the insect-repelling MON810 variety developed by Monsanto, now part of German conglomerate Bayer.

According to Wang, the Monsanto seed is entering the Chinese market through two main channels: by breeding it from GMO corn found in imported animal feed, or by smuggling it directly from the US.

Pushing back

The big question is how Beijing will choose to respond to this situation. Early signs suggest that the government is generally lying low. This year's *Number One Document*, Beijing's annual list of priorities for agricultural policy, gave little away on potential GMO reforms.

Some provincial governments, including Heilongjiang, Inner Mongolia and Shandong, have launched fresh crackdowns on GMO seed dealers in an attempt to reassure the public.

But the *Science and Technology Daily*, the official publication of the Ministry of Science and Technology, has been taking a more bullish line. In July, the paper published a report arguing that farmers use illegal seeds because they "love" GMO and that the government should wipe out the illicit seed trade by simply legalizing commercial planting of GMO corn.

The message the ministry appears to be sending is that Beijing has now succeeded in preparing its domestic seed producers to compete internationally. In other words, conservatives' worries that GMO legalization would lead to American companies dominating the Chinese market are no longer valid.

Beijing has made intense efforts to make its seed industry more competitive, consolidating a number of small producers, promoting partnerships with state-run research centers and encouraging firms to acquire global intellectual property rights.

In 2016, state-run chemicals conglomerate ChemChina acquired Syngenta, one of the world's top GMO seed producers, for \$43 billion—one of the largest corporate acquisitions ever made by a Chinese company. This has allowed China to create its own vertically integrated seed and agrochemicals giant to rival Bayer and DowDuPont.

According to Pay of China Policy, the ban on domestic cultivation is actively

holding back Chinese firms.

"A lot of Chinese companies are already set up to be globally competitive," says Pay. "In order to do that, the easiest way is to have a market at home."

Next steps

Where Beijing chooses to go from here is likely to depend mainly on political calculations by China's top leaders.

"Ultimately, the decision [over commercialization] lies with the State Council and everyone will have to do what the top leaders say," says Cao.

According to Kai, the moment may be too sensitive for any bold moves on GMO.

"There are other things that the government needs to pay attention to: the economic slowdown, the China-US trade war, the problems in the financial and real estate markets—those are emergencies," says Kai. "So, if you're the leader of China, you're in no hurry to approve GMO."

For Puette of China Ag, any reforms are more likely to come next year. "ChemChina is still integrating Syngenta, while ChemChina itself is likely to be merged with SinoChem in the coming months," Puette points out. "The corporate landscape has to settle somewhat before such a large endeavor can take place."

Pay agrees that there are signs of momentum toward a policy change further down the line. In February, the government announced plans to open a new GMO research base in Heilongjiang, China's northmost province, the first such facility to be built in a major grain-producing region.

"There has never really been a break in refining and improving the regulations that would enable commercialization eventually," says Pay. "The more these research initiatives see investment and expansion, the more I think it's only a matter of time."

China's research community, however, appears tired of waiting. At a seed industry meeting in July, Liu Yaoguang, a member of the Chinese Academy of Sciences, summed up the mood well.

"If China waits until the entire general public accepts GMO to commercialize them, that day will never come," Liu said. ■

CO-WORKING CAPITAL

Investment is flowing into China's shared office market.
But will the returns justify the eye-watering outlays?

By Mable-Ann Chang



Co-working spaces are a booming industry concept in China thanks to billions of dollars in funding. But how long before the lack of profits causes a shake-out?

Walk into any of the most popular co-working spaces in China and you will instantly understand their appeal. They feel different to the average office, with their stylish designs, open office plans, laidback atmosphere, endless supplies of coffee and beer, and trendy young unicorn-hopefuls bouncing around.

Co-working spaces are essentially shared office workspaces that are leased out to individuals or groups on a flexible basis. They offer a desk to work at, usually along with amenities such as conference rooms, hot-desks, lounge areas, sporting facilities and more. The spaces were created originally for the likes of freelancers, startups, entrepreneurs and small teams in mind. But many larger companies have found that the arrangement works for them too.

The business of shared rented office space has boomed internationally over the past decade and leading the pack is WeWork. An American company founded in 2010 and armed with \$6.5 billion in equity funding, WeWork now has co-working offices in 32 countries and reported revenues of \$421.6 million in 2018, with 268,000 clients in-house at the end of June last year. It expanded into China in 2016, after raising nearly \$700 million from Chinese investors. WeWork has already extended from an initial four to around 60 locations throughout the country's biggest cities, with Beijing,

Shanghai and Shenzhen hosting the majority of the company's office spaces.

"Next year, it will be even faster," says Sern Hong Yu, regional head of project delivery at WeWork China, speaking of expansion plans for 2019 at an event in December. Significantly accelerating WeWork's growth in China was the company's acquisition of its main rival, Naked Hub, in 2018 for \$400 million, absorbing that company's 24 locations. The acquisition also served notice to other Chinese competitors, all of them fighting hard for market share.

WeWork's top competitor in China now is Ucommune, which is the only Chinese unicorn—defined as a privately-held startup company valued at over \$1 billion—in the co-working space market, with a valuation of \$3 billion. It raised \$768 million from Sequoia Capital China, among others, and has 200 locations spread across 37 cities, with 160 of those locations in China. But WeWork is the premium player with better locations and market positioning.

Co-working China

The co-working office trend has helped offset two problems in China's property market—oversupply of commercial space and declining usage of shopping malls.

"Co-working [companies] can absorb large vacant spaces and provide more flexible office spaces to startup companies," says Regina Young, Director



WeWork members working at the Dalian Road location in Shanghai

and Head of Research & Consultancy at Knight Frank in Shanghai. “They are often large tenants in a building with several floors offering over 5,000 square meters of office space.”

“In terms of location, co-working operators favor Grade-A office buildings or renovate other types of properties involving shopping malls and hotels to meet the demand for space,” says Young.

Co-working spaces in China offer services that are a good fit for the needs of Chinese startups. China has seen a surge in startups in recent years, and the trend has received increasing support from the central and local governments in the form of investment and preferential tax policies, with a flow-on benefit for co-working spaces at all levels. Home-grown technology companies often start life in such spaces, and the Chinese government has been embracing technology in its drive to developing a more self-reliant economy. The country now has 120 homegrown unicorns, making up over 50% of the global number of 234.

“If you are a startup, sometimes co-working spaces can act like a sort of incubator, such as helping you meet potential investors,” says Hannah Ryder, CEO of Development Reimagined and previous client of co-working spaces InCube and Vanke. “They can help you with all of your administration and registration of the business.”

Convenience is a key factor for tenants of co-working offices.

“I like the fact that I don’t have to worry about anything here,” says Zennon Kapron, director of research and consultancy firm Kapronasia, and a client of WeWork in Shanghai. “For us, the benefit [at WeWork] is predictability, so I probably wouldn’t look to move back into our own office. The startup culture in China is just not a very comfortable culture in general. You’re usually working long hours, so I think that WeWork is cushier. WeWork is like a Starbucks experience. I think the Chinese co-working spaces are a bit more bare-boned.”

Kapron refers to “the 996 mentality”—working 9 a.m.-9 p.m., six days a week—

The free beer offered by WeWork doesn’t fit with the heavy workloads and lifestyle of Chinese startup people



KR Space

which is typical of Chinese startup culture. But the intensity of the experience is offset by the relaxed atmosphere of the typical co-working environment. A key factor for young businesses is keeping rental costs down, and staying flexible, not getting stuck with long-term leases on space that is no longer appropriate—either because it is too big or too small.

Ryder also highlights that co-working spaces are particularly valuable for startups in China because all companies are required to have a physical address.

“The big difference with China is that when you have a business you need to have a registered office address, which in other countries—such as the UK—is not required,” says Ryder. “You can open a business and work from home, so the co-working space demand is not so high, whereas here in China [the demand] is created by this regulation of having to have a commercially registered offered space.”

The windings of WeWork

Backed by Japanese tech and telecom giant SoftBank Group, WeWork’s recent global run-up in funding—it raised some \$4 billion in 2018 alone—has given the company the firepower to expand quickly without worrying too much about immediate returns. But it is not sticking just with co-working office space, and doesn’t view itself as being simply a co-working office operator. “We are a community building company,” one WeWork staff member said.

Co-working spaces are indeed just one aspect of WeWork’s ventures. The company has pursued a diverse range of investments in recent years. In 2016, it launched a dorm-style housing venture in the US called WeLive, and it recently added a fitness center brand, Rise, that costs \$180 per month to join. It has also acquired a software startup called Teem which gives enterprises the tools and data to optimize their office space.

The strategy of expanding beyond co-working spaces is one that they have also applied to China. “Earlier this year, we launched a new real estate strategy offering a range of options for partnership with our landlords including participating leases, management deal and revenue sharing,” says WeWork’s Greater China General Manager Alan Ai. “By doing this, we offer our partners an opportunity to share in the upside with us.”

The real benefit of WeWork, the company says, is that it facilitates collaboration and enhances value.

“We create value,” says Ai. “WeWork’s presence, and the community it creates both within and around buildings we occupy, allows landlords to expand their tenant pool and has a positive effect on rental and real estate values.”

WeWork also says that the services it offers could help combat China battle the infamous “996” work system. WeWork’s Sern Hong Yu, says, “A lot of people like the [WeWork] workplace so much that stay longer than usual. But in the meantime, we do remind them of the work-life balance.”



Coffee, beer and fruit-infused water at a WeWork office bar in Shanghai contribute towards a more relaxed atmosphere, said to help combat China's "996" working culture

However, WeWork has come under criticism for not understanding the culture of the Chinese workforce. The company that is probably number three in the China market—Kr Space—says that the free beer offered by WeWork doesn't fit with the heavy workloads and lifestyle of Chinese startup people, and is instead providing no-charge add-ons like financial and legal consulting services.

The biggest issue facing WeWork, however, is how to sustain the fast pace of growth which underlies its market valuation. The company has yet to achieve profitability. In its first-ever release of financial results last year, WeWork said total revenue rose to \$421.6 million in Q4 2018, up from \$198.3 million in the same quarter in the previous year. But it also reported a net loss for the first half of 2018 of \$723 million, up from \$154 million a year earlier.

Co-working crash

Is the co-working space market a long-term and viable business, and if so, at what valuation level? Is WeWork worth the high valuation the market has given it? Some critics have described WeWork as being really a real estate company with a tech company valuation. The *Financial Times* in a special report in July 2018, estimated saying that WeWork's valuation, then around \$20 billion, had an actual worth

closer to \$3 billion due to weakening rental yields and low barriers to entry.

Slowing economic growth is also impacting on the prospects for the co-working office market in China. At the beginning of 2019, a number of China's co-working operators were forced to shut down due to a lack of financing, and a shortage of funding from venture capitalists has had a big impact on the industry, with even major operators struggling to keep up.

Between January and October last year, 40 companies disappeared from China's co-working scene, and almost 40% of the industry's remaining players were struggling with an occupancy level of less than half, according to a report by the China Real Estate Chamber of Commerce (CRECC), an information exchange platform for China's property sector. The going rate varies from RMB 1,500 (\$22) per desk per month in some locations to as much as RMB 8,500 for a private office in a handful of prime locations.

"The reason co-working operators are in the doldrums is quite simple: they are leasing desks quite cheaply while their office acquisition and operating costs are high," Gary Wen, head of the commercial department at Savills North China, told the *South China Morning Post* in January. "They have been telling investors that they can rent out a desk at RMB 4,000 a month

but they haven't been able [to]."

Whether there is an adequate supply of funding can be a matter of life and death for co-working startups, given the problems of achieving profitability. Without the financing to support them, they are unable to keep up with the price war initiated by deep-pocketed giants such as WeWork. Smaller startups will either have to close down or find a way to be acquired.

Kr Space recently said it has become much more careful with its expansion plans, which is a sharp contrast to what founder Liu Chengcheng's stated mid-2018 that the company planned to add 10,000 desks per month in its race to beat WeWork. But given its lack of an operating profit, even WeWork needs to be concerned about financing.

"I don't see financing as a short-term risk [for WeWork], but in the next couple of years I think it would be a bigger a concern. What concerns me the most is just how fast they are expanding; the available space appears to be gradually exceeding the number of people that need the space," says Kapron. "You've gone through this period of economic growth ... you have to consider an environment where funding is no longer as readily available."

A head above water

WeWork is still confident in what it is bringing to the co-working table, and it has deep-pocketed investors. In addition to that, the market potential is still viewed by many investors as huge. Sullivan Data Management, for instance, estimates that by 2022, the Chinese market for co-working office space will reach a staggering value of RMB 409.22 billion. Significant industry consolidation can be expected before then, however, and the question is who will the survivors be?

"The future of the spaces will depend on two factors, one, the government regulations for requiring commercial space—if these are relaxed co-working spaces may not be so helpful for small entrepreneurs—and two, whether they can find cost-effective business models to continue to prosper. This is still a work in progress," says Ryder.

CASE STUDY

The Business of First Aid

How First Respond turned first aid into a business opportunity

By Zhu Rui and Wei Ding

In China, over 540,000 people die from sudden cardiac arrest (SCA) every year, with 60% of those incidents happening outside of a hospital. When there is an emergency, the first reaction of many would be to call for an ambulance, yet for SCA there is only a 4-minute window of “golden opportunity” to act before irreversible brain damage is caused.

Victims of SCA can be saved through the immediate actions of bystanders, as long as those people have received the proper training, says Lu Le, founder and CEO of First Respond. However, in China, only 200 out of every 100,000 people have first aid knowledge, compared to 25,000 in the US and 45,000 in Japan. Lu wanted to improve that number in China and saw a real business opportunity in the field.

First Respond, founded in 2012, is a social enterprise aimed at establishing an emergency first-aid platform. It started by providing services at Chinese marathons, and in 2016 Lu exported the model abroad to cover the Tokyo Marathon, an international marathon that is considered to be one of the safest in the world. Through years of on-site experience and data accumulation, First Respond's first aid service is now offered in 39 cities and has guaranteed the safety of participants at over 270 large-scale events, saving over 10 victims of SCA.

It is one of the first Chinese companies in mainland China to achieve a B-Corp certificate, which is granted by the global

non-profit B Lab to companies that use business as a force for good. Globally, around 2,600 firms, including companies such as the French multinational food-products corporation Danone, have been certified as B Corps.

Achievements made by companies such as First Respond mean a great deal to China, a country that has suffered with an inadequate emergency care system for a very long time.

How did First Respond grow to become what it is today? And what can be learned from the experience of First Respond in terms of achieving both social and commercial value?

First step: combat prejudice

In the beginning, Lu and his colleagues formed a small volunteer team that offered free first aid services at marathons. They were often asked, “If existing systems—including hospitals and healthcare professionals—are unable to save runners from SCA at marathons, how can you?” Indeed, before 2012, a lack of first-aid personnel and rescue management systems meant that it was difficult to save SCA victims taking part in long-distance races within the 4-minute time frame. To prove that a newly established social enterprise could accomplish something that even the current system cannot was a daunting task. For Lu, the only way to combat that prejudice was through hard data.

The first successful case for First Respond was in 2013, when a female victim experienced SCA after finishing a marathon. As her husband stood by her side, the First Respond volunteer arrived within a minute and completed first aid, performing CPR, using an automated external defibrillator (AED) and recovering a heartbeat. The victim's life was no longer at immediate risk by the time an ambulance arrived 15 minutes later.

Fast forward two years to the Wuxi International Marathon in 2015, where First Respond once again saved a runner struck by SCA. The data recorded by the AED on-site clearly revealed that the victim's heart had stopped beating, but it was quickly recovered through the volunteer's rescue efforts. With such hard evidence, the medical community and general public started to recognize First Respond. It was then that First Respond gradually expanded from its headquarters in Shanghai to offer its services to the whole country, covering not only long-distance races, but also other types of races. This was when the company entered its next phase of development.

In 2015, First Respond received investment from Tencent, and the first thing Lu did was to set up an IT team and digitize all its data and past experiences. Lu and his team believed that only by digitizing and analyzing the data that has been collected, and continuously testing and updating their risk model, could their emergency



management system be enhanced and sustained, as well as made applicable to various situations.

First Respond also launched a “life-saving map” to help locate nearby AED equipment. Together with its tech-supported emergency system as well as their team’s first aid training, the company promised to provide an all-society rescue system, so that whenever an emergency arose, there would be a reasonable chance that a trained individual could help the victim within the golden 4-minute window. However, to achieve this, they needed to answer some tough questions: What type of data would they need to collect and how would they utilize the data? How would Lu and his team go about revamping the existing model to create a new, more efficient rescue system? And finally, how could they ensure having enough qualified volunteers?

These are the three crucial issues that First Respond had to tackle to ensure its model would succeed.

Data, data, data

The Chinese Athletics Association stipulates that all sporting events have to have medical stations, ambulances, mobile first-aid points and first-aid team members every 2 to 5 kilometers. Yet, in reality, such measures are far from adequate, as tragically illustrated at the Standard Chartered Hong

Kong Marathon in 2018, where a runner fell to the ground, unconscious. The nearest medical staff member patted the runner on the back, trying to wake him up. The second emergency responder arrived 10 minutes later. The ambulance did not arrive until 26 minutes later. The runner died three days after the marathon took place.

To better optimize rescue plans, allocate aid resources and more accurately assess the risks of any race, Lu and his team turned to big data. Many factors, such as track conditions, weather, and the athlete’s physical health, could affect how they provide assistance. First Respond set up an independent research team to evaluate every factor and assess the effects they may have. The team also breaks the race down into different sections for independent analysis.

By studying the connection between the various factors and their impact on events, the team obtained many unexpected results. For example, contrary to the popular belief that participants have a higher chance of falling during energy-consuming uphill sections, it is in fact the downhill stages that have a higher rate of accidents, especially for sections of more than 1 km with a slope between 0.8% and 1.2%. By collecting and utilizing such data, First Respond established an ever-improving IT platform that helps their first-aid teams better prepare for emergencies.

Breaking the tradition: Flat management

Time is a very important, if not the most important, factor when it comes to saving lives. But in traditional first aid, cross-departmental collaboration between multiple agencies such as the Sports Bureau, the Public Security Bureau and the Bureau of Health has been inefficient. An incident report usually has to pass through two levels of staff before reaching the level responsible for deploying medical personnel and ambulances. Thus, it is very unlikely that someone could complete the whole process within the golden four minutes. First Respond changed this typical management process.

On the First Respond app, there is a button that anyone in the company’s first-aid team has access to. Once the button is pushed, everyone on the team is notified and the command center dispatches the nearest ambulance immediately. Nearby volunteers also receive a notification and rush to the area to support the team. The company’s data shows that first-aid personnel who carry AED equipment can arrive within 30-60 seconds of receiving a notification of an emergency.

Simply put, First Respond breaks the traditional bureaucratic procedure of first aid and tries to make the process as efficient as possible. It is premised on the successful operation of the first-aid

app—the company’s rescue platform, which decentralizes on-site management and improves efficiency as well as the professionalism of volunteers—the volunteer who first detects an emergency has to be able to make an accurate judgment on whether the health issue is caused by physical exertion, cardiac arrest or another factors.

To make sure that volunteers are able to make accurate assessments, First Respond requires all volunteers to have at least two certificates: the American Heart Association (AHA) certificate and the track life support certificate, granted by the company itself. Before each event, every track commander receives additional training.

Training and managing volunteers

First Respond sees volunteers as the core of all of its activities. To ensure effective emergency services, Lu and his team standardized the volunteer training mechanism and management system in order to ensure a level of consistency among their different volunteer teams.

Unlike some other organizations, First Respond is strict with its volunteers. Everyone has to pay a fee to participate in the company’s rigorous training, and also has to pass peer review tests to become a qualified member. The organization now has over 13,000 qualified volunteers and only two full-time managers, as most volunteers are “mutually managed,” with volunteers supervising each other and rating each others’ work.

For volunteers who actively respond to task calls, the company arranges regular comprehensive assessments incorporating promotions and downgrades. After every event, all volunteers involved, no matter what role they play, are evaluated, with the score affecting their promotion and rating in the system. Those who receive a low score are either downgraded and require further training, or are removed from the volunteer list entirely. For volunteers who are consistently too busy to participate in company activities, the system places them on a “gray list.”

Given that volunteers can forget

rescue skills if they don’t practice them for a period of time, the company gives a test to “activate” volunteers’ memories every three months. With artificial intelligence technology, volunteers are tested on whether they can stay calm under pressure, and the system automatically starts retraining those who fail.

First Respond volunteers have to work more diligently than in other social organizations. This “harsh” mechanism helps the company find the right people—those who are really interested in participating in first-aid activities and who feel that it is an honorable job worthy of hard work and their devotion.

Balancing commercial and social value

Since First Respond is a commercial entity, it is worth studying its business model. Its main businesses include public service, safety support for events, first-aid training (public and institutional) and first-aid equipment sales. Event services account for 20%-25% of total revenue, first-aid training accounts for 30%, while equipment sales and the safety and first-aid services provided to companies accounts for 45%-50%.

The training service industry has a low barrier to entry and there are many different training organizations out there, but First Respond grew to be the best in just a few short years. Lu credits its rise to word-of-mouth, training courses based on grassroots needs, the organization’s use of big data and advanced volunteer management.

First Respond puts “meeting grassroots’ needs” as a priority when designing training courses. They emphasize three goals: awakening the public’s consciousness, increasing the popularity of first-aid skills, and providing avenues for public participation.

Members of the public are typically not professional emergency workers. When an emergency happens, the first question one faces is not “how to save,” but “should I save?”

In China, some notorious cases have made people think twice before helping

people who fall down as they worry that they could be wrongly blamed and even asked to compensate the injured. Furthermore, if someone needs resuscitation, should the rescuer worry about mouth-to-mouth contact with a stranger? In other words, how can a rescuer protect themselves? Few training courses can provide answers to these questions.

In First Respond’s trainings, they try to address these concerns. As an example, the first thing a trainee is taught to do in an emergency situation is to turn on the cameras on their mobile phones and shout “I have started recording!” This step is absent in the American Heart Association course, but it is useful in the Chinese context, as it collects real time information, avoids ambiguity and most importantly increases people’s willingness to help.

Overall, the commercial value of First Respond is reflected in the organization’s revenues and its potential value to society. First Respond aims not only to ensure the safety of athletes and expand first-aid skills, but also to solidify society’s base of skilled volunteers who are qualified to provide emergency services.

Opportunities and challenges

In the hope of helping a great number of people, First Respond is working with local governments to build an all-society rescue system. Competition in the industry has become fierce in recent years, as more companies have seen opportunities in the market. Many of them have copied First Respond’s model and even provide free training, although there is no guarantee of the quality of their volunteers. How should First Respond react to this competition and maintain its lead in the market? Can the company maintain and grow its revenue so that it can further develop its rescue system? These and many other challenging questions still need to be answered. ■

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CKGSB BUSINESS CONDITIONS INDEX

A Trend of Recovery

After a run of poor results last year, 2019 sees investment and recruitment prospects becoming more positive



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

CKGSB's Business Conditions Index (BCI) surprised us by rising dramatically in early 2019. In March, the positive trend continued, with the overall index reading 60.8. Since the record lows in October 2018, BCI forecasts have rapidly corrected themselves, with March's BCI being at almost the same level as the highest records of the past two years.

In March, the BCI continued to improve on February's leap in confidence, rising from 54.0 to 60.8.

Introduction

Since June 2011, CKGSB has conducted a monthly survey of executives about the macro-economic environment in China called the Business Conditions Index (BCI). The BCI is skewed toward small- and medium-sized enterprises (SMEs) that are competitive in their industries, and so provides a reliable snapshot of business sentiment among successful private companies.

The BCI is a set of forward-looking diffusion indicators. The index takes 50 as its threshold, so a value above 50

means that the variable that the index measures is expected to increase, while an index value below 50 means that the variable is expected to fall. The BCI uses the same methodology as the PMI index.

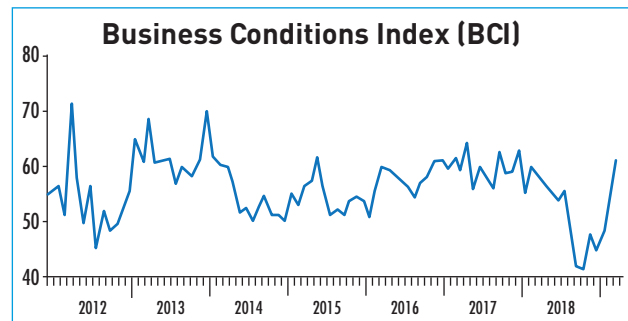
Key Findings

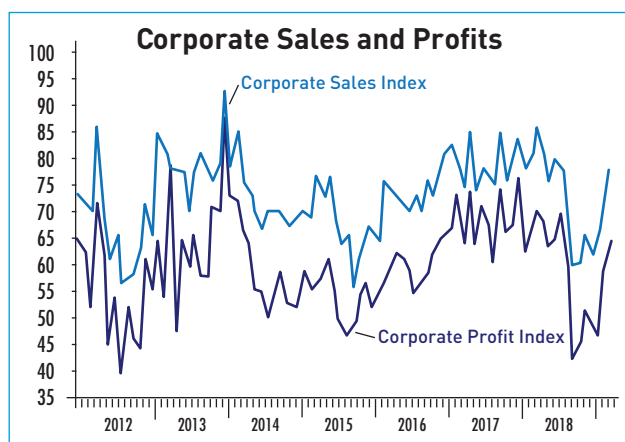
- The financing conditions index has now crossed over to the positive side of the confidence threshold of 50.0, something that has not happened since December 2016. This means that financing options for China's private firms have increased considerably, which suggests we are witnessing a major government policy transition in progress.
- Apart from the main BCI, labor cost and overall cost forecasts have fallen, indicating that government tax and fee reductions are already bearing fruit.
- A-share markets are on the rise, and as a barometer of the economy, positive A-share performance seems appropriate to the overall improvement in economic conditions this spring. This data tells us that an economic rebound is clearly in progress.

Analysis

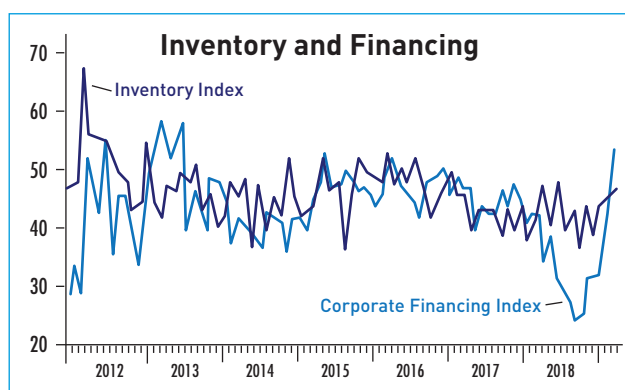
The CKGSB BCI comprises four sub-indices for corporate sales, corporate profits, corporate financing environment and inventory levels, three of which measure future prospects and one, the corporate financing index, measures the current climate.

In March, all four of the sub-indices rose. The corporate sales index rose from 70.2 to 77.5, and the corporate profit index rose from 59.9 to 63.9.





March's corporate financing index rose from 42.7 to 53.0, marginally rising above the confidence threshold of 50.0, while the inventory index rose somewhat from 45.0 in February to 46.9.



March's labor cost forecast was 81.1 and the overall cost forecast was 80.0. Both these forecasts were down somewhat from February's figures. Regardless of how the economy is performing, these two indices have remained stubbornly high. As a result, the recent downward trend is something to be noted.

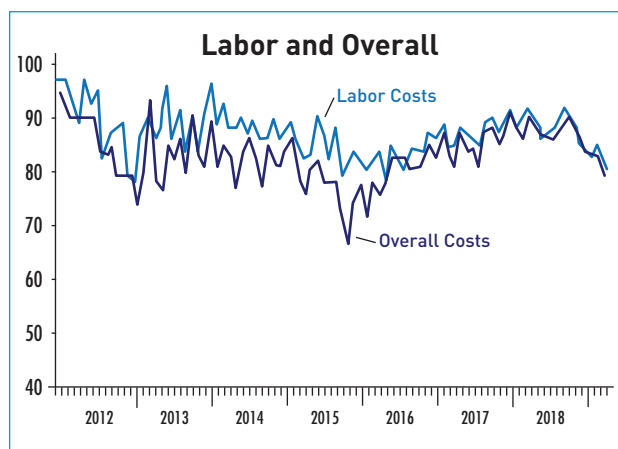
We now turn to investment and recruitment. These two indices have been consistently at the more confident end of the scale since the BCI began. In recent months however, both have weakened, especially recruitment. Despite this trend emerging, March's investment index rose to 67.4, and the recruitment index rose to 65.3.

Conclusion

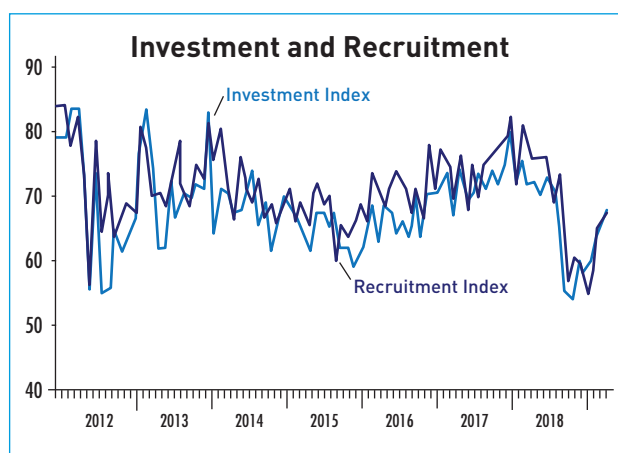
Looking back, the economic downturn last year seemed out of control, which took China by surprise. Why was there such a sharp downturn in 2018?

It was mainly due to deleveraging. Many domestic and foreign institutions have shown how, since the "four trillion RMB" stimulus plan was enacted in 2008, China's

macroeconomic leverage rose rapidly, undermining economic sustainability. With the country awash with money, it was high time for a national deleveraging campaign. The problem is that private enterprises, especially small and medium-sized enterprises, were in a weak position in the capital markets.



The issue is that in China today, the private sector creates more than half the country's GDP and brings in more than half its taxes. The vast majority of new jobs each year are created by private firms. At a national level, employment is not only about the economic development of the people, it is also a country's most important social stabilizer. With this in mind, every level of government policies should be specifically designed to ease financing troubles for private enterprises as quickly as possible.



In the final analysis, the goal can be summarized in a sentence: Let us not allow private firms to become the victims. Judging from changes over the past two years, the Chinese government has retained a relatively strong ability to govern the economy, but can this be adapted to address more complex multi-objective dilemmas? For this, we will have to wait and see.

CKGSB BUSINESS SENTIMENT INDEX

Improved Endings, Uncertain Beginnings

Last year's Business Sentiment Index ended on a four-year high. However, given the recent slowdown in consumption, there is now a substantial level of uncertainty about 2019



The BSI project is directed by Gan Jie, Professor of Finance at CKGSB

Despite widespread pessimism about the Chinese economy, CKGSB's Business Sentiment Index stood at 51 for all four quarters of 2018, making it the first year of overall expansion since the survey was launched in 2014.

Other signs of improvement included a slight expansion in electricity consumption, domestic orders and private firm production. These positive developments can be attributed to the supply-side reforms and curtailment of production capacity in the past two years. However, investment was still sluggish and overcapacity remained prevalent.

Introduction

This report is based on data collected from our quarterly surveys of around 2,000 industrial firms in China. Conducted through telephone interviews, this study is now in its fourth

year, having launched in the second quarter of 2014. If we exclude the agricultural, real estate and financial sectors from China's gross domestic product (GDP), the industrial sector accounts for 50% of the non-agricultural economy.

Our survey design ensures that our sample fully represents industry, region and company size. As a result, we are able to construct business indices that are, to the best of our knowledge, the most informative ones available about the Chinese economy.

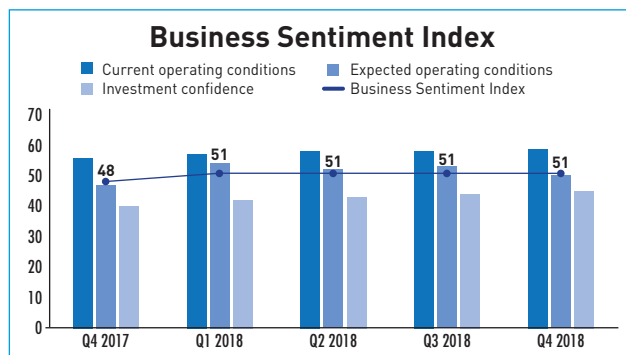
Key Findings

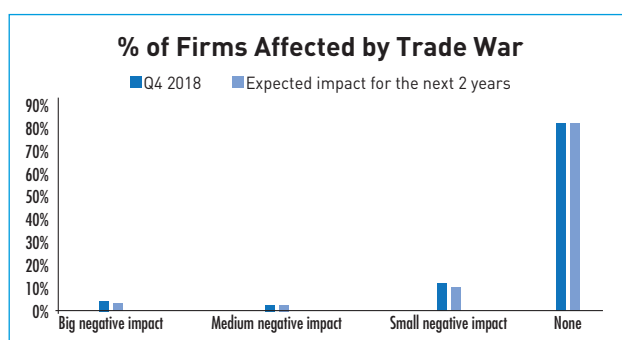
- Operating conditions continued to improve, reaching a four-year high score of 59.
- The impact of the trade war continued to emerge in Q4, although the overall impact was limited. The proportion of affected firms increased by 3 percentage points to 18%, whereas the proportion of firms reporting a significant impact stayed flat at 4%.
- Costs continued to rise, but to a lesser extent. The diffusion index of unit costs was 61. Firms with a significant increase in costs (i.e., quarterly costs rising above 5%) decreased significantly from 6% in last quarter to 3% in Q4.

Analysis

Similarly to the last quarter, this quarter's expansion was mainly driven by state-owned and foreign firms, with the diffusion indices being 59 and 56 respectively (Q3: 60 and 56).

Other signs of improvement included a slight expansion

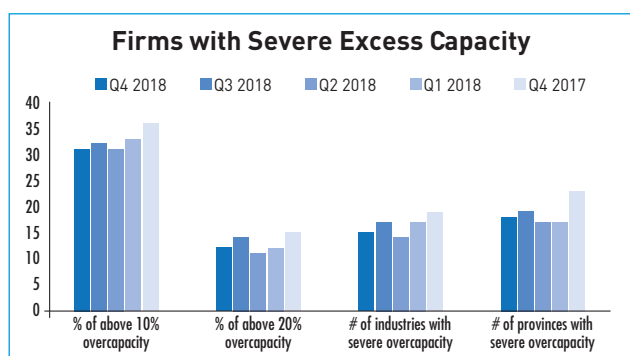




in production, electricity consumption, domestic and foreign orders. At the same time, the expected operating conditions stayed flat, with a diffusion index of 50. Investments were still weak but continued to increase in Q4.

Firms affected by the trade war were mainly export firms, which accounted for 34% of our sample. Among these export firms, 31% were affected in Q4 and 7% reported a significant impact (Q3: 29% and 8% respectively).

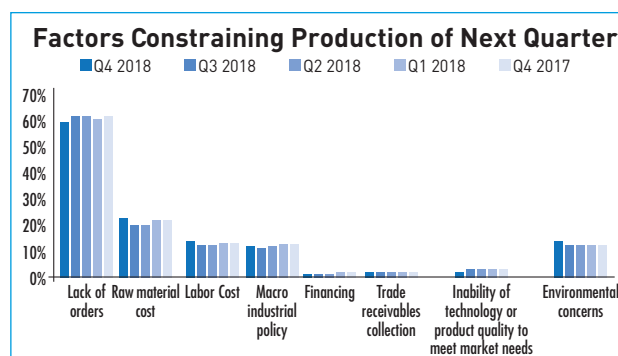
The top five most-affected industries are Textiles, Rubber & Plastic Products, Paper Products, Cultural & Sports Products and Transportation. Among industries seeing a significant impact, the two most affected ones were Textiles (12%) and Rubber & Plastic Products (10%).



Inflation continued to ease in 2018. The diffusion index of product prices dropped from 56 in 2017 Q4 to 51 in 2018 Q4. The best-performing industries in 2018 were Gas Production & Supply, Production & Supply of Water and Power Production & Supply.

Weak demand is still the biggest challenge for the industrial economy. In Q4, for example, 60% of the firms surveyed cited a lack of orders. Rising costs came the second, with raw materials and labor costs cited by 23% and 14% of firms, respectively. Twelve percent of firms cited macroeconomic and industrial policies as limiting factors. Fourteen percent of firms cited environmental concerns. In addition, financing was not found to be a bottleneck, with only 1% saying that financing was a limiting factor, a finding consistent with past surveys.

Overcapacity was still at historically high levels throughout the year. In each quarter, over 60% of the firms reported oversupply in the domestic market, with a diffusion index of above 80. Neither was there any substantial improvement in the severity of overcapacity, measured by the proportion of firms reporting supply-over-demand by 10% and 20%.



It is also worth noting that overcapacity in the international market was substantially less serious than in the domestic market. Weak demand has not caused inventory problems: the finished-goods inventory stayed largely flat, thanks to the “order-based” production model adopted by many Chinese firms.

Overcapacity, combined with rising costs, in general results in low profit margins. Profit margins in 2018 were similar to 2017. In Q4, there were about 2/3 of firms with gross margins below 15%. Taken together, low margins may make it difficult for firms to invest in R&D and industrial upgrading.

Contrary to the skeptical opinions of some in the West, the legal institutions in China have provided reasonably good protection for business operations.

Conclusion

Overall, the biggest challenge facing the industrial economy was overcapacity. Its prevalence remained at a historically high level, and there was no substantial worsening in the severity of overcapacity, measured by the proportion of firms reporting supply-over-demand by 10% and 20%. Financing was not a main limiting factor for the industrial economy. In the fourth quarter of 2018, however, small firms faced greater financing challenges, due to the overall tightening of liquidity.

It is worth noting that, in 2018, R&D spending declined noticeably, while the firms’ confidence about the country’s legal environment dropped significantly.

Given a lack of confidence and the slowdown in consumption, there is substantial uncertainty in 2019. Policy should focus on promoting long-term growth. Loosening of monetary policy can only be a short-term tool to prevent financial instability. The government needs to formulate systematic policies to promote technology innovation, which is the only path to long-term growth of the industrial economy. ■



HUNGRY FOR PROFITS

Ordering takeout has revolutionized China's dining scene, but what is the real price of food deliveries and can it last?

By Mark Andrews

Go to any restaurant in China around meal time and you'll find blue, red and yellow-clad food delivery riders often outnumbering the diners. It is a trend that has benefited everyone who likes to eat at home, but is causing chaos on the roads and also creating major losses for the companies trying to make money delivering takeout foods.

Food delivery has become a cornerstone of city life in China over the last decade. The number of delivery businesses initially mushroomed and then faced off in an intense battle for market share that has left only a handful of significant players still standing, most notably Ele.me—controlled by online retail giant Alibaba—and Meituan Dianping, whose largest shareholder is Alibaba's top rival, Tencent.

Ele.me (pronounced UH-luh-ma, which literally means, 'are you hungry?') employs 15 thousand staff and delivers more than 9 million orders daily.

Meituan is larger, delivering not only food but other consumer products. It has surged from providing 1.7 million deliveries in 2015 to 11.2 million deliveries in 2017.

But both companies are still losing money.

"They have improved the efficiency of getting food for digital natives," says Xue Yu, research manager for the internet and blockchain at IDC. "But it seems like the war between Alibaba and Meituan will continue for a long time."

He says China's online food delivery business was valued in 2017 at \$32 billion

with registered users numbering 300 million, up from 110 million in 2013, and with 80 million active users monthly.

Meituan last year raised \$4.2 billion in an initial public offering (IPO) on the Hong Kong stock market, valuing the company at \$52.8 billion. It was the world's largest internet-focused IPO for the past four years, but the company's share price has struggled. Meituan's third quarter figures released in November showed both a tripling of its operating loss, and a slowing in market growth compared to the first half of 2018.

The key element for the industry is the mobile phone applications that each food delivery platform operates. Easily downloadable, each app lists restaurants in the user's vicinity that take orders for delivery. Within seconds after an order is placed, the restaurant begins preparing the order for the delivery rider to collect and rush to the customer, usually on an electric bike, within an agreed time. The entire process can be monitored by the diner-to-be on the app, with details including the delivery driver's name, phone number and real-time location. Ele.me counts 1.3 million registered merchants spread across 2,000 urban areas while Meituan has 7 million merchants in 2,800 cities.

Despite the efficiency of the app, the financial foundations for the instant food delivery business in China are far from solid. Players in the *waimai* industry, as the food delivery business is known, are using a combination of innovation and discounts

to keep afloat.

In January, Meituan received the International Innovation Enterprise Brand Award for its work with distribution robots and in February it was named the world's most innovative company by *Fast Magazine* in its annual ranking of the 50 top companies around the world—the first time a non-US company had claimed the number one spot. But it is the discounts that are hurting the companies most.

Meals on wheels

"Ultra-convenience and—until recently—heavy subsidies are the rocket fuel which have driven China's on-demand food delivery market," says Michael Norris, strategy and research manager at AgencyChina, a China-focused marketing and sales agency.

The delivery companies initially charged the restaurants nothing to get them to join their networks, and also provide other benefits such as cheap advertising to keep them involved. On the consumer side, discounted pricing is used to lure customers. Meituan revealed that it spent RMB 4.2 billion (\$626 million) on discounts in 2017, and in an effort to boost market share, Alibaba pumped in RMB 1 billion every month into Ele.me from July to September last year. Meituan now has about 63% market share, while Ele.me is at 35%, according to a report published by Beijing-based 3rd-party market researcher DCCI.

"Last year, one hotspot for competition between Meituan and Ele.me—Wuxi, a city just west of Shanghai—saw meals subsidized to the point of effectively being free," says Norris.

Competition between Meituan and Ele.me has become so fierce that customers now say that their services are similar to the point of it not making a difference who they order food delivery from. "I order meals from Ele.me once to twice a week," says Xu Shanshan, an officer worker in Shanghai, "I don't find there to be much of a difference between what Meituan and Ele.me offer."

In 2017, the average order value on Meituan was RMB 40 but that is usually

Ultra-convenience and—until recently—heavy subsidies are the rocket fuel which have driven China's on-demand food delivery market



Michael Norris
Strategy and Research Manager
AgencyChina

not for just one person. Most office workers spend in the region of RMB20-25 to order their lunch using the apps, and discounts play a big role. “If it was expensive I would not order it,” says Liu Jie, a white-collar worker in Shanghai, who regularly uses Meituan.

Everyone is gaining from the discount war, except for the delivery companies themselves. “Certainly the main beneficiary is the customer, but the restaurants and the delivery riders also benefit from this,” says Xue. “Restaurants can gain more customers, and riders can get a job with good pay — both get money.”

Delivering profits

Baidu, the third of China’s internet giants after Alibaba and Tencent, originally had its own player in the game, Baidu Waimai, but sold the business to Ele.me in 2017. The car ride hailing business Didi Chuxing attempted to enter the market in 2018, and Meituan retaliated by entering the car ride hailing business. They then agreed to a truce.

“Didi and Meituan aggressively dipped their toes in each other’s core business last year, but seemed to have reached a truce. Didi isn’t planning to invest further in food delivery, and Meituan isn’t eyeing up ride-hailing markets beyond Shanghai and Nanjing,” says Norris.

Meituan in particular has come under intense scrutiny over its profitability since its IPO. In its accounts for 2017, the company showed an 8.1% gross profit margin for its food delivery business, but that was only part of the picture.



A Meituan food delivery driver on his way to deliver meals in the snow in Shanghai

The biggest cost shown was payments to delivery riders, but what was not included were the costs of obtaining the sales in the first place. Meituan does not break down its selling and marketing expenses and so it is impossible to know how much it specifically dedicated to food delivery. Marketing and sales was the company’s largest other cost in 2017 and is one of the main contributions to the company’s operating loss. “That loss widened over the [2018 third] quarter, which spooked investors,” says Norris.

For many young unskilled workers, food delivery seems like a good option to make a decent income

Geoff Crothall
Communications Director
China Labour Bulletin

The company consists of three business units: food delivery, hotel and travel, and what it describes as “new initiatives.” New initiatives include Mobike which Meituan purchased in 2018 and a number of other non-food delivery merchant solutions. “Meituan’s ‘new business initiatives’ is where they are bleeding lots of cash,” says Norris.

Like any business, Meituan and Ele.me have two options to deliver profitability — increase revenues or reduce costs. But it is getting tougher to deliver either. The apps are trying to get more money out of restaurants and reduce the amounts spent on delivery riders—anything to avoid raising prices to the consumer.

In China’s major cities, the companies now typically charge restaurants a commission for each delivery, of around 18-20% in Shanghai—a similar level to the amount charged by food delivery companies in the US.

For the delivery rider brigade, rates have been cut and now start at just RMB 3.6 per delivery. The average target time for a delivery has also been reduced from 40 to 36 minutes; meanwhile fines for late delivery have increased.

“For many young unskilled workers, food delivery seems like a good option to make a decent income and work on their own schedule but it is a very high pressure job and if they are involved in an accident they might be out of work for months on end and have substantial medical bills or even have to pay compensation to a third party if they were deemed to be at fault in an accident,” says Geoff Crothall, communications director of the China Labour Bulletin.

Increased prices for consumers is the toughest option. Savvy consumers can click on this app or on that app to get the best deal, and Ele.me and Meituan know that raising prices will likely push customers to defect to the other app. “It’s trying to strike a delicate balance between commissions, delivery fees, driver efficiency and platform subsidies,” says Norris.

He says that in tier-one cities, such as Beijing and Shanghai, it is already nearing

the inflection point where it is cheaper to eat out than in.

Riders on the storm

The *waimai* business depends on speedy delivery, meaning that riders often have to take risks to deliver on time. The result, inevitably, has been disregard for traffic regulations and a large number of accidents, sometimes fatal. Figures from Nanjing reported by the *People's Daily* in September 2017, said that food delivery riders are involved in 90% of all traffic accidents, while in Shanghai there is a fatal accident involving a delivery driver every 2.5 days, according to statistics given by the *Worker's Daily*.

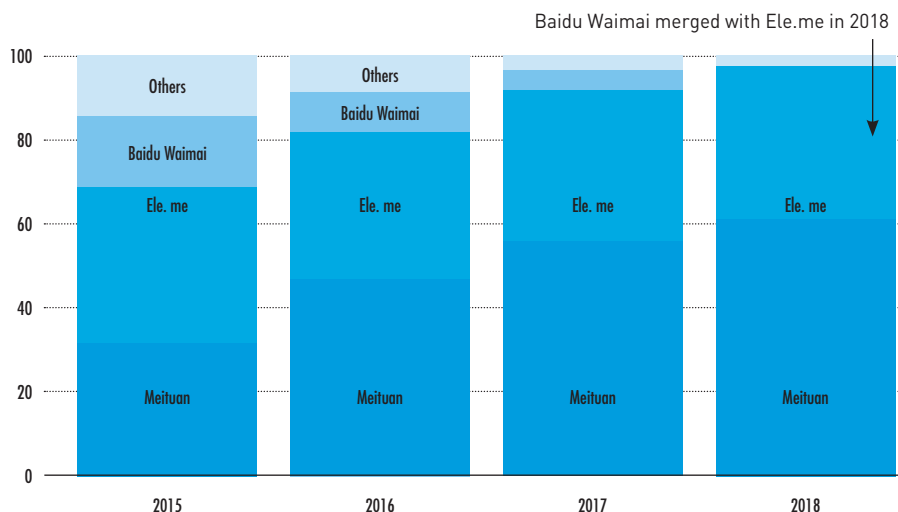
"In the event of injuries, or even deaths, no one seems to take corporate responsibility because there is 'no boss' who can be held legally accountable," says Jenny Chan, assistant professor at the Department of Applied Social Sciences, Hong Kong Polytechnic University. Chan notes that most delivery workers are classified as independent contractors rather than employees.

China Labour Bulletin reported that there were 15 known cases of strikes by food delivery workers over the summer of 2018 alone. "I think it is fair to say that for many workers conditions are not improving," says Crothall. "However, there is some evidence that the delivery companies were willing to make some concessions after workers staged protests. That said, the basic business model seems to be the same and workers are still at the mercy of arbitrary and unilateral management decisions."

Despite the obvious risks of the job, young workers are still attracted by the opportunity because if you work hard you can earn a good income, and payments from the companies are reliable and quick. "It is true that money can be made quickly by delivering food and drinks every day and every night," says Chan. And, she says, delivery riding is usually a better bet than being a construction worker, where pay often only comes on completion of a project and is sometimes withheld.

Technology under trial such as voice-controlled systems for riders may go some

Shares of China's food delivery market (in percent)



Source: Nikkei Asian Review, Bernstein

way to making their lives easier and safer. The companies are also experimenting with drone and robot delivery, but these automated options are unlikely to replace delivery riders within the next two to three years.

Waste not want not

The delivery business has created another problem which is annoying Chinese urban residents and causing headaches for urban administrators—more garbage. "China's booming food delivery and e-commerce industries have resulted in a growing flood of plastic trash, with single-use food containers, plastic bags, spoons and disposable chopsticks clogging the country's landfills," says Yuan Cheng a campaigner with Greenpeace in Beijing. Greenpeace estimate that delivery by Meituan alone results in disposal of 60 million single-use plastic containers and cups a day.

"It's pretty clear that an unnecessary number of plastic bags and packaging are used in food deliveries," says Lena Turlaeva in Zhejiang, a province south of Shanghai, who orders meals from Ele.me two to three times a week. "The restaurants always include excessive amounts of disposable cutlery without even asking how many people the order will serve."

Food hygiene issues have also been raised, with many of the food vendors

providing food to the delivery companies found to be unlicensed. In the first half of 2018, Beijing Food and Drug Administration reported finding 20,000 illegal food vendors.

Second thoughts

For now, the main strategy for the two main delivery operators in clawing their way toward profitability is the integration of more products into their operations, and despite the shaky financial model, both are likely to continue to grow because of the obvious market interest in the services they offer.

Alibaba has described Ele.me as a "local life services platform," and Norris believes that is a strong indication that its services will extend well beyond food. "Given Meituan and Ele.me are starting to compete in a greater range of on-demand, lifestyle and localized services, these 'super-apps' have continued domestic growth prospects," he says.

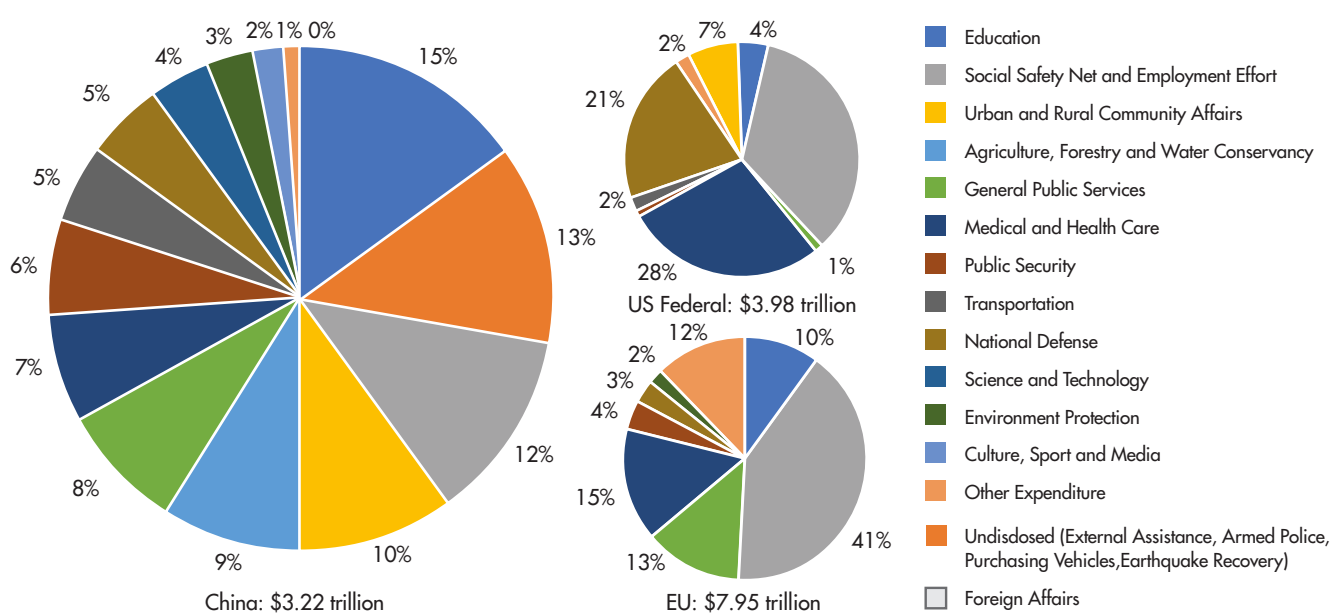
Despite the problems, these Chinese companies have created a business model that will survive and change eating habits everywhere. "China's on-demand food delivery market is probably leading the world in a few respects: market scale, user uptake, market pervasiveness, service variety and payments integration" says Norris.

Government Spending

What is the government of China, the world's second largest economy, spending its money on?

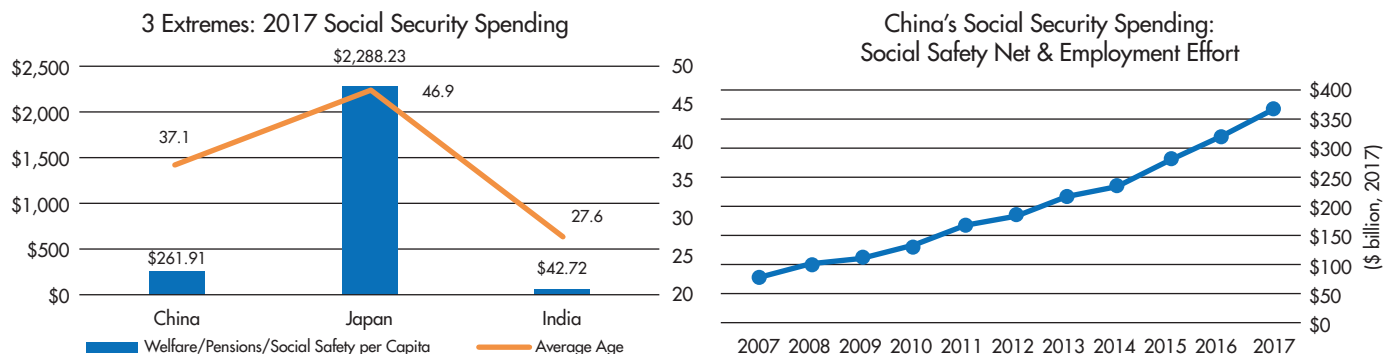
The Breakdown

China's fiscal spending rose 7.7% in 2017 to RMB 20.33 trillion (\$3.22 trillion), while revenues rose 7.4% to RMB 17.26 trillion. The country has said that it will step up government spending this year to support the economy, focusing on further cuts in taxes and fees for small firms.



Social Security

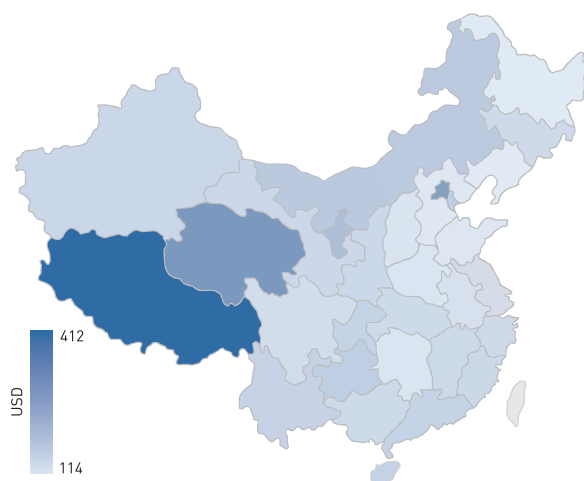
With a low birth rate and a rapidly aging population, experts say that China's social spending will require reform and drastic increases in order to meet its' populations future social needs.



Sources: National Bureau of Statistics, Eurostat, Congressional Budget Office

Health Spending

2017 Health spending per capita

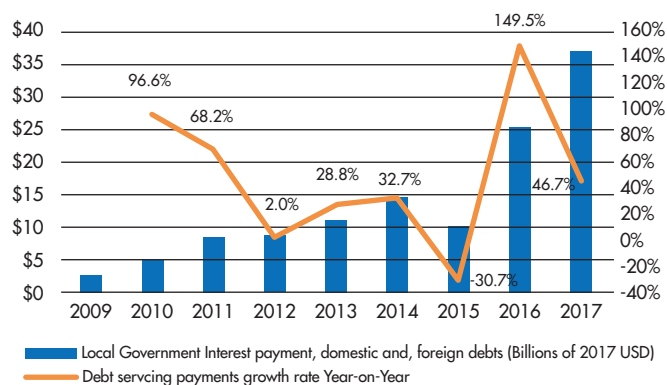


Education spending is concentrated on the east coast, while the western regions of China receive dramatically more health spending per capita than anywhere else, with the Tibet Autonomous Region spending 63% more than Shanghai on each resident's health.

Heavy government investment on infrastructure in recent years to stimulate the economy has been tied to an exponential growth in government debt. Related to that, China's debt servicing payments grew more than 45% in the 2017 local government budget.

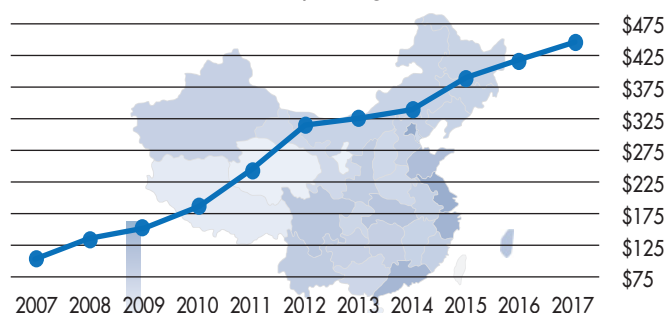
Debt Servicing

Local government interest payments on domestic and foreign debt



Education

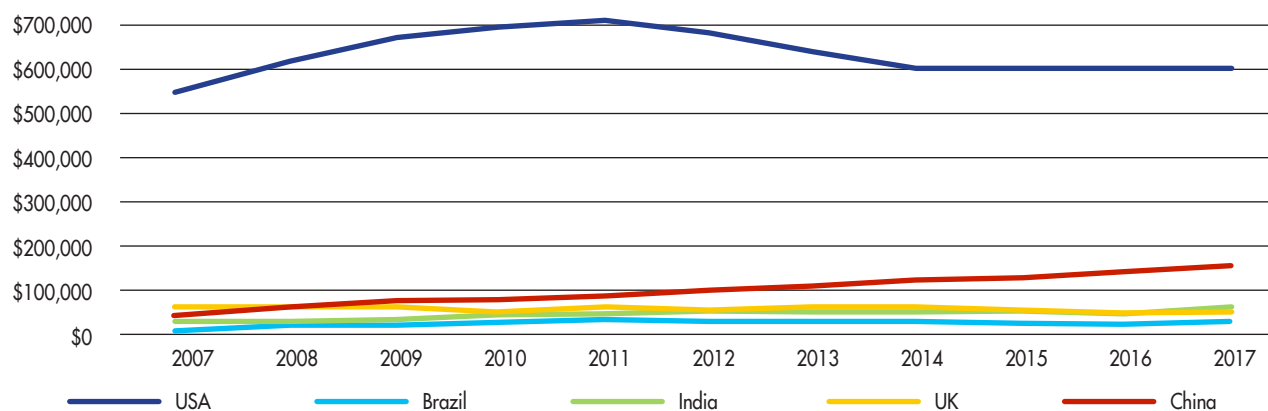
Education spending (USD billion)



Defence

In the last 10 years, China's spending on defence has increased from 12% to 37% of the US' total defence spending and continues to increase steadily each year.

Defence spending by country 2007-2017



Sources: National Bureau of Statistics, Stockholm International Peace Research Institute



The stats you need to know

Macro



Beijing's population falls

In 2017, Beijing's population declined for the first time in **20 years** in 2017, with new data showing that it fell even further in 2018. The city's permanent population fell by **165,000** in a single year, hitting **21.5 million**.

Source: Caixin

Investors' quota doubled

China doubled the quota for overseas investors in the country's equities in January, opening the way for global funds to get a bigger bite of A-shares traded in Asia's second-largest stock market. The combined quota under the qualified foreign institutional investors (QFII) scheme has been doubled to **\$300 billion**.

Source: South China Morning Post



Rising pollution

China's average concentrations of lung-damaging particles known as PM2.5 rose by **5.2%** in January and February. The nation's average PM2.5 readings came in at **61** micrograms per cubic meter according to a Ministry of Ecology and Environment survey of **337** major cities, with only **83** reaching the national standard of **35** micrograms.

Source: Reuters

Gig economy backstop

The gig economy—a labor market characterized by freelance work with no fixed contract—typically absorbs unemployed workers from other industries, but their ability to do so has been hampered by China's economic slowdown, the saturation of markets and tighter regulations. An estimated **33.37 million** workers are estimated to be working in the gig economy.

Source: South China Morning Post



Technology



Startups feel chill

Startups are feeling the effects of a slowing economy with the number of China's venture capital deals dropping to **713** in the fourth quarter of 2018, down **25%** from a year earlier, with the amount of funding shrinking **12%** to **\$18.3 billion**.

Source: South China Morning Post

Virtual red envelopes

China's dominant search engine Baidu Inc. handed out RMB **1 billion** (\$148 million) in virtual red envelopes for Spring Festival this year, during state broadcaster CCTV's Spring Festival Gala, an annual variety show watched by about a billion people. Alipay, TikTok and Tencent's short-video app Weishi also gave out RMB **500 million** each.

Source: Caixin



Closing Innovation Gap

China is slowly but surely closing the innovation gap with the US. A new report from the Information Technology and Innovation Foundation examined **36** indicators of China's scientific and technological progress—including R&D spending, venture capital investment and number of researchers—vis-à-vis the United States a decade ago versus today. The report says that had China been **80%** behind the United States a decade or so ago, it would be just **50%** behind now.

Source: USNews, Information Technology and Innovation Foundation

Consumer



E-Commerce powers China

E-commerce is expected to grow more than **30%** in China this year to account for **35.3%** of the overall China market, with predictions that China would account for over half of all global e-commerce sales by the end of 2019. By comparison, e-commerce still accounts for just a small portion of all retailing in the US, expected to make up about **10.9%** of sales this year.

Source: Caixin

Marathons race ahead

More than **1,100** marathons were held in China in 2017, up massively from only **13** in 2010. The number of races is expected to top **1,900** by 2020, with more than **10 million** runners crossing the start line. The industry is estimated to rake in **\$19 billion** annually by then, up from **\$10 billion** in 2017.

Source: Caixin



Hermès still in luxury

Luxury groups rely on Chinese consumers for over a third of sales, with many labels heavily exposed to markets where Chinese tourism appears to be suffering due to slowing economic growth. Hermès, however, is still on the rise in China, with the group posting a **9.6%** rise in 2017 Q4 sales.

Source: Reuters

Business



Investment banker surplus

Competition among Chinese investment banks has become so intense that five firms recently agreed to split a **0.001%** fee for arranging a private share placement. That compares with the more than **5%** that's usual for follow-on stock offerings on Wall Street. Average fees for all equity deals in China in 2018 tumbled to a five-year low of **3.9%**.

Source: Bloomberg



Gyms muscle-up

A combination of health awareness, lifestyle-related consumption upgrade, innovative use of digital technologies, and high-quality manufacturing is spurring a boom in China's fitness industry. By the end of 2018, the industry boasted more than **53,000** facilities, which shaped forecasts of a **RMB 70 billion (\$10.4 billion)** business by 2020, with an estimated 20% annual sales growth.

Source: China Daily

Tycoons' wealth topples

Almost half of Hong Kong's tycoons have lost a portion of their wealth over the past year as a result of China's economic slowdown and a softening property market. The biggest loser was Pollyanna Chu, who saw **73%** of her fortune wiped out due to how her company's shares were overly concentrated among a small group of investors. She lost her spot as Hong Kong's richest woman as her fortune slipped from **\$12 billion** to **\$3.3 billion**.

Source: Financial Times



Waste-free cities

China has published an ambitious "no-waste city" pilot plan that aims to minimize solid waste generation and maximize recycling in urban areas. The country faces a solid waste backlog of **60-70 billion tons**, and the new program—which would include the participation of ten cities in its first phase—would aim to cut down on the amount of waste produced and improve treatment rates.

Source: Reuters



BOOKSHELF

Linking China's Past and Present

Jeffrey Wasserstrom, author of *China in the 21st Century: What Everyone Needs to Know*, recommends books that put forward compelling views on how China rose to become a global power.

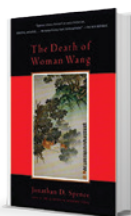
Jeffrey Wasserstrom is Chancellor's Professor of History at the University of California, Irvine and has written, co-authored, edited or co-edited more than 10 books, including *Eight Juxtapositions: China through Imperfect Analogies from Mark Twain to Manchukuo*, and *The Oxford Illustrated History of Modern China*. A graduate of Harvard and Berkeley, he has also contributed to general interest venues, including *The New York Times*, *the Wall Street Journal*, *the Financial Times* and *the Atlantic*. In this selection, Wasserstrom explores the social history of China and suggests books that will help you understand how modern China came to be.

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



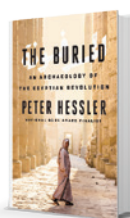
Until recently, when asked this question, I would suggest *China in Ten Words*, a wonderful collection of cultural and political essays by novelist Yu Hua. I still like that book, but it came out in 2011 and a set of important changes, some of them very worrying, have taken place since then. So, now I want to suggest that people read something quite different instead of—or in tandem with—Yu Hua's memoir-infused commentaries. Namely, *China's Third Revolution: Xi Jinping and the New Chinese State*, a clear-eyed, critical look at current trends by political scientist Elizabeth Economy.

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



The Death of Woman Wang by Jonathan Spence was one of the first books I read about China, when it was on the syllabus for a college class I took during my first year at UC Santa Cruz. Since then I've often assigned it to my own students, both in classes on modern Chinese history and in classes on historical method. I've read it dozens of times and always find new things to appreciate in this slim, stylish, experimental work that tries to capture the meaning of the lives of ordinary people who lived centuries ago.

What are you reading currently?



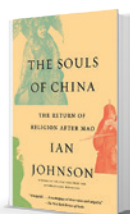
I'm currently reading page proofs of *The Buried: An Archaeology of the Egyptian Revolution*, which will be published in May. It's by Peter Hessler, who lived in China for years, writing about the country beautifully for *The New Yorker*, before moving to Cairo. His new book is a wonderful read and has some sections that bring in his time in China and some that focus on the activities of Chinese people living in Egypt.

What book totally changed your perspective on a certain topic?



Susan Mann's *The Talented Women of the Zhang Family* was an eye opening read that changed my perspective on various issues associated with gender and family during the Qing Dynasty. This elegantly written work has so much to offer that it is hard to know where to start, but it altered the way I thought and now teach about the ties between generations within Chinese families, the role of poetry in the lives of elite women, and how a period's main events can look different when we focus on female experiences rather than male ones.

Which China book do you think is the most underappreciated?



If asked to name an underappreciated writer, I'd have said either Zhang Ailing (Eileen Chang) or Lao She. Outside of China, if people know them, it tends to be as the authors of *Lust*, *Caution* and *Rickshaw Boy*, respectively, but each produced fascinating works very different than these. For an under-appreciated book, I'll say Ian Johnson's *The Souls of China: The Return of Religion after Mao*. It got good reviews but it deserved to be on lots of book of the year lists and it wasn't. It's an expertly crafted, carefully researched work on a topic of enormous importance.

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