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KNOWLEDGE @ WHARTON | SPECIAL REPORT

# CHINA

## New Ambitions, New Directions



## INTRODUCTION

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### China: New Ambitions, New Directions

China's remarkable story of economic growth is well-documented. Some 800 million people have moved out of poverty over the last 40 years thanks to market-based economic reforms. The annual 10%-plus GDP growth that dominated for years may have moderated, but the latest five-year plan calls for a still-robust 6.5% annual GDP growth rate.

Economic ambitions, however, have not become more moderate.

China's "One Belt, One Road" initiative, for example, would stitch together roads, ports, railways and other links from East China through Southeast, and South and Central Asia over to Europe. It exceeds in scope the Marshall Plan that rebuilt post-war Europe. Beyond that, China is by far the biggest source of financing for many of its neighbors. The Export and Import Bank of China alone lent \$80 billion in 2015, compared with \$27 billion from the Asian Development Bank. All this expands China's economic and geopolitical sway across Asia, the Middle East, Europe and Africa.

For now, however, the pace of reforms needed to push that process forward has been slowing and is unlikely to regain momentum until certain political cycles are completed in March 2018. What seems clear is that Beijing is committed to globalization, and to the integration of its markets and financial systems – but on its own terms, at its own pace. This includes transitioning from an export-based economy to a consumer-based one, and a deeper integration into global financial markets.

This report considers many of these issues and also offers a closer look at two sectors: retail, which is ground zero for any consumer-oriented transition; and high-tech, through the eyes of a company that wants to link-up Israeli tech innovation with Hong Kong investors and market it all into China.

As the experts interviewed in this report note, many Chinese have never owned a PC or had a fixed telephone line – mobile is their first internet connection. Leap-frogging old technologies has allowed many Chinese businesses to tear down entry barriers and grow rapidly. It has also helped China become an innovator in its own right. It is no accident that China has the world's most advanced mobile payment systems.

Potential stumbling blocks remain, of course, and serious debt issues can be added to the list of needed economic and financial transitions already mentioned. But China continues to create big plans to deal with its massive challenges.

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## Where Will China's 'One Belt, One Road' Initiative Lead?

**AS ADVERTISED BY BEIJING, THE “ONE BELT, ONE ROAD” (OBOR) initiative, China's grand scheme for knitting a network of roads, ports, railways and other links from East China through Southeast and South and Central Asia all the way to Europe exceeds both in scope and ambition the Marshall Plan used to rebuild Europe after World War II.**

The “belt” of land-based links is paired with a 21st century “Maritime Silk Road” stretching from Australia to Zanzibar. Chinese President Xi Jinping launched the OBOR initiative in 2013, two years after then-U.S. President Barack Obama initiated the Trans-Pacific Partnership (TPP) trading bloc across the Pacific region. Now that Obama successor Donald Trump has carried out his pledge to withdraw from the TPP, the expectations are that Chinese-backed strategies like the OBOR will gain momentum. China experts say that this is a positive development, but there is skepticism over whether Beijing will follow through with the gargantuan amount of funding needed,

with more than \$27 billion from the Asian Development Bank. Chinese involvement in building railways, ports, roads, dams and industrial corridors is helping to expand its economic and geopolitical sway across Asia, the Middle East, Europe and Africa.

China experts and economists say that the initiative makes sense and that it will accelerate as the U.S. turns more insular under Trump. “It is unfortunate that many U.S. diplomats and members of the previous administration worked for nearly a decade to push toward the TPP and now it is torn apart,” says Louis Kuijs, head of Asia Economics at Oxford Economics in Hong Kong. The U.S. is turning its back on the rest of the world at a time when the world needs an open and engaged America, he says. “It is very likely and understandable that China ... will try to fill those gaps with this initiative, and that is very logical — it's something the U.S. will later deeply regret,” Kuijs says.

The OBOR effort has not gotten the degree of attention it deserves, says Pieter Bottelier, visiting scholar of China Studies at Johns Hopkins School of Advanced International Studies in Washington. “I am concerned that its significance is underrated in the U.S. and in the West in general. It is a very positive initiative and a major vision of how China can collaborate with countries in its neighborhood, Europe, Latin America and Africa in a way that is in the long-term interest of China and [the global economy],” Bottelier says.

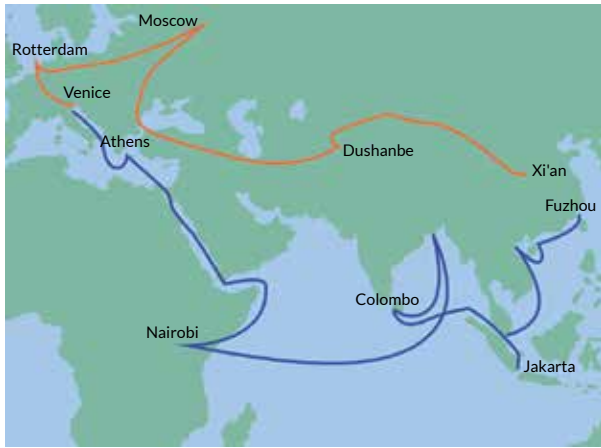
**“I am concerned that its significance is underrated in the U.S. and in the West in general.”**

—Pieter Bottelier

whether big debt-financed projects bankrolled by China will benefit the recipient countries, and whether those projects will actually make sense in the long run.

For many countries in the region, China is by far the biggest source of financing: Beijing's Export and Import Bank of China alone lent \$80 billion in 2015, compared

The geopolitical aspects of the OBOR initiative could eventually draw attention from the Trump administration, given its strong stance on national security. “It is an economic initiative, but along the way China will expand its military bases and so forth,” says Wharton emeritus professor Franklin Allen, who also is a professor of finance and economics at Imperial College London. “On the sea routes they will develop their military capability and on the land routes, too.”



From Kuijs' point of view, Beijing views the OBOR initiative as a strategy needed to support its growing economic might. "Many outsiders are skeptical and do not know exactly what it is, but it is taken very, very seriously by the Chinese government and we should take this very seriously," he says. "The Chinese government is thinking, 'We are the second-biggest economy in the world, and it may take 10 years or 20 years but we will be the world's biggest economy at some point.'"

While it is sweeping in scope like the stalled TPP, which aims to create a trading bloc around the Pacific Rim, the "One Belt, One Road" plan is not a free trade agreement. It's more of a blueprint for integrating China's trading partners by developing their infrastructure — ports, roads, airports and railways — in a way that complements Beijing's own interests. Infrastructure-led development worked well for China, in Beijing's view, and now it wants to expand that approach internationally, Kuijs says.

The "One Belt" refers to a "Silk Road Economic Belt" from China through Central Asia to Europe. The "One Road" refers to Beijing's concept of a "21st century Maritime Silk Road" to connect China to Europe via the South China Sea and Indian Ocean. The initiative involves developing six economic "corridors": a China-Mongolia-Russia corridor; a new Eurasian "Land Bridge"; a corridor from China to Central Asia and Western Asia; a China-Indochina peninsula corridor; a China-Pakistan economic corridor; and a Bangladesh-China-India-Myanmar economic corridor.

Chinese President Xi Jinping said in his speech at the World Economic Forum in Davos, Switzerland in January that more than 100 countries and international organizations have given warm responses and support to the initiative and that more than 40 countries and international organizations have signed cooperation agreements. So far, Chinese companies have made more

than \$50 billion of OBOR-related investments and launched a number of major projects in the countries along the route, he added. At least 65 countries are included in the OBOR initiative.

## UNANSWERED QUESTIONS

While the grand vision is laudable, there are many unanswered questions: How would it be done? And what would be the project, environmental and engineering standards implemented under this umbrella?

"There would be serious doubts over protection of minority populations and environmental concerns," Bottelier says. As for the scale of OBOR, there's no consensus over how many projects it would involve at what cost and in what time frame. "It is pretty obvious that there is no limit to the amount of infrastructure that is needed in those countries."

The Asian Development Bank says infrastructure development in Asia and the Pacific will exceed \$22.6 trillion through 2030, or \$1.5 trillion per year. In a recent report, "Meeting Asia's Infrastructure Needs" issued in February, the estimate rises to more than \$26 trillion, or \$1.7 trillion a year when costs for climate change adaptation and mitigation are included. "This is a grand vision, and it may take a decade, but there is no rush. You cannot really put any number on the total investment," says Rajiv Biswas, Singapore-based Asia-Pacific chief economist at IHS Markit.

**"One Belt, One Road is relevant for Europe since China wants to link its rail to Europe. So, China wants Europe to be part of [OBOR], but not as a key driver."**

—Rajiv Biswas

The China-led Asia Infrastructure Investment Bank, or AIIB, is seen as a linchpin for OBOR financing. So far, however, it has provided only \$1.73 billion to support infrastructure projects in seven countries, including Pakistan, Bangladesh, Tajikistan, Indonesia, Myanmar, Azerbaijan and Oman since it was launched in January 2016.

Noriyoshi Ehara, chief economist at the Tokyo-based Institute for International Trade and Investment, says the financial infrastructure for OBOR is gradually taking shape. Apart from AIIB, China also has a \$40 billion Silk

Road Fund and a New Development Bank to fund the OBOR initiative. “There has been good progress in getting these frameworks in place,” Ehara says. Ultimately, he adds, Beijing may not limit OBOR to infrastructure but may make it the foundation for regional and bilateral free trade areas (FTAs). “We are not sure if China will succeed, but the world is changing, and more and more countries are joining this initiative,” he says. With the TPP in trouble, OBOR is getting more attention.

**“It is quite likely that China will succeed in this initiative, though it may take a half-century.”**

—Franklin Allen

### CHINA'S DEEP POCKETS

Already, more than \$900 billion in projects are planned or underway, Fitch Ratings says in a report titled “China's One Belt and One Road Initiative Brings Risks.” It says most funding will likely come from China's policy banks, the Export and Import Bank of China, China Development Bank and its largest commercial banks. “We estimate that outstanding loans from Chinese banks total \$1.2 trillion, and a large portion of that has financed infrastructure projects involving Chinese state-owned enterprises,” the report says. China also has other major financial resources such as its sovereign wealth fund and foreign exchange reserves.

One project that got a head start was construction of a railway link from the port of Piraeus in Greece to Eastern Europe. Piraeus is a gateway to Europe for Chinese products, and major Chinese companies have been using the port to enter the European market. China, through its China Ocean Shipping Company, bought a 67% stake in the port's Pier I from the Piraeus Port Authority SA in January 2016.

The European Union (EU) is welcoming OBOR, but cautiously. “China basically owns Piraeus Port close to Athens and this railroad is meant to link all the way up to Budapest in Hungary, which also is an EU member,” notes Kuijs. “The EU is now looking at this project, which clearly is projecting China all the way into Europe, to see to what extent it is compatible with EU rules and principles.”

Apart from questions over whether Chinese-led projects might conform with global standards on such issues as environmental protection and labor rights, some economists question if a massive, policy-led OBOR

push on infrastructure development will turn out to be economically sound. “Let's see what kinds of projects they are getting in the next couple of years and what kinds of returns they are getting,” Biswas says. “Because in the end, if they are not delivering on the returns, then the banks that are lending will eventually say we need to be careful and we cannot keep doing this without any returns because it has to be commercially viable.”

A flood of lending to smaller countries lacking strong foreign exchange reserves might not be able to repay the loans if projects fail to generate revenue as expected. Fitch warns in its report on OBOR that some of the loans are large enough to have an impact on borrowing countries' public finances, if debt-servicing from project proceeds becomes a problem.

That problem already is surfacing in Sri Lanka, where China signed a deal in late 2016 to further develop the strategic port of Hambantota and build a huge industrial zone nearby. China has spent almost \$2 billion so far on Hambantota and a new airport. But hundreds of Sri Lankans clashed with police at the opening of construction in January of the industrial zone in the south, saying they would not be moved from their land. It was the first time opposition to Chinese investments in Sri Lanka turned violent. Newly elected Sri Lankan President Maithripala Sirisena had said the new port deal with China was unfair in his campaign, but after taking office approved an agreement to lease an 80% stake in the port to the China Merchants Holdings for 99 years in exchange for \$1.1 billion in debt relief.

Concerns over the ability of smaller developing countries to protect their own interests underscore the need for involvement of Western countries, especially from the EU, since Japan and the U.S. have continued to shun the AIIB. “You have weaker institutional capacity and weaker governments like in Cambodia and Central European countries. They may be persuaded by Beijing to take on large debt to finance projects. They and other developing countries in the past ended up with large debts incurred to finance dubious projects that do not help their economies. That is the risk for countries that do not have the capacity to independently make cost-benefit analyses,” Kuijs says.

While there's nothing wrong with investing more in poor countries, and in increasing economic interactions between poor countries and China and the rest of the world, “it would be beneficial for Western countries to take this initiative very seriously and to become its counterparts in this rather than having China sort it by itself,” he says.

Of course, that begs the question of whether China would welcome their involvement. “This is China's initiative, but

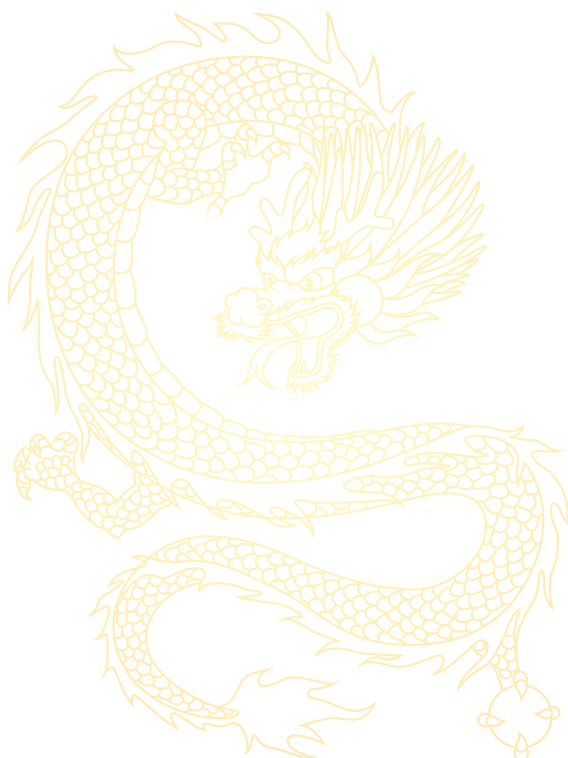
this is not the AIIB. They want the rest of Asia to be part of it, but more on a bilateral level,” says Biswas. China’s vision is of a partnership with other developing countries in Asia. “Having Europe be part of it is a different story,” he says. “One Belt, One Road is relevant for Europe since China wants to link its rail to Europe. So, China wants Europe to be part of [OBOR], but not as a key driver,” Biswas added.

## CHINA'S SLOWDOWN IS A CATALYST

One of the main factors driving the OBOR effort is the slowdown in China’s own economy. The Communist Party is striving to transition away from growth led by investment and exports to development led by domestic consumer demand and services, and to keep growth at more sustainable levels than in the past. The government set a growth target of 6.5% in 2017 at the National People’s Congress in March, down from a 2016 target of 6.5% to 7%. In a sense, China is seeking to export the investment-led part of its economy, to help its own overbuilt heavy industries and provinces.

But Kuijs doubts OBOR projects will do much to help China with its huge overcapacity problems in many industries, especially steel, glass and cement. Compared to the size of China’s steel industry or other industries, it would take a very long time for demand from the projects to be big enough to make a difference, he says. “Many of the projects are far away from China, and some types of steel are worth transporting but not all kinds of steel. It would not help reduce excess capacity of cement because it is not economically viable to transport cement over such long distances,” Kuijs says. Bottelier, also, sees overcapacity as only a marginal factor in the OBOR plan.

Looking back at how far China has come since it launched its market-oriented reforms and opened its economy, there’s reason to hope the OBOR strategy will have a significant impact over time, Allen says. “It is quite likely that China will succeed in this initiative, though it may take a half-century.” ★





# China's Global Financial Integration: How Far and How Fast

**CHINA'S NEWLY RECLAIMED ROLE AS THE "MIDDLE KINGDOM,"** showcased at a recent gathering of world leaders in Beijing to celebrate China's "New Silk Road," should have vanquished any lingering doubts about China's commitment to weaving its markets and manufacturers more closely into the global economy. "We need to seek win-win results through greater openness and cooperation," President Xi Jinping proclaimed at the Silk Road event. Xinhua, the state-run news agency, declared Xi an "ardent champion of globalization" and the "architect" of China's plan to connect countries with a 21st century version of the ancient Silk Road.

But the pace of reforms needed in China to push that process forward has been slowing and is unlikely to regain momentum until at least after a key Communist Party Congress in the autumn, or maybe after President Xi Jinping's next administration presumably takes office in March 2018. And no matter how much Xi strives to claim the lead in open trade and battling protectionism, Beijing's commitment to globalization and integration of its markets and financial systems will come on its own terms, at its own pace.

**"China needs to do a lot of work. For example, its capital markets do not work well."**

—Franklin Allen

However, China's influence on world markets far outweighs the degree of integration of its own banks and financial markets with the rest of the world. While the country has only gradually eased controls on its capital account and foreign exchange markets, illicit

flows of capital are playing an outsized role in overseas real estate and stock markets, and investments by its big corporations are altering the world industrial landscape. State enterprises and private companies, meanwhile, are investing aggressively in strategic areas such as food, energy, robotics and infrastructure.

Caution prevails ahead of the party congress. While Xi needs the economy to remain on an even keel, expanding at a fast enough pace to avoid major layoffs, his priorities lie elsewhere, says Pieter Bottelier, a visiting scholar of China studies at Johns Hopkins School of Advanced International Studies in Washington. The lingering effects of the global financial crisis is a key concern. "The international system is so unstable and they have become increasingly reluctant to join the system. Joining the international system may increase instability and volatility," he says.

## CHINESE M&A SLOWS

China's robust mergers and acquisitions pace is driven not so much by a desire to snap up lucrative assets or the opening of more markets as it is about upgrading Chinese industries with improved technology. The aim is "increasing Chinese content of Chinese industry up to 70% by 2025," says Chi Lo, a senior economist for Greater China at BNP Paribas Investment Partners in Hong Kong. "It's a mid-term program to upgrade the Chinese economy so that Chinese can compete with the world's advanced economies."

China's central role as a world factory floor is not matched by advances in its financial sector. Despite their huge size, China's banks lack a major global footprint. Its capital markets also lag behind, even though China's two stock exchanges in the Mainland — in Shanghai and Shenzhen — when combined are the world's second largest by market capitalization, says Franklin Allen, an emeritus professor of finance at Wharton and a professor of finance and economics at the Imperial College London.



"China needs to do a lot of work. For example, its capital markets do not work well. The bond market is improving but the stock markets are still a problem and are not representative of the Chinese economy," Allen says. "They need to reform IPOs, delisting procedures and corporate governance. There is a lot to be done there." The Shanghai and Shenzhen stock exchanges are tightly controlled and limit participation by foreign investors.

Also slowing down needed reforms is the impact of capital outflows on the value of the yuan, or renminbi. A devaluation in August 2015 roiled world financial markets and Beijing saw the pace of overseas acquisitions falter in 2016 as China slowed capital outflows to prop up the yuan. China's foreign reserves have fallen by about \$1 trillion since June 2014 as it bought its own currency to defend it. "Some of the reforms were affected by that, and they cannot move as fast with them anymore as they originally wanted," says Rajiv Biswas, Asia-Pacific chief economist at IHS Market in Singapore.

China's restrictions on capital outflows mean that individuals, for example, cannot take out more than \$50,000 annually, and only for non-investment purposes like education, medical care and tourism. In reality, much more escapes the country both through individual and corporate investments. Since capital outflow pressures remain, any let up in the controls would just start them back up, says Biswas. "They want to stabilize the situation but they are nervous about what could potentially happen." The very large size of recent mergers and acquisitions, such as Qingdao Haier's \$5.6 billion purchase of GE's appliance business, means China will remain cautious about allowing reserves to fall any further, he says.

Developing more comprehensive, well-functioning capital markets with a wider choice of financial products would help counter concerns about capital outflows and currency volatility, according to a recent report by the Asian Securities Industry and Financial Markets Association. Beijing has to choose between financial stability and the freedom and flexibility of a global currency demanded by international investors, the report noted. The lack of investment and financing options puts too much access to credit in the banking sector and limits China's capacity to provide investment returns needed to support economic growth and provide adequate social welfare. Ultimately, Beijing needs to make the yuan fully convertible if it wants it to gain recognition as a truly global currency like the euro, yen or U.S. dollar, the report said.

"If people have confidence in yuan, then that will give them more capacity to use the yuan to do a lot of M&A deals, trade and investment without having to use foreign

exchange reserves," Biswas says. Once China becomes the world's largest economy, expected to happen in the coming decade, it will need to have a currency that is on that level to match its stature in global affairs.

## **SLOW-PHASED REFORMS**

For now, though, China is moving slowly on reforms to avoid putting further pressure on its foreign reserves, says Louis Kuijs, head of Asia Economics at Oxford Economics in Hong Kong. China still has the world's largest foreign reserves, at \$3.009 trillion in March, up from \$2.998 trillion in January. But that is down from a peak of \$3.99 trillion in June 2014.

The 2008 global financial crisis and the wild gyrations that followed China's last round of currency liberalization in 2015 have convinced Beijing that pushing ahead with internationalizing the yuan at this stage would carry more risks than benefits, says BNP Paribas's Lo, who has authored several books on China.

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To gain the Chinese currency's acceptance for use in the International Monetary Fund's Special Drawing Rights basket of international reserves, regulators removed a cap on deposit interest rates in July 2015 and a month later shifted away from a de facto peg of the yuan to the U.S. dollar, allowing more flexibility. China also signed swap lines with more than 30 central banks. Lo notes that a decision by Argentina in late December 2015 to use its swap line, selling \$3 billion worth of yuan for U.S. dollars to replenish its reserves, rattled Beijing. Short-selling by foreign traders has also added to downward pressure on the yuan.

Small wonder that China slammed on the brakes. Recently, "we have not seen any opening up of new sectors for foreign investors," Lo says. "China wants to open up more sectors to foreign investors, but that is a long-term thing," he said. The service sector, especially, remains largely closed especially for private commercial banks and other financial institutions.

China has managed to keep its financial markets largely insulated from potential outside shocks thanks to the rapid accumulation of wealth that has fueled strong investment by Chinese individuals, companies and pension funds. “It is basically a domestic market and that is what the Chinese government wants. They do not want a huge foreign ownership because it could be destabilizing — you get hot money flowing in and out,” Biswas said.

But China’s economic woes continue. Earlier this year, Moody’s downgraded the country’s credit ratings for the first time since 1989 on the expectation that China’s financial strength will erode over the coming years, with debt continuing to rise as potential growth slows. It downgraded China’s long-term local currency and foreign currency issuer ratings to A1 (medium to high quality) from Aa3 (low risk).

## “China wants to open up more sectors to foreign investors, but that is a long-term thing.”

—Chi Lo

“While ongoing progress on reform is likely to transform the economy and financial system over time, it is not likely to prevent a further material rise in economy-wide debt, and the consequent increase in the contingent liability for the government,” according to Moody’s. It expects the government’s direct debt burden to rise gradually toward 40% of GDP by 2018 and closer to 45% within a decade. A report by Capital Economics’ chief Asia economist, Mark Williams, says this: “We agree fully with Moody’s view that reform over the past year has been slow. As a result, further slowdown in growth now seems increasingly likely.”

Separately, there have been incremental changes in China’s market-opening efforts. Earlier this year, China opened its foreign exchange market to allow hedging by private foreign investors, up to the amount of funds they are managing inside China. It also is allowing foreign investors to invest in the onshore bond market, a small step toward opening the country’s capital account fully to foreign direct investment and portfolio flows.

Recently, the Asset Management Association of China gave a green light to Fidelity International to launch a fund in China for Chinese institutional investors and wealthy individuals. It was the first time a foreign fund manager was allowed entry into the potentially lucrative private

investment sector. The Fidelity China Bond No. 1 Private Fund will invest in China’s \$9.4 trillion bond market. Fidelity, which split from U.S. mutual fund giant Fidelity Investments decades ago, doesn’t have any quotas as part of China’s Qualified Domestic Institutional Investor program that lets Chinese institutional investors invest overseas. But it is teaming up with Chinese banks that have quotas under the program.

## ONSHORE INVESTMENT MOVES AHEAD

Progress on opening to foreign government institutions has come a bit faster. In 2016, Beijing opened China’s onshore stock, bond and foreign exchange markets to official foreign financial institutions such as central banks and sovereign wealth funds. “If you speak with any central bank, they now face no restrictions on investing in China and getting their capital back,” Lo says. “It is basically capital account convertibility for official foreign institutions.”

Although China’s regulators are wary of external shocks that open capital markets can bring to exchange rates, share prices and the financial system, they understand such reforms are needed. But proceeding cautiously is key. “If they go too fast ... the changes could crash its financial system before they see the benefit,” Lo says. “If you are talking about full capital account opening, it will be a very long-term process. I see it taking at least 10 years to see China open its capital account completely like Japan.”

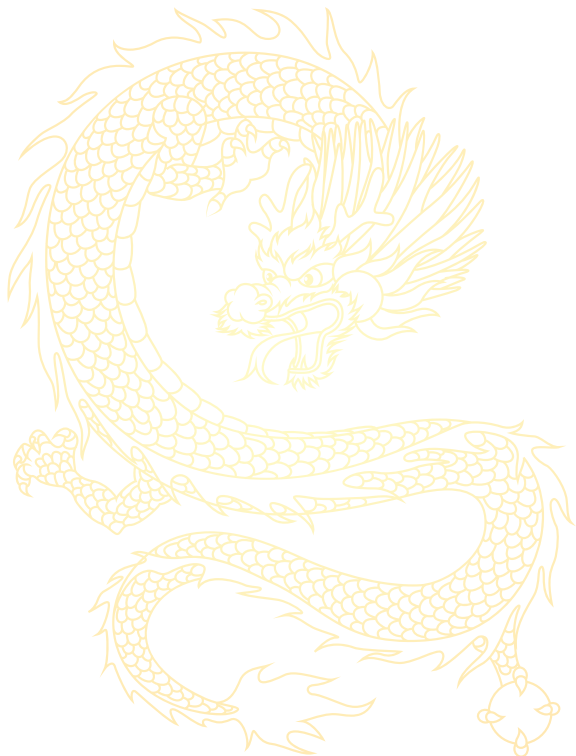
Keeping China’s financial markets relatively closed off from the rest of the world will not, as some like Martin Wolf of the *Financial Times* contend, prevent it from affecting global financial systems. Lo concurs: “We already feel Chinese influence with a relatively closed Chinese financial market. I do not think that keeping the Chinese market closed will help shield the world from Chinese influence. The Chinese economic system is so integrated in the global system in terms of supply chain that whatever happens in China, it would send shock waves to the world economically.”

Some experts, like Bottelier, doubt China will ever truly adopt a free-floating exchange rate. He sees policy shifting more to the political left, which is a party-dominated form of state capitalism that puts the party’s interests ahead of a convergence toward global norms. How soon will China integrate its financial markets globally? “Under the current political system, not ever,” he says. “Overall, I fear that the momentum of financial sector liberalization is essentially dead.”

But many other analysts expect reforms to accelerate once Xi has further consolidated his power after the

party congress, which occurs once every five years, in the autumn. While the government will find it more difficult to control prices, closer integration with world markets would help bring more discipline to China's somewhat disorderly bourses, which some Chinese experts have likened to "casinos." Adds Allen: "It's a political issue. Do they want companies to pursue shareholders rights? ... How much do they want to control capital flows because of the issue of people taking money out of China? These are political issues. It may become easier to do financial reforms after the party congress."

The underlying agenda is liberalizing China's markets, Biswas says. But the experience of the past few years has left China's leaders understandably cautious. "They want to liberalize the domestic capital market and to create more efficient markets and improve investor product ranges," he explains. "It will be very slow reforms because they do not want to destabilize markets with sudden reforms and create big volatility in capital flows." ★





## What Can China and the U.S. Learn from Each Other about Retail?

*George Hongchoy is the CEO of Link Asset Management Limited, which includes the Hong Kong-listed Link Real Estate Investment Trust – the first REIT in Hong Kong and the largest in Asia. The experience of his company acquiring a large number of retail properties from the government, then upgrading them, gives him a unique view of how the retail sector in Hong Kong and China is evolving. In this Knowledge@Wharton interview, he offers his views on online-to-offline retail, the differences between the retail sectors of China, Hong Kong and the U.S., and what lies ahead.*

*Hongchoy is also chairman of the supervisory committee of the Tracker Fund of Hong Kong, an exchange-traded fund that follows the performance of the Hang Seng Index. He was named Business Person of the Year in Hong Kong as part of the DHL/SCMP Hong Kong Business Awards in 2015, and he received the Asian Corporate Director Award from Corporate Governance Asia. He was also named the Best CEO by FinanceAsia's poll of Asia's best companies in 2012-2015.*

*An edited transcript of the conversation follows.*

**Knowledge@Wharton:** Please tell us about your company.

**“The Chinese consumer market has been growing rapidly, although it has seen some slowdown.”**

**George Hongchoy:** The Link Real Estate Investment Trust – or Link REIT, as we refer to it – was listed in 2005. It was the first real estate investment trust in Hong Kong. It acquired a portfolio of community shopping centers from the Hong Kong government. The government had been

building these shopping centers as part of low-cost housing real estate, and the properties were put into the REIT.... We have since been transforming these assets, improving the retail space.

Over time we have also expanded beyond Hong Kong to China, with assets now in Beijing, Shanghai and Guangzhou. We have also expanded into new property types. Beyond the retail properties we also have offices, office buildings and car parks. The market cap of Link REIT is now roughly \$18 billion.

**Knowledge@Wharton:** How do REITs in Hong Kong differ from those in the U.S.?

**Hongchoy:** To a large extent, how [REITs are] operated is very similar. The income, at least 90% of the income, needs to be distributed. We do not have the tax advantages of REITs in the U.S. ... [which is] the only major difference, but by and large the main features are similar with gearing limits and with the minimum payout. The history obviously is that the REIT market really started in the U.S. in the 1960s and there are now over 1,000 REITs in the U.S. In Hong Kong there are only about a dozen, so it is a new market; it's a new investment vehicle. But we have a lot of interest from investors all around the world and also retail investors in Hong Kong.

**Knowledge@Wharton:** We know that in the U.S., bricks-and-mortar stores are suffering – not only the stores but whole chains have been going out of business at a pace we haven't seen for years, even as the U.S. economy seems to be improving. One result: A lot of malls have vacancies, a lot of malls are closing, or they are trying to repurpose their space and put in health clubs, office space and other uses. The culprits usually cited are the fact that there are too many stores in the U.S. and so there is a shakeout underway. The other big cause cited is competition from online sales,



notably Amazon, often through the use of mobile. How does the retail experience for brick-and-mortar properties in Hong Kong and China differ from the U.S.?

**Hongchoy:** The history of the development of consumer sectors overseas is very different, yet we have seen a somewhat similar sort of trend growth of online retail. But the experience of having only started building shopping centers in the last 10 to 15 years means that there are not a lot of properties that were here 20 or 30 years ago, which don't fit a current purpose as in the U.S., where some of them really have to change the layouts, and the type of services and products they are offering in the mall.

The Chinese consumer market has been growing rapidly, although it has seen some slowdown, but it still far exceeds the global average growth. We've seen double-digit growth in the early parts of 2010-2014. More recently, in 2016, it was still growing by 7%. So we have very strong growth in consumer spending, and the government policy is also shifting towards the consumer-driven rather than export-driven, which has helped consumer growth. And, wage levels have increased quite a lot in the last 10 years.

Online has indeed grown very fast. It now accounts for 13.5% of total retail sales compared to only 7.7% in the U.S. [A big part of the reason for that] is ownership of smartphones, especially in the last few years – there are very well-developed mobile payment solutions, and very easy and inexpensive delivery services. A lot of Chinese shoppers like to compare prices, and so online allows them to do that more easily than walking from shop to shop.

A combination of these factors has helped. I know [Wharton] professor David Bell has written a lot about what sort of products should be online or offline. We also are seeing, similar to other countries, that the online companies are also moving to have an offline presence and building a physical presence, or investing in physical retail chains. Over time it's really a merger of the two experiences, to serve the consumers wherever they want to shop.

**Knowledge@Wharton:** In the U.S. you've got Bonobos and Warby Parker, and now Amazon has some physical stores. They are working to create a more seamless experience between the physical store and the online experience. What do you see in Hong Kong and China that relates to this approach? Are there lessons for the West?

**Hongchoy:** We have to realize firstly that a lot of people in China have never owned a PC, have never had a fixed line. So when mobile comes along, that's the first thing that they have. What happened to drive the whole change is that the barrier to entry is a lot easier to overcome when you're thinking about only building a business on mobile.

So, skipping that technology legacy has helped China and a lot of the businesses to grow a lot faster.

And in the consumer mindset – every shopper is really just thinking about, “Okay, I want to buy something. How fast can I do that? What is my journey?” And during that journey, whether it is through the app or through the experience, they can actually gain some pleasure out of it. So there's a lot of talk about that experience-based business model rather than the transactional – how we can actually make this fun for people. Even buying weekly groceries, why should that be a chore? Can't it be fun?

Those are some of the things that I think a lot of businesses in China have been trying to come up with – new models for doing it. And maybe this is a part of globalization, but a lot of U.S. companies are trying to learn how China is doing it, and a lot of Chinese companies are going to the U.S. to learn.

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**“Online has indeed grown very fast. It now accounts for 13.5% of total retail sales compared to only 7.7% in the U.S.”**

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I think there are a few advantages, though, in China. One is the payment solution. Most of the consumers in China either use Alipay or WeChat Pay. And having only one or two, or very few payment solutions will help the shoppers because they don't have to open their wallet and choose from 10 different ones, and think “which one should I use this time?” On the flipside, merchants also do not have to install that many options – they wouldn't know which shopper uses which [payment method] and so they would have to install 10 different machines on the countertop [if there were many payment solutions].

So, having fewer payment solutions [helps]. I see that in the U.S., Amazon and eBay don't really have a payment system well embedded in their own platforms – relying on, I guess, other payment platforms. That is one issue. The other is this incumbent problem. If some of the retailers already have “X” number of stores, the incentive to move towards online becomes more difficult because every time the decision is, first, about how to strengthen the current physical presence. It makes the decision a lot more challenging. But if you don't do it, I guess someone else will be eating your pie – you have to react.

The other thing I have noticed is that the consumer does want to go online to do a lot of research, but at the end of the day they want that physical touch and feel in the store, and so that cannot be replaced. In the end, I think one thing that is important is the social aspect of being with other

people — whether it's family, friends or classmates — in a physical location. That is something that [will continue]. But it has to be fun.

So how can you make it easy [for consumers]? Make sure they know how to find what they want — whether there's a parking app to find their car or an e-directory. And [retailers need] the sort of data analytics to understand the type of customer coming into the mall. There is a lot of research being done on both sides, both in the U.S. and Asia. And I think retailers are less worried than five years ago when everybody was sort of scared that it could be the end of physical retail. Now I think people have understood it more, and O2O [online-to-offline] has become the buzz word these days.

**“In Hong Kong or any compact city with high density, a good transport network does help because then it's easy to get to the shops.”**

**Knowledge@Wharton:** In Hong Kong, e-commerce and mobile shopping haven't caught on as much as in China, partly because of Hong Kong's unique geography. It's compact; it's easy to get around. Can you talk about that difference, and also, I'm wondering if what you see in Hong Kong would also apply to places in the U.S. like New York City, for example? That's also island.

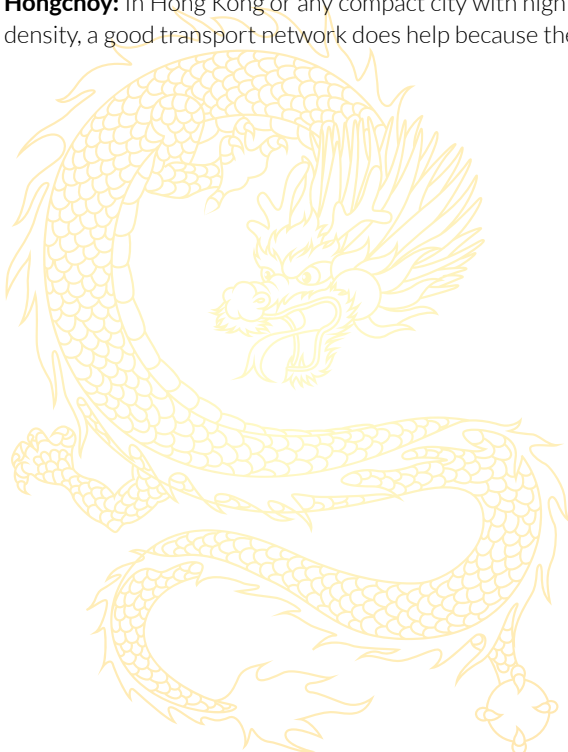
**Hongchoy:** In Hong Kong or any compact city with high density, a good transport network does help because then

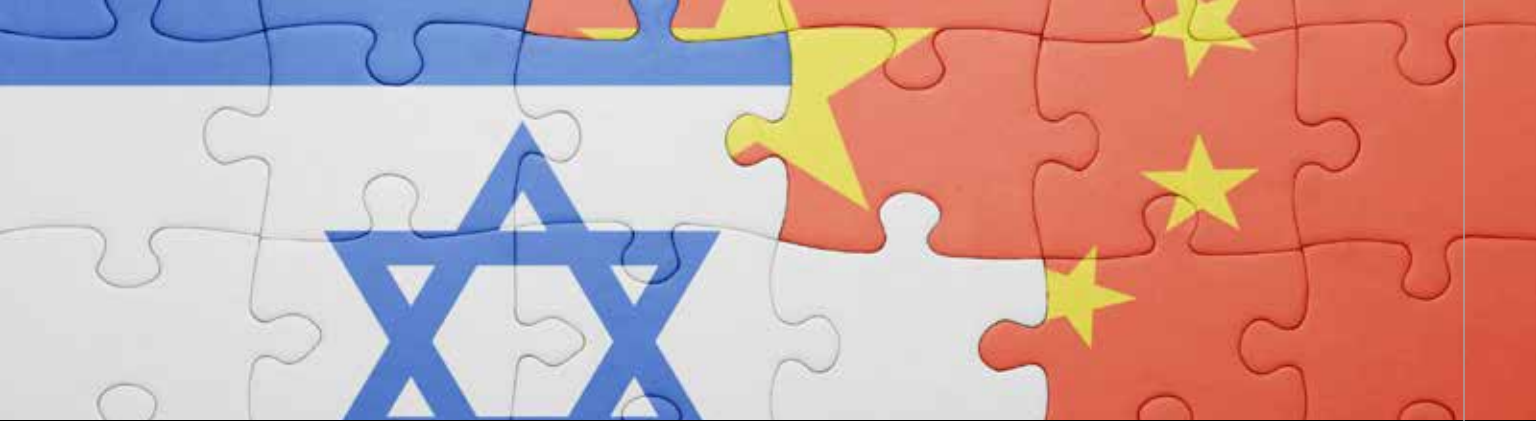
it's easy to get to the shops. And shop hours: Hong Kong shopping centers and shops tend to remain open very late into the night hours. Some people work until very late; in a lot of cities you can't find anywhere to pick up your food [when it's late], and there are other things that you want, but in Hong Kong the hours that shops remain open helps.

And then we have very small apartments [in Hong Kong]. When you have small apartments, the consequence is that it is very hard to entertain your friends and relatives at home. Shopping centers provide a place [and become] a much bigger part of your social life — it is not just for shopping but also for dining and entertaining. So, it's not too different in New York — there are a lot of restaurants, and they do very well.

And [another] trend seems to be the case in a lot of places in the last couple of years where people have moved away from this heavy consumerism. How many shirts and pairs of trousers can you buy? The past recession also made people [conscious of owning so much], and so now there is not a revolution — but certainly people are saying, “We actually want the experience; we actually want the entertainment, the gathering of people” and all that. In a compact city, that's even more so than in a more spread out country.

In Hong Kong, the number of people shopping online has still gone up a lot — from 7% in 2004 to about 23% in 2014. The number is still behind China, but it is indeed rising, and people are trying it. And I think that is certainly the experience for any similar city, whether it's New York or London. 🌟





## Is There a Match for Tech Between China and Israel?

*Catherine Leung is a principal and co-founder of MizMaa Ventures, a Hong Kong-based investment firm that focuses exclusively on Israeli technologies. Leung formerly was vice chairman of JPMorgan Asia investment banking for 20 years until 2015, where she spearheaded efforts in Greater China. During her tenure, JPMorgan was named the best foreign investment bank in Hong Kong at various times by The Asset magazine and also FinanceAsia. She has been involved in many high-profile IPOs, mergers, acquisitions and other transactions. In this Knowledge@Wharton interview, Leung shares her views on technology, innovation and the opportunities for collaboration with Israel's tech industry.*

*An edited transcript of the conversation follows.*

**Knowledge@Wharton:** Israel is well-known for its tech prowess and rich start-up culture. Hong Kong, meanwhile, is one of the world's largest financial centers, and so it seems like the two would be a great match just on the face of it. In fact, the name of your company, MizMaa, is a combination of two Hebrew words that mean East and West. Why did you make the change from investment banking and why the focus on Israel today?

**Catherine Leung:** You only have so long of a working life, I would say. People can say, I want to stop [working] at 50, people can say I want to stop at 60, some people don't stop at 70, it depends on what your perspectives are, but there is going to be a limit to the work life. And I think that having done 20 years of investment banking gives me plenty of perspective, plenty of experience and plenty of scars and celebrations and victories. Where the world is now, the most interesting thing I think is actually tech.

The irony is I don't come from a tech background. I was not a tech banker. I was not an engineer. But there is a role to be played if you think of the construct you could create, and be a part of the tech scene ... if there are like-minded

investors who are interested in investing in some of the best technologies in the world. You alluded to Israel having a very strong prowess in tech — I would absolutely agree.

There is a business to be built around tech where you can be an investor and you can absolutely put the money to work. But money, frankly, is a commodity these days. Where you make a difference in this construct is you can actually help companies grow, go to market, commercialize, bring connectivity to parts of the world where they don't seem to have it just yet.

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**“Israel is a unique case in point whereby the tech prowess is unquestioned but technology itself is not everything.”**

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Israel is a unique case in point whereby the tech prowess is unquestioned but technology itself is not everything. You need to be able to find an application in the technology that would change our lives for the better — where people would use it and you will become successful, in simple terms. Israel has always been very successful going to the West — to the U.S. by and large, right? [Israeli firms] find customers there, and there are many companies in the U.S. that come from Israeli roots. You've got Check Point, Palo Alto Networks, you've got the latest acquisition by Intel of Mobileye. Those are the giants ... everybody knows about.

It's harder for Israel to go to the East. This is a supply and demand thing, because there needs to be interest by Israeli companies that want to go to market in the East, and there needs to be the market and the customers in the East who want to use Israeli technology.

I do think there's a very good match there because you've got China, where there's a massive demand. And China itself ... has done a lot of innovation and is actually ahead of the world in certain aspects like payments. ... They are ahead in the world in terms of how they have innovated and transformed, and leapfrogged [some legacy payment technologies]. And China is very open to taking on board Israeli technology and then scaling that.

China is not the only [big market], think about [the rest of] Asia as well — and Hong Kong is very much a big part of China. There is a thesis to be had whereby you have the money behind you, you put it to work, but you also then play a key role in adding value to your company that you invest in by bringing the customers, the market to them.

## “The key is how do you make sure that the best deals go to you?”

**Knowledge@Wharton:** How do you make the business marriages between the two regions work? I see that your company specializes in cyber security, connected car technologies, fintech, artificial intelligence, machine learning and cloud technology.

**Leung:** I would probably be too bold, frankly, if I were to go into Israel by myself. I have a partner [Isaac “Yitz” Applbaum] who has been going to Israel for the last 25 years. He is connected politically there [as senior advisor to the mayor of Jerusalem for Public Private Partnerships]; he is connected commercially there. ... He's an entrepreneur himself and he's been in the venture business for two decades. So, we partner up whereby I would be able to find like-minded people in the East to go in with us.

But my partner is part of that ecosystem in Israel, and to some extent in the U.S. and Silicon Valley as well. He has a network to source, frankly, some of the best deals and inventions. The key is, how do you make sure that the best deals go to you? I think that's the trick.

That's why it's a partnership, and once we come together we basically ... picked out the domains that you just talked about because we think those are the ‘unfair’ competitive advantages of Israel compared to the other technology centers in the world today, like Silicon Valley, maybe China, Canada, London. ... We also talk to the local VCs, we talk to the best entrepreneurs locally, we look at the incubators. And the word gets around in terms of the kind of value add we want to bring to the table. People see the value, and you find that chemistry, and overlap.

**Knowledge@Wharton:** Tell us a about your sources of funding.

**Leung:** By and large, the source of funding is an investment vehicle comprised of only three LPs [limited partners]. Other than myself and my partner, the bigger contribution to the pool is one of the most prominent families in Hong Kong. And the total amount — we won't be able to talk about, but I would say it's a very, very substantial amount as far as early stage venture investing is concerned.

**Knowledge@Wharton:** One company you have invested in is Armeron, a web security company. This is very interesting today — everyone's talking about hacking, and we've had all of these security breaches. Tell us about that company.

**Leung:** Armeron is a very interesting company because it is going to take on the biggest player in web application firewalls, and that big player out there is a listed company called Imperva. To make it simple for everybody: The traditional way of preventing attacks is to blacklist, come up with a blacklist of people who cannot enter the system, and your list grows. But then, you can have a lot of problems such as false negatives, false positives, and it's very cumbersome to actually execute. You have people involved, you have a machine involved, you've got all sorts of different combinations and it's still not working very well.

Armeron takes on a completely different approach. Instead of ‘blacklisting’ they do ‘whitelisting.’ There doesn't need to be a blacklist. Once a source comes through the web application firewall, [they take] the defense approach in technology — they can figure out whether you're a good guy or a bad guy [based on] where you come from, how you came through, and where you're going.

I want to be able to explain it in very simple terms, and I'm sure this is not the most technical of terms that one can use to describe it, but this is really what it's trying to do. Shifting from a methodology of ‘blacklisting,’ which I think people are familiar with, into a very new methodology called ‘whitelisting.’

**Knowledge@Wharton:** You have had a front-row seat to the history of China's transformation. You were involved in one of the top investment banks in China for 20 years. What are some of the highlights you've seen, some of the major themes you've witnessed in finance but also in other areas?

**Leung:** China learned very fast from the best practices outside of China. They take it home, they then basically find their own version of what works and they scale it up. And they do it in a way that is quite unique and forward-looking, and state-of-the-art. I admire China for that.



You can see it not only in financial services ... [but] in how the giants in China have taken advantage of the internet. The Alibabas, the Tencents and Baidus of the world, they are leapfrogging in fintech ... they are leapfrogging in payments in Alipay and WeChat Pay. ... These are giants in their own right.

You can say, 'look they started off with a model similar to the West and they took it from there.' Maybe, I don't know. But I think they've gone on in leaps and bounds with tailoring what the Chinese consumers, users, gamers need, and they've taken it to a completely different level. And I'm not singing the China song because I'm Chinese, I think anybody who looks at who are the internet giants in the world today would count Google, Apple, Facebook, Twitter, but they would also count Alibaba, Tencent and Baidu. They are sort of in the same club now. They've come about much later, but they've done it at a pace which was staggering.

It goes back to my point — China learns very quickly, and China will take things to the next level and they will make it work for them. I do think that's a very important takeaway for having, as you say, a front-row seat in this part of the world. I also think that a more top-down economy definitely has its benefits in the growth of China. But there's a lot of debate about that and a complete laissez-faire [system] driven by a market economy and all that — and China being sort of [a mix of] communism, socialism with laissez-faire characteristics, right?

They actually make it work for them. They manage to keep the economy growing, albeit at a slower growth pace now than 10 years ago but still growing. They managed to keep unemployment at a relatively managed and acceptable level. Monetary policy, fiscal policy — they are all as much in sync as possible. If you were to be educated in the Western world you would say: How can centralized economies be the best approach? But I do think that the hybrid here of sort of government centralized approach with sort of blossoming of the entrepreneur, and the market, and the laissez-faire, that combination is very unique in China and it actually works.

The press in the West doesn't really give China enough benefit of the doubt. Frankly, a lot of the press don't understand China, and a lot of it is more probably a bit of ... writing for sensational reporting. I do think that China has

figured out a formula that actually is very unique. Russia didn't do that, they didn't get back in terms of the balance between laissez-faire and centralized planning.

I don't know any part of the world that can actually do that as well as China. It's still sort of an emerging economy, it has some ways to go, so there will be growing pains. But I do think that they have the right people at the reins to make it work, given the ability to be able to plan centrally but let things blossom at the same time.

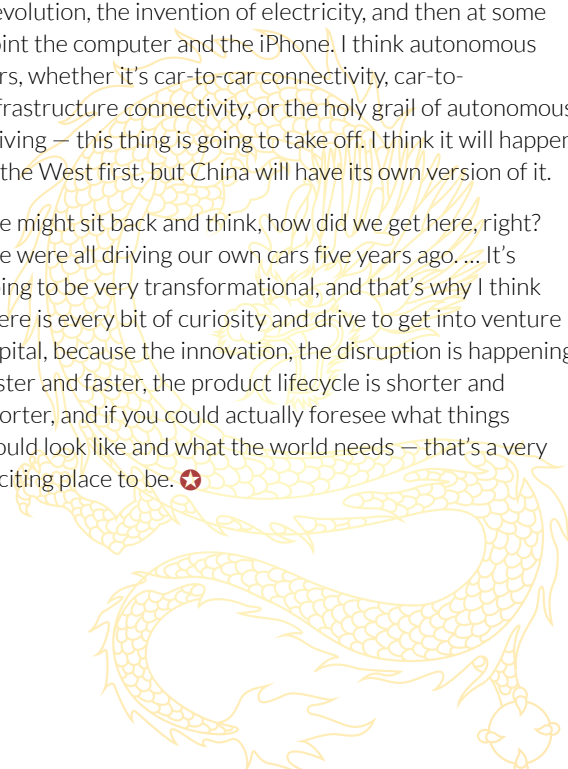
**Knowledge@Wharton:** Where do you see the big changes over the next three to five years?

## **"A more top-down economy definitely has its benefits in the growth of China."**

**Leung:** China will continue a very straight trajectory of having very strong entrepreneurs that are going to come up with business models that work perfectly for China. Given the size of the market they will be big companies. And you will see in terms of the top 10 internet companies in the world, there will be more Chinese names there instead of just the three that we see today. There will be a blossoming.

In things like autonomous vehicles, which I think is the next sort of iPhone, if you think about the major disruptions in the world today, you [might include] the Industrial Revolution, the invention of electricity, and then at some point the computer and the iPhone. I think autonomous cars, whether it's car-to-car connectivity, car-to-infrastructure connectivity, or the holy grail of autonomous driving — this thing is going to take off. I think it will happen in the West first, but China will have its own version of it.

We might sit back and think, how did we get here, right? We were all driving our own cars five years ago. ... It's going to be very transformational, and that's why I think there is every bit of curiosity and drive to get into venture capital, because the innovation, the disruption is happening faster and faster, the product lifecycle is shorter and shorter, and if you could actually foresee what things would look like and what the world needs — that's a very exciting place to be. 🌟







# CHINA

## New Ambitions, New Directions

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