

PROLOGUE



The stage lights beamed so brightly that I could barely see. I wiped the sweat beading on my brow and squinted to my left, where Dylan Ratigan, the host of his eponymous MSNBC show, sat readying to question me about China's changing economy and the release of my book *The End of Cheap China: Economic and Cultural Trends That Will Disrupt the World*.

On air, Ratigan hulks as a towering presence—physically imposing and unafraid to grill guests. In real life, Ratigan looms even larger, like an NFL linebacker. He rotated his head to gaze at me. The way he looked at me reminded me of a lion stalking prey.

I tried to hide my nerves. I had appeared on television many times before but never from 30 Rockefeller Center in Manhattan, where NBC records shows I had grown up watching, such as *Saturday Night Live*. I could not believe 18 hours earlier I had been home in Shanghai and now sat on the same stage many of the world's famous had sat. I saw Eliot Spitzer, the former New York governor caught frequenting \$1,000-an-hour hookers, heading toward a green room to get his microphone. *Was I really in 30 Rock*, I wondered, *or was I dreaming?*

"On air in 3, 2, 1," a stagehand yelled out, and I hurtled back to reality. The show aired a clip of Secretary of State Hillary Clinton musing about China–United States relations. She posed a question: "What happens when an established power and a rising power meet?" Would tensions between the two be inevitable as with Germany and the United Kingdom before World War I, or

would the nations create a new paradigm for cooperation among superpowers?

Once I heard Clinton's sound bite, I knew Ratigan would grill me. After all, it was just months before the 2012 presidential elections, and anti-China hysteria was at its zenith. *New York Times* columnist Paul Krugman harped seemingly every day that China was a "bad actor" for manipulating its currency. The only issue Republican and Democratic candidates could agree on was conveniently to blame China for all of America's economic ills.

In the corner of my eye, I saw Ratigan flanked by his three regular guest hosts, former Republican candidate for Congress Krystal Ball, author and cultural critic Touré, and policy wonk Ari Melber, poised to pepper me with tough questions.

Ball did not mince words: "How stable is the government, and how threatened are they by protests?" At the time the 2012 Arab Spring, a wave of uprisings, was in full bloom, and Senator John McCain argued the Spring would come to China sooner or later.

McCain was simply wrong, I answered, pointing out the nonpartisan DC-based Pew Center found most Chinese supported the direction the central government was taking the country. Harvard professor Anthony Saich has also come to similar conclusions in his research. Mounting concerns about local government corruption and pollution needed to be addressed, I told Ball—yet there was no chance of an Arab Spring-style mass movement any time soon.

Melber followed by asking if rising income inequality would cause social instability. Good question—the gap between rich and poor had spread wider, and people who had not yet managed to buy a home were frustrated that property price growth outpaced wage increases.

China's economy had reached a dangerous point, the so-called middle-income trap, I answered. When per capita income hits

\$6,000, wage growth tends to stagnate. The rich get richer and the poor get poorer, causing social instability, which is what happened in Thailand and explains why the land of smiles had yet another military coup in 2014. Only a handful of countries, such as Japan, have overcome the trap after World War II. China must spread wealth more or run the risk of failing to develop a stable middle class, the backbone of healthy economies.

To combat stagnation, the Chinese government must enforce labor laws, raise minimum wages, and shift the economy more toward innovation, services, and consumption. More Chinese need access to health care, affordable housing, and a safety net similar to Social Security.

Ratigan pounced, asking whether it was fair to accuse China for “screwing” America with “rigged trade” and intellectual property infringement. At the time China’s economy remained robust with 8 percent gross domestic product (GDP) growth, whereas the highest unemployment rates since the Great Depression savaged America.

As I parried Ratigan’s and his cohorts’ questions, I realized many Americans believe China’s 30-year economic growth since its opening up in 1978 was predicated on copying intellectual property, rigging the currency rate, and stealing American jobs.

Few knew about China’s moves up the manufacturing value chain, that the currency called the yuan had appreciated more than 25 percent against the U.S. dollar since 2005, or that China was now itself losing light industrial jobs to even cheaper countries, such as Sri Lanka, Indonesia, and Cambodia.

They did not realize Chinese consumers had started shunning Louis Vuitton (LV) knockoffs to become the second-largest global buyers of luxury items and the biggest-spending tourists to America and France per capita. They spent more per capita for the London 2012 Olympics than any other nation. In the

meantime, China had become America's second-largest trading partner after Canada and accounted for nearly 30 percent more trade than the European Union.

That day, I pushed back against Ratigan and his cohorts, arguing Chinese consumers had "saved America's agricultural sector by buying corn, nuts, and meat proteins." Without them, America's heartland would be far worse off. By 2013, the U.S. Department of Agriculture announced China was the largest recipient of American agricultural exports, more than \$26 billion, up from seventh just a decade before. China's rise also created opportunities for American companies, such as Starbucks and Apple.

After 9 minutes the interview ended. I let out a sigh of relief. Ratigan shook my hand and furnished me a big smile. He has that politician's charisma; he made me feel like I was his best friend. A few months later he walked away from a multimillion-dollar contract and fame at MSNBC to launch hydroponic farming to employ American war veterans. I wouldn't be surprised if he runs for political office in the future.

Fortunately, my book was well received, and organizations from all over the world invited me to discuss its conclusions. The strategic market intelligence firm I started in 2005, the China Market Research Group (CMR), saw business take off as multinationals, private equity firms, hedge funds, and Chinese firms engaged us to understand and develop strategies to deal with the changes occurring.

Over the next two years, I seemed to live in boardrooms, hotels, or airplanes as I keynoted conferences and met with businesspeople in Sydney, Tokyo, San Francisco, Cape Town, Bangkok, Singapore, and New York.

I met dozens of billionaires, hundreds of senior hedge fund investors, and the boards and chief executive officers (CEOs) of

the world's largest firms. They all wanted to know the main trends in China and what they meant for business. Few had reliable, current information on what really happened on the ground.

Pundits such as independent economist Andy Xie, former professor at Tsinghua University Patrick Chovanec and former macroeconomist for China for CLSA Andy Rothman had hijacked the media with controversial stands. They manufactured great sound bites but did not offer the nuance needed to make investment decisions. Perma bears, analysts who always hold negative opinions toward China's economy and have claimed for years an imminent crash, such as Xie and Chovanec, never seemed to regard positive data whereas Rothman overlooked the very real dangers in the economy emerging.

The truth is the economy is not heading toward disaster—or toward perpetual growth. Reality lies somewhere in the middle, with companies adjusting quickly to changes profiting while lumbering ones go the way of the dodo.

What worked three years ago might not work anymore, and it certainly won't work three years from now. Most executives I met thought the country based growth on heavy investment, exports, and theft of intellectual property—few realized 50 percent of growth in 2013 derived from consumption.

Only a handful were aware that some of the world's most innovative companies—firms such as Alibaba, Tencent, and Lenovo—were Chinese and that many outspent their foreign counterparts on research and development (R&D). In 2013 for instance, telecom maker Huawei invested \$5 billion in R&D versus \$4.9 billion by Ericson, its major competitor. Many of these had firms had started expanding to Southeast Asia, Eastern Europe, and Africa.

Few executives understood the role of urbanization in kick-starting the economy. Prime Minister Li Keqiang set the goal of

reaching a 60 percent urban population in the next five years, up from 30 percent in the 1990s and 52 percent currently. To give context, before it started two decades of stagnation, Japan hit a 90 percent urbanization rate in 1992.

Most urbanization is being pushed into the hundreds of smaller third-, fourth-, and fifth-tier cities few foreigners know, cities such as Shantou, Anshan, and Nanping with populations of more than 1 million, by easing *hukou* (household registration) and home-buying requirements, while limiting population growth in metropolises, such as Shanghai and Beijing.

During meetings, I showed why China's growth model of exporting and building roads to economic success is broken and that innovation, services, and consumption need to account for a larger proportion of growth. The shift is happening but risks abound as local governments have become addicted to growth fueled by cheap credit.

I wrote *The End of Cheap China* to show the country faces an aging population, soaring rents and salaries, and a labor force that wants to realize its white-collar dreams rather than toil away in factories. I argued U.S. companies needed to move up the manufacturing value chain, relocating to other countries or cheaper parts of the nation or potentially reshoring operations to the United States. Reshoring is happening with companies such as the toy manufacturer K'NEX, which is already relocating operations to America. Foxconn, maker of many of Apple's products, has invested billions in Indonesia and Vietnam.

I said it was time to sell into the country. Over the past three years I have been proved right—costs there have continued to rise, squeezing margins, and the China cost advantage no longer really exists in light industry. Thousands of companies have gone bankrupt or lost money, unable to adjust to new realities. Profits for Western firms selling into the country with the right strategies

soared, with the nation becoming the largest market globally for companies such as health and beauty multilevel marketer Amway, sports car Porsche, and semiconductor company Qualcomm.

As I traveled I realized the changes and reforms taking place were happening so fast that they were hard for people outside the country to follow. Seemingly every day the government issues new regulations, whether it be liberalizing cash deposits for banks, reducing regulatory oversight for cross-border investments, or even something relatively small, such as extending the inspection validity periods on automobiles from one year to six, but which will change entire industries. Even for people within China, all the changes can be hard to keep up with.

I decided to write this book, *The End of Copycat China*, as a follow-on to show the changes happening in the economy since my last book and to predict the next decade's megatrends to provide a framework for investors and executives.

Slowing growth is the new reality but should not be feared—it shows the government, especially China's new president, Xi Jinping, has finally recognized the need to rein in cheap credit and focus on economic efficiency and is confident enough to do both. Xi has consolidated power, overcome embedded constituencies, and harnessed the bureaucracy to follow his lead to move toward a healthier China. Xi's far-reaching anticorruption campaign to reform the bureaucracy has won support from everyday people, and he has arguably emerged as the most powerful Chinese leader since Mao Zedong.

The changes boil down to two key changes businesspeople and investors must know.

First, Chinese companies no longer just copycat business models from America and Europe. They still grab low-hanging fruit but focus more on innovation. Multinationals must adjust to increased Chinese competition, which no longer competes just

with good-enough products at cheap prices but with value and innovation.

Companies such as telecom maker Huawei have taken market share from Ericson and Cisco. Lenovo replaced Hewlett-Packard as the largest maker of personal computers (PCs) in 2013, not just by competing on low price and distribution. Lenovo's chair and CEO, Yang Yuanqing, was the first person from Asia to receive the Edison Achievement Award in 2013, alongside Elon Musk, CEO and product architect of Tesla Motors and CEO and chief technology officer of Space Exploration Technologies (SpaceX).

Other companies acquire technology by scooping up Western firms, as automaker Geely did with Volvo.

Second, Chinese consumers no longer slavishly copy trends from America and western Europe, or even their own peers in China. The movement to define the Chinese dream and renewed pride in Chinese culture has resulted in consumers moving away from images portrayed in Western advertisements. A high price tag and big flashy logos won't work anymore as marketing and sales strategies. Brands need to truly segment target markets and understand hopes, dreams, and aspirations.

Rampant pollution and unaffordable housing prices have made middle-class Chinese reprioritize what is important and how to spend money. They have gravitated toward niche, authentic, understated brands and experiences. Formerly dominant brands, such as sportswear company Adidas and luxury player LV, must adjust strategies or else China could drag on growth. Changes also mean opportunities for brands to carve out profitable niches, including premium sportswear brand Michael Kors or outdoor apparel company North Face.

Brands need look no further than titans, such as food giant Nestlé, to see how failing to adjust quickly to evolving consumer trends devastates bottom lines and careers. Nestlé lost its China

head in 2014 under the cloud of poor performance against fiercer competition from formidable domestic players, such as Kunlun Mountain water in its bottled water division or Yili in ice cream, that were nimbler in launching new products.

This book is an effort to show these changes up close and to provide a framework for businesspeople to prepare for these changes. Chinese firms and the Chinese government focus on innovation, the application of improved solutions to meet market demand with better processes, technologies, services, and ideas. Innovation differs from invention, which is the creation of the idea or method in the first place.

Known more for rampant piracy, state domination of the economy, and a heavy regulatory hand that stifles innovation, China might surprise by how much it is starting to evolve. Innovation is becoming part of the discourse, consumers are shunning *shanzai* (knockoffs and imitations), and the government is starting to encourage, rather than stifle, innovation.

China is progressing along an innovation development curve from:

1. Copycat stage, to
2. Innovation for China stage, where it is now mostly, and from here to
3. Global innovation stage, where China begins innovation for the rest of the world, already partially underway in some sectors, such as mobile devices and services.

The impetus for the shift toward stages 2 and 3 is being driven by Chinese consumers who want the best products and services developed for them directly and by ambitious, well-capitalized companies looking to offset a slowing, more competitive economy by becoming global players.

To get that up-close vantage point, I interviewed everyday consumers, business executives, billionaires, and founders of some of China's most innovative and most profitable firms. I even talked to officials—including some heads of state—of countries that have dealt closely with the Chinese government to provide a macro-level view. I also relied on more than 50,000 surveys of consumers my firm, CMR, has conducted.

Case studies of winning and failing companies are included to provide concrete knowledge of what works and what doesn't.

The chapters of this book are grouped into four sections based on the three stages of China's innovation development curve:

1. For most Chinese companies in the past 35 years, little reason existed to try to be innovative or even to build brands. Growth relied on heavy investment and low-hanging fruit dangled enticingly, incentivizing companies to copycat other successes, focus on the short term, and make a quick buck. Facing rapid growth and lack of property rights, Chapters 1 and 2 will show Chinese companies did not look at the long-term picture and viewed investing in innovation as too expensive and risky—and so did private investors.
2. The low-hanging fruit in China's economy is now disappearing as competition and costs rise. Executives are becoming focused on the long term, seeing profits derive from innovation for China specifically, stage 2 on the innovation curve. Much of the innovation currently can be defined as business model rather than technological innovation. Chapters 3 and 4 will examine what sectors see the most innovation and how far along they are toward achieving stage 3, where companies innovate for the rest of the world. This section will also look at what barriers and challenges, such as a weak education system

that focuses too much on rote memory, exist that hamper the pace of innovation.

3. As Chinese redefine the ideal Chinese dream, they are changing what they spend their money on. Chapters 5 through 9 will examine shifting spending patterns and how renewed patriotism is affecting their purchasing habits. I will look at how mobile, e-commerce, food and beverage, tourism, and entertainment and leisure sectors will continue to rise whereas the department store, luxury, apparel, and footwear sectors will face challenges and how companies can overcome the obstacles.
4. In the last part of the book, Chapter 10, I will look at how the changes in China's economy will affect Cambodia, Indonesia, and other nations in Asia, such as how factories relocating to Indonesia will help create its own emerging middle class, yet tension with nations such as Japan, the Philippines, and Vietnam is bound to increase.

China's continued economic success is not guaranteed. Rising nonperforming loans, weakening middle-class consumer confidence, and tension with neighbors could slow or even halt its economic rise.

The only thing guaranteed about China is that it is changing fast and that its shifting economic growth will affect and disrupt the rest of the world—it is no longer a copycat nation. To find out where the nation is going, we have to see where it once was, and that is where I will start the book.