U.S. ACCESS TO CHINA'S CONSUMER MARKET

HEARING

BEFORE THE

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

ONE HUNDRED FIFTEENTH CONGRESS
FIRST SESSION

THURSDAY, JUNE 22, 2017

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UNITED STATES-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

WASHINGTON: 2017

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

The Commission was created on October 30, 2000 by the Floyd D. Spence National Defense Authorization Act for 2001 § 1238, Public Law No. 106-398, 114 STAT. 1654A-334 (2000) (codified at 22 U.S.C. § 7002 (2001), as amended by the Treasury and General Government Appropriations Act for 2002 § 645 (regarding employment status of staff) & § 648 (regarding changing annual report due date from March to June), Public Law No. 107-67, 115 STAT. 514 (Nov. 12, 2001); as amended by Division P of the "Consolidated Appropriations Resolution, 2003," Pub L. No. 108-7 (Feb. 20, 2003) (regarding Commission name change, terms of Commissioners, and responsibilities of the Commission); as amended by Public Law No. 109-108 (H.R. 2862) (Nov. 22, 2005) (regarding responsibilities of Commission and applicability of FACA); as amended by Division J of the "Consolidated Appropriations Act, 2008," Public Law Nol. 110-161 (December 26, 2007) (regarding responsibilities of the Commission, and changing the Annual Report due date from June to December); as amended by the Carl Levin and Howard P. "Buck" McKeon National Defense Authorization Act for Fiscal Year 2015, P.L. 113-291 (December 19, 2014) (regarding responsibilities of the Commission).

The Commission's full charter is available at www.uscc.gov.

September 6, 2017

The Honorable Orrin Hatch
President Pro Tempore of the Senate, Washington, DC 20510
The Honorable Paul Ryan
Speaker of the House of Representatives, Washington, DC 20515

Dear Senator Hatch and Speaker Ryan:

We are pleased to transmit the record of our June 22, 2017 public hearing on "U.S. Access to China's Consumer Market." The Floyd D. Spence National Defense Authorization Act for 2001 § 1238, Pub. L. No. 106-398 (as amended by the Carl Levin and Howard P. "Buck" McKeon National Defense Authorization Act for Fiscal Year 2015 § 1259b, Pub. L. No. 113-291) provides the basis for this hearing.

At the hearing, the Commissioners heard from the following witnesses: Michael Zakkour, Vice President, Tompkins International; Richard Cant, Asia Counsel, ADX Net Inc.; Cathy Morrow Roberson, Head Analyst, Logistics Trends & Insights; Michael Hirson, Asia Director, Eurasia Group; Anne Stevenson-Yang, Research Director, J Capital Research; Zennon Kapron, Director, Kapronasia; and Christine Bliss, President, Coalition of Services Industries (statement for the record). The hearing examined recent developments in China's e-commerce, logistics, and financial services sectors, identified opportunities and challenges for U.S. companies, and explored recommendations for what actions the U.S. government can take to promote greater market access.

We note that the full transcript of the hearing is posted to the Commission's website. The prepared statements and supporting documents submitted by the participants are now posted on the Commission's website at www.uscc.gov. Members and the staff of the Commission are available to provide more detailed briefings. We hope these materials will be helpful to the Congress as it continues its assessment of U.S.-China relations and their impact on U.S. security.

The Commission will examine in greater depth these issues, and the other issues enumerated in its statutory mandate, in its 2017 Annual Report that will be submitted to Congress in November 2017. Should you have any questions regarding this hearing or any other issue related to China, please do not hesitate to have your staff contact our Congressional Liaison, Leslie Tisdale, at 202-624-1496 or ltisdale@uscc.gov.

Sincerely yours,

Carolyn Bartholomew	Hon. Dennis C. Shea
Chairman	Vice Chairman

cc: Members of Congress and Congressional Staff

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U.S. ACCESS TO CHINA'S CONSUMER MARKET

THURSDAY, JUNE 22, 2017

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

Washington, DC

The Commission met in Room 188 of Russell Senate Office Building, Washington, DC at 10:00 a.m., Commissioners Byron Dorgan and Glenn Hubbard (Hearing Co-Chairs), presiding.

OPENING STATEMENT OF COMMISSIONER BYRON DORGAN HEARING CO-CHAIR

HEARING CO-CHAIR DORGAN: We're going to call the hearing to order this morning. My name is Byron Dorgan. I'm joined by the co-chair for this hearing, Glenn Hubbard, and the other commissioners on the U.S.-China Economic and Security Review Commission.

This is the seventh hearing of the Commission for the 2017 Annual Report cycle, and we appreciate all of you for joining us today, and we hope to have a very interesting discussion.

Rising incomes in China, we hear a lot about it, and we know they create an enormous new class of consumers in China. I was reading through some of the material last evening, and I was thinking about the fact that they now say that there are very close to 700 million Chinese with smartphones that have access to the Internet and therefore access with respect to e-commerce to purchase goods and services.

And it's pretty startling. I was thinking back then to about 15, 20 years ago at a technology conference I held in North Dakota, which I held every year, and a fellow stood up who was a technologist, and he held out his phone, which is the phone that opens up. This is before there were smartphones. And he opened it to the crowd, a thousand people or so, and he said in another dozen years or so, this will be your everything. Right now you can make phone calls with it, but in a dozen years, it will be your everything. It will be your music. It will be your Internet. It will be your compass. It will be your everything.

And, of course, now it is our everything, and in China, halfway around the world, nearly 700 million Chinese have their everything in a smartphone. And so what does that mean? What does it mean to the Chinese marketplace? What does it mean to American interests in the Chinese marketplace?

And today's hearing is going to consider a subject we've considered for a long, long while, the U.S. companies' access to China's consumers, and we're going to especially look at e-commerce, logistics and financial services.

China has made some progress opening up its services sector and its goods sector to U.S. businesses and opportunities, but far, far more needs to be done, and frankly the accession to the WTO was accompanied by many promises that have not been realized with respect to China, and so that's why we continue to look at this and study it and understand what more needs to be done and how do we persuade them to do it.

China's rebalancing to a more consumer-centric economy provides opportunities for us or should provide opportunities for those of us in the United States who look to ship and to sell goods to China, and the growth of e-commerce in the context of all of this in China is breathtaking.

It's the largest e-commerce market in the world with sales reaching $672 billion in 2015. According to the Department of Commerce, an estimated one out of every three retail dollars in China will be spent online, which is the highest percentage in the world.

E-commerce has also been a key driver in improvements to China's logistics sector--$2.2 trillion logistics sector--and we're going to be talking about that in a second panel today.

E-commerce and the growth of e-commerce doesn't work very well unless you have logistics that accompany it. Their logistics industry in China, however, remains underdeveloped due to the country's historical focus on improving export logistics at the expense of domestic logistics, and that has caused it to be a bottleneck for the country's e-commerce sector.

Their efforts in China to develop and modernize express delivery industries could offer U.S. logistics firms like FedEx and UPS opportunities to expand their China operations. I say could rather than necessarily will because a lot depends on China and how it views its willingness to open its marketplace.

China has traditionally provided the world with a lot of manufactured goods. Their e-commerce boom, however, has tipped the balance slightly in the other direction with more and more Chinese consumers purchasing foreign goods. In the run-up to the Alibaba conference in Detroit yesterday, which I know some of our witnesses attended, Jack Ma touted the "tremendous opportunities" in Chinese markets that are offered to U.S. small businesses and farmers, and we certainly welcome those opportunities.

But I want to--this morning I was looking at the trade figures with China. These are expressed in goods rather than goods and services. But I went back 15 years because I actually voted for accession to the WTO. I've gritted my teeth some since. But let me just describe something. Fifteen years ago--when you look at the growth of U.S. exports to China, in 15 years, our growth has been about $90 billion above what it was 15 years ago. That's impressive if you just read that number by itself.

During the same period, the Chinese growth of exports to the United States has increased $340 billion. So it's not so impressive if you put both figures together. We've actually lost a substantial amount of ground rather than gained ground, and I think my interest in these hearings, and this one especially, is what opportunities exist for U.S. firms to do business in China? Is this a trade relationship that will be mutually beneficial? Is it now? What changes might be necessary to make it mutually beneficial with respect to those of us that care about the success of our economy and our business enterprises?

Let me with that call on Glenn Hubbard, the co-chair. Glenn, thank you very much, and this I think is your first hearing, and—

HEARING CO-CHAIR HUBBARD: It is indeed.

HEARING CO-CHAIR DORGAN: And we welcome you.

HEARING CO-CHAIR HUBBARD: Thank you, Senator Dorgan.

PREPARED STATEMENT COMMISSIONER BYRON DORGAN
HEARING CO-CHAIR

U.S. ACCESS TO CHINA'S CONSUMER MARKET

Opening Statement of Byron Dorgan
June 22, 2017
Washington, DC

Good morning, and welcome to the seventh hearing of the U.S.-China Economic and Security Review Commission's 2017 Annual Report cycle. Thank you all for joining us today.

Rising incomes in China are creating an enormous new class of consumers. Today's hearing will consider U.S. companies' access to China's consumer market, focusing on China's e-commerce, logistics, and financial services sectors. Services make up the largest part of our economy and services trade is a key facet of the U.S.-China economic relationship. While China has made some progress with opening up its services sector to U.S. companies, far more needs to be done.

China's rebalancing to a more consumer-centric economy presents opportunities for U.S. companies looking to sell and ship goods to Chinese consumers. One of the most dramatic changes in China's consumer economy has been the remarkable growth of e-commerce. China is currently the largest e-commerce market in the world, with sales reaching $672 billion in 2015. According to the U.S. Department of Commerce, by 2019, an estimated one out of every three retail dollars in China will be spent online, the highest percentage in the world.

E-commerce has been a key driver of improvements to China's $2.2 trillion-dollar logistics sector.

However, China's domestic logistics industry remains underdeveloped, due to the country's historical focus on improving export logistics, at the expense of domestic logistics infrastructure. This has caused logistics to become a major bottleneck for the country's e-commerce sector. China's efforts to develop and modernize its express delivery industry could offer U.S. logistics firms like FedEx and UPS opportunities to expand their China operations.

While China has traditionally provided the world with its manufactured goods, China's e-commerce boom has tipped the balance slightly in the other direction, with more and more Chinese consumers purchasing foreign goods. In the run up to Alibaba's conference in Detroit yesterday, Jack Ma touted the "tremendous opportunities" the Chinese market offers for U.S. small businesses and farmers. Such opportunities certainly are welcome.

But while the size of China's e-commerce market offers opportunities for U.S. retailers and brands, it remains an open question whether U.S. companies have truly equal access. U.S. e-commerce companies like Amazon and eBay have been unable to establish even a toehold in China's e-commerce market. And recent media reports indicate foreign brands are losing market share in China's consumer goods market. Finally, IP issues remain a major challenge for U.S. consumer goods companies operating in China. Last December, the U.S. Trade Representative placed Alibaba's Taobao platform back on the list of "notorious markets" due to the prevalence of counterfeit goods on the site.

I hope today's hearing will give us an unvarnished assessment of the market potential of China's consumer market for U.S. companies and recommendations for what the U.S. government can do to improve market access.

We will hear testimony from the first panel this morning before adjourning for a lunch break at 11:45 am. We will reconvene in this room at 12:45 pm for the second panel on U.S. access to China's financial services sector.
Let me now turn to hearing co-chair Commissioner Glenn Hubbard for his opening remarks.

OPENING STATEMENT OF COMMISSIONER GLENN HUBBARD HEARING CO-CHAIR

HEARING CO-CHAIR HUBBARD: Good morning, everybody, and I would like to thank especially our witnesses for being here today and for all the great work you've put into your statements. I would also like to thank my home state senior Senator Schumer and his staff for assistance in getting this space for today.

In the second panel today, we are going to examine the state of China's financial services sector, which is critical both for China and for the United States, and try to assess some challenges faced by U.S. companies. Financial services have been a significant driver of growth in China's services sector, but Chinese consumers' and Chinese businesses' access to financial services still is inadequate, and improved access is going to be critical for something to which Senator Dorgan referred— trying to raise domestic consumption. China cannot continue to grow rapidly until it fixes that problem.

In addition, China has made some limited progress on implementing reforms to improve the market orientation and efficiency of a financial sector that is currently really a negative value-added sector.

Financial services are also, of course, a critical part of our economy, which is a good part of the Commission's interest, and a major services export to China.

As the Senator noted, it has been more than 15 years since China joined the WTO, but U.S. and other foreign financial services firms and banks and asset management and insurance continue to face significant market access barriers in China. Some of these barriers are informal and formal bans on equity caps, on entry, on licensing restrictions and data localization, and China's new cybersecurity law, which entered into effect earlier this month, can pose some additional threats to U.S. financial firms that try to operate in China.

As a result, American financial institutions, dominant in much of the rest of the world, have actually had stagnant or declining market share in China--a concern obviously significant for policy makers in the United States, but I would argue these concerns should also be significant in China. Again, my view as an economist is China cannot continue to grow at its present rate without a better financial system.

Meanwhile, of course, Chinese companies have largely unfettered access to the financial services market here, and that generally is a good thing. They are using their U.S. financial markets' locations as a corporate haven. Chinese online payment companies are expanding into the United States, most recently with Alipay's partnership with First Data for mobile payment solutions.

I look forward especially to hearing about China's financial services landscape and how the United States can best improve its market here for financial services firms.

Before we proceed further, I would like to remind you that testimonies and transcript from today's hearing will be posted on the website, uscc.gov, and mark your calendars for the next upcoming roundtable on "The Health of China's Economy," on July 12.

Senator, back to you.

HEARING CO-CHAIR DORGAN: Thank you very much, Glenn.

PREPARED STATEMENT OF COMMISSIONER GLENN HUBBARD

U.S. ACCESS TO CHINA'S CONSUMER MARKET

Testimony before
The U.S.-China Economic and Security Review Commission

June 22, 2017

Thank you, Commissioner Dorgan, and good morning, everyone. I want to thank our witnesses for being here today, and for the time they have put into their excellent written testimony. I would also like to thank Senator Schumer and his staff for their assistance in securing this space for the hearing.

In the second panel of today's hearing, we will examine the current state of China's financial services sector and assess opportunities and challenges for U.S. companies. Financial services have been a major driver of growth in China's services sector. However, Chinese consumers' access to financial services remains inadequate and improved access will be critical for raising domestic consumption levels, which remain low. In addition, China has made limited progress on implementing reforms to improve the market orientation and efficiency of its financial sector.

Financial services are an important part of the U.S. economy and a major services export to China. It has been over 15 years since China joined the WTO, but U.S. and other foreign financial services companies continue to face significant market access barriers in China. These include informal and formal bans on entry, equity caps, licensing restrictions, and data localization requirements. China's new cybersecurity law, which entered into effect earlier this month, poses additional threats to U.S. financial institutions operating in China. As a result, U.S. firms' market share in China's financial sector has been stagnant or declining in recent years.

Meanwhile, Chinese companies have relatively unfettered access to our financial services market. Chinese companies are increasingly using U.S. financial markets as a corporate haven. Chinese online payment companies are expanding into the United States, most recently with Alipay's partnership with U.S. payments processor First Data to make its mobile payment solution available in the United States.

I look forward to hearing from our experts this afternoon on China's financial services landscape and how the United States can best improve market access for U.S. financial services firms.

Before we proceed, I would like to remind you that the testimonies and transcript from today's hearing will be posted on our website, www.uscc.gov. Also, please mark your calendars for the Commission's upcoming roundtable on "The Health of China's Economy," which will take place on July 12.

PANEL I INTRODUCTION BY COMMISSIONER BYRON DORGAN

HEARING CO-CHAIR DORGAN: The first panel is a very distinguished panel, a group of experts, beginning with Michael Zakkour. Let me introduce the three of them and then ask you to proceed.

Michael Zakkour is the Vice President of the Asia Pacific and Global E-Commerce practices at Tompkins International. Previously, he was Managing Director of China BrightStar, a China-focused strategy consulting firm, and Vice President at Beijing Gong Mei, a Chinese manufacturing conglomerate.

He will provide testimony on the Chinese consumer trends, China's e-commerce ecosystem, and opportunities and challenges for U.S. retailers and brands.

Next, we will hear from Richard Cant, Asia Counsel at ADX Net, a diversified technology company. Previously, he was North America Director for Dezan Shira & Associates, where he guided U.S. and Canadian companies through the process of establishing and expanding their businesses in China.

He's also a partner at Ernst & Young in Australia. He will testify on opportunities and market access challenges for U.S. companies in China's e-commerce market.

And then finally we will hear from Cathy Roberson. Is it Roberson?

MS. ROBERSON: Roberson.

HEARING CO-CHAIR DORGAN: Roberson. She's the founder and lead analyst at Logistics Trends & Insights, a global logistics market research company. Previously, she was a senior analyst at Transport Intelligence and a government operations specialist at UPS Supply Chain Solutions.

Ms. Roberson will discuss China's logistics landscape, how China's e-commerce boom is driving logistics in China, and opportunities and market access barriers for U.S. logistics companies.

I want to thank the three of you for your testimony. If you'll keep your remarks to seven minutes, we'll have enough time for questions and answers, and I understood in visiting with you that you were all in Detroit, last week, I believe, or yesterday perhaps for Alibaba and that program. Anyway, thank you very much.

Mr. Zakkour, you may proceed.

OPENING STATEMENT OF MR. MICHAEL ZAKKOUR, VICE PRESIDENT, CHINA/ASIA PACIFIC & GLOBAL E-ECOMMERCE PRACTICES, TOMPKINS INTERNATIONAL

MR. ZAKKOUR: Thank you, Commissioner Dorgan, and thank you to the Commission and all the commissioners for doing the honor of inviting me to be here today to be a witness and to share my experiences in China-U.S. trade.

I've been in China for 15 years. I started out in the manufacturing operations logistics end of the business and helping American companies and other companies make, procure, source and move their products around the world from a China base.

In 2005, I started really thinking about someday China might become not only the manufacturing hub of the world but the most important and largest consumer market in the world, and I founded a company called China BrightStar that focused specifically on working with American brands, retailers, investors to approach the Chinese consumer.

Since 2010, I've been a part of Tompkins International. We're a global supply chain consulting firm. I run the China-Asia Pacific practice and I also run the Global E-Commerce Strategy practice, and sometimes I get funny looks when I tell people I run both of those practices.

But the truth is you can't really talk today about consumption and retail in China without talking about e-commerce, and you really can't talk about e-commerce without talking about China, and we'll detail certainly today some of the mind-blowing statistics that support that point.

But really what I do with my clients, and when I'm out speaking or writing, I try to set a framework for people to understand that there's a bigger context for all this, which I started writing about five years ago, called Globalization 2.0, and from the first globalization wave, what we looked at from the early '70s to about 2010, three megatrends emerged:

The reemergence of China in all of its substantial powers, first as a manufacturing and supply chain hub and then as a consumer power.

The second megatrend was the birth and evolution of e-commerce, and now what we're seeing is the transformation and the needed transformation of U.S. companies and companies around the world for digital operations. It's not just about e-commerce; it's digital transformation.

And the third, and this is one that doesn't get talked about a lot, but I'm sure Cathy will have a lot to say about it, is emergence of supply chain as the key business driver in the world today. Supply chain used to be a function.

So in this Globalization 2.0 world, if Globalization 2.0 got pregnant and had twin boys, they would be named Jeff Bezos and Jack Ma because Alibaba and Amazon are the ideal examples of what a Globalization 2.0 company is. They're the beneficiaries of the world that's been created in that context. They're also the drivers of that world.

And so what we're trying to get American companies to understand is it's not just about the e-commerce itself; it's at the top you want to transform the digital operations, you want to become a uni-channel company for consumers, you want to internationalize, and China has to be a part of that, and so we ask what part of your make it, move it, and sell it strategies and operations does China play?

And so from a purely consumer point of view, the 12th and 13th Five-Year Plans that China produced over the last ten years made it clear that China can no longer grow and sustain itself for the next 30 years on the businesses and industries and practices like they did for the 30 years of opening up and reform.

And the two key areas they focused on in both plans was the growth of consumer-driven GDP and the growth of the services industry. They've done an amazing job in driving economic growth through consumption. I think they still have a long way to go as referred to earlier in the services sector, in particular, finance, insurance, real estate, and that's not necessarily my area of expertise, but I do understand what we call the FIRE industries--finance, insurance, real estate--play an undergirding role in not only our economy and their economy but the global economy.

So my focus today is more on the progress that China has made in the consumer markets. Where I feel pretty strongly is there's very few barriers for American companies to enter the Chinese retail and consumer landscape. The doors are more or less open there, and the tools and the avenues--sure, there are some regulatory issues to overcome. You know if we look at what are some of the issues that a lot of American companies have, it's finding that the ground does shift under them sometimes in terms of regulations and laws, but by and large, the door to Chinese consumers is open.

One of the companies we're going to talk about today a little bit is Alibaba. Alibaba is the largest e-commerce company in the world. All three of us were at the Alibaba Gateway '17 conference yesterday in Detroit and got to hear Jack Ma, the chairman, talk about the opportunities for small and medium-sized enterprises, farmers, and agricultural concerns to sell to China.

But just some of the top line numbers. There are right now 650 million online shoppers in China so more than double the entire U.S. population is shopping online every month in China. What's really astounding about that is that's only less than 50 percent penetration. So there's a runway of growth for half the population to start shopping online in China.

In general, there are 800 million Chinese consumers with some substantial level of disposable income today. Cross-border commerce is a fairly new development where American companies are able to sell directly to Chinese companies without having to open a business entity in China. Cross-border is the next big thing in e-commerce, and China and the U.S. will be the top two destinations.

Sellers and buyers in cross-border. I'll close with one number--the total global retail industry in five years is going to be $28 trillion. Twenty percent of that is going to be through online shopping, and roughly $4 trillion of that is going to be through cross-border e-commerce, and about half of that number will be between trade between the U.S. and China.

So I look forward to answering all of your questions today. I've been engaging the Chinese consumer and working in e-commerce in China for 15 years, and I hope I can bring some enlightenment to the proceedings.

Thank you.

HEARING CO-CHAIR DORGAN: Mr. Zakkour, thank you very much.

PREPARED STATEMENT OF MR. MICHAEL ZAKKOUR, VICE PRESIDENT, CHINA/ASIA PACIFIC & GLOBAL E-ECOMMERCE PRACTICES, TOMPKINS INTERNATIONAL

U.S. ACCESS TO CHINA'S CONSUMER MARKET

Testimony before
The U.S.-China Economic and Security Review Commission

June 22, 2017

Part One – Introduction

China by the numbers: 800 Million Consumers – 650 Million E-commerce Shoppers – 450 Million Alibaba Customers.

In October of 2014 the book I co-authored *"China's Super Consumers: What 1 Billion Customers Want and How to Sell It to Them"* was published by Wiley. The book's central thesis was that China's consumer class is now the largest and fastest growing in the world and the most important and powerful since the rise of the "American Super Consumers" of the mid-late 20th century. We posited that the fate of brands, retailers, technology companies and service providers from around the world will, in many ways, depend on successfully engaging and serving 800 million, soon to be 1 billion Chinese consumers.

When asked by Wiley to write a book about China (subject matter of my choosing) I reflected on my extensive business and cultural experiences in, and the accumulated knowledge I gained, over 15 years of advising American and global companies, brands, retailers and investors on opportunities for engagement in China, there was no doubt in my mind that *the* story was the journey China and Chinese citizens made from a closed, planned economy with little more than the bare essentials of life for sale to the second largest economy in the world and the most important emerging consumer class on Earth.

We called them 'Super Consumers' because of their sheer numbers (800 million), spending power and insatiable appetite to buy everything from locally produced commodities and necessities to the best products and services from the West, to luxury products and services.

The questions that needed to be answered were: How did China progress from Feudalism to Fendi? From Sandpaper (used on ladies' faces due to make-up not being available) to Sephora? From Chairman Mao to Chairman Ma (Alibaba founder Jack Ma)?

Over the last twenty years we can track the growth of China's consumer market in three stages.

Phase I - "The First Consumers" 1994-2000 – The first significant wave of Chinese entrepreneurs, executives and white collar workers realize success in business, especially in the manufacturing sector, and are able to spend disposable income on foreign products and brands. The Chinese government encourages foreign brands and retailers to enter the market by relaxing and in some cases eliminating laws and regulations that had previously hampered retail operators. The majority of early non-Chinese products and retailers are in the luxury space. During this phase, there were roughly 100 million Chinese consumers with significant disposable income.

Phase II - The Consumer Boom - 2000-2012 – The second and third waves of consumers with significant disposable income developed during this period. Spending on luxury, foreign restaurants, fashion and technology spreads beyond first tier cities like Beijing, Shanghai and Guangzhou to vast stretches of the Eastern and Southern coastal areas. E-commerce, once a novelty with little impact, is introduced to the market on a mass scale. Alibaba, who previously was known for its manufacturer/buyer B2B service Alibaba.com turns its attention to consumer products, first with its EBay like 'Tao Bao' and then its digital mall 'Tmall.com.' Consumer appetite for foreign brands, products and retail experiences expands rapidly and hundreds of non-luxury multinational companies enter the market. During this phase, there were 300-400 million consumers with legitimate disposable income.

Phase III – The Age of the Super Consumer – 2012 to Present – Fueled by government directives to realize economic growth through consumption (detailed in the 12th and 13th 5 Year Plans) the rise and ubiquity of E-commerce; rising urban incomes; 300 million people out of poverty; a rapidly expanding urbanized middle class; millennials supported by the 4-2-1 family (four grandparents, two parents, one child); and 150 million outbound travelers per year, the age of the China Super Consumer/ "China Global Consumer Demographic" begins and matures rapidly.

There are now 800 million Chinese consumers with varying, but substantive, levels of disposable income. They run the gamut from rural villagers who can now afford mobile phones, automated farming equipment and Western personal care products to urban middle/upper middle class consumers eating out at American restaurants, drinking French wine and buying luxury apparel and homewares, to the very wealthy who can afford all of the luxury products and experiences the world has to offer.

***

While American companies have been, with varying levels of success, addressing the Chinese consumer market on a mass scale for more than ten years, the opportunity is now bigger than most realize, but the rules of engagement and keys to success have changed dramatically. The upside to engagement has never been higher, but the competition has never been fiercer.

It is my opinion, informed by 24 years of experience in international business, technology/e-commerce and China that the three key realities that American companies must embrace to succeed in China and thus globally are:

- E-commerce ubiquity and the new cross-border e-commerce model.
- The effects that Globalization 2.0 and China's role in the new paradigm has had on all aspects of global business and the need to reset "make it-move-it-sell-it" strategies and operations for China and beyond.
- The emergence of a "Global China Consumer Demographic" that American companies must address in order to engage, connect with, and sell to Chinese speakers. They are "mobile and mobile" (e.g., Chinese consumers are traveling the world, investing abroad, being educated and entertained abroad and participating in the global economy at every level) and live their lives through mobile phones. Simply engaging Chinese consumers within the borders of China itself is not sufficient anymore.

The opportunities for American companies to grow and prosper through engagement with China and China's Super Consumers as a whole are numerous and widespread.

Part Two – The Digital World and Globalization 2.0

From roughly 2000-2014 the foundations of the digital business, commercial and lifestyle paradigm and the seeds of E-commerce ubiquity were laid. It is critical that U.S. businesses understand that the key to future growth and prosperity in retail, consumer products and branding is through the "New Retail" model.

Globalization 1.0 spanned the period from roughly the early 70s to 2010. Globalization 2.0 began around 2010 and the three megatrends it produced were:

- The reemergence of China as a Global Economic, Cultural, Consumer, Supply Chain and Manufacturing Power and the emergence of "China's Super Consumers" as the largest and most important new consumer class in the world.
- The emergence of tech driven, efficient and cost effective Global, Regional, Local and Hyper-Local supply chains and logistics that has made it possible to sell and ship from anywhere to anywhere in both the B2C and B2B.
- The maturity of E-Commerce and the beginning of a digitally (not IT) driven business world.

In this model, E-commerce is a set of channels within a larger framework for sales, distribution, customer engagement and loyalty, and operations. Building the model for global consumer product and retail success includes the following steps:

- Transition to digital strategies, operations, tactics and tools and to become a **Digital Company**.
- Transition to a **Multi-Channel/Uni-Channel** model whereby digital operations connect all sales channels, customer experiences, internationalization, branding and marketing.[1] Employ all or some combination of the **5 major E-commerce models** as tools for sales, distribution, marketing, consumer relationship management, and supply chain.

Part Three – Chinese Consumer Trends

It has been accepted wisdom in tracking China's rapid evolution in consumption, technology and logistics that changes are counted in dog years as compared to the West. Business models, consumer trends, technologies, and infrastructure build-out changes that would take 7 years in the West happen in 1 year in China. While this might be a slight exaggeration, in many important ways it is only slight.

There is no arguing however that changes in Chinese consumer trends, tastes, and activities regarding what they want to buy, where they want to buy, how they want to buy and from who they want to buy from has seen massive changes and overhauls over the last five years. The following are some of the most important new trends to emerge recently and which are most likely to have the greatest impact on American company's engagement with China.

- E-commerce – By far the most important development in Chinese commerce is the near ubiquity and importance of E-commerce across almost all categories, demographics and income levels. As Alibaba's Jack Ma once said, "In the U.S., E-commerce is dessert. In China, it's the main course." China's retail environment remained largely underdeveloped in most of the country (with exceptions being the biggest 3-4 cities) throughout the boom in consumption in the 2000s. As a result there were few legacy systems, infrastructures and industry leaders to overcome, so China largely jumped straight to digital commerce/E-commerce. This phenomenon is similar to China's rapid and complete adoption of mobile communications in skipping over land lines.
- Interactivity/Shopping As Entertainment – Chinese consumers view shopping as entertainment/sport/competitive activity. Digital tools and E-commerce deliver all of these experiences to consumers and as a result drive higher engagement/spending than other markets.

[1] There is no longer a battle between E-commerce and bricks and mortar retail. The companies that survive and prosper over the next 5-10 years must employ stores and E-commerce in conjunction. The biggest names in E-commerce are now heavily investing in bricks and mortar operations. While it is true that thousands of retail stores are closing, the long term reality is that thousands more will open. The winners and losers will be separated not by E-commerce vs. bricks and mortar, but by who creates a uni-channel experience that employs both models in tandem.

- Mobile – Chinese consumers are now, on average, making 80% of their E-commerce purchases on mobile devices. The convergence of E-commerce ubiquity and mobile living has created a perfect storm of consumption enablement.
- American Products – Chinese consumers' desire for American products and brands has never been higher and this demand is on track to grow exponentially over the next ten years. Chinese consumers appreciate the brand story, lifestyle implications, quality assurance, authenticity and safety of American products.
- Personal Care – Spending has shifted away from products in the luxury sector (although luxury is growing) to experiences and a focus self and wellness. As a result demand for American vitamins, supplements, foods, beverages, medical products and high quality apparel is soaring. If it goes in and on the body Chinese consumers will spend more on foreign products.
- Grocery is a rapidly expanding category for online shopping and U.S. food and beverage companies and farmers have a great opportunity to sell in the medium.

Part Four – E-commerce Trends in China

E-commerce in China is no longer just about buying and selling products and services – rather it has become a part of the fabric of life in China. This is largely due to:

- E-commerce filling the space for consumption and retail that was largely underdeveloped at the time when E-commerce was maturing in the West and being introduced in China.
- Chinese citizens adopting the mobile phone as their primary tool of communication, consumption, entertainment and socialization.
- Alibaba and JD.com developing ecosystems that combine retail, supply chain, data/technology and entertainment. These two companies dominate almost every aspect of E-commerce in China. Alibaba accounts for approximately 72% of all E-commerce transactions, JD.com for about 22% and the remainder split among specialty marketplaces, big brand standalone sites and digital native sites.
- Mobile based shopping has become dominant in China. Alibaba reported that 82% of 11-11 Singles Day holiday sales were made through mobile devices
- Augmented Reality – Adding digital images/video over real life camera view images to "gamify" shopping
- Virtual Reality – Using VR headsets to shop virtual stores or stores that are hundreds or thousands of miles away. In November 2016, I used VR to shop Macy's NY flagship store from Shenzhen China.
- Unichannel Commerce and "The New Retail Model" – Chinese internet/E-commerce companies are investing heavily in bricks and mortar commerce. The "New Retail Model" is "Uni-Channel"—providing customers seamless integration and experiences that

combine all online/offline buying, entertainment and returns. It is now accepted that online and offline must be a single experience connected by digital operations and channels.

- Entertainment/Sports – Chinese E-commerce and technology companies are integrating entertainment and sports into all aspects of the E-commerce experience. In China, shopping IS entertainment and entertainment drives sales. The same can be said of sports. Sporting products, teams and lifestyle is a major new avenue for brands, retailers and teams in Chinese E-commerce. The NFL, NHL, NBA and major European soccer teams are now all integrating their products and messaging across all E-commerce channels in China.
- Social Commerce – China is home to many of the most robust social media platforms in the world. In particular Tencent's We Chat is central to the lives of its 700 million users. We Chat has launched mobile payments, electronic malls and a wide array of marketing vehicles to serve customers who research and buy through mobile device based/social media enabled retail.

Part Five – China's E-Commerce Landscape

The total global retail E-commerce market is estimated to reach US$ 2.5 trillion in 2017, maintaining a double-digit growth pattern established over the past 5 years. China and the Asia Pacific region are the largest retail markets in the world and have and will continue to contribute the highest growth in the E-commerce and will maintain its leading position in the retail E-commerce market with almost 60% share of total worldwide revenue.

China for example already has an estimated 700 million internet users and 650 million E-commerce shoppers. Both numbers represent only about half the population of China so the runway for growth is incredibly long. In Southeast Asia, there are currently about 500 million online consumers and penetration is only 40%, again presenting a long runway for growth.

Accelerating internet penetration, the rise of a digital business, consumer and retail ecosystem, and eager online shoppers, as well as increasingly large Asian middle class, led by China, India, and Indonesia and their corresponding disposable income, have fueled the China/APAC growth.

Unlike the U.S. and Europe where there is a mature middle class and high internet E-commerce penetration, APAC is still in "adolescent" mode and the growth opportunities are huge. By 2020, there will be over 300 million new Chinese online shoppers for a total of almost 950 million, 3x the total population of the United States, the 3rd most populous country on Earth.

China, fueled by Alibaba maintains its top position in the retail E-commerce market, currently accounting for about half of worldwide sales which are estimated to double by 2020. Having the largest internet population in the world (680 million active users in 2016) and the largest pool of future middle-class consumers (338 million households worth US$ 6.5 trillion in 2020), China is poised to continue driving E-commerce development in Asia and globally.

As Amazon dominates in the U.S. and Europe, China is dominated by Alibaba; with over 80% of all transactions touching an Alibaba owned or affiliated business. However, unlike western countries where web based and desktop based shopping is dominant, Chinese online shoppers overwhelmingly connect online and shop through mobile devices. On Alibaba's Singles Day in 2016, 82% of sales ($18 billion USD in GMV) were made through mobile.

The Single's Day festival was pioneered by Alibaba – a 24 hour shopping marathon where discounts and promotions are made available on over one thousand product categories; it is now considered to be the largest online shopping day of the year with a sales record of US$ 17.8bn within 24 hours on November 11, 2016. Mobile is not only the most common purchase medium, it has also become one of the most popular payment methods/tools, where the largest payment platforms such as: Alipay and Tenpay are made available.

E-commerce growth in China is not only taking place domestically but on a cross border E-commerce basis, growing over 60% growth in the past 3 years; The US, Japan, and South Korea are the top 3 destination countries for cross border purchases. With somewhat slower but stable market growth in the next 3-5 years, the following trends are expected in E-commerce in China and by extension East Asia:

- Movement towards greater growth in B2C (vs. C2C) in China where Tmall will be the key platform, followed by JD, and Suning

- Upsell and premiumization where average spend per transaction, by product and by category, is gradually increasing - up 20% annually the last two years.

- Stricter regulations and demand for higher quality products as consumers become more sophisticated

- Rapid expansion of product category coverage and participating brands (especially international brands)

- Faster growth in luxury goods and larger size/ticket items

- Diversification in consumer engagement models (e.g., use of E-commerce satellites for agricultural sector, where online E-commerce can promote high quality crop products such as fruits or vegetables based on the cultivation and harvesting data, or emerging social commerce, where online shoppers can do transaction with sellers via social media platform post receiving friend's recommendation or reading / watching targeted ads / news)

- Food and beverage; cosmetics and personal care; mother and baby products, and healthcare-related products will continue to be fast growing and important categories

While China's E-commerce market offers attractive opportunities for foreign companies, many international marketplace/platform players have not been able to survive in the Chinese market. Companies like Amazon and EBay are now irrelevant in the Chinese market, regardless of the amount of investment and sound strategic moves they made to support their businesses. Hence foreign retailers and brands must work with the dominant local players (e.g., Alibaba and JD) to conduct e-business in the Chinese market.

Macy's, for example, decided to open its Chinese online store through Alibaba's Tmall for a faster, more cost effective, and meaningful entry. Even Amazon was forced to open an Amazon store on Tmall. This is the equivalent of Target admitting it cannot compete with Walmart and opening mini Target stores inside Walmarts.

Part Six – E-commerce in China vs. the U.S.

There are two major differences between E-commerce in the U.S. and China:

- In China, 90% of all transactions take place on marketplaces. Marketplaces are the electronic malls where thousands of brands have their stores set up. Less than 10% of all sales happen on a company's owned and operated .Com or .CN site.
    - In the U.S. Amazon is the dominant marketplace, accounting for about 50% of all new E-commerce transactions but 50% of all sales still occur on owned and operated .COM sites or 3rd party specialty retail sites.
    - Chinese E-commerce is dominated by two companies, Alibaba and JD.com, who account for almost 90% of all transactions.
- In the U.S., aside from Amazon, transactions are split between 3rd party retailers, digital native brands, and owned domains. In China the vast majority of transactions take place on mobile devices. In the U.S. less than half of transactions are made on mobile devices.

Part Seven – Alibaba – The Company That Touches 80% of All E-commerce Transactions in China

Alibaba is not only the largest E-commerce, technology, data, and marketing company in China, and Asia, it is one of the most dynamic, innovative and ambitious companies of any kind in the world today. They are a perfect result of, and key driver of, a Globalization 2.0 World.

As I said in a recent *Financial Times* interview, "If Globalization 2.0 got pregnant and had twin boys they would be named Jeff Bezos and Jack Ma." In China, Alibaba's tentacles reach into almost every aspect of life: shopping, finance, chatting, healthcare, entertainment and news. You can go for weeks in China without cash, swiping your phone to pay for coffee, clothing or utility bills. Alibaba is responsible for *one-tenth of China's retail sales* and has the biggest money market fund (Yu'e Bao has Rmb1.14trn under management). It is the company that chased eBay and Amazon out of China and bested Yahoo, acquiring its operations there in 2005.

Alibaba has built a dynamic, efficient, scalable and comprehensive ecosystem of platforms, services, technologies and business enablers for China, for Asia, and now for the world.

Alibaba has 450 million customers in China, and it is expected they will reach 750 million in the next five years. They are pursuing the SEA, Indian, and NE Asian markets aggressively. They also have a comprehensive system in place to enable European, American and South American companies to sell to Chinese consumers across a number of domestic and Cross-Border platforms.

Engaging with Alibaba is a must for a robust China E-commerce consumer play; especially China's fast growing 20-50 year old premium and luxury consumers. As Alibaba transforms the entire retail, distribution, consumer and logistics models to a new "current state" and resets the shopping experience across all categories in China, it becomes clear that it is impossible to be successful in China without them, online and off.

Engaging with Alibaba with the right strategies and right operations (it is easy to get it wrong by pushing structure before strategy, relationships and win-win narratives) not only opens the door to the future of China, but also provides a clearer path to success in all of Asia and eventually in Africa, South America and the developed economies of the West.

For example, Alibaba is making a major push to become a major player in the global wine and spirits business and in many ways has a significant head start on Amazon and other marketplaces and tech companies from around the world.

Finally, Alibaba is committed to enabling the success of others. They do not compete with or harm in any way the brands, retailers and service partners they engage with.

Alibaba's business units are categorized into A. Core Commerce B. Digital Media & Entertainment C. Local Services/Marketing Services—and all are powered and driven by the company's:

- **Alicloud Technology/Cloud Computing** – Alibaba's data collection, analysis, and deployment capability; commercial enabler; smart device/life enhancer - The core of the company's ecosystem.

- **Cainiao Logistics Network –** Alibaba's outsourced supply chain and logistics arm that makes it possible to run a massive domestic and cross-border commerce business efficiently and cost effectively.
- **Alipay –** The world's largest e-payment system. Alipay is owned by Alibaba leadership and outside investors. It was spun off from Alibaba group prior to the company's 2014 IPO and is central to the growth of E-commerce in general in China and beyond.

Alibaba is aggressive, innovative and strategic in the development of its own technologies and business enablement systems and has invested heavily in making Alicloud one of the largest cloud systems in the world.

Payment is not only a needed function for Alibaba's core Commerce activities but it helps open new markets and is a key to tying together its entire ecosystem.

Logistics is a key part of Alibaba's strategy to further their impact in China, the rest of Asia and globally. Importantly the Cainiao Logistics Network is being enhanced and scaled to be *the* key driver of Alibaba's cross border e-Commerce strategy.

THE ALIBABA ECOSYSTEM:

Alibaba's mission statement is "to make it easy to do business anywhere".

This mission statement has driven Alibaba to build its product and service offerings around buyers and sellers through an enablement approach. It created marketplaces as a platform that enables buyers and sellers to conduct transactions directly with each other and launched finance/payment units to facilitate payment for transactions made in their marketplaces. Their finance and banking arm, Ant Financial, offers funding for sellers to enable them to sell on marketplaces. Its smart logistics solutions enable sellers to deliver their products reliably, cheaply and quickly providing buyers with value-added customer delivery experiences.

The data collected from all of these operations is integrated into a system that helps sellers to better sell their products and buyers to gain better shopping experience. While each business seems to operate independently, they act as components that complement one another to create an end-to-end solution for both buyers and sellers across any B2B, B2C, C2C, B2B2C and O2O platforms.

The Alibaba ecosystem is central to the company's success, profitability, dominance in market and coming globalization.

CORE COMMERCE BUSINESSES

Chinese consumers are eager to spend money—and they spend a lot of time shopping. In China, shopping is about more than just the transaction. It's about entertainment, discovery, and social engagement with friends, celebrities, and internet influencers. On average, China's consumers spend almost 30 minutes a day on Alibaba's Taboo, the country's leading E-commerce marketplace, nearly three times longer than an American consumer typically spends on Amazon. And they're very brand conscious, if not particularly brand loyal. For instance, the typical Chinese teenager can recall 20 cosmetics brands while the average US teen can identify just 14. China's young people are also the most "spend friendly" in the world: 42% feel the need to buy more things, compared with 36% in both the UK and the US.

Marketplaces

The core of Alibaba's consumer business model lies in providing sellers and buyers marketplaces along with affiliated platforms that:

- Enable entrepreneurs, small to medium sized businesses, mega brands, retailers and multinational companies to sell their products and services on a B2C, B2B, B2B2C and O2O basis
- Enable individuals and entrepreneurs to sell their products and services on a C2C basis
- Provide Chinese consumers with multiple platforms from which they can buy products from domestic and foreign sellers

Alibaba.com

Alibaba.com was Alibaba's first platform and first business model. Launched in 1999 Alibaba.com was and is the largest B2B platform in the world. The primary purpose of the site was to enable foreign companies, brands, retailers and entrepreneurs to find, contact, and do business with Chinese factories, manufacturers, agents and suppliers.

Alibaba.com also solved a massive problem for Chinese suppliers; how to find foreign customers for their products. Within a short time hundreds of thousands of Chinese suppliers signed up and listed their products, contact information etc. on Alibaba.

Huge companies like Softbank, Yahoo, and Goldman Sachs invested in Alibaba early and provided the capital for fast and comprehensive expansion. Alibaba had taken the first steps to becoming a major player in China's internet and manufacturing industries.

Taobao

Taobao is Alibaba's C2C marketplace where Chinese netizens and small business sell and buy with each other. Taobao was the company's first foray into the consumer products world. Taobao was launched in 2003 after, and as a response to, U.S. Auction and C2C giant E-Bay bought China's leading auction site at the time "Eachnet".

E-Bay experienced initial success in China but Alibaba quickly reacted by offering free listings, instant chat (important to Chinese consumers) and other local features. Perhaps most important to Taobao's success was the introduction of 'Alipay', Alibaba's financial payment platform, which proved to be a hit with Chinese consumers because as an escrow service, it provided trust and assurance that they would not be victims of fraud.

Eventually a number of E-Bay missteps, Alibaba's innovations, and Ebay's difficulties with the government forced it to abandon China.

Soon after, Taobao became the most popular and important E-commerce platform in China. To this day it still generates the majority of Alibaba's core Commerce revenue. According to internet ranking company ALEXA, Taobao is the 10^{th} most visited web site in the world. Taobao has more than 400 million shoppers and almost 800 million product listings at any given time.

The Taobao platform, while C2C, is the main gateway that connects Alibaba's users with its other marketplaces. Users can search in Taobao, but get results or suggestions for products on all of the Tmall platforms. This was a smart way to educate users about Tmall when it first came out since everyone were already using Taobao, which is now a one-stop platform for shoppers online.

Alibaba is trying to build its brand globally and burnish its reputation and for this reason the significant problem with counterfeit items on Taobao is a major concern, prompting Alibaba to invest hundreds of millions of dollars in anti-counterfeiting measures. As of today, Taobao is, somewhat unfairly, listed on the USTR blacklist.[2]

Taobao, as a C2C marketplace, is becoming less significant as Tmall continues to grow and dominate in China and beyond. However it is still important to note that Alibaba started with Taobao and:

- Alibaba aims to ensure more US and global products on Taobao and Tmall via its June event in Detroit
- Taobao is still an important Gateway to all of Alibaba's platforms and services for Chinese consumers
- Alibaba is dedicated to eliminating fakes on Taobao. In May 2017, they sued the maker of fake Wuliangye spirits for RMB 123,000. This is part of a bigger civil and criminal prosecution effort to remove fakes from Taobao and replace them with only real products.

Tmall

Tmall is Alibaba's major B2C retail marketplace in China (and soon to be in other markets) that "caters to consumers looking for well know branded consumer products, luxury products and a premium shopping experience". It is also the biggest and most dominant B2C retail marketplace in China accounting for 56.6% of all retail E-commerce sales- Competitor JD.com trailing behind at 24.0%. The estimated gross merchandise value (GMV) of B2C E-commerce in China totaled USD $707.5bn in 2016, which is up 23.9% from USD $572bn in 2015.

Tmall is the primary platform for high profile international brands and retailers to sell directly to Chinese consumers.

It was originally launched as an offshoot of Taobao, called Taobao Mall. When it was officially spun off from Taobao it was renamed Tmall.

Foreign brands and retailers can establish a "Flagship Store" on Tmall. The store is the official presence for the company with Alibaba.

[2] For more on Alibaba's efforts to deal with the sale of counterfeit and pirated goods on its platforms, see Michael Zakkour, "U.S. Agency Puts Tao Bao on Notorious Markets List—Here's Why They're Wrong," Forbes.

The store is usually built and managed by a specialty company called a "Tmall Partner" or "E-Commerce Service Provider" (ECSP). The ECSP handles listings, merchandising, customer service, logistics and relations with Alibaba's Hangzhou based category and product managers.

Having a flagship store on Tmall is crucial for global brands hoping to succeed in China because:

- It is the most important online retail channel to sell directly to Chinese consumers
- The name and tagline of 'Official Flagship Store' is also meaningful to Chinese consumers because it is an assurance that purchasing there means the product is 100% genuine and safe.
- It is essentially a certification/acknowledgement that the brand is big and notable.
- Flagship stores are the most popular vehicle for established global brands. Having an official flagship store on Tmall, or not, is often a benchmark for consumers on whether a brand has a true and real presence in China and is committed to the market and to serving their wants and needs.

The Tmall marketplace is of vital importance to brands and retailers, consumers, and Alibaba

For Brands and Retailers

Brands and retailers benefit from Tmall not just through sales, but by raising brand awareness in China as a whole. To wit: Through Tmall, "Bosch is able to efficiently showcase all of its consumer products and engage a great number of consumers". Companies like Bosch are also able to leverage Alibaba's position as a data company to use big-data-based digital marketing, engage in China's Internet of Things (IoT), and to establish Uni-Channel/O2O retailing.

An industry example is Napa Valley winery Robert Mondavi, who has been running their Tmall flagship store for over six months. Mondavi found that "data provided by Tmall – if analyzed and acted upon- provided detailed demographic insights and enabled the brand to target customers at multiple price points and segment its market". The testimonial from Mondavi reveals that "Tmall is not just simply a transaction platform… working with Tmall, what we have learned the most is the power of collecting all this data, so we understand who is buying our wine". Mondavi is able to determine their consumer profile for all China retail through Tmall data.

Tmall is not afraid to innovate with its client brands and tries to cooperate and develop customized strategies that work. For Bosch, Alibaba launched a “cross-category flagship store, the first of its type on Tmall, to sell all Bosch-branded products and build a holistic brand profile”.

A major attraction of Tmall for international and Chinese brands is the ability to exercise full control over their own branding and merchandising by operating their own storefront with unique brand identities. This is especially important for luxury brands wishing to control identity, pricing, experience, messaging and exclusivity as well as their intellectual property.

As Alibaba Group President, Michael Evans, stated that, “brands maintain control over the entire consumer experience” including pricing, branding and merchandising; delivery and returns; and data that supports all critical-decision making on Tmall. Examples of such successful Flagship Stores include Apple, Burberry, and Estee Lauder”.

For Consumers

To Chinese consumers, Tmall is the epitome of the fine online shopping experience in China. Chinese consumers associate Tmall with sophistication, quality, authenticity, superior service, and the best brands in the world. Tmall provides Chinese consumers with experience, selection, price, and convenience.

Convenience is a key in winning the hearts of Chinese E-commerce consumers. If one can purchase the same goods as at the department store or street level store with a click on the phone and later delivered to their door, why not? This is why it comes as no surprise that 2016’s “Single’s Day” data shows online shoppers prefer mobile to computers (82 percent of all transaction made were mobile, rising from about 70 percent last year) as people can reach into their pockets and buy on the go.

China has the necessary infrastructure to support an ecosystem like this, but more importantly, it fits tightly with the lifestyle of Chinese consumers as mobile shopping is perceived to be trendy, fashionable, and technologically savvy.

In addition, the promise that consumers are buying 100% authentic goods from Tmall also defines the Tmall shopping experience. In China, counterfeit items are not uncommon. As the lifestyle of the average Chinese improves with the rise of the middle class, people are increasingly cautious about fakes and WANT - genuine goods – in no small part to “show-off” status symbols in front of families, coworkers, and friends. Hence, the Tmall promise that all goods sold on the platform are legitimate attracts many buyers around the nation. This fact is also a driver toward 'premiumization' as consumers are assured that the luxury goods that they buy are guaranteed by both Alibaba and individual brands and retailers.

Lastly, the reliable service from Tmall is also something consumers value greatly and appreciate. The 7 day unconditional return policy is unique to the Tmall platform. Returning purchased goods in China, unlike in the West, is usually a major hassle.

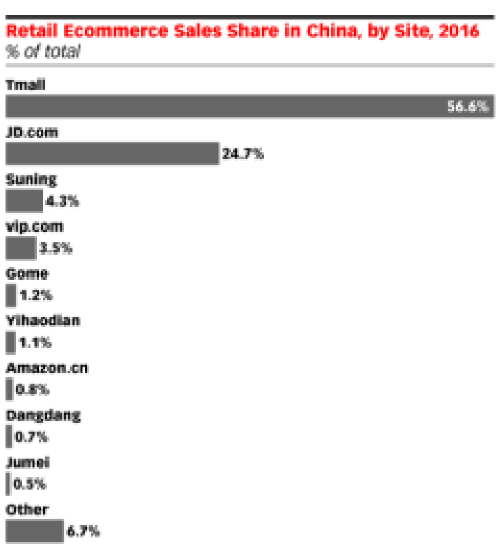
However, with the Tmall 7 day return policy, consumers are given extra incentive to explore and buy.

The combination of convenience, assurance of genuine goods, and implementation of excellent service, drives consumption on Tmall. The platform has become so pervasive in the lives of the Chinese that most people start searching on Tmall even if they decide to ultimately buy a product offline.

For Alibaba

As a platform itself, it generates revenue through commissions and advertising and marketing fees. Tmall is also the primary source of data on how businesses sell to consumers via Tmall Partners.

Tmall, in addition to being a sales and marketing platform works as a data collection and sharing platform enabled through Tmall Partners.



Tmall Global

Tmall Global was launched in 2014 as an extension of Tmall. It is Alibaba's primary B2C Cross Border E-Commerce platform. Brands and retailers set up Flagship Stores on Global just as they would on Tmall.com and the experience for the Chinese consumer is largely the same.

Tmall Global is primarily for big global brands and retailers who want to sell into China but who have not or are not ready to set up a fully realized business entity and operations in China. Tmall Global would not be appropriate for Moët Hennessy as the company already has a business in China.

Tmall Global shares many of the same characteristics as Tmall. For instance, Tmall Global also uses Taobao's infrastructure and payment system, Alipay (one of Alibaba's affiliated businesses), so "Chinese users are familiar with all the services, and the trust mechanism that they have been using for years."[3]

Trust has been driving success for Alibaba as customers are guaranteed products sold online are genuine since Tmall Global, like Tmall, only accepts verified brand and retail stores, which builds customer trust and ultimately conversion rates. Another advantage, which will be explored in greater depth in the Big Data section, is that "Tmall and Global have exceptional analytics tools… the daily update analytics and daily sales reports can help merchants make strategic decisions and compare data against peers in Tmall."[4]

While sharing many of the characteristics and traits of Tmall, Tmall Global differs from the operations of Tmall for brands and retailers, consumers, and Alibaba itself. Brands and retailers selling on the Tmall Global platform are foreign entities that don't have local operations in China, in comparison to Tmall, where all vendors need to be businesses with registered business licenses and trademarks. On the consumer side, "Tmall Global greatly simplifies the process for Chinese to purchase goods from overseas."[5] This used to be a troublesome process that consumers had to go through as they had to speak a certain level of English and also possess a credit card with access to foreign currency, not to mention the long wait time for delivery that "would take up to 30 days or more, whereas products in Tmall Global are guaranteed to be delivered within 14 days from overseas or 2-3 days when brands store goods in a bonded warehouse in a FTZ (Free Trade Zone)."[6]

Finally for Alibaba, Tmall Global is the most important strategic asset for its cross-border and globalization initiative. Tmall Global allows Alibaba to further tap into the greater Asia markets

[3] Quoted from Misha Maruma's post on "China's Tmall Global: Everything You Need to Know"
[4] Quoted from Misha Maruma's post on "China's Tmall Global: Everything You Need to Know"
[5] Quoted from Misha Maruma's post on "China's Tmall Global: Everything You Need to Know"
[6] Quoted from Misha Maruma's post on "China's Tmall Global: Everything You Need to Know"

through enabling cross-border e-Commerce businesses. This expansion towards globalization is pivotal to Alibaba's success in Asia and the rest of the world.

Part Eight – The Chinese Government's Role in E-Commerce Development

Government support for E-commerce, retail and consumption in general has been robust, consistent and ubiquitous in China.

In 2010, the Chinese government released its 12th Five-Year Plan. In it the Chinese government makes clear that the pillars of China's growth and prosperity over the first 30 years of the "Opening Up and Reform" era could not sustain China's continued growth for the next 30 years.

The key takeaways from the plan, in regard to consumption, and later reiterated and reinforced in the 13th 5 Year Plan (2015):

- Low value add manufacturing and exports will not support economic growth and higher standards of living over the next 30 years
- China's economy must shift to a consumption based model
- China's economy must shift to a services based model
- The government will support indigenous innovation in technology (in the form of support for technology and E-commerce companies)
- The government will support retail infrastructure
- The government will support the expansion of E-commerce and cross border E-commerce
- The government will support small and medium sized enterprises in E-Commerce and their efforts to sell their products and services to a global customer base

Additionally the government has supported the establishment of Free Trade Zones (FTZs) that encourage foreign direct investment, cross-border e-commerce and expanded retail activity.

The benefits of the FTZs for U.S. companies engaged in a number of business categories in China and especially with regard to cross-border E-commerce include:

- Choosing a virtual office instead of a real one;
- Procedures registering in a FTZ are much quicker and easier;
- Less – or no – (import/export) taxes;
- Easier conversion from RMB to foreign currencies;
- Special customs monitoring system:

    - Detailed customs clearance is only needed in a later stage;
    - Faster custom clearances of goods;
- No import tax when imported into the FTZ;
- Bonded warehouses;
- Broadening of investment horizons.

For cross-border E-commerce this means that U.S. brands and retailers can ship goods to a FTZ, and store them in a bonded warehouse without the goods having to pass through customs. When an online shopper orders a product from Tmall Global or JD Global, the third party logistics provider managing the distribution center picks and packs the product, fills out an individual customs forms and send the product to the customer.

Cross-border E-commerce and the FTZ's mean that small and medium sized businesses who want to sell to Chinese consumers do not need to establish a business entity in China, pay taxes in China, or hire employees in China.

Also, China does not charge customs fees on products/packages delivered via cross-border commerce into China with a worth less than RMB 800 ($120).

Part Nine – Opportunities for U.S. Businesses to Sell to Chinese Consumers Through E-commerce

American companies, including those in the business to consumer, and business to business categories, are already engaged with selling to China via E-commerce. Many of them are realizing top-line and bottom line growth by doing so. Companies like NIKE, Apple, Gillette, Proctor and Gamble and COSCTO are all running successful E-commerce businesses in China by selling through Alibaba and JD.com platforms.

U.S. companies have only begun to scratch the surface of the opportunity that Chinese consumer and Chinese E-commerce represents. To date most engagement with Chinese E-commerce has been limited to only the largest U.S. companies. This was due to the cost, investment needed, and formerly restrictive legal and regulatory environment in Chinese E-commerce as well as the initial focus from Chinese E-commerce marketplaces on mostly multi-national companies.

This is no longer the case. Chinese consumers and Chinese E-commerce operations are now open to a wide array of companies across all categories. There is an entire ecosystem of technology, logistics, strategy, and software service providers in the U.S. and China focused solely on enabling U.S. companies to sell to Chinese consumer through E-commerce either in China or cross-border.

It is in the best interest of the United States and its businesses that further efforts are made at in the public and private sectors to help enable more U.S. companies to sell to Chinese consumers.

Chinese consumers are the most important new consumer class in the world. There are 800 million of them in China, and another 200 million living outside of China. Their preferred and primary channel of consumption is E-commerce. American companies can no longer consider themselves serious international players without planning for and engaging Chinese consumers through E-commerce.

Further, China's biggest E-commerce players are rapidly expanding into South East Asia, India and other developing markets. But engaging with these major players the door to not only China is opened but the entire developing world.

The following are key opportunities that U.S. companies should be taking advantage of with support from federal, state and local governments.

- Multinational U.S. companies should be selling on Alibaba's Tmall where they can manage and operate a flagship store. The Tmall flagship is the most visible online presence a U.S. company can have in China and is the key vehicle for sales, brand positioning and marketing.
- Multinational as well as small and medium sized enterprises should be selling on Alibaba's Tmall Global, the primary vehicle for selling cross-border and which allows direct access to Chinese consumers without the need for a Chinese business entity.
- Entrepreneurs, small businesses, farmers and agricultural concerns should sell to Chinese businesses and consumers through Alibaba's B2C and B2B platforms designed specifically for their needs.
- Multinational and small and medium sized enterprises should be selling on JD.com. JD operates on a more traditional wholesale/retail model. U.S. companies sell their products to JD and then JD owns, merchandises, sells, the products directly to Chinese customers.
- Multinational and small and medium sized enterprises should sell on JD Global for cross-border.
- B2B – Alibaba and JD, as well as others have launched several E-commerce platforms to enable B2B and B2B2C commerce between the U.S. and China. Taobao Global and Alibaba Direct Import are the two most prominent platforms.
- U.S. companies should transform their operations, strategies and expansion for a world where CHINA/DIGITAL & CROSS-BORDER/SUPPLY CHAIN/FINANCIALIZATION are the four major mega trends shaping all aspects of national and international business.

Challenges U.S. retailers and brands face in China's E-commerce market:

- *Need for more consistent IP enforcement*. IP protection is the most common concern faced by multinational retailers and brands operating in China, including sales through E-commerce channels.[7] While the Chinese Government has ample laws regarding IP on the books, enforcement efforts have at times been uneven. One bright spot is Alibaba's massive effort toward solving IP issues on its Taobao C2C platform. IP issues are not a major concern on Tmall as the stores are owned and operated by the brands and retailers themselves. Alibaba's TaoProtect program and its aggressive moves to bring civil and criminal charges against IP infringers are already showing results.

  The key in fighting infringement in China can only be overcome by a coalition effort from government, marketplace and brand action. Jointly setting up policies and controls for copyright and trademark protection and ensuring early registration of patents and trademarks in China are key to ensuring brand and product integrity. One successful case study we can point to is the UK-China Copyright Protection effort. Twenty leading British brands have participated in the initiative which includes being involved in regular roundtable meetings with Alibaba and flash sales initiatives to promote the brand story and educate consumers towards product authenticity, etc.

- *Regulatory uncertainty.* In its effort to continually spur economic growth and to ensure stability in the country's business and financial markets, the Chinese government is in a constant cycle of experimentation with laws and regulations. In my decade and a half in China this has been the number one frustration for the executives and companies I have worked with. Laws and regulations can change frequently and without warning. This makes long-term planning difficult at times. From population control and property ownership, to emerging trends such as E-commerce, the government is trying to stay ahead of and cope with change. There are upsides as well as downsides to uncertainty though.

  As for e-commerce, while the regulatory development stage is still somewhat immature, there has been much positive movement from the government to increase cross border E-commerce with the aims of better regulating the marketplaces, improving consumer safety, and enhancing domestic consumption.

  Like many regulatory changes the recent regulatory upgrades in E-commerce (including the new "positive list") are viewed as not only benefiting domestic cross-border E-commerce platforms like Tmall Global or JD.com but also to give time and room for the key supply chain stakeholders including the Chinese government to prepare and align

[7] It should be noted that IP protection is a major concern for E-commerce the world over. A recent study showed that 1 in 4 of all movies and DVDs sold on Amazon are fakes and Nike and Adidas have had major issues on the big South American marketplace Mercado Libre.

themselves on standards and procedures, especially for products in need of greater health and safety regulation.

- *Hometown Heroes and Indigenous Innovation*. The Chinese Government has implemented a number of indigenous innovation policies in recent years that favor some domestic companies in regard to the development of new technologies, business models and market access. In addition the Chinese government is focused, as any government would be, on promoting best in class companies to be not only market leaders in China but globally. These issues must be navigated with delicacy, care and focus, especially in the new technology sectors.

- *Product specific issues.* To successfully sell in China requires a clear strategy of go global and go local ("glocal"). From labeling, spec detailing, to testing and product registration as well as branding and marketing, requirements can be very complex and costly. While selling to China through cross-border E-commerce does not require legal entity setup, U.S. brands and retailers who want to be successful in this regard require a dedicated team and focus to satisfy the requirements to successfully build a brand and sell it in China. Companies with long-term plans and focus in China have been successful and the rewards generally exceed the efforts and investment made in the long run.

  U.S. companies now have greater access to the China market than ever before, but as stated earlier, the right strategy, and structure must be built before implementation. While some significant barriers to entry and success still exist there is more than abundant proof that with the right products(s), right strategy and right investment, China's Super Consumers and the E-commerce channels they prefer to buy through present the greatest opportunity for expansion, growth and profitability for American brands, retailers and service providers on the international stage.

Increased private and public sector partnerships can and should play a key role in U.S. companies engaging Chinese consumers and integrating China into their global E-commerce structure. Some recommendations to help improve market access, awareness and deployment include:

- Initialize a high level round of negotiations on cross-border E-commerce between the United States and China to: 1.) Better define what barriers actually exist to greater market access to China via E-commerce and vice versa. 2.) Define new terms on trade rules, regimes and remedies that have not been adequately addressed since China joined the WTO almost 20 years ago. 3.) Define and negotiate new bilateral and regional trade agreements with a focus on E-commerce; cross border commerce; rules of the road for data and technology transfers; and intellectual property protection.

- Educate and empower national, state and local chambers of commerce to provide education, resources, grants and support for U.S. companies who need help in redefining themselves for Globalization 2.0/Digital Paradigm success and to promote the opportunities they have in selling to Chinese consumers, Asian consumers and developing market consumers via cross border commerce.
- Work with Amazon to better understand their ongoing globalization efforts and what they can do for U.S. companies seeking customers in China and beyond.
- Standardize product information and classifications for all key supply chain stakeholders in the U.S. and China markets – one example is the strategic cooperation between Alibaba and GS1 Australia through a signed memorandum of understanding to formalize, promote, and strengthen online trade between China and Australia
- Seamless cross-border E-commerce trade rules – a recent example being the Malaysia Digital Economy Corporation signing an MOU with Alibaba and the Hangzhou Municipal Government to establish an electronic World Trade Platform (eWTP). The platform offers SMEs easier access and easier procedures for customs clearance, inspection, and permit issuance for their cross-border e-commerce trade with China
- Support of the U.S. Country Pavilion on Tmall to support Chinese consumer education on American product quality and authenticity. For example, the Denmark Ministry of Foreign Affairs signed an MOU with Alibaba to help increase exports and strengthen cooperation on anti-counterfeiting as well as IP protection
- Work directly with Chinese marketplaces in a multipronged effort at combating fraud. Minimizing IP infractions will take a coalition effort by businesses, brands, marketplaces, and U.S. and Chinese government agencies.

Appendix of Graphs, Charts, and Visualizations

Figure A: The Four Current E-Commerce Models for International – All Overlayed by Cross-Border E-Commerce

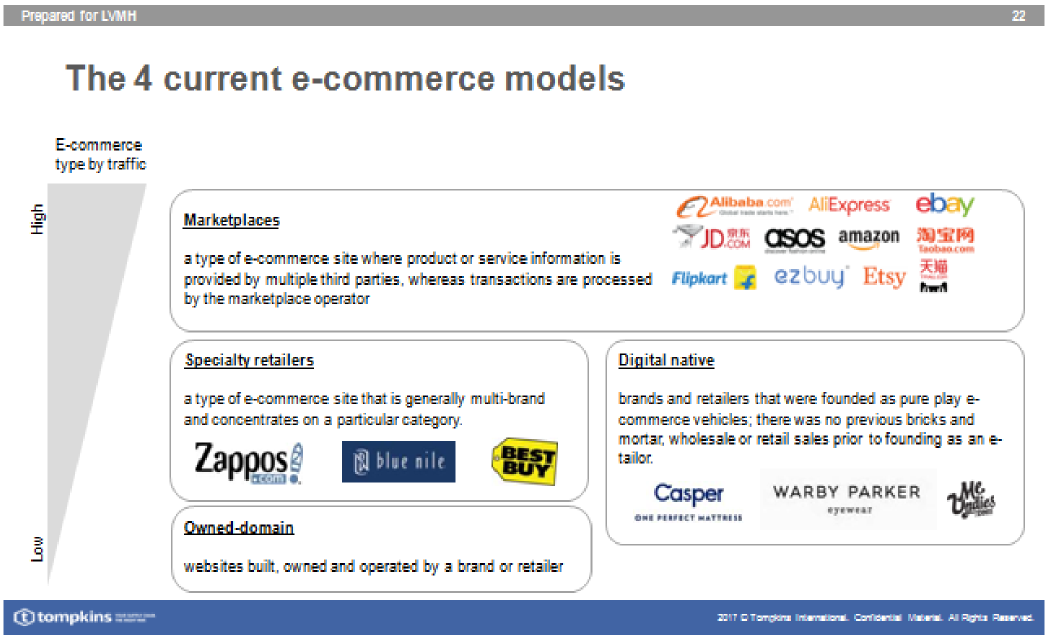


Figure B: Global E-Commerce Sales 2013-2017

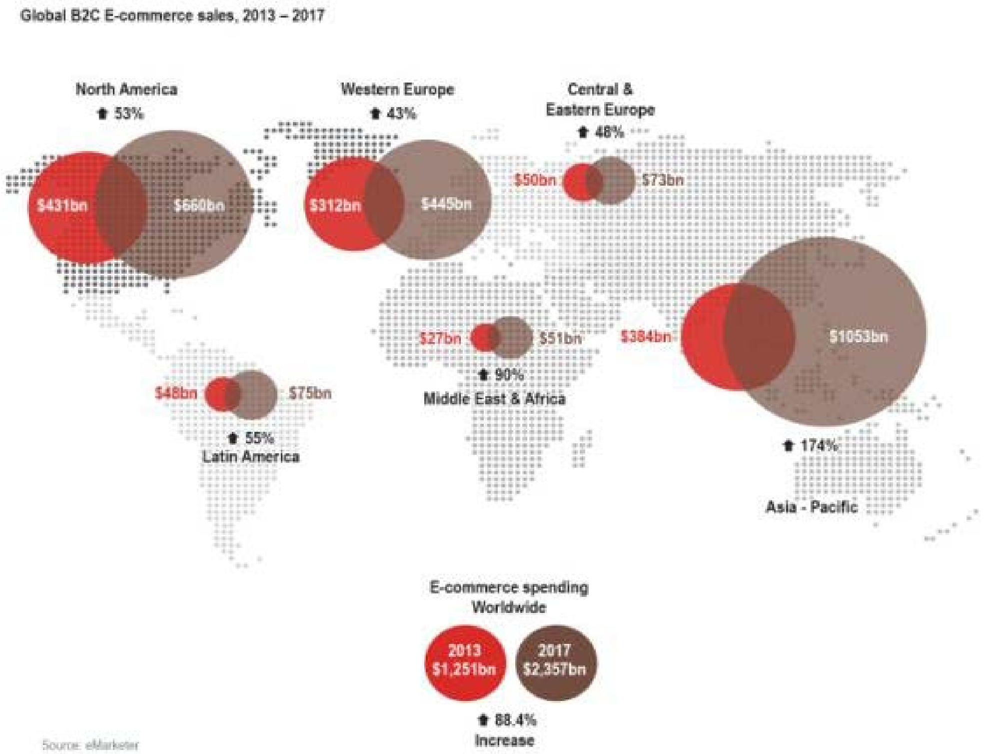


Figure C: Total E-Commerce Sales – U.S. and China

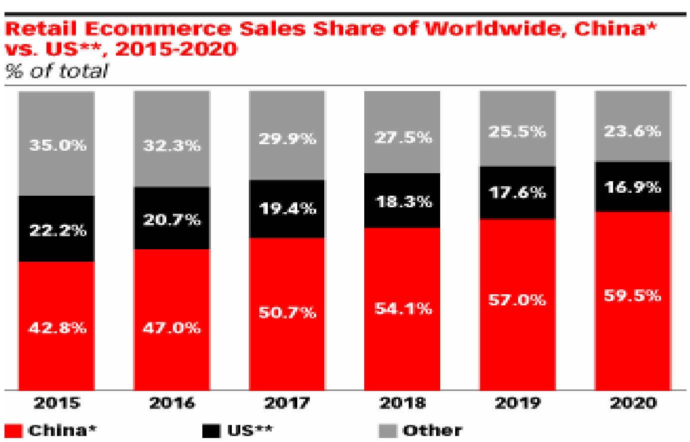


Figure D – Alibaba's Businesses

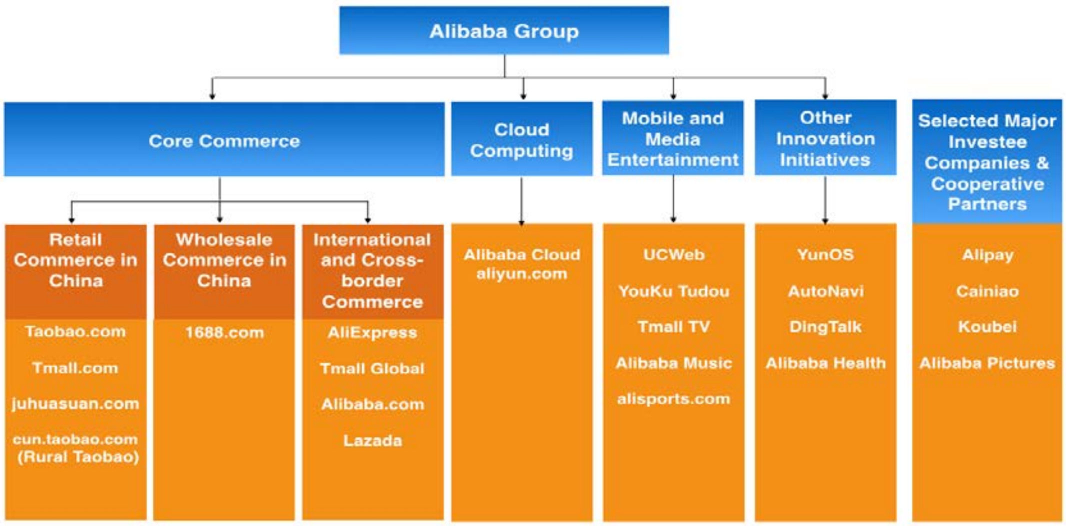


Figure E - Amazon Leads in Developed Countries through Local Presence and Operations

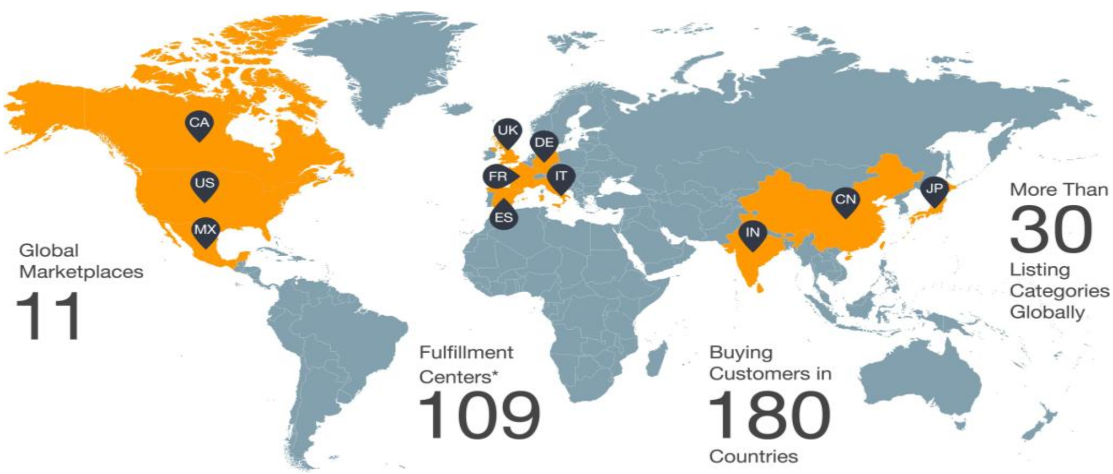


Figure F – Alibaba's Business Units and Ecosystem

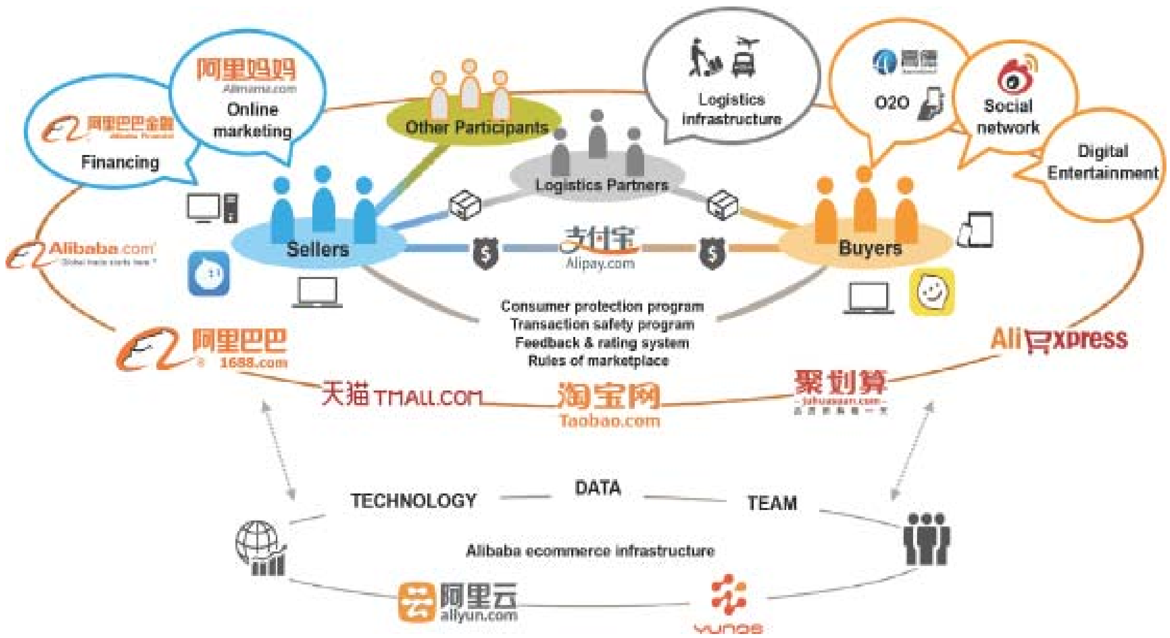


Figure G – Cainiao, The Largest Logistics Network in China

OPENING STATEMENT OF RICHARD CANT, ASIA COUNSEL, ADX NET INC.

HEARING CO-CHAIR DORGAN: Mr. Cant.

MR. CANT: Thank you, Senator Dorgan, Commissioner Hubbard. Thanks to the esteemed members of the Commission. Thank you for having me here. It's a great honor for an Australian lawyer to sit here in the capital addressing you about China. That's globalization. I mean--

[Laughter.]

MR. CANT: My name is Richard Cant. I'm an Australian attorney and CPA. I've been working in international business now for about 30 years, the last 15 or so in China. I've lived in China for 15 years, both in Shanghai and Beijing, and worked advising U.S. and other foreign companies how to do business in China, particularly doing a lot of technology businesses and e-commerce sales in the last five years or so with the explosion of e-commerce in China.

I touch on a number of issues in my written testimony, a lot about the superlatives. We could talk for hours about the superlatives of China. Jack Ma did a great job yesterday.

I want to concentrate, though, on a few issues in the oral testimony, and that is really how American businesses can actually do business with China; how can they sell products? What are the regulatory constraints on U.S. businesses, particularly tech businesses, in China? And what are the problems and challenges facing U.S. businesses, if I might?

The first way--there's four ways American businesses can sell to China--sell products to China. The first is really selling directly from the U.S. So you have a U.S. website, and you might translate it into Chinese, and then you try and sell across the border to Chinese consumers. It doesn't really work that well, and a lot of U.S. businesses think that if they translate their website, their U.S. website, the Chinese customers will flock, and that doesn't really happen because the Chinese e-commerce platforms--sorry--system is totally different to the one we use in the West.

If you look at a Chinese website, it will be totally different. You won't know how to navigate it. It looks different. It feels different. It has different payment systems. It has different--it reflects different consumer behavior.

So Western approaches to marketing and selling goods just simply don't work in China quite frankly. So most times, Western businesses just use their website here it doesn't work at all.

The second really way of doing it is really to set up your own company in China so in order to have a Chinese website, which is a .cn in Chinese, that will be easy for Chinese consumers to find when they google on, not google, when they Baidu, because China search engines are through Baidu, not Google. The problem with this is that it takes a long time and a lot of money to set up a Chinese subsidiary.

And once you even get a Chinese subsidiary, then it takes another step to set up a website and get that approved. You also have an obligation to set up a physical retail store so that takes a lot of cost, a lot of money, a lot of time, and it's still no guarantee, of course, you can attract Chinese consumers because you've then got to go into Chinese search engine optimization procedures in order to get the Chinese consumers to your site.

Then you've got to provide payment systems, Chinese payment systems. You've got to provide shipping systems. You've got to provide all sorts of things. Generally, as a rule, I've found that Western-owned single-purpose Chinese sites don't work, and that's really--there's been a number of failures, and maybe you've had some experience in this, and therefore it really is a lot of money spent for no good return.

The third way, and Michael just alluded to this, is really third-party platforms, and this is the rise of these great Chinese mega-platforms. The two biggest ones, of course, are Tmall, which is Alibaba, and then JD.com, which is the competitor. Tmall, of course, has about 50 percent, maybe 60 percent, of the market. Richard Liu's JD.com, which is the challenger, has about 20, 25 percent.

These are great way of selling to Chinese consumers because they've got a captive audience, hundreds of millions of Chinese consumers. They've got payment systems in Chinese. They're all in Chinese. They are designed in a Chinese manner, and the search engine optimization is also via Chinese systems.

The problem is for Western companies is they're not designed for Westerners to use or, you know, they're really very much designed for Chinese consumers, Chinese products, Chinese consumers, Chinese e-commerce platforms. So although it's getting better at the moment, and we can talk a little bit about the changes, it still is very difficult for smaller Western companies. They're very much catered towards the big brands. The Fortune 500 companies, the established brands, can easily get on to these platforms. But if you haven't got an established brand or you haven't got an established business in China, and you're a Western company, it's very difficult to get on to these platforms.

The Chinese e-commerce platforms saw these problems, and they've created what they've called international platforms, and this is Tmall Global and JD International. Theoretically, these are designed to attract Western brands that can get an easy entry into China through those methods.

It hasn't been that successful. It's getting better as we go on. The rules to get onto these platforms are very high. The fees you pay to not only to the sites but also to intermediaries who are meant to usher you through these sites are very high also. So in my experience, they haven't been that successful quite frankly.

But I understand that, and certainly we had some indications from Alibaba yesterday that it's making it easier, and they're looking for different ways for foreigners, American companies, to get their products on to these platforms.

And the other way--the fourth model--is selling through what we call cross-border e-commerce channels. And that basically is the Chinese government are aware, and they're really trying to promote the e-commerce sector. What they've done is they've nominated a number of cities in China--Shanghai, Beijing, Hangzhou, so on and so forth--to become pilot areas for easier cross-border e-commerce, particularly in the logistics area, particularly in customs, taxation and so forth.

This is a relatively new avenue, and it's been an absolute boom, and millions and hundreds and millions of dollars' worth of products is going through these channels.

The problem is, is that again it's quite expensive to do, and the Chinese government and authorities are changing the rules constantly because once these CBEC, cross-border e-commerce platforms, became successful, there was a distortion in the market, particularly on price, and the Chinese merchants were being priced out. So therefore the government is tinkering with how the tax will go and so on and so forth.

So it's a work in progress, but, as Michael said, this is probably one of the biggest boom areas we'll see in the future--a work in progress though.

Just quickly, some challenges. Tax system is still very much slighted in favor of Chinese companies. There's no even playing field, particularly in the way it's operated. In many ways, China is for Chinese. As I said before, it's really designed for Chinese products, Chinese consumers, and sometimes it feels that there's really no room for Western products unless you're a big brand in that sense.

E-commerce platforms we talked about.

Competition. I think this is the toughest, most competitive market in the world that we've ever seen. Every country is there trying to get a part to the Chinese consumers. And a lot of times American companies don't really appreciate this level of competition and the amount of money and dedication you need to spend to be successful there.

IP and counterfeit issues, we've heard a lot about. It's getting better, but it's still a problem.

Logistics and supply chain, we'll talk about.

Human resources. It's really difficult to find good people in China. It seems crazy, but trying to get very good staff to manage your supply chain, manage your company, it's very difficult.

There's what we find from U.S. particularly mid-market to smaller companies is a lack of overall understanding of the market. There's a view that we'll just go to China with our Western marketing plan and it will succeed. A lot of money has got to be spent, a lot of time has got to be spent, to adapt, to reboot your U.S. or your European marketing strategy for China.

The other big thing is lack of capital. A lot of mid-market to smaller companies simply don't have the capital for a Chinese adventure, let's call it. Very few banks will lend money to--whether they be banks in the U.S. or whether they be banks in China--will lend money to smaller foreign companies doing business in China.

So what you do is you're using your own money there, and you take--it's a hard decision for a local CEO or CFO to spend a lot of money, and it takes a lot of money in China. China isn't cheap, and that's a problem.

I think the other problem is people have over expectation of the Chinese market. People believe that if they get their product in front of the Chinese consumer, that's it. They'll make a million dollars. Nothing could be further from the truth. I mean the Chinese are the most discriminating consumers at the moment. They're willing to have a look, they're willing to try, but, you know, whether--and they're very fickle. In the e-commerce landscape, the trends change every six months.

Not even the Chinese companies know what's going to happen next. So to be nimble, to be flexible, to be able to adjust your marketing strategies, I think a lot of U.S. and foreign companies simply are more rigid in their thinking and aren't willing to maybe adapt their way of selling, their way of doing things at will.

That's all I wanted to say today and thank you for the opportunity.

HEARING CO-CHAIR DORGAN: Mr. Cant, thank you very much for your testimony.

PREPARED STATEMENT OF MR. RICHARD CANT, ASIA COUNSEL, ADX NET INC.

U.S. ACCESS TO CHINA'S CONSUMER MARKET

Testimony before
The U.S.-China Economic and Security Review Commission

June 22, 2017

Senator Dorgan, Commissioner Hubbard and esteemed members of the Commission. Thank you for inviting me to testify before the Commission. It is a great honor and I appreciate the opportunity to appear before you today to discuss the issue of US companies' access to Chinese consumer markets with particular emphasis on e-Commerce and logistics.

1. INTRODUCTION

My name is Richard Cant and I am an Australian attorney & CPA that has been working in international business for over 30 years. Currently I am the Asia Counsel for a US mid-market technology company based in Minneapolis MN. This company has business interests in a number of Asian countries including China.

Prior to this I was the North America Director for an Asia based consulting company, Dezan Shira & Associates, which is one of the larger companies advising US and other businesses on how to do business in China and other Asian countries. In 2015 I established an office for Dezan Shira in Boston MA to primarily advise mid-market and smaller US businesses on how to establish and operate businesses in China and the rest of Asia. Prior to establishing this office, I lived in China for over 10 years. During that time, I have established my own and others businesses, worked for a Chinese finance company, consulted to Western businesses and headed up Dezan Shira's Shanghai office for about 6 years where I came into daily contact with US and other foreign companies and individuals wanting to establish businesses in China, operating existing businesses in China and wanting to expand their businesses in China.

During this testimony I have referred to and cited a number of sources. I'd particularly like to acknowledge the resources of China Briefing (www.chinabriefing.com) which is the publications subsidiary of Dezan Shira & Associates, and the White Paper produced by the Stanford University's Business School: 'U.S.-TO-CHINA B2C E-COMMERCE: IMPROVING LOGISTICS TO GROW TRADE' in August 2016 (https://www.gsb.stanford.edu/sites/gsb/files/publication-pdf/vcii-white-paper-us-china-ecommerce-imrpove-logistics-grow-trade.pdf) which is an excellent resource.

2. CURRENT STATE OF CHINA'S ECOMMERCE MARKET

The online retail sector in China continues to attract the world's attention for its headline growth and transformative effects on the country's business environment and social fabric. It seems that every day we read more superlatives and bigger number coming out of China in relation to this area.

Exemplifying this growth, China's biggest business-to-consumer (B2C) platform, Tmall, operated by Alibaba, created the popular Singles' Day on 11 November 2009. With much anticipated discounts on offer, subsequent Singles' Days have broken consecutive world sales records for a single day. On 11 November 2016, the total gross merchandise value of goods sold on its marketplace on Singles Day was $17.8 billion, compared with $14.3 billion in 2015. The 2016 sales figure is about four times what the worldwide Black Friday sales are expected to be this year.

Just this month Alibaba, one of the world's largest tech company announced that it is very bullish on the future of China ecommerce sector. They predicted revenue growth for next year to exceed 40%. That's on top of 2016 growth of 56%.

China's ecommerce industry is experiencing massive growth-online sales topped USD622 billion in 2015, a 33% increase on the prior year. Previous YoY growth has been around the 50% mark since 2010.

For 2016, the figure is $752 billion representing 26.2% growth from 2015—more than double the growth rate of overall retail sales. Total retail sales amounted to $4.98 trillion in 2016, up 10.4% year over year. In comparison, online sales in the United States were close to $342 billion in 2015.6 China's e-commerce market is projected to reach a transaction value of $1.56 trillion by 2018.7. Even with dark clouds over the Chinese financial landscape, retail sales (both traditional and online) show tremendous growth. Compare this with the flat or no growth in the US and other Western economies.

The Chinese online marketplace is by far the biggest in the world. It is estimated that by 2020, the size of the Chinese online market will overtake the combined US, UK, France and Japan markets with an estimated 750 million online shoppers.

This growth trajectory is only forecast to continue-online shopping for goods and services is a social mainstay of urban, upwardly mobile classes of (especially) young consumers (see Appendix 1). This is driven in part by urbanization, better payment systems and technologies, better logistics, higher wages, and more competition and choice.

There is a fundamental difference between the Chinese ecommerce model and the more traditional model found in the USA. The Chinese marketplace is dominated by online marketplaces like Taobao, TMall, JD.com and the like. I will discuss these later. These marketplaces (think Amazon and EBay) dominate up to 90% of the entire Chinese online market. Contrast this with the USA where independent merchant sites have approximately 75% of the market. Amazon currently holds about 15%, Walmart 4% and a range of retailers like Costco, JC Penny, Target, Kohls, Sears, etc. holding 1% or less. (Statista 2017)

The uptake of e-commerce in China is significantly different to its evolution in other markets. In China it is driven not by PC shoppers but by consumers using mobile devices. More than 40 per cent of Tmall's transactions are made by mobile consumers. According to the Chinese authorities, 520 million Chinese access the internet via a smart phone, from a total population of 632 million internet users. The Chinese Government's target is to connect 1.2 billion people – 85 per cent of the population – to 3G or 4G mobile internet by 2020. Mobile technologies play, and will play, an important role in this growth. There is almost a 15% increase in 2015 in the percentage of online shoppers which will utilize mobile technologies. There are over 600 million smart phone users in China and an increasing number are using those smart phones to shop online.

It's not just B2C that is booming. Business-to-business (B2B) e-commerce is also growing rapidly due to its low costs and accessibility of information. In 2013, sales in China's online B2B market reached RMB 7 trillion (US$1.2 trillion) with a year-on-year growth rate of 19.7 per cent. Alibaba's 1688.com remains the prevailing platform for such transactions, spanning 16 industries including food, raw materials, clothing and accessories, and furniture. The site controls over 40 per cent of the B2B market, followed by Global Sources (a Hong Kong-based B2B media company) and HC360 (a comprehensive B2B platform covering more than 70 industrial clusters).

Cross Border Ecommerce (CBEC) is also an emerging trend and of most interest to US businesses. As the growth of the consumer revolution emerges in China, there is increasing interest in foreign goods and services. It has recently been estimated that CBEC amounted to an estimated $40 billion in 2015, more than 6 percent of China's total consumer e-commerce, and it's growing at upward of 50 percent annually. A number of the Chinese ecommerce market places has established dedicated sites that cater to international ecommerce-TMall Global, JD Worldwide (discussed later).
The Chinese consumers are buying from countries such as the USA, Canada, Japan, South Korea, Australia, New Zealand and Europe in increasing numbers. The reasons driving this are numerous but generally center on higher quality, lower prices due to better logistics, brand awareness, unavailability in local markets, lack of trust in local brands, etc.

Foreign brands have a strong appeal to Chinese consumers (e.g., US brands like Apple, Nike, Gap, Disney, Starbucks, Buick, etc.; Asian brands like SK, Panasonic, Sony, and Samsung; European brands like Mercedes, Chanel, etc.).

Foreign products though are expensive even when purchased through legitimate cross border ecommerce routes. VAT, consumption tax on luxury goods and import duty can mean that foreign goods can cost up to 40-100% more in China.

This booming demand for foreign goods but not having to pay the steep import taxes has led to a 'underground' import channel which is so called parallel or gray importing. Chinese consumers who do not buy products abroad themselves or through friends have a number of options for ordering goods online. Purchasing agencies, or *daigou* agencies, buy products abroad on behalf of consumers for a fee, provide assistance on payment and delivery, and allow consumers to pay in Chinese Renminbi (RMB). However, the process may take a long time to complete, agencies may not be reliable, and they may import goods illegally.

Chinese consumers may also buy products directly from overseas shopping websites. This is a more reliable and legal process, but consumers may face language barriers and need to settle payment in foreign currencies. Both models described above are likely to avoid import taxes, since packages enter the country as personal items with low declared values, resulting in low or no tax liability.

MAJOR CHINESE MARKETPLACES

See generally Appendix 2 for a representation of the major players. The Ecommerce industry in China is dominated by two large players, **Tmall** and **JD.com** all with different focuses and orientations affecting their prospects for foreign sellers:

Tmall:

- Market share: 55-60%
- Online Mall
- Focus: General merchandise
- Estimated number of users: 407 million
- Shipment and delivery: Third party delivery outsourcing
- Ownership: Alibaba Group listed on NYSE
- Suitable for: Large international brands with demonstrated potential to achieve a large volume of sales or high revenue

JD.com

- Market share: 25.1%
- Hypermarket
- Focus: General merchandise
- Estimated number of users: 132 million
- Shipment and delivery: In-house delivery and logistics
- Ownership: Publicly listed on NASDAQ
- Suitable for: Dominates the home, appliance and consumer electronics categories in China and therefore favors 3C products

Both market places have established dedicated platforms for international transactions: Tmall Global and JD Worldwide (discussed later). The reason for this is that, as we will see, the Chinese marketplaces are primarily established for Chinese sellers and buyers. They are not an appropriate platform for foreigners due to a number of factors including Chinese government policy and regulatory issues, cultural and the platforms' own internal regulations. In fact the operators actively discourage foreigners from participating on these platforms. I'll discuss this in more detail later.

Let's take a look at the current ways foreigners can sell products to Chinese consumers.

Different Investment Models for Foreigners to Access China's e-Commerce Market

Model 1: Selling directly from a website hosted outside of China

Under this model, Western businesses simply adapt their existing website to suit Chinese consumers.

This appears to be the easiest as it does not require a Chinese entity or website to be registered. However, it is not recommended and usually fails for the simple reason that Chinese consumers will have difficulty finding your site even if there is a Chinese language version. Then there is the problems of how to pay the retailer. Most Chinese consumers don't use traditional Western forms of payment (credit cards, PayPal) and most Westerners don't accept Chinese forms of payment (China Union, AliPay, WePay).

Furthermore, under this model the consumer has to organize to get the goods through Customs and pay any Import and Value Added Tax (VAT) which is a burden they are not generally willing to take on. There are also issues as to who will arrange the shipping, and how the consumer will return the products and get a refund.

Model 2: Selling via a self-owned website in China

In order to set up your own website in China which sells your own products, you need first to establish a subsidiary in China. This has all the advantages of selling through Model 1 but avoids delivery and customer support issues. Also payment can be made in local currency and via local payment systems.

However, the entity must be a trading company which is authorized to buy and sell goods, and import products into China. This means going through the tortuous and long (and expensive process) of establishing a Chinese Wholly Owned Foreign Enterprise (WOFE) which can take up to 6 months. It also requires an Internet Content Providers filing which can be burdensome. There are also ongoing compliance, operational and other expenses of maintaining an entity in China and also issues finding good staff to maintain it.

There's also a requirement that you establish a physical retail store which sells the same products as the online store. This can be very expensive and usually the reason a foreigner sets up an online store is to avoid the need for a retail store.

Probably the biggest issue is the continuous investment in digital marketing and search engine optimization that is required to attract consumers to your online store. This can be a major expense with no guarantee of success particularly if the foreigner is a new player to China and doesn't really understand Chinese consumer behavior which is vastly different from Western consumer behavior.

Over the years I have seen many Western companies attempt and fail to penetrate the Chinese market via this method. It takes a lot of time and capital, and a great Chinese marketing plan, to have success with this model

Model 3: Selling through a third party B2C platform within China

We briefly touched on two of the largest platforms: TMall and JD.com. Opening a shop or placing products on these platforms is an effective way to reach and sell to Chinese customers. They have a ready-made audience, logistics, and payment platforms and are established in the ways of Chinese consumer behavior. Furthermore it avoids a foreigner having to go it alone and spend large amounts of capital on entities and operations.

The problem is that the marketplaces do not really encourage Western companies to go onto the platforms. As said previously, they are Chinese platforms designed to sell Chinese products to Chinese consumers. There are tens of thousands of sellers and millions and millions of consumers and products. In many ways there's simply no room for smaller foreign companies and brands. Whilst international foreign brands are encouraged, smaller ones are not.

Consequently the Chinese marketplaces have developed their own internal rules for entry by foreign businesses onto the platforms. These rules set very high barriers to entry (entity, capital, trading history, IP registration, etc.). They also impose very high fees like consumer protection fees (in the case of trade mark and counterfeit disputes of up to $50,000) and commissions of up to 5-6%. Taken all together the effect is to keep out the smaller Western players

TMall Requirements

- Companies must be an established business entity in China and hold a Chinese retail business license.
- Companies must already have on-the-ground operations in China and store merchandise in the country. Tmall strongly prefers companies that have had a presence in China for a minimum of three years, and if not, they must prove that they have enough capital to penetrate the Chinese market.
- Companies are required to prove they have the capabilities to ship orders within 72 hours of placement, and be able to track shipments.
- Merchants must provide customers with the option to return a product for a full refund with no questions asked within seven days of receipt.

JD.Com Requirements

As is the case with Tmall, JD requires that merchants be registered companies in China. To qualify for JD, companies must be registered for at least a year and have a registered capital of at least RMB 500,000. Companies must also present a product quality check report and a customs inspection declaration for any imported goods, both dated within a year from the date of application.

International Platforms

Because it is so difficult for foreigners to participate and succeed on the Chinese platforms, both Tmall and JD.com have launched international gateways namely **Tmall Global** and **JD Worldwide.**

The **Tmall Global** requirements are not easy and can be onerous.

The ideal Tmall Global partner has been operating for at least two years, has annual sales over US $10 million, and has had a presence in China between zero and two years. Tmall Global prefers engaging with brand owners who sell their own products.

Tmall Global enforces strict entry requirements for overseas companies seeking to create a storefront on the platform. To build up a reputation for product trustworthiness and quality, Tmall Global established an invitation and third-party application system to filter out counterfeiters and disreputable companies. A third-party (TP), also known as a Tmall Partner or Trusted Partner, is an agency that offers international companies lacking physical presence in China access to Chinese e-commerce platforms, particularly Tmall Global. Prominent brands are either directly invited by Tmall to open a storefront or have easier access if they express interest. Other brands must enlist a TP certified by Tmall Global to lobby the platform to allow them to create a storefront.

The search for an appropriate TP and the potential fees can be overwhelming. Any investor expanding into China must budget for the extensive costs of entering a new market. Alibaba promotes Tmall Global as a “fast track into China”, and many companies see e-commerce as a way to test drive products in a new market before fully establishing a physical presence. However, investors often underestimate the costs of establishing an e-commerce storefront, and the costs associated with engaging a TP are often overlooked entirely. Indeed, in many cases, companies are unaware of the need to enlist a TP in the first place.

TPs generally charge sales commission in addition to quarterly service fees as incentive to provide effective service. Engaging a TP costs upwards of RMB one million (US$154,000) per year, and often several times that amount depending on the kinds of services provided and the amount of commission made. TPs have different rates depending on their size, reputation, services offered, and uniqueness of their expertise. This is in addition to the costs of using each individual e-commerce platform. For instance, Tmall Global requires a US$25,000 security deposit, a US$5,000 annual fee, and a 0.5-5 percent commission depending on the product category. Success on these platforms is not guaranteed either: the Wall Street Journal reports that about 70 percent of stores on Tmall Global have “almost no volume”.

JD International is a little better. These are some of their requirements:

A foreign company is required to be an overseas legal entity with qualifications for retailing and trading overseas. Companies on JD Worldwide need to provide a location for returns in mainland China, provide product information in Chinese with metric units, and offer Chinese speaking customer service staff. JD Worldwide prefers companies with previous e-commerce experience and proven success. The following documents are required for JD Worldwide:

- Proof of company registration
- Bank account certificate
- Brand authorization
- Proof of supply chain capabilities
- Legal representative's ID
- Company introduction

Model 4: Selling through cross border pilot platforms (CBEC)

Model 4 selling through cross border pilot programs, is a relatively new but promising option for tapping into the ecommerce market. Available in major cities such as Shanghai, these programs allow for 24 hours customs clearance services and tax incentives.

Cross border e-commerce (CBEC) is a special import channel which allows products to be sold directly online sale to consumers (B2C). The channel has temporary exemptions to tariffs and other regulatory requirements which apply to conventional international trade (B2B). It was established in 2014. There are 13 pilot CBEC cities including Shanghai, Hangzhou, Ningbo, Zhengzhou, Shenzhen, and Guangzhou.

This measure led to a boom in China cross-border e-commerce which was dramatic and exponential.

As the Stanford white paper states:

Operating through the pilot zones is very beneficial to all parties involved. A benefit for sellers is a much less rigorous screening and verification process for imported goods.47 Benefits to consumers include:
• Lower customs duties: China Customs levies import duties on these orders at the rates applicable to personal items, which are usually lower than tax duties for general trade.
• Better customer support: Language challenges associated with shopping on a foreign website are eliminated. Merchants are also required to set up a customer service channel in China, with service in Chinese, to handle returns and customer complaints.
• Payment in local currency: Customers can pay in RMB, and third-party payment service providers (e.g., Alipay, Tenpay) will convert the money to foreign currencies.
• Shorter delivery time: When goods are delivered from the bonded areas, customers benefit from a shorter delivery time compared to shipments from abroad

It has led to strong share price growth of brands that have been particularly favored by Chinese consumers. But it also led to distortions in the market and it was always clear that the Chinese authorities would at some stage seek to better regulate cross-border e-commerce. As of 2016, the policy was substantially revised and extended by the Chinese authorities until at least May 2017 when we expect further reform and changes. The area is still in flux.

3. REGULATORY REGIME FOR CHINA'S ECOMMERCE MARKET

Above I have described the Chinese ecommerce landscape for US businesses attempting to sell products and services into the Chinese marketplace.

There is a further major obstacle that impacts on US companies doing business in China particularly in ecommerce and other technology based industry segments. Historically under China's Foreign Investment rules, non-Chinese companies are generally prohibited from operating businesses in the telecommunications industry and thus many businesses that utilize the internet to do business like ecommerce platforms. This is part of the severe restrictions on foreign technology companies doing business in China. The Panel will note that most if not all Western tech companies are prohibited from entering the Chinese market in any meaningful or direct way. The reasons are essentially protectionist but there is also a desire to ensure that Chinese consumers and internet users are not subject to 'unfiltered' access to Western information and data.

This is part of a wider prohibition on foreign companies providing services to Chinese consumers and businesses. Currently it is generally illegal for foreign companies to conduct business in the key service areas like telecommunications, financial services, education, healthcare, transportation, entertainment and similar service areas. Interestingly these are the industry areas that foreigner businesses, particularly American companies, do very well. It represents the next great potential wave of foreign investment into China. The Chinese authorities have promised reform to allow investment into these industries but the pace of reform is glacial. I'll discuss this further below.

A number of very complicated legal arrangements (namely Variable Interests Entities or VIE's) have been constructed to get around the prohibitions and have tacitly been approved by the Chinese authorities. It is interesting to note that all of the major players in the Chinese internet and technology scene (Alibaba, China Telecom, Sina, Baidu, JD.com, Tencent, etc.) are in fact foreign companies as they are listed in either New York or Hong Kong (a foreign country to China). Theoretically then, they should be prohibited from operating in China. But by dint of questionable VIE arrangements they control huge swathes of the Chinese telecoms and internet market. The Chinese authorities give their tacit approval to these arrangements.

Whilst the future of the VIE arrangement is currently unsure, the arrangements are really only open to large foreign companies. The complexity and cost of establishing such arrangements for smaller companies is prohibitive. For this reason smaller foreign tech companies tend to stay out of the Chinese market because it is too hard, do business with China from outside China (which has its own operational problems) or enter into gray or possibly illegal business activities in China.

The Chinese authorities have promised to reform this area as part of a broader reform of the ability for foreign companies to provide services to the Chinese consumers and businesses. A key component of this was the establishment of the Shanghai Free Trade Zone (SFTZ) in 2013 and the subsequent expansion of the FTZ concept to a number of other locations.

Essentially the SFTZ was, amongst other things, to be a testing ground for the liberalization of the policies that prohibit foreigners investing into the service sectors noted above. Great promises were made but very little has been practically delivered. Probably the area in which the most progress has been made has been financial services but in a very limited way.

For many years the Chinese authorities have theoretically allowed foreign companies to invest into the Chinese telecoms and internet sector but only as a minority shareholder with a Chinese partner. However, even if a US company found an appropriate Chinese partner (which is difficult), as a rule it was impossible for that joint venture to obtain the necessary operating (Value Added Telecommunications Service (VATS), Internet Content Provider (ICP) etc.) licenses to enable it to operate. I only know of a few joint ventures that secured such licenses in the last 10 years or so.

Only recently has it been allowed that foreigners can fully own a Chinese subsidiary that can establish and operate an ecommerce platform. Firstly it was only in a Free Trade Zone like SFTZ. Then they extended it to the whole of China. However, despite the ‘opening up’ of this sector to foreigners, the first ever VATS license that is required to operate was only issued in April 2016 to a Japanese company. I’m aware of a number of applications by foreign owned Chinese companies that have yet to be approved.

Despite all of the above, I’m quite positive that the industry barriers will eventually be removed but it will take a long time.

It should be noted that some US tech companies are making inroads in China although often through indirect methods. Amazon has recently introduced its popular Amazon Prime service. Walmart now fully owns the successful fresh food and grocery site YiHaoDian, and also owns nearly 10% of JD.com. And of course Uber made a tactical retreat from the Chinese market (after spending billions on a questionable Chinese strategy) by essentially leaving China and taking a 17.7% stake in Chinese rival DiDi Chuxing. All eyes are currently on AirBnB and their latest Chinese push.

Suffice to say that the above are some of the largest tech companies in the world with unlimited resources. As you can appreciate a smaller foreign company really has no or little chance.

4. BIGGEST CHALLENGES FOR US COMPANIES

I have discussed above the Chinese ecommerce regulatory and operating environment and the technical and practical difficulties it presents tor US and other foreign businesses.

I’ll now touch on a range of issues that also present challenges for US and other foreign businesses. These range from external factors (government policies, HR, tax, etc.) which are widely known and discussed to internal factors (management, marketing, strategic, etc.) which are not so widely discussed.

China is for Chinese: China is a huge self-contained market place that is essentially conducted by the Chinese in Chinese for Chinese consumers. Foreign participation (whether products, brands or businesses) is tiny other than in certain specific areas like cars. Western businesses tend to assume the Chinese marketplace is similar or a copy of the Western model. Nothing could be further from the truth. From the layout and 'feel' of Chinese websites to Chinese consumer behavior patterns, the Chinese marketplace is vastly different. Often it seems like there is not a place for Westerners in this model.

Chinese Government Policy: As discussed above, Chinese government policies and procedures do not actively encourage foreign investment in the ecommerce sector or the sale of Western products other than through Chinese ecommerce platforms which in themselves can be difficult to penetrate. The policies are often protectionist, arbitrary, ambiguous and subject to unilateral change.

Tax System: The Chinese tax system is a work in progress particularly in operation and practice. At times it is arbitrary, ambiguous and regionally diverse. Often it appears it is used as a protectionist trade tool against foreign companies operating in China. Chinese and foreign companies do not operate on an even playing field when it comes to the implementation of the tax laws as it seems that Chinese companies can 'get away' with a less than optimal adherence to the tax laws.

High import duties like customs duty, consumption tax and import VAT also make importing goods into China very expensive.

Chinese Ecommerce Platforms: As discussed above, these platforms do not make it easy for foreigners to participate in a transparent and easy manner. Furthermore, there is an implicit and practical moratorium on foreigners operating ecommerce platforms in China

Competition: The Chinese marketplace is the most competitive in the world. The Europeans, the Japanese, the Koreans and the North Americans and not to mention the Chinese (and the Taiwanese, the Singaporeans and the Hong Kongers) are all battling for the hearts, minds and purses of the Chinese consumers in the most dynamic, fastest moving and innovative marketplace in the world. Quite frankly many US businesses are not ready for such levels of intense competition having grown complacent in their relatively moribund domestic market.

IP & Counterfeit Issues: The Chinese IP registration and protection landscape is a work in progress to say the least. It is getting better, but progress is slow.

Foreign businesses still are very slow to make the requisite TM and other IP registrations in China. And then cry foul when a Chinese business 'appropriate' their mark or brand. Chinese see this as a business opportunity not IP theft.

Ecommerce Payment Platforms: Because the US and foreign financial institutions and credit card companies have been excluded from operating in China, China has evolved its own unique payments system particularly in ecommerce. There is no PayPal, checks, Amex, Visa or Mastercard. In its stead there's Union Pay, WePay and AliPay, the latter that work via QR codes which are virtually unknown in the USA. It is almost practically impossible to transplant a western business with its inherent payments systems into the Chinese context. Chinese consumers simply cannot pay for the goods unless payment methods are localized.

The large US and multinational banks have been very slow to integrate with the Chinese payment systems largely because they have been excluded from the Chinese banking and financial system. The Chinese banks have not integrated with the western systems largely because they are not 'international'.

The situation is changing and slowly being remedied largely due to the large number of Chinese tourists travelling to the West.

Logistics & Supply Chain: Whilst the supply chain logistics for products moving from China to the West is well established, the reverse has never been that smooth particularly when the products land in China. Problems with Chinese Customs and internal delivery logistics have caused numerous headaches over the years. The Chinese Government has made tremendous improvements to these areas and now the situation is much better particularly if a CBEC channels are used.[8]

Human Resources: Despite the size of the Chinese labor market, for a variety of reasons it is difficult for foreign businesses to find good Chinese staff and partners, and retain them. China is running out of workers and Chinese professionals who speak English and understand Western business practices are in high demand and have no loyalty as a rule. In many cases, suitably qualified Chinese staff would rather work for a Chinese firm. There is also a wage growth explosion happening in China which has made the costs of retaining great Chinese staff even harder and costlier.

Without great local staff, Western businesses are at a disadvantage in competing and understanding the Chinese market.

Lack of Overall & Marketing Strategy: As a general proposition, I believe that many US and other foreign businesses are often ill prepared for establishing and operating businesses in, and with, China. There is a lack of cultural awareness that borders on arrogance. There is a lack of understanding of the Chinese market place and consumer. There is a lack of appreciation that Chinese business is conducted in a completely different manner from Western business. There is a belief that a successful an longstanding Western business model and marketing approach and strategy is adequate for China and will be able to be successfully executed with a modicum of localization like translating a website or marketing materials.

There is a reluctance to spend capital on an overhaul of the foreigners marketing approach which

[8] Please see an excellent discussion in the Stanford Business School Ecommerce Whitepaper note above: https://www.gsb.stanford.edu/sites/gsb/files/publication-pdf/vcii-white-paper-us-china-ecommerce-imrpove-logistics-grow-trade.pdf.

acknowledges that China is a distinct consumer market with its own unique traits and that it is constantly changing. There is often a lack of flexibility when it comes to adapting to the ever changing Chinese market.

Impossible Goals & Over Expectation: I think there is a tendency to overplay the potential success of a China 'adventure' and downplay the risks, cost and timeframe of success. Time and time again I have seen only very rudimentary business plans which play to this over expectation. These business plans often display unachievable and wildly ambitious revenue, sales and profit targets.

Lack of Capital: China is much more expensive than most Western businesses think. To succeed in China even in a modest way takes much more time and money that is expected. US businesses regularly underestimate the amount of capital it takes in China. There also seems to be a reluctance by headquarters of Western businesses to commit the required amount of capital and finance to adequately fund a Chinese business.

Sources of capital and finance are in short supply. Because of the foreign exchange restrictions imposed by China, foreigners are not freely able to transfer foreign exchange (like USD) into China. Even if a subsidiary is established, the amount of capital to be invested must be approved by the Chinese authorities, and any subsequent transfer of capital must similarly be approved. It is almost impossible for Western owned Chinese businesses to borrow money in China. Furthermore, most Western banks will not lend money to mid-market and smaller Western businesses looking to establish a China business. Hence, most capital that is earmarked for a China business is the companies own money. This too leads to a reluctance to spend and fund adequately.

5. RECOMMENDATIONS

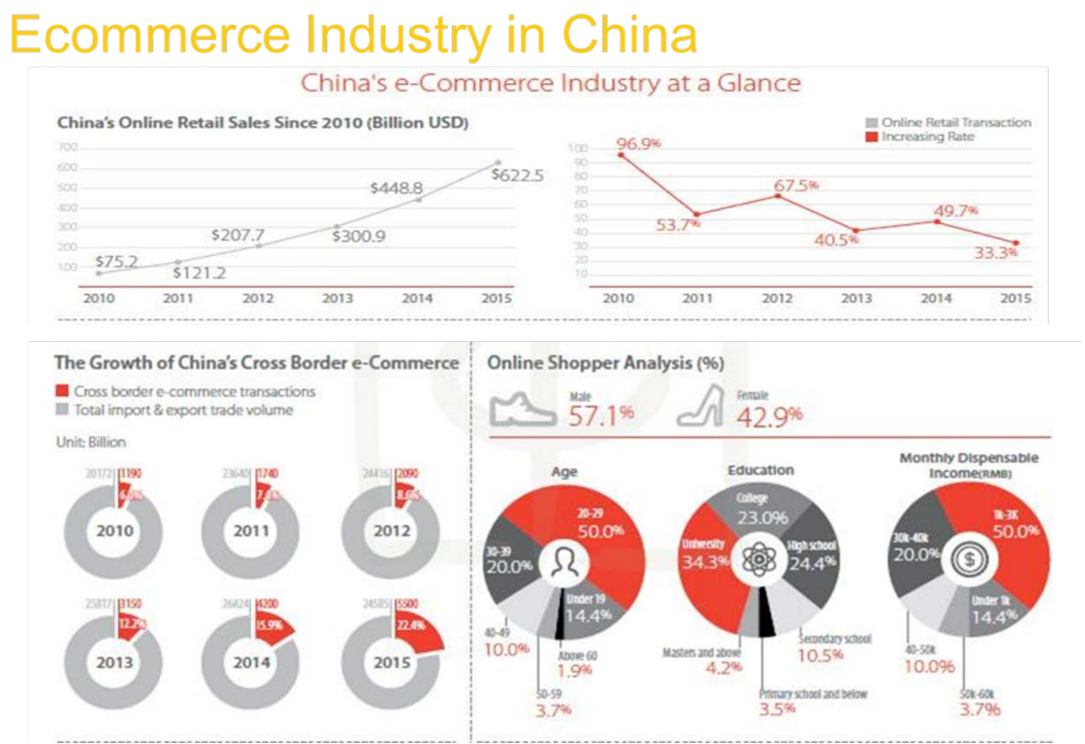
a. On a macro level, I think it would be a great step if the Bilateral Investment Treaty could be concluded with China. This Treaty could go a long way to resolving a number of outstanding issues regarding foreign investment into both China and the USA by companies of each country.

b. USA to agree to be a part of the Trans Pacific Partnership. Although China is not a party to the TPP, the Treaty represents the 'gold standard' of trade treaties and would be a huge step forward in liberalizing and simplifying trade and investment amongst the Pacific nations. If implemented, many other nations (including China) would in time seek to become a part of it. This would be a huge step to liberalizing and reforming the ability to do business with, and in, China.

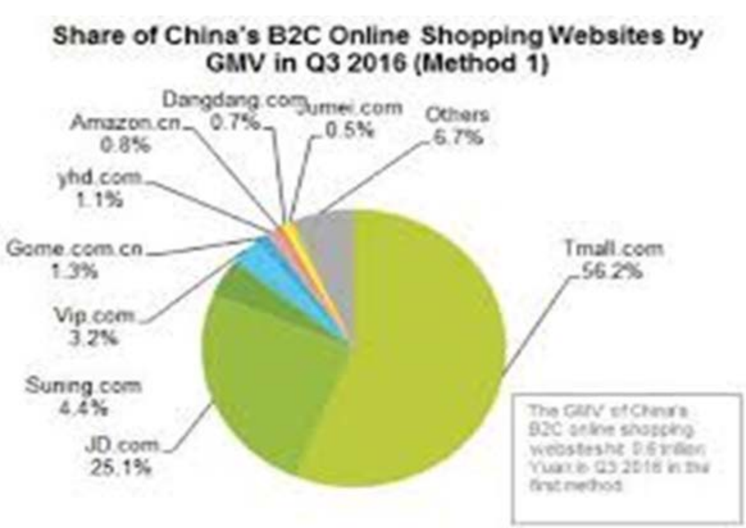
c. The international trade and investment arm of the Department of Commerce, the US Commercial Service, should be boosted and tasked with a program to educate mid-market and smaller US business on accessing the Chinese ecommerce market. The USCS currently does a tremendous job in assisting US exporters and others that are doing business in China and other places in the world. I believe a unique targeted campaign on the practical ways

US businesses can engage in trade with China via ecommerce platforms and other methods. The respective trade and investment offices of Canada, Australia and New Zealand have recently undertaken such targeted campaigns with excellent results.

APPENDIX 1



APPENDIX 2



OPENING STATEMENT OF MS. CATHY MORROW ROBERSON, FOUNDER AND HEAD ANALYST, LOGISTICS TRENDS & INSIGHTS LLC

HEARING CO-CHAIR DORGAN: Ms. Roberson, why don't you proceed?

MS. ROBERSON: Thank you very much. Thank you.

It is an honor to be here. I appreciate the invitation. My background is primarily in research so anything dealing in research I'm all over it.

[Laughter.]

MS. ROBERSON: I fell into logistics like so many people just by chance when there was a job opening down the road at UPS needing a market researcher. Go figure. So I spent about almost 11 years with them doing due diligence for their 30 plus acquisitions they made in their supply chain group. I've done operations. I've done entry, going into new markets, new products and such with GPS. So I like to say I still bleed brown with a little bit of purple from Memphis and a little bit of orange and yellow for our friends over in Germany as well.

But as far as China goes, it is absolutely one of the most fascinating countries. It's been like that for at least 20 plus years for sure in terms of logistics. And to understand China today, you've got to take a step back and look at where they've come from. Their infrastructure, their economy was very export driven, and I would venture to say it's still very dependent on those exports, more than their imports.

But with that being said, the infrastructure was built to support the exports. The ports, the airports, all roads were leading to the ports or to the airports, same as the rail, and as such, as international companies came into China, so too did their logistics providers, their freight forwarders, such as the UPSes, the FedExes, the DHLs, Kuehne+Nagels, you name it, they all established a presence in China.

Now the requirements as far as barriers to entry for freight forwarders, it requires a license, and at the time, and I'm not sure what the most current is, it wasn't that difficult to get a license to move goods out of the country because those ports backed up pretty fast, and you had to get them out of the country really quickly.

So in the midst of all of this, you had the express and you had the small parcel markets being developed, and it was what I've always described as the wild, wild West--highly fragmented, many, many, many competitors. Mom and pops, individuals, you name it, they were all either delivering at a specific city, a specific province. Nobody was doing it national. Nobody had a nationwide logistics network.

And this was being done by bicycle, by motorcycle, a truck here and there if you're lucky, and so on. It was an absolute mess, and today, you can still see some of that mess, and it was all based on the rate. Everyone competed on the rate. Quality wasn't what you'd expect. You didn't have a uniformed gentleman or a lady coming to your front door. It was whomever and whenever they would come and make that delivery because there was no transparency. You could not track your package.

So for me being a big e-commerce shopper, it's kind of hard for me to comprehend. But over the years, as China benefited as being the world's manufacturer, there was more disposable income for the Chinese middle class. You saw that rise of the middle class. And so our friends at UPS, FedEx and DHL started thinking, you know, we can make deliveries within the domestic market.

But the problem is they're not Chinese, and they had to go and apply for the license. Individual cities, they had to apply to get agreement. So if you can imagine, you may have a license to deliver in Beijing, but you may not in Guangzhou. So establishing that network is not the easiest thing nor is it cheap, and UPS and FedEx and DHL did get a certain amount of license, but they ended up having to partner with quite a few local providers.

DHL several years ago pulled out of the domestic market because it was too expensive for them to run. They've since kind of backtracked, and they do it through their e-commerce division, but not to the extent that they had ever hoped. It's very similar to what happened here in the U.S. when DHL tried to come in and compete against UPS and FedEx, and they lost about $10 billion in the process. It's not a cheap industry to get into.

So like I said, there's a limited number of licenses that UPS and FedEx have in terms of that last mile delivery within the domestic market.

So meanwhile, like I said, the middle class was emerging and then there became that shifting focus. We need to balance out the economy here, you know, from depending on exports, we need to also have domestic consumption and imports. So at that time, you saw the beginning of the rise of e-commerce and also the growth of Chinese express providers, such as SF Express, YTO, STO.

These were still very focused from a regional perspective. They were still not nationwide so that was still that problem, connecting from eastern part of China to the western part of China even though the western part of China is not near as populated as the eastern side.

So, and then again limited technology, and technology is a big, big thing in logistics. You've got to have it in order to run efficiently. You've got to be able to track your package. You got to know where it is at all times, and e-commerce is indeed based on logistics. Simple fact. Not only based on logistics but also data. Data is king in the e-commerce world, as well as logistics. You've got to know how to manipulate that data, know where that--and how--where to put the warehouses and the various sortation centers and so on.

So many companies, many businesses establish their own logistics division because of the fact that the Chinese market was so fragmented, and it's still very much fragmented. So a lot of businesses have their own and just fell into like JD.com established their own logistics arm, which is kind of like I envision them. I think of them more as an Amazon type of player, whereas Alibaba took a completely different route, and it's fascinating because they established this ecosystem, this partnership with the various express providers and small parcel providers for the domestic as well as international.

And from that ecosystem, I like to think it was Alibaba and JD.com that more or less standardized--helped standardize a lot of the logistics in the last mile delivery because they've also established a technology hub to gather data from all these deliveries. They've created tracking and tracing of products and parcels. Customers can rate their delivery people and their delivery services. So all of that data that Alibaba is getting in return is fascinating. To me it's almost scary that you're giving up that much data to a company from a privacy perspective, but so be it.

So as where the government is in all of this, the post office--China has a very well thriving post office, and it is, it is controlled by the government, and it's a very interesting--I have to admit I don't know as much about the post office as I should. They're not the most forthcoming of people. I've tried. Trying to get on the phone with them to talk is next to impossible. But it's very protective, you know, not surprising. They have--the post office has created a logistics arm so they are competing with the 3PLs, third-party logistics providers.

They also own airplanes unlike ours where we have to--where our post office leases them through either an agreement with one of the integrators or all three of the integrators.

And so like he said, it's a very protectionist, and there's also that "preference"--I'll put that in quotation marks--a "preference" towards using China's logistics providers. And so UPS and FedEx have faced a lot of hurdles within the domestic market. But thanks to e-commerce and, as my colleagues here have alluded to, cross-border e-commerce is huge. It is absolutely huge, and it is the next--I mean it's really the next big push.

In Thomas Friedman's book The World is Flat, the world is indeed flat. It's getting smaller and smaller. So instead of trying to create a network, a domestic network, UPS and FedEx are beginning to turn their attention more towards cross-border e-commerce. In fact a couple of weeks ago, a few weeks ago, UPS announced a partnership with SF Express in terms of cross-border. UPS will handle that international and customs clearance, whereas SF Express will do the last mile delivery in China, and it's also reciprocal. UPS will do the last mile delivery here in the U.S. for SF Express.

I think that's going to be an interesting trend. I think it will be a trend as you see more and more providers partnering up for such as that. Also speaking of our friends at UPS, the Alibaba conference, something I learned when the CEO of UPS, David Abney, spoke. He talked about their Shenzhen facility offering a 24-hour customs clearance location for cross-border services.

So I think that fast delivery, it's fascinating to see, and also the pilot cities that you referred to is another area worth looking into. They're almost like our free trade zones for e-commerce--fast clearance, bonded warehousing, and such as that to get the goods out fast, and that's the key. You want to get the goods out fast.

Fulfillment feeds into delivery. The faster you can do both of those, the faster it will come to your front door, and that's the name of the game. No longer do you want to wait five to seven days for a package. You want it yesterday and that goes for cross-border too. People aren't going to be willing to wait three to four weeks for that.

So our friends at UPS and FedEx have indeed invested in cross-border. They've acquired companies such as i-parcel for UPS and Bongo for FedEx simply to make that cross-border easy with currency conversions, websites, translation and so on.

So some of the issues, though, for cross-border, and you'll know one of my recommendations is to speed up the process as much as possible. In my household we do a lot of ordering from Asia simply because I've got an IT nerd that lives in the family. In fact, all three of us are nerds when it comes to IT. So any parts and such, we order that way, and it will take three weeks to a month if we're lucky.

Alibaba's goal is to do cross-border delivery in 72 hours or less. One of the examples that Mr. Ma gave was the fact that the Canadian government came to them with we've got all these lobsters, love to sell them to you, and you know what they did? They delivered it, they delivered Canadian lobsters to the front door of Chinese customers in 72 hours. I think that's pretty amazing.

HEARING CO-CHAIR DORGAN: Were they alive?

[Laughter.]

MS. ROBERSON: Believe it or not, they were. Yeah. I'm not--yeah, as far as the freshness--uh--but, you know, that's another area of interest is that whole cull chain. Chinese consumers are very interested in food, importing food from a quality perspective. Our cherries, our lobsters in Canada as well as along Maine, they are fascinating. That's what they want. They're looking for that. So am I over time? Yeah. Okay. I'm sorry. I knew I was going to ramble.

Thank you.

[Laughter.]

PREPARED STATEMENT OF MS. CATHY MORROW ROBERSON, FOUNDER AND HEAD ANALYST, LOGISTICS TRENDS & INSIGHTS LLC

U.S. ACCESS TO CHINA'S CONSUMER MARKET

Testimony before
The U.S.-China Economic and Security Review Commission
June 22, 2017

Thank you for the opportunity to testify today. As the second largest economy in the world, China's logistics market has struggled to keep pace with its growth. Government investments in infrastructure to connect the entire country has been ongoing for numerous years. However, despite the investments, China is geographically diverse and its population is unevenly distributed so establishing a nationwide logistics network is costly.

As such, logistics costs account for a large proportion of corporate costs. On average, China's logistics costs as a ratio to GDP is 16%. This is compared to about 8% in the US.

Opportunities abound for foreign investment and China has said it is opened to such investments. However, the regulatory environment is deeply embedded within the government and the practice of subsidies and state-owned enterprises continues and negatively impacts true competition.

This testimony covers China's transformation from an export dependent economy to one in which is slightly balanced but still favoring exports. China's infrastructure plans and achievements, the Silk Road Initiative, the growth of e-commerce and overviews of logistics providers including e-commerce giants Alibaba, JD.com and Amazon are all discussed along with recommendations for U.S. companies and the Administration.

Exports Drive Growth

With its entrance into the WTO in 2001, China's export-driven economy took off. In general, the early 2000's was a period of global expansion for many companies. Supply chains began to expand outside countries' boundaries and outsourcing became the expectation to keep costs low for companies. First textiles and then apparel and by the mid-1990s, high-tech manufacturing (laptops, mobile/smartphones etc.) were outsourced to China. As a result, China became known as the "world's manufacturer". According to The Economist, in 1990, China produced less than 3% of global manufacturing output by value.[9] By 2015, it is nearly a quarter. China produces about 80% of the world's air conditioners, 70% of its mobile phones and 60% of its shoes.

[9] Made in China? The Economist, http://www.economist.com/news/leaders/21646204-asias-dominance-manufacturing-will-endure-will-make-development-harder-others-made

As such, China's logistics market has focused on its exports. China's government played (and still does) an integral role in infrastructure investments which targeted ports, airports and road and rail improvements connecting manufacturing locations to transportation hubs. To take advantage of the growth and demand for foreign logistics expertise, global third-party logistics providers (3PLs), freight forwarders and transportation providers established a presence in China, many via joint ventures with Chinese partners.

The majority of China's manufacturing has traditionally been located along its southeastern coastline, close to ports such as Shanghai, Shenzhen, Ningbo, Guangzhou, Hong Kong and Dalian.

In 2000, China's government introduced its "Go West" strategy, encouraging infrastructure investments and manufacturing further inland.[10] These regions account for more than 70% of China's land but only about 20% of economic output. They are inland areas, often remote and with primary access via roadways and rail. By 2012, thanks to government incentives and encouragement Foxconn established a presence in Chongqing. In turn, its clients such as Hewlett-Packard, Cisco Systems and Epson also established a presence. Meanwhile, Chengdu has attracted manufacturing lines for AG Siemens, Motorola and Intel.

As noted, above, these inland areas have had to rely heavily on roadways and rail. As of 2012, China's trucking industry comprised primarily mom-and-pop providers with the top ten Chinese trucking companies accounting for only 3% of volume. Airports were either non-existent or needed to be expanded meanwhile the closest access to ports were hours away. As a result, transportation costs, on average were higher. However, as we will see later, China's Silk Road Initiative has helped Western China to connect to Europe, providing an additional transportation option for Chinese companies to utilize.

The Great Recession – Balancing the Trade Imbalance

According to Nake M. Kamrany, professor of economics and director of program in law and economics at the University of Southern California, during the recession of 2007-2009, China's exports dropped 15-18% causing 23 million workers to be laid off.[11] But 98% of the unemployed readily found jobs as the economy bounced back and the unemployment rate dropped to 4% with a $586 billion stimulus package. The strategy was to adopt a serious fiscal stimulus package that provided job creation and infrastructure buildup.

Among the strategies was a shift away from an export-driven economy to a more balanced one.

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10 Has China Lived Up to its Go West Strategy? Supply & Demand Chain Executive, http://www.sdcexec.com/article/10765488/has-china-lived-up-to-its-go-west-strategy

11 China's Rapid Recovery in the Great Recession of 2007 – 2009, Huffington Post, http://www.huffingtonpost.com/nake-m-kamrany/chinas-rapid-recovery-in-_b_825194.html

However, the infrastructure had supported exports and so investments in infrastructure that support domestic consumption was in order. This included warehouses, roads and rail.

Twelfth Five-Year Plan for Economic and Social Development (2011-15)

In China's Twelfth Five-Year Plan for Economic and Social Development (2011-15), the focus on restructuring the country's economy to rely less on exports and fixed investment was mandated.[12] Policies favored the development of the outsourcing, banking, insurance, e-commerce, logistics, and supply chain management sectors. In addition, the plan highlighted emphasis on increasing urbanization, narrowing the income gap between urban and rural citizens, and connecting China's cities with rural areas. China would invest up to ¥7 trillion ($1 trillion) to develop urban infrastructure, including ¥700 billion ($102.5 billion) on urban rail transit during the 12th FYP period.

Indeed, during this period, according to KPMG, China's online retail gross merchandise value exceeded RMB 3.5 trillion in 2015, seven times the 2010 figure and representing an annual growth of 50%. It was also during this period that new business models such as cross-border e-commerce emerged as new growth points in global trade, growing 30% in 2015.

In China's Thirteenth Five-Year Plan for Economic and Social Development (2016-2021)

E-commerce, logistics and supply chain management continue to be key focus areas in China's Thirteenth Five-Year Plan.[13] In addition, technology will play a leading role through "smart manufacturing", "smart cities", and "smart logistics". As such, a national big data strategy will be implemented.

Cross-border e-commerce will also be emphasized. KPMG expects Chinese firms to expand their overseas e-commerce businesses through equity investments or acquisitions while consolidating operations in China's domestic market to build a global network of e-commerce services. In addition, linkage between online and offline platforms (O2O) will be incentivized by the General Office of the State Council to improve offline customer experience, delivery and after-sales services.

Infrastructure projects are focused on primarily moving people—improving rail, highways and development of international aviation air hubs, regional airports and increase routes and frequency for intra-regional flights. Additionally, cargo moving projects are on the agenda including:

12 China's Priorities for the Next Five Years, China Business Review, https://www.chinabusinessreview.com/chinas-priorities-for-the-next-five-years/
[13] The 13th Five year Plan – China's Transformation and Integration with the World Economy, KPMG, https://assets.kpmg.com/content/dam/kpmg/cn/pdf/en/2016/10/13fyp-opportunities-analysis-for-chinese-and-foreign-businesses.pdf

- A nationwide drop and pull transport network. This was trialed a few years ago whereby the Ministry of Transport established a fund to subsidize drop and pull trucking projects with up to RMB 10 million per project. The government further introduced a new policy to exempt several fees and taxes for companies operating drop and pull trucks.
- Development of intermodal freight hubs and logistics parks
- Intelligent logistics networks
- Public information platform for transport, shipping and logistics for cross-border logistics covering Southeast Asia and South Asia
- Pan-China international logistics core network

The 'One Belt, One Road' Silk Road Initiative

Launched in 2013, China's One Belt One Road Initiative involves infrastructure investments in countries along Marco Polo's old Silk Road linking China to Europe, the Middle East and North Africa. The initiative calls for new roads, high-speed rail, power plants, pipelines, ports, airports and telecommunication links that will boost commerce between China at least 60 countries.

According to former US Assistant Defense Secretary Chas Freeman, the Belt and Road project can be described as "potentially the most transformative engineering effort in human history." [14] Indeed, countries involved claim about 55% of global economic output, 70% of the world's population and 75% of known energy reserves.

The plan includes maritime and road components.[15] For example, the Chinese controlled Greek port of Piraeus will serve as a maritime gateway to Central Europe with a planned Belgrade-to-Budapest high-speed rail link. In terms of rail, there are about 39 lines that connect twelve European cities with sixteen Chinese cities. There are plans for an additional twenty European routes. London was added to the network and welcomed its first Chinese train earlier this year. Traveling 18 days, the train included laptops, smart phones, and apparel and food items.

For shippers, goods traveling by rail take less time versus ocean. Also, pricing of rail transport is reportedly less than air, but more than ocean. Major logistics providers including DB Schenker, DHL, Agility, DSV, Kuehne+Nagel, Panalpina and UPS are among a growing number of providers to offer solutions for this initiative. Many of these solutions are multi-modal and include full container and less than container load cargo on the rail followed by truck or other mode for final mile delivery in Europe and/or China.

[14] Belt and Road Initiative: china Plans $1 Trillion New 'Silk Road', NBCnews.com, http://www.nbcnews.com/news/china/belt-road-initiative-china-plans-1-trillion-new-silk-road-n757756
[15] Analysis: China to Shape International Trade via Belt and road, Journal of Commerce, http://www.joc.com/international-trade-news/infrastructure-news/china-infrastructure-news/analysis-china-shape-international-trade-belt-and-road_20170609.html

Components of China's Supply Chain

Airports

As of mid-2015, there were about 60 inland airports under expansion with another 30 new regional airports under construction. Government planners estimate China's airports will increase to 240 by 2020 from around 200 in 2015. Much of this growth is attributed to rising business travel and growth in outbound tourism fueled by an increasingly wealthy middle class. However, there are also 'white elephant projects – airports going unused/not fully utilized as well as many existing airports suffering financial losses because of big upfront investments.

In terms of cargo, Airports Council International's Top 20 Cargo Airports for 2016 listed 4 in China.[16] The largest cargo airport in the world is Hong Kong with 4.6 million tonnes, up 3.5% from 2015. Shanghai is the third largest global cargo airport with 3.4 million tonnes, up 5.0% from the previous year. Beijing with 1.9 million tonnes was ranked 15th, up 2.8% and finally Guangzhou was ranked 18th with 1.6 million tonnes, up 7.4% from 2015.

With the number of airports being built or expanded, trade flows are shifting. Hong Kong has long been the 'go-to' airport for manufacturers particularly in the Pearl River Delta. Goods were typically trucked to Hong Kong to be shipped. However, airports such as those in Guangzhou and Shenzhen are located closer to manufacturers and so the reliance on the Hong Kong airport has lessened over the years.[17]

But Hong Kong is fighting back and has jumped on the e-commerce bandwagon. HACTL, the group that manages Hong Kong's airport and port facilities, established a subsidiary to work with Chinese and Hong Kong post offices and with its expedited customers. The subsidiary, Hacis, has eight depots on the mainland. Air cargo is routed through the depots headed to and from Hong Kong Airport. Hacis also contracts final mile delivery.[18]

Ports

With 90% of global trade attributed to ocean vessels, port operations are important. China has spent billions on building and expanding ports over the years. As a result, based on World Shipping

[16] Preliminary 2016 World Airport Traffic Rankings, Airport Council International, http://www.aci.aero/News/Releases/Most-Recent/2017/04/19/ACI-releases-preliminary-2016-world-airport-traffic-rankingsRobust-gains-in-passenger-traffic-at-hub-airports-serving-transPacific-and-East-Asian-routes

[17] The Chinese Airports Snapping at Hong Kong's Heels, South China Morning Post, http://www.scmp.com/news/china/economy/article/2096465/chinese-airports-snapping-hong-kongs-heels

[18] Hactl Taking on Mainland E-Commerce Boom, Air Cargo World, Air Cargo World http://aircargoworld.com/hactl-taking-on-mainland-e-commerce-boom/

Council's Top 50 Global Container Ports, Chinese ports represent 24% of the rankings:[19]

Global Ranking	Port	TEUs (millions)
1	Shanghai	36.54
3	Shenzhen	24.2
4	Ningbo-Zhoushan	20.63
5	Hong Kong	20.07
7	Qingdao	17.47
8	Guangzhou Harbor	17.22
10	Tianjin	14.11
15	Dalian	9.45
16	Xiamen	9.18
24	Yingkou	5.92
29	Suzhou	5.10
30	Lianyungun	5.01

China's port sector has increasingly turned its focus to expanding globally. State-owned enterprises such as Cosco Group, China Merchant Holdings International and China Harbor Engineering have done just that, spending billions in ports around the world. As a result, as of 2015, nearly 70% of global traffic passed through Chinese-owned or Chinese-invested ports.

Road

To accommodate its export-driven economy, China's investments in road infrastructure were made to connect manufacturers to ports or airports. Eventually, road networks were formed connecting Tier 1 cities to smaller cities and further to rural areas.

Today, roads are connecting China to neighbors such as Pakistan, India, Russia, Southeast Asian

[19] Top 50 global Container Ports, World Shipping Council, http://www.worldshipping.org/about-the-industry/global-trade/top-50-world-container-ports

countries and more as the country invests in its Silk Road initiative linking Asia to Europe, Middle East and Africa via road, rail, air and sea.

Rail

Rail plays a major role in China's Silk Road initiative and it is also playing a role within China, moving bulk and container cargo as well as passengers. At the end of 2015, China had 121,000 kilometers of railway lines.

According to The Economist, less than just a decade ago China had yet to connect any of its cities by bullet train.[20] Today, it has 12,500 miles of high-speed rail lines, more than the rest of the world combined. It is planning to lay another 15,000km by 2025. However, China Railway Corporation, the state-owned operator of the train system, has debts of more than 4trn Yuan, equal to about 6% of GDP. Much of the financial loss is on lines that are further away from the densely populated areas of Beijing, Guangzhou and Shanghai.

Still, China plans to spend 3.5 trillion Yuan ($503 billion) to expand its railway system by 2020.[21] The high-speed rail network will span more than 30,000 kilometers (18,650 miles) under the proposal and cover 80% of major cities in China. The Chinese government will invite private investment to participate in funding intercity and regional rail lines.

Warehousing

Rising consumer consumption and the e-commerce boom have contributed to the rapid growth of warehouse construction from 2012-2015. Foreign investors such as Blackstone, Warburg Pincus and Temasek invested in the sector. However, questions of a glut as well as the RMB's depreciation has made the rental yield less attractive to foreign investors.

According to the China Warehousing Industry Bluebook 2015, total warehouse space in operation totaled 955 million square meters, a 5% increase from 2014.[22] Modern warehouse space expanded to 30.6 million square meters making up 3.2% of total warehouse space. A modern warehouse is best described as one in which has fully computerized tracking systems and the latest in technology and automation.

As China shifted its focus towards the domestic market, the lack of warehousing has presented problems for the country's logistics sector. Unlike the US, where there is typically a nationwide

[20] China has Built the World's Largest Bullet-Train Network, The Economist, http://www.economist.com/news/china/21714383-and-theres-lot-more-come-it-waste-money-china-has-built-worlds-largest
[21] China Turns to $503 Billion Rail Expansion to Boost Growth, Bloomberg, https://www.bloomberg.com/politics/articles/2017-06-08/china-seen-loosening-screws-on-south-korea-over-missile-shield
[22] China Real Estate (Warehouse) Sector, DBS Group Research, https://researchwise.dbsvresearch.com/ResearchManager/DownloadResearch.aspx?E=cebackhag

warehousing network, owned or leased by a 3PL or business, China's warehouses tend to be near only tier 1 cities. Delivery times to smaller cities and rural areas are often longer as a result. In addition, many of the existing facilities simply serve as a storage area, lacking in technology, value-added services as well as organization. As a result, late deliveries and damaged and lost packages have become a problem.

In 2015, old chain warehouse capacity increased 12% over 2014. This specialized warehousing is a growth potential for investments. China's consumers are keenly aware of food safety and a recent vaccine scandal. In addition, e-commerce providers are offering food items, often imported from overseas, for sale online.

China's E-Commerce Market

China's e-commerce market is big, growing at double-digit rates annually. Goldman Sach's estimates 2016 Chinese e-commerce sales at $750 billion and will grow at a compound annual growth rate (CAGR) of 23% through 2020.[23] Nearly 25% of sales are apparel, footwear and accessories. Another 20% is electronics and appliances where JD.com and Alibaba's Tmall (the two main e-commerce providers in China) each have a 40% share.

China's existing express delivery market has not been able to support the growing demand for e-commerce and it still struggles with the country's e-commerce volumes. According to some estimates there are over one million couriers in China. Much of the Chinese delivery business depends on partners and a large fleet of couriers. For example, ZTO Express operates through 7,700 network partners and has 26,000 direct employees in China and more than 200,000 across its entire network. In comparison, UPS has 444,000 employees worldwide and 6,194 employees in China. In terms of infrastructure, UPS has 228 operating facilities in China, while ZTO has 74 sorting hubs.[24]

While the market is fragmented, the express market has also been all about the rate, where companies offering the lowest rates usually win the business. This in turn resulted in businesses operating at a loss, low standards and lack of transparency in the delivery process. E-Commerce providers such as Alibaba and JD built their own express delivery/logistics offering in response—extending the brand all the way to the consumer's front door or click & collect location.

Trends to consider are:

- Mobile Commerce (m-commerce) – Alibaba's Singles Day shopping festival, the largest

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[23] Chinese Ecommerce Market Pegged at $1.7 Trillion by 2020, Multichannel Merchant, http://multichannelmerchant.com/news/chinese-ecommerce-market-pegged-1-7-trillion-2020/

[24] For Couriers, China's Ecommerce Boom can be a Tough Road, New York Times, https://www.nytimes.com/2017/01/31/business/china-courier-delivery-labor.html

shopping day witnessed 82% of Chinese shoppers shopping on their mobile phones.

- Social Commerce – m-commerce is often tied into social networks such as WeChat. WeChat has over 800 million active users, and companies can sell to consumers directly using its built-in payment system.
- Online payment – WeChat's payment system along with Alibaba's Alipay are providing alternative means of payment for some consumers that have relied on cash on delivery (COD) or hesitant in using credit cards.
- The growth of cross-border e-commerce – A recent DHL report estimates that cross-border e-commerce will grow at a 25% CAGR through 2020 from $300 billion in 2015 to $900 billion in 2020, twice the pace of domestic e-commerce growth.[25]

To encourage e-commerce and in particular the growth of cross-border e-commerce, the national government introduced e-commerce pilot zones. Several cities throughout China including Ningbo, Shenzhen and Guangzhou were designated import e-commerce pilot zones. A white paper from Stanford's Graduate School of Business describes them as thus:[26]

> *Each zone has an online e-commerce platform operated by state-back or licensed companies through which all cross-border transactions related to that zone take place. Qualified e-commerce companies can set up a bonded warehouse within the e-commerce zone where goods can be temporarily stored after they were shipped in bulk from abroad. Tariff payments are made after goods are sold to consumers and leave the zone. Foreign merchants can use a direct shipping approach and shipped directly to Chinese consumers after they have placed the orders. Customs duties are charged together with the price at the time of ordering and orders are shipped to the customer directly from the foreign country under the supervision of China Customs. Goods sold through the pilot zones go through an expedited customs process. In May 2015, a policy was implemented in which customs clearance procedures are to be completed within 24 hours once goods enter local customs*.

China's Leading e-Commerce Providers

Combined, Alibaba and JD.com command well over 80% of China's e-commerce market. Amazon's portion is about 1% to 3%. In terms of logistics, Alibaba and JD.com have each created a unique network. JD.com has built their network, similar to that of Amazon's, while Alibaba has created partnerships through its Cainiao subsidiary. Together, these providers have redefined logistics within China and are on their way to doing the same beyond China's borders as each

[25] 21st Century Spice Trade, DHL, http://www.dhl.com/content/dam/Campaigns/Express_Campaigns/Local_Campaigns/apem/express_campaign_spice_trade_apem_en.pdf
[26] US to China B2C E-Commerce: Improving Logistics to Grow Trade, Stanford School of Business, https://www.gsb.stanford.edu/sites/gsb/files/publication-pdf/vcii-white-paper-us-china-ecommerce-imrpove-logistics-grow-trade.pdf

establish partnerships outside of the country and build out cross-border capabilities.

To understand China's e-commerce and logistics markets, one must look at each provider individually.

Alibaba

Founded in 1999 by Jack Ma, Alibaba.com let exporters post product listings that buyers could browse. In 2003 Alibaba launched Taobao. By 2005 Taobao overtook its U.S. rival eBay, the previous market leader in the consumer-to-consumer market in China. Alipay.com, a third-party online payment platform, was launched in 2004 and controls control just under half of China's online payment market as of October 2016. Finally, in 2010, Tmall was spun off from Taobao to focus on B2C transactions.

Cainiao Logistics was founded by Alibaba Group in 2013 with a consortium of logistics/property management companies including:

- Alibaba
- Yintai
- Fosun
- Forch
- SF Express
- STO Express
- Yunda Express
- ZTO Express

Alibaba owns about 47% of the subsidiary. Cainiao operates a proprietary logistics information platform that links a network of logistics providers, warehouses and distribution centers together. Domestically, it manages last mile delivery, fulfillment and a data intelligent network among express couriers. It is also expanding pick-up spots where consumers can collect their orders. Some 20,000 are already operating and the company plans more on college campuses, in communities by partnering with real-estate companies like Greentown and Vanke, and in convenience stores.

From an international perspective, it has established warehouses in several countries to support Alibaba Group's cross-border e-commerce efforts. Delivery channels have been opened between China and the U.S., China and Australia, and China and Korea in partnerships involving companies such as DHL and Shanghai YTO Express (Alibaba has invested in this Chinese express provider).

Domestic fulfillment capabilities include seven regional hubs with a total of 4 million square meters in operation. Same day delivery is available in at least 150 counties and cities and next day delivery is available in at least 1,000 counties and districts. Among its smart supply chain services includes:

- Omnichannel[27]
- Online warehousing and inventory management
- Supply chain financing
- Data analytics

Cainiao's data intelligent network provides a variety of services including standardizing addresses, e-shipping labels, real-time status updates, smart routing and real-time package volume forecasting for distribution hubs and routes. Customers are also allowed to rate delivery service providers.

The majority of Alibaba's revenue is from domestic China. As it connects Tier 1 cities with smaller cities and the rural regions, it is also focusing on omnichannel. In 2015, Alibaba invested $4.6 billion in Sunning, one of the largest electronics retailers in China. The investment will allow Alibaba's customers to go into one of Suning's 1,600 outlets in China to try out a product before purchasing it on Alibaba's website using their smartphone. In addition, Sunning joined Alibaba's distribution network to deliver goods in as little as two hours. Earlier this year, Alibaba invested in Intime which operates 29 department stores and 17 shopping malls across urban China.

Using China as a springboard, the company has established partnerships with post offices around the world including USPS, Royal Mail and Australia Post. These partnerships have been established to drive cross-border services for Chinese consumers to shop and sale internationally.

Cross-border is important and recent press indicates that Alibaba is looking to establish warehouses along the Silk Road rail network to speed up delivery. In addition, in 2016, it acquired e-retailer, Lazada, an 'Amazon' like player that just happened to have a nice logistics network in Southeast Asia. Using this acquisition along with Singapore Post which it has an equity stake in, Alibaba wants to dominate Southeast Asia, a region with great potential.

Acquired by Alibaba in 2010, OneTouch provides Chinese exporters with online services such as customs clearance, trade financing, foreign exchange and logistics. Free for exporters, OneTouch makes its profit by marking up loans, 10%, to businesses that need to purchase materials they need to produce an order for export. In addition, the businesses also must find an affordable shipping company, monitor shipments and file the proper documents for customs clearance.

Through OneTouch, loans are made possible by it partnering with at least seven Chinese banks. Through the platform, SMEs can borrow from RMB 1 million (US$161,000) up to RMB 10 million (US$1.61 million) depending on company's prior six-month export history and creditworthiness.

[27] Omnichannel refers to the linking of physical stores, online stores, and mobile.

Determining the creditworthiness of a business is done through the data Alibaba gathers through the platform. For example, Alibaba pays subsidies to encourage Chinese suppliers to use OneTouch. As part of these subsidies, manufacturers and suppliers are paid up to 0.03 Yuan for every $1 in value of export transactions handled through OneTouch. Furthermore, payments are settled electronically within the system with logistics companies having access to exporters' payment histories and other information provided by Alibaba to help determine creditworthiness.

According to Alibaba, in 2015 more than $3 billion in credit was extended to suppliers registered. That, in turn, encouraged global buyers to place more than 1.2 million orders through the company. "Online trading value on OneTouch totaled $15 billion in 2015, and we expect it will total $50 billion this year," noted the President of the Alibaba business unit. Since 2014, when the program started, more than 100,000 suppliers have benefited from the program's credit facility.

Currently there are more than 100 logistics companies and 1,700 freight forwarders offering their services through Alibaba Group's international B2B site including DHL, FedEx, UPS, Kuehne + Nagel and WCA Ltd. WCA which is a network of freight forwarders worldwide will vet and approve international logistics providers and freight forwarders for Alibaba.com customers. The collaboration currently offers shipments generated by Alibaba.com's members to the U.S., India and the U.K.

In addition, ocean carriers Maersk and CMA CGM have also signed onto the OneTouch platform. For CMA CGM, the carrier will provide export services within its Mediterranean and Adriatic port of calls including Barcelona, Valencia, Trieste and Rijeka. For Maersk, bookings will be made on select routes including AE1, AE5 and F3 between five Chinese ports and eight overseas destination ports.

JD.com

Founded in 1998, its B2C site went live as jdlaser.com in 2004. By 2007, it was known as 360Buy before finally changing its name to JD.com in 2013. Unlike Alibaba, JD.com has invested heavily in its own fixed assets such as warehouses and delivery trucks. As of March 31, 2017, it had 256 warehouses, 6,906 delivery stations and pickup stations and 7 fulfillment centers. Total aggregate warehousing space is 5.8 million square meters. In addition, JD.com standard provides same-day delivery in more than 130 counties and districts, and standard next-day delivery in another 850 counties and districts across China.

JD.com also is planning to invest in a drone delivery network of hundreds of routes and drone bases throughout China. Its drones will deliver products weighing as much as a metric ton, or about 2,200 pounds, or more and will target deliveries to more rural areas of the country's northern Shaanxi Province. It already operates 40 drones in four provinces —Beijing, Jiangsu, Guizhou and

Sichuan.

In 2015, JD Daojia, JD.com's O2O platform (Online-to-Offline), established a partnership with Yonghui, a supermarket chain in China. As of February 29, 2016, JD Daojia has partnered with 56 Yonghui stores in 5 cities to provide 2-hour delivery service for customers' grocery orders. In total, JD Daojia provides O2O services in 12 major cities across China. However, despite expansion progress, the company concedes the lack of standardization of fresh food packaging is an issue and as such it is working with its supermarket partners to improve this in order to fulfill fresh food items more effectively.

Also in 2015, JD.com invested $70 million in FruitDay, a Shanghai-based importer of fresh produce. FruitDay, which already sells fresh fruit on JD.com, announced it would use the funds to build out additional infrastructure to store, ship, and track fresh produce.

In 2017, JD.com officially launched JD Logistics to provide business partners with comprehensive supply chain solutions, including warehousing, transportation, delivery, after-sales services as well as logistics services, including smart and cross-border logistics.[28] Looking out within the next five years, JD Logistics plans to expand its logistics facilities to more than 50 million square meters, build a trans-regional aviation logistics network and operate more than 20 self-run overseas warehouses—as well as cover over 100 countries and regions along the Belt and Road Initiative, with its B2B logistics covering more than 300 cities.

Like Alibaba, JD.com has international aspirations. In 2015, it expanded to Russia via a partnership Russian logistics operator SPSR Express. JD.com plans to develop its own logistics and warehouses in the future. Meanwhile it says five days as the minimum time for delivery.

In 2016, JD.com bought Wal-Mart's Yihaodian local shopping platform. As of February 2017, Walmart has taken a 12.1% stake in the Chinese e-commerce provider. In addition, Walmart plans to close its own ecommerce mobile app in China. JD.com will also serve as the online shopping platform for 20+ Walmart stores in China.

The agreement gets even cozier between the two retailers as Walmart's Sam's Club entered the Chinese market in late 2016 with plans to stock merchandise in JD's warehouses and use JD's same- and next- day delivery service. In addition, Walmart Stores will also utilize JD's two-hour delivery service for orders placed JD Daojia, JD.com's grocery business in select Chinese cities.

After it announced a good first quarter earnings, JD.com officially launched JD Logistics. Long in the works and waiting for the green light from the Chinese government, this new business unit will

[28] JD.com Unveils new Logistics Services Arm, 4-Traders.com, http://www.4-traders.com/JD-COM-INC-ADR-16538052/news/JD-com-unveils-new-logistics-services-arm-24267990/

offer integrated supply chain solutions such as warehousing, transportation, delivery and after-sale services, to e-commerce sellers and other companies. Additionally, JD.com plans to invest more heavily in logistics automation, including automated warehouses and drone deliveries.

Imagine the international logistics network that JD can build using Walmart's existing stores and distribution/transportation network in the US—and quite possibly in Mexico and the UK as well—and connect it all to China and perhaps Indonesia/Southeast Asia. This would benefit not only JD but also Walmart, which has also struggled with international growth.

Like Alibaba, JD.com is looking towards Southeast Asia for expansion. In May, it was reported in several publications that it was in talks to invest in Indonesia's PT Tokopedia, its largest online marketplace. There has been no confirmation of discussions.

US Logistics Providers with a Presence in China

Forwarders and 3PLs

Much of the focus for US logistics providers remains on international transportation and customs brokerage assistance. They also tend to follow customers to China. Barriers to entry for foreign non-asset based forwarders and 3PLs are low. In 2014, China's Ministry of Transport, as part of its decentralization initiatives, transferred its administrative licensing authority for non-vessel operating common carrier (NVOCCs) to individual provincial transport departments. The differences between forwarders and NVOCCs are minimal.

Expeditors International of Washington began operations in the 1980s focusing on the China-US trade lane. Today, this remains their largest trade lane in terms of revenue and volume. Since its beginnings, Expeditors has expanded services to include warehousing and transportation services within China.

C.H. Robinson's acquisition of Phoenix International in 2012 gave it a presence in China trade. Like Expeditors, Phoenix is a highly-respected forwarder that focuses on the US-China trade lane.

XPO Logistics' acquisition of Con-Way and primarily its subsidiary Menlo Logistics gave the large third party logistics provider (3PL) a small presence in China. In 2007, Menlo Logistics acquired Shanghai-based Chic Holdings Ltd.[29] Menlo gained an established logistics network with over 1,500 employees working from 130 operating sites in 78 cities, providing a wide range of domestic third-party warehousing, logistics and transportation management services throughout the country. In addition, through its acquisition of French logistics provider, Norbert

[29] Menlo Worldwide Completes Acquisition of Shanghai-Based 3PL Chic Holdings, Canadian Shipper, http://www.canadianshipper.com/transportation-and-logistics/menlo-worldwide-completes-acquisition-of-shanghai-based-3pl-chic-holdings-ltd/1000070917/

Dentressangle, XPO acquired the former Schneider Logistics freight forwarding group which had a presence in China, thanks to prior acquisitions. Norbert had acquired the operations in 2010.

SEKO Logistics is one of the more interesting 3PLs. It has fully embraced e-commerce and is establishing itself as one of the leading cross-border e-commerce logistics providers. In 2016, it added an additional 100,000 square feet of warehousing and fulfillment capacity in Hong Kong to support retail and high tech cargo owners targeting China's online consumers. Earlier this year, it signed a logistics partnership with Alibaba.

Express Providers (Integrators)

For express providers, FedEx and UPS, China represents a host of opportunities. Each has established a significant presence in the country and provides warehousing, domestic and international transportation, value-added warehousing services, freight forwarding, customs brokerage solutions and cross-border e-commerce solutions. Primary customers tend to be international. In 2012, the Chinese government granted both companies' rights to provide intra-China express package services. As of 2014, UPS had 33 licenses in China, while FedEx had a total of 58 licenses. At the time, Stifel Nicolaus analyst David Ross noted, "Even if they get domestic operating licenses, it looks like (highly profitable) document traffic (packages <1 lb) will still be off-limits. Over time, FedEx and UPS, if they can build out domestic China networks, could potentially offer better service at a lower cost, but that would require significant density, and we are a long way away from that, in our view. We believe both companies should continue to grow China import/export business but should remain relatively non-existent in domestic China over the next few years."[30]

It has been a struggle for international express providers such as UPS, FedEx and DHL to operate in China's domestic market. Protectionist moves by the Chinese government favor domestic providers such as SF Express, YTO Express and others. The waiting period for foreign firms to receive approval for domestic licensing is often long. In 2011, German express provider, DHL pulled out of the domestic express market claiming financial losses. Today, the company maintains it has a presence in China's domestic express market but it focuses more on the international express market.

Likewise, US express providers UPS and FedEx are focusing on China's international express delivery market. The current focus for UPS is shortening international transportation with later cut-off times for packages, likely in response to the growth of e-commerce. UPS has also recently signed an agreement with SF Holding, parent company of SF Express. According to the press release, "the joint services offerings combine the strengths of SF's extensive Chinese network,

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[30] UPS, FedEx Receive More Licenses for Domestic Express Package Services in China, Logistics Management, http://www.logisticsmgmt.com/article/ups_fedex_receive_more_licenses_for_domestic_express_package_services_in_ch

encompassing more than 13,000 service points in the world's largest and fastest growing package delivery market, with UPS's market leading globally integrated network with coverage between more than 220 countries". The joint venture will initially focus on supporting these highly competitive joint service offerings on the China-to-US lane, with planned expansion to markets in the rest of the world. The relationship will expand both companies reach internationally for SF Express and China domestic for UPS.

UPS' acquisition of Marken, a niche clinical trials logistics provider, also bodes well for further growth in China. UPS has established a network of warehousing and distribution facilities in which some offer cold chain capabilities. According to UPS' China fact sheet, it operates 200 weekly flights connecting China to US, Europe and across Asia. Its main air hubs are located in Shanghai and Shenzhen.

FedEx has also expanded its cold chain capabilities in China and through its acquisition of TNT Express, additional clinical trial/pharmaceutical logistics capabilities. FedEx's major air hub is Guangzhou. FedEx Express operates 30 weekly flights between China and the US.

Amazon

Amazon entered China in 2004 through its acquisition of Joyo.com, an online retailer. However, it failed to gain traction in the domestic market thanks to the strong presence of Alibaba and JD.com. Much like other logistics and express providers, Amazon is focusing more on cross-border solutions. In 2015, Amazon filed an application with the Shanghai Shipping Exchange that would allow its Chinese subsidiary, Beijing Century Joyo Courier Service, to serve as a shipping broker to countries in Europe, Japan and the United States. Agfsimilar application to the US Federal Maritime Commission was filed as well, allowing it to serve as a NVOCC for ocean freight services to other US-based companies that wish to export to other countries.

Amazon also introduced Prime to Chinese consumers that includes free, cross-border shipping from the Amazon Global Store as well as no minimum free domestic shipping. These international orders will be delivered by Amazon fulfillment centers in the U.S. through its global logistics capabilities and Prime members will receive those packages in an estimated 5-9 days in 82 cities. Much of the cargo will travel through China's first FTZ located in Shanghai. In 2014, Amazon signed an agreement with the Shanghai FTZ and Shanghai Information Investment Limited to open its cross-border e-commerce platform within the FTZ.

Post Offices

China Post

China Post Group Corporation, is a state-owned enterprise that operates the postal service, the

Postal Savings Bank of China and EMS, its logistics and express service. EMS operates as a complete 3PL offering warehousing value-added services such as parts management, supply chain financing and industry-specific services (e.g., automotive, pharmaceutical and fast moving consumer goods). EMS also operates as a delivery service including air, rail and truck.

The postal group owns about 25 airplanes and has been expanding service not only throughout China but overseas including Korea, India (includes also cold chain) for cross-border e-commerce services. In addition, the postal group has integrated into social media, WeChat, whereby consumers can scan a QR code to pay for items.

USPS

USPS financially struggles to meet certain requirements but it has been innovative in its own right. In the United States, it has established lockers in certain locations as alternative delivery locations. It has also dabbled in grocery delivery services. Parcel volume growth has increased greatly over the years thanks to e-commerce and relationships with UPS, FedEx and DHL to manage some final mile delivery on behalf of these integrators.

In addition, USPS has signed agreements with Alibaba for cross-border cooperation and has partnered with international post offices for international delivery services and it delivers packages to consumers 7 days a week.

Recommendations

- Bottlenecks exist in cross-border e-commerce. As such, it is recommended that the US Customs Border and Control collaborate with US businesses and logistics providers to speed up the process. This would in turn benefit businesses (particularly small to medium-sized businesses) as well as the final customer. Some suggested areas to focus on include:
    - Collaborating with US businesses and logistics providers to improve their transparency/track and trace capabilities throughout the process.
    - Counterfeits need to be addressed
    - Establish a return process that is not costly
    - The US should establish FTZs or specialized facilities focused on cross-border e-commerce. These facilities can serve as inspection points, speed customs clearance, and provide value-added services such as returns and temporary warehousing
- High-value logistics offerings for specific industries such as pharmaceutical and luxury items – There is a need for skilled logistics providers with specific industry knowledge and experience in logistics handling. As part of China's 13th Five Year-Plan, the government plans to invest in and encourage the growth of the biopharmaceutical industry; specialized warehousing and handling and transportation services will be needed. U.S. logistics

companies like UPS and FedEx are well-placed to meet this demand.

- Technology **–** In its 13th Five-Plan, China has identified the creation of “smart cities” and “smart supply chains” as a priority. US technology companies could potentially provide consulting and support in this area.
- International vs. Domestic - The domestic market is highly fragmented and is typically based on price. Average delivery costs are around $2.00, a rate not sustainable for many foreign competitors. In addition, government support of some Chinese logistics players creates an uneven playing field. Therefore, greater opportunities exist for foreign companies in China’s international express delivery market, particularly with providing logistics offerings that benefit the Silk Road initiative.

PANEL I QUESTION AND ANSWER

HEARING CO-CHAIR DORGAN: Ms. Roberson, thank you very much.
We were generous beyond the red light because we have time, and we now have an hour for the commissioners to ask you questions.

I thought your testimony was really, really interesting, and I have a lot of questions, but I'm going to defer to others for the time being. But, you know, your description of how to do business in China, your point about U.S. firms if they're going to be successful have to understand the culture and have to understand what you do to be successful to attract the consumer, that's absolutely correct.

But, you know, Ms. Roberson, your discussion about the requirement to go to municipalities one after another to get permits and so on, and then your point about having to partner with local interests in order to be successful, that's not accidental. That's all policy coming from the government, and in many cases, its circumstance where Hubbard Enterprises decides they make widgets, but they'd really like to just set up their company in Shenzhen to make widgets. You know, look, the Chinese will want a company set up where Hubbard--Mr. Hubbard from Hubbard Enterprises has 49 percent, and the Chinese interests have 51 percent.

That's the way things work in the world. It's not fair necessarily if you're trying to aspire to have open trade back and forth and reciprocal requirements, and so I'm going to call on others for questions, but ultimately I want to ask the question, given all that you've described, tell me how closely the Chinese market resembles ours in terms of openness. Think about that a bit, and we'll get to it.

Commissioner Hubbard, do you want to begin asking questions?

HEARING CO-CHAIR HUBBARD: Thank you. I thought, as well, that the testimony was really excellent.

I wanted to touch on a theme, I think, Mr. Cant, you made most central, but all of you touched on, which is the tension between normal issues with which a company has to deal when it goes into a foreign market--and that's not a policy concern-- and more significant barriers to foreign firms. You each touched on some of these. But if you were to think as a group about one or two barriers — again, in the e-commerce logistics setting — that you think are the most vital, I would appreciate hearing your perspective.

MR. CANT: The biggest issue is lack of market access. The Chinese authorities still have not acceded to the open society that we expected through the WTO. There are still significant barriers, particularly on technology companies, e-commerce companies, from Europe and USA, to doing business in China.

In fact, if you look--the panel--you should note that not one U.S. or foreign tech company is really operating in China in a meaningful way. Most of the Chinese e-commerce and technology companies that are dominating the market are actually U.S. companies or Hong Kong companies because they're listed there, and they're foreign companies. So they have gone into very complicated arrangements to get around the Chinese laws.

The single biggest thing that could open up this market I think and make it easy would be to allow Western technology and e-commerce companies to operate freely without the need for these licenses. Terribly difficult to get operating licenses. It's one thing to actually set up a company up there. It's another thing to get the operating license to, which is almost impossible.

Then, of course, you've got to go into the joint venture situation. You become a minority partner, and there's all those problems there. So I think really if we're talking this way, I mean it's really opening up that market. I mean apart--that's more of a regulatory issue than a cultural issue. I mean there are very large cultural issues also. We could talk for hours about that.

But, you know, slowly but surely, I think Western companies are getting attuned to the Chinese culture, the consumer behavior, the consumer markets, but without those regulatory barriers being removed, it's still very difficult.

MR. ZAKKOUR: Yeah, two points there. First, I think there is a tendency sometimes in the West to over-exoticize China and to over-exoticize the opportunity, the regulations, the barriers. Certainly there are challenges. I'm not here to argue that there aren't barriers, that there aren't challenges, but at the same time, and Commissioner Hubbard, you referred to this, and, you know, coming from Columbia Business School, you know that there are challenges and expenses and, you know, you have to spend a lot of time and money no matter which market you're going into, and it's always funny to me when I hear, you know, some companies say we want to go to China.

In a way, that's like saying we're going to take our brand to Europe. Really? If you overlaid China on a map of Europe, they're roughly the same size. They have roughly the same number of languages, regions, geography, climate, levels of development, level of income, focus. So saying you're going to China is like saying I'm going to Europe, and that I'm going to treat Macedonia the same way I treat the UK. You just can't do it.

So, yes, does it take expertise and intermediaries to help you understand the Chinese culture? And my book, you know, China's Super Consumers, the first 80 pages, I don't talk about business. I talk about start understanding the culture, the language, the philosophy, the history, the motivations of the Party, the multiple levels of thinking, because if you're trying to sell soap in China, believe it or not, something that the English did to the Chinese 140 years ago matters. It matters.

So I just want to be careful that we don't over-exoticize that China is "x-times-ponentially" more difficult to enter, and I'm not talking about just policy, but from a cultural, market, consumer point of view, let's not over-exoticize. That's a mistake.

That being said, I think we also need to differentiate the difference between we're talking about regulatory barriers for tech companies and technology companies in China, which is very different, and we have to differentiate, from the consumer opportunity. So the retailers and brands who want to sell to Chinese consumers have a door that is probably 80 percent open where these technology companies have a door in many ways that's only 20 percent open.

So there's a lot more work to do in that regard, but I also want to say don't completely sell Chinese technology companies short. They have innovated their technologies for their audience. And in a lot of ways, sure, they might have taken the initial idea for Weibo, which is their Twitter, from Twitter, Jack Ma may have gotten an early glimpse at eBay and created Taobao, and so on and so on, but we've reached a point right now where Shanghai and China are usually ranked number two or number three in technology innovation in the world, and so it's not just a matter of looking at how U.S. companies can better access the Chinese market, but how are we going to work with the Chinese companies who are bringing their technology to the world?

So the largest social media platform in China today is WeChat, produced by the giant Tencent. There are 700 million people in China on WeChat, and they did not copy anybody. It is the most dynamic, impressive, useful, functional social media platform in the world today, and actually Facebook and Apple are now starting to integrate ideas that WeChat introduced into their systems.

So I just want to differentiate. On the tech side, you know, in my report, I do state that from an e-commerce point of view, Amazon and eBay are irrelevant in China, that if you are going to sell through e-commerce in China, you need to deal with Alibaba, JD.com, Suning.com, Vip.com, the local players.

And interestingly, a couple years ago, Amazon actually set up their own store in Alibaba so it's almost like Target throwing in the towel and setting up shops within shops at Walmart. So I just wanted to make sure we differentiated there. But from a consumer point of view, it is difficult sometimes to set up a business entity. It can be expensive, but not much more difficult than it would be in anywhere else in the world.

HEARING CO-CHAIR DORGAN: Commissioner Wortzel.

COMMISSIONER WORTZEL: Mr. Cant, I wanted to just clarify a point you made about physical presence, and I would like to know whether the requirement for a physical presence in China is restricted to foreign firms or to stores like Alibaba also? Are they also required to have a physical presence or companies like Alibaba?

MR. CANT: Yeah. If you want to sell products in China domestically, you need a company there. So you have to set up--

COMMISSIONER WORTZEL: Well, that's a company. I mean you--I think what you said was a store, a brick and mortar physical presence.

MR. CANT: In order to have your own website, if you want to set up a company in China, and then have your own website to sell your products to Chinese consumers, you need to have a physical store. So there is a requirement that you have a retail store and then the e-commerce.

I mean it's become quite, it becomes quite burdensome because getting a physical store is quite difficult because of rent and so forth. But the major problem with having your own store, though, is basically attracting Chinese consumers to that store, and I've seen a lot of it.

I don't know, Michael, you might have something to comment. I've seen a lot of people come into the country, set up a consumer strategy, and really fail because they can't attract customers to their store basically or their marketing strategies. They haven't spent enough money or they don't know really what consumers to target and so forth. They don't know their social media, how to use that in their favor.

The other problem with going onto Taobao or Tmall or JD.com, which are the Chinese e-commerce platforms, is they have their own internal requirements so you have to--what Tmall, for example, wants, it's quite difficult. You've got to be in China for two to three years, you have to have a certain level of sales, you have to have a certain level of capital that's been invested, you have to have IP protection, and all sorts of things like that. So it's actually quite difficult unless you're a major brand to get onto those e-commerce platforms. So it's sort of a double-whammy I suppose is the word.

COMMISSIONER WORTZEL: I mean pardon my ignorance, but I'm inferring from what you've said that Taobao has a physical brick and mortar store somewhere?

MR. CANT: No.

MR. ZAKKOUR: I can--

COMMISSIONER WORTZEL: And that Jack Ma started with a physical brick and mortar store?

MR. ZAKKOUR: Okay. I can clarify on this. So if you want to sell on JD.com or Alibaba's Tmall, you need to have a legal business entity in China.

COMMISSIONER WORTZEL: Okay.

MR. ZAKKOUR: And you have to have your official trademarks registered with the Chinese government. That's one.

COMMISSIONER WORTZEL: And that is what you mean by a physical presence?

MR. CANT: No.

MR. ZAKKOUR: No, no, no, no, no.

COMMISSIONER WORTZEL: I got it.

MR. ZAKKOUR: No, no, no, no, no. No, no, no, no.

COMMISSIONER WORTZEL: Oh.

MR. ZAKKOUR: Okay. You do not have to have a physical retail store to sell on Tmall or to sell on JD.com. If you're a fashion company, if you are maybe a jewelry company, it behooves you to set up a flagship store in a big city or perhaps set up distribution, but you are by no means required to have a bricks and mortar store, and that's even if you want to sell on these China business entity based websites.

If you're doing cross-border commerce through JD International or through Alibaba's Tmall Global, okay, you don't need to set up a Chinese business entity. You don't have to have your trademarks registered in China. It's an expedited path to selling directly to Chinese consumers, but there are certain product categories where you would really not be doing yourself any favors by not setting up some sort of physical presence.

And the follow-on from that is the big trend right now when we talk about the new retail model, Amazon and Alibaba are both competing to completely redefine the entire retail experience, and so the big news of the past year, and most prominently last week with the Whole Foods purchase, is that the biggest e-commerce companies in the world are now making all of their big investments in physical retail--right--because this old question, the battle of the last ten years, clicks versus bricks, can retail survive, will bricks and mortar survive, is e-commerce going to take over, and actually the biggest e-commerce companies in the world figured out no, no, actually e-commerce can't survive without bricks and mortar, and bricks and mortar can't survive without e-commerce.

And this is a concept that I referred to called uni-channel. Digital transformation, uni-channel operations, and using the four tools and models of e-commerce is where all of retail is going. So if we look at what Amazon and Alibaba are doing, to really understand, you know, the bigger subject matter of how you get to Chinese consumers, you need to understand that those two companies are in a race to become the first global e-commerce platform with two billion customers, physical retail, right. That's where all this is going.

And so Alibaba has invested in buying department stores in malls. They invested 20 percent in Suning, a big electronics supplier. That's, you don't have to have that store.

HEARING CO-CHAIR DORGAN: Commissioner Wessel.

COMMISSIONER WESSEL: Thank you all for being here, and this is very helpful.

Please also understand that we, many of us, and Senator Dorgan and I years ago had worked on a lot of market access issues, and I remember the Chevy Nova example of the company coming to Congress asking for help in selling the Chevy Nova in Latin America, having trouble and thought it was market access issues. It was Nova, as you know, in Spanish means "won't run."

MR. ZAKKOUR: "No go."

COMMISSIONER WESSEL: It was an issue. So the comments you're all making, we understand. But you just talked about it being a race, and for me, this is an unfair race. Alibaba in China, you know, is running a marathon and they're forcing Amazon and U.S. players to run in a potato sack.

We don't have the access. Alibaba is not only able to skim all the profits off of U.S. companies getting into the market since they're going to be the platform for e-commerce, but because, as you said, Ms. Roberson, about the scary or the fear factor as it relates to data, Alibaba is going to have all that information.

I went on their website the other day to look at how they interact with U.S. small and medium-sized businesses with Jack Ma says he's this great gift to the U.S. That's going to, you know, provide pricing, quality, customer information, which they can ultimately use to advance Chinese companies in the China market.

Data is king; right? Their potential acquisition of MoneyGram gives them access to remittance data, et cetera. So, you know, I look upon Jack Ma's visit here yesterday not with excitement but with fear that this is a sign that China has said if you want to sell in China, you got to do it our way, not just in--and I understand we have to have sites that are attractive and run along the way that Chinese consumers want.

But we're not given the unfettered access, a free market, we would hopefully get under the China WTO accession. We're going to have to do it through the Alibaba system, and we are going to lose something as a result of that. Now, maybe we can't overcome that, but Amazon has tried and has found major impediments to getting into the Chinese market. So disagree with me. I mean, you know, is this a fair system?

MR. ZAKKOUR: Yeah. Well, I disagree with you in one sense, okay. We got to be clear about the differences between Alibaba and Amazon, and it's interesting that you mention owning data. The key is if you're selling on any Alibaba platform, you own the data. If you're selling on Amazon in any way, shape or form, they own your data. You don't have access to it.

COMMISSIONER WESSEL: But they're still tracking, right, on--

MR. ZAKKOUR: Everybody is tracking.

COMMISSIONER WESSEL: No, no, no--

MR. ZAKKOUR: That's going to be--

COMMISSIONER WESSEL: When I say own the data, I don't mean from the cloud related issues, even though Alibaba and Amazon are competing on cloud services.

MR. ZAKKOUR: Right.

COMMISSIONER WESSEL: I mean on customer data, on B2B, B2C, that's going to all be there, and rather than a U.S. company being able to profit maximize by selling to the Chinese consumer--understanding Amazon takes some of those profits as well--because Alibaba, we can't compete as much, JD, to an extent, et cetera, they're going to be able to take profit maximization out of our hands.

MR. ZAKKOUR: Okay. Perhaps, but the key is that Amazon hosts millions of sellers from China and around the world on Amazon.com. So I bought a replacement fan for my laptop two weeks ago, and the package I received was postmarked Shenzhen, China. I bought it on Amazon. Okay?

COMMISSIONER WESSEL: Right.

MR. ZAKKOUR: So what Amazon is doing is they are tracking everybody's sellers' information. Here's a key difference. Okay. You want to talk about competitive balance and fairness. Let's look at Amazon. Amazon, Jeff Bezos said many years ago, your profit, your margin is my opportunity. The guy said it out loud.

COMMISSIONER WESSEL: Right.

MR. ZAKKOUR: Okay. And if we look at what Amazon is doing around the world and the U.S., they're looking to put everybody they're partnering with out of business eventually, and so Amazon's biggest growth area right now is in private labeling. Well, how did they determine which private label products to go out to the market with? They own all the data of sales for companies who sell on Amazon, and they say we're using this data to build our own private label businesses.

COMMISSIONER WESSEL: I'm not sticking up for Amazon. I mean, understand, I have problems with what Amazon does as well, but Amazon does not have a collusive, let's say, relationship with the U.S. government in terms of access impediments, and Alibaba has essentially a monopoly, somewhat of a monopoly, in terms of a global strategy right now.

And so coming to Detroit and saying, you know, we're God's gift to the U.S., we're going to help solve the trade deficit that the Senator raised earlier, and I want to sell more U.S. products in China, I also want to have U.S. firms, again maximize the profits, and the way the system is structured as it relates to e-commerce is not fair to U.S. players. Do you agree or disagree?

MR. ZAKKOUR: I look at it more from, you know, a pure market point of view, a capitalism point of view, whereas today, you know, how many foreign marketplace platforms are in the United States? I mean, when you come to marketplaces in the U.S., it's Amazon, it's eBay, and then there is nobody else. So if you look at China today, you have Alibaba, and you have JD, about 75 percent of the market, and then the rest is fragmented from small players in 25 percent.

So I do understand what you're saying. I'm not sure if you fully understand how Alibaba makes their money though, which is simply on small commissions per sale and on advertising and marketing fees. So I'm just saying from that point of view, where is Mercado Libre, the largest marketplace in South America, in the U.S.? Where is Rakuten, the largest e-commerce marketplace in Japan? I mean, I'm just trying to balance it. I don't see any of those guys here either.

COMMISSIONER WESSEL: And again I understand it is a market penetration, and again going back to the Chevy Nova, you know, Amazon is the brand here. But it's not a brand because of governmental interference or sponsorship, and that's where I think we have to do much more as a public policy effort here to try and break down those barriers--the logistics barriers, the question of physical presence, trademarks, and all the various other things that Chinese companies don't have to go through selling on our platforms, but we have to go through there.

MR. ZAKKOUR: Agree.

HEARING CO-CHAIR DORGAN: Ms. Roberson, would you like to respond, because you had some of it in your testimony with respect to Mr. Wessel's question?

MS. ROBERSON: Yes, sir, I understand where you're coming from because there's always been that gray area, the Chinese government, Alibaba, you know, what's going on? But with Amazon, Amazon did try to go into the Chinese domestic market, couldn't compete against Alibaba for probably obvious reasons there. So they backed out. Well, I mean they still have a presence, but their emphasis is cross-border.

They've got a freight forwarding--excuse me--an NVOCC license, which is slightly different, and they are--

COMMISSIONER WESSEL: They are operating Prime. I mean, again, they have some small sliver and growing.

MS. ROBERSON: Exactly. Exactly. So they are encouraging Chinese merchants to trade on the Amazon platform here in the U.S., so it's kind of an opposite thing going on.

COMMISSIONER WESSEL: Okay.

MS. ROBERSON: So Amazon is wanting the Chinese to sell here, whereas Alibaba is wanting our people, our small businesses, to sell over there. So that's one of the reasons why Amazon is building out their supply chain network, you know, NVOCC license, they've got over 40 airplanes licensed now to control from the beginning to the front door of the supply chain. It's interesting, and it is perplexing, I agree.

COMMISSIONER WESSEL: Thank you.

HEARING CO-CHAIR DORGAN: Commissioner Goodwin.

COMMISSIONER GOODWIN: Thank you, Senator.

Just to follow up on this discussion and certainly not wanting to focus on Alibaba exclusively, but, Mr. Zakkour, you indicated in your testimony, they certainly benefited from these emerging trends in globalization over the last several decades. But I think, as Commissioner Wessel's questions would suggest, they've also benefited from involvement by the Chinese government. And, you know, one commentator noted in Forbes a couple years ago that in almost every single line of their businesses, Alibaba is by and large protected by the government from foreign competition, with the result being, again in this commentator's view, that the Chinese Communist Party has succeeded in building a global publicly traded brand.

What's the significance of that for Western companies trying to compete there and for policymakers?

MR. ZAKKOUR: I'm not sure I would agree fully with the statement that the Chinese government has built a global brand in Alibaba. I think the people within Alibaba, led by Jack Ma, built that company. Indigenously, do they benefit from if you want to call it protection, that's a fair word, but support certainly, and working together with the government, absolutely.

I'm not an expert on how deep the Party is involved with private businesses at that level, but I do think it would be unfair to say that the Chinese government was responsible for Alibaba's global success.

COMMISSIONER GOODWIN: And I don't want to minimize--

MR. ZAKKOUR: Yeah.

COMMISSIONER GOODWIN: --his acknowledged business acumen. But suffice it to say if you're getting access to capital, you're benefiting from restrictions on foreign investment in the largest market in the world--

MR. ZAKKOUR: Uh-huh.

COMMISSIONER GOODWIN: --and you have arguably exclusive access to government procurement contracts, you're able to leverage your primacy in that market to compete internationally.

MR. ZAKKOUR: Yeah, I agree, and I think it's a bigger question for U.S.-China trade relations, you know, where do we go from here in dealing with what I guess we'd call China's state capitalism? You know, during the early reform and opening era, they really made a big effort at privatizing a good chunk of the state-owned enterprises. I think what we've seen in the last five years, certainly under the new leadership, is that there's been an effort to reinject the state and the Party into more businesses.

I think there are 88,000 Party members within, you know, like what would be the Fortune 50 of Chinese companies now, and there are certainly Party cells in all these state-owned enterprises. So there is the challenge in the U.S. of how do we compete with Chinese state-owned enterprises?

And certainly the state is interested in creating, you know, what we call hometown hero companies, whom they want to go out in the world and become global brands and global players. For me, from where I'm sitting, you know, again, I'm less of an expert in that area and more on do American retailers and brands have access to Chinese consumers? Yes, they do.

Is it the ideal situation right now? No. We need to work on it. But for me, the bigger question is do we ignore or turn our backs on China and Chinese consumers or do we find a way forward with them? So I can't speak very well to, you know, how deep the state is involved with a company like Alibaba. I agree with you that there is state support of these companies, and not Alibaba alone, but companies like Huawei and others, and I remember when a Chinese company five years ago bought Smithfield pork, we actually had a national security review to make sure, you know, that it was going to be okay for a Chinese and U.S. pork company to get together.

So I understand the sensitivities there. I'm just not sure how we deal with state influence. You guys are smarter about that than I am. And by the way, I just want to say one funny story that Commissioner Wessel reminded me of on the importance of naming. When Best Buy went to China a few years ago, they didn't do very well, mostly because they didn't understand the consumer or the structure, but it also had something to do with the fact that their Chinese name when read by a Chinese consumer meant "think a hundred times before you shop here."

[Laughter.]

COMMISSIONER GOODWIN: Definitely not going to attract the impulse buyers with that.

MR. ZAKKOUR: No, definitely not.

[Laughter.]

COMMISSIONER GOODWIN: But with my limited time, I'd like to just make two quick questions, if I can, Senator, two facts that jumped out at me in your prepared testimony, and I want to see if the panel could comment on it. First, it seemed like there was a significant emphasis in the written testimony regarding one of the key distinctions between the two e-commerce markets, Western markets and the Chinese market, primarily being the fact that most Chinese e-commerce is conducted on mobile devices as opposed to desktops. I'd like to get your insight on that.

And, then, Ms. Roberson, I was also struck by the fact that with this expanding logistics market necessary to fill all the orders of this burgeoning e-commerce and what's going to be the largest market, there are fewer modern warehouses in all of China than there are in the city of Boston, Massachusetts. Needless to say, it seems like an enormous investment opportunity for Chinese and international companies alike, and I'd like your thoughts on that.

HEARING CO-CHAIR DORGAN: And if you can give us some brief responses. The time has expired on that so if you will respond to both and offer brief responses.

MS. ROBERSON: Okay. In terms of the warehousing, that's correct. That's a little outdated. I think that article came out a few years ago, but for the most part, yes, there is a growing need for modern warehousing, which means more automation. Automation within the warehousing is to speed up the fulfillment, to get into the back of the package car, truck--excuse me--that's UPS-speak--and to get it to the front door as quick as possible, but you're right, there are some opportunities there.

So it's been building out over the past couple of years, but there's been a bubble. There's been almost overinvestment in the space.

HEARING CO-CHAIR DORGAN: Commissioner Slane.

MR. ZAKKOUR: Just real quick.

HEARING CO-CHAIR DORGAN: All right.

MR. ZAKKOUR: So, two things. Yeah, mobile accounts for about 82 percent of e-commerce transactions in China today, and also coming back to where Chinese people shop, what's different about the U.S. and China is that about 90 percent of all purchases are made on a marketplace. So if you think about e-commerce happening, several models. You have marketplaces, you have own domain, which is your dot-com or your dot-cn. You have digital native companies, like Casper, who never had a store; they just started selling mattresses online. And then you have third-party specialty retail.

In the U.S., it's about 55 percent marketplaces and 45, 50 percent of all the rest, whereas, in China, 90 percent of the purchases take place on marketplaces, and about 75 percent of that is JD. And so then within that 82 percent. So, for instance, last year, during the Singles Day global shopping festival in China, Chinese consumers spent $18 billion in 24 hours for that--18.

By comparison, Amazon sold about $1.3 billion worth of goods in 24 hours on cyber Monday. They did 18 billion. 84 percent of those purchases were made through mobile phones. So I always say Chinese consumers are mobile and mobile. They're traveling the world, they're being educated in the U.S., they're buying homes around the world, they're investing in businesses around the world, and they're always on their phone. They travel and live with the phone and the airplane.

HEARING CO-CHAIR DORGAN: Commissioner Slane.

COMMISSIONER SLANE: Thank you.

Very, very interesting. I'm fascinated by this concept that bricks and mortar is not going to go away. Can you elaborate a little more on why you're saying that?

MR. ZAKKOUR: Yeah, sure. So if we look at some of the recent numbers out there, over two years here, we're looking at about 10,000 bricks and mortar stores closing in the United States, and that really presents a gloomy picture for the traditional retail industry in the U.S.

The good news is over that same period, 12,000 bricks and mortar retail stores are opening across the U.S. So there's a misperception out there. There's actually a net gain in stores opening. It's the types of stores and the types of companies and the types of brands that are failing or succeeding.

And largely the companies, whether you're a brand or a retailer, who are successfully digitizing their operations, putting supply chain at the forefront, understanding how to deal with e-commerce as a tool, those are the companies who are thriving and surviving.

So my outlook for retail in the U.S., while there is some short-term pain, I'm very bullish and very optimistic for retail in the U.S. It's just a different kind of retail. Now where my concern is, is we're seeing the deepest cuts and losses, and this is a bigger problem for retailers in the U.S. overall, is the loss of the middle market in retail.

So with the decline of some areas of income and stagnation with the middle class in the U.S., you can pretty much track how the middle class is doing by which retailers are going out of business. So, you know, I grew up in the '70s, I was born in the late '60s, and you know, Sears was everything. I grew up in a suburb and, you know, we lived at Sears and Macy's, and if you look at these companies, these are the companies that are really in big trouble, and some of them are really close to being out of business if not already out of business.

And so you're seeing a lot of investment and growth at the top end, right. You're seeing luxury malls open. You're also seeing Dollar Stores literally open by the thousands each year. So my concern is how do we support the middle market, how do we support the middle class, because those are the companies who, you know, serve that market, and they're the ones who are doing the worst.

Part of it is also they haven't adapted well to the e-commerce age, but that's really where I think just from an American perspective, we can help support those companies by helping them internationalize and digitize. But, yeah, retail is going to be alive and well. No matter how you look at it, at best, in the U.S., in the next 20 years, e-commerce transactions will not account for more than 17 percent of total transactions. So--

COMMISSIONER SLANE: Thank you.

HEARING CO-CHAIR DORGAN: Commissioner Shea.

VICE CHAIRMAN SHEA: Thank you very much for your testimony.

A lot of things running through my head so I don't know how articulate I'm going to be. I guess my first reaction was, first thought is hundreds of millions of people flipping through web pages on their phones while shopping doesn't sound like a particularly healthy or safe thing to be doing. I hope they're not driving while they're doing that.

So, secondly, you've sort of heard some of the skepticism before. When China joined the--and I'm going to share in a little bit of that skepticism and see if you can react--when China joined the WTO, there was tremendous enthusiasm in the United States, you know, huge market opportunity, and over the past 15 years, you know, many, some companies have done well.

Some U.S. companies have done well in China, but many others have not, and it's been a disappointment, and as this Commission has remarked over the years, you know, China sets its plans, sets its goals very explicitly in its Five Year Plans and various plans, and there are just segments of the economy they're simply not going to allow Western companies to dominate or have a significant share of. It's just not going to happen. And it's largely those industries that they have identified in their respective plans.

And now here 15 years later where there seems to be some enthusiasm around e-commerce is a tremendous opportunity for U.S. companies, and I'm a little skeptical. I think it sounds like we're going to have a repeat of what the experience has been over the past 15 years, and I could see the Chinese government saying there are certain consumer areas that we're just not going to give up to Western companies.

For example, I cannot see FedEx or UPS being allowed to have a significant share of the express delivery market in China. I mean, would the Chinese government allow Amazon to buy major supermarket chains in China? I don't know. I don't know the answer to that.

Then you have another thing that I've read. In our paper, in our briefing book, we had a paper from the Demand Institute, which had a statistic which really struck me: 76 percent of GDP in the U.S. is consumption; 28 percent of GDP in China is consumption. But they predict that by 2025, it will still be 28 percent. The economy will be bigger so it's 28 percent of a larger economy, but it's still 28 percent.

And with the demographic changes, the aging of the population, I'm just wondering if there's a little bit of a hype around, you know, potential U.S. access to the Chinese e-commerce market? Long-winded statement, but please react.

MR. CANT: I think you've hit on a salient issue here, and that is from a regulatory perspective, the fact that China doesn't allow Western companies to get involved in all those great service areas we're talking about--logistics, transportation, e-commerce, financial services--you'll be talking about this afternoon--education, entertainment--all of these areas are currently prohibited from foreign companies doing any meaningful investment.

I mean what if Amazon and eBay had been allowed to go into China ten years ago? We don't know what would have happened. I mean so I think there's a big regulatory issue here, and it comes down to market access.

From a practical point of view, I mean the fact that Western companies, you know, didn't have the right approach or didn't have the right understanding of the culture is a significant factor also. I think that's been demonstrated over and over and over again, even by the big guys and the smaller guys also.

So we really have a twin problem here. It's regulatory access and also the market approach or the market understanding of a lot of Western and U.S. companies.

MR. ZAKKOUR: Your skepticism is healthy and well-placed. You know, again, I don't approach China from, you know, a position of being naive or pollyannaish, and I'm certainly not an apologist for China, but what I do seek is balance, and I've spent the last 15 years trying to build useful business, cultural, personal bridges between the U.S. and China because the fact is China is not going away; right? It's here now, and this misconception that China has, you know, emerged on the world stage is a misconception. China has reemerged back to where it's traditionally been for about 3,000 years; right? It took about a 120 year nap, and it's woken up now.

So the point is, yes, there are a lot of restricted industries in China right now, and that is a problem for Western companies, it's a problem for U.S. companies, and again for you guys, policymakers, influencers, you know, that's your area to work out. And I'm just trying to, you know, break down some of these trade barriers piece by piece.

But let's not discount the idea that there have been some huge success stories for American companies in China. Let's take Starbucks for a moment, okay. Starbucks is starting 500 new stores this year in China. China already passed Canada as Starbucks number two market after the U.S. And China will shortly surpass the U.S.--yes, believe it or not, there will be more Starbucks in China than U.S. We laugh. There's one on every corner. I think they're going to have them right next to each other in Shanghai.

So Starbucks is doing phenomenal in China, and Nike is doing phenomenal business in China. The GM Shanghai auto joint venture is a resounding success where GM sells more cars in China every year than they do in the U.S.

So there are challenges. There are barriers certainly, but let's look at the guys who are getting it right, and there are a lot of them, and, you know, after having taken 300 companies over the past 15 years into China, I'm proud to say I've helped, you know, I think in some very small way American businesses to profit and grow and hire people back here.

But, you know, I agree with Commissioner Shea. I mean there are restricted industries here that I don't know how we break through those. One thing you'll know is I think a lot of them have to do with information; right. That's where we have to kind of key our focus on is the most sensitive area in China in regulation is in the creation and distribution of information.

And one very simple example of that is Disney; right. So Disney last June opened up their Shanghai Park, and it's been a resounding success. They exceeded the guest expectations for the first year. They're making a lot of money. But interestingly, the month before the park opened, the Chinese government made them shut down their online app store. So they couldn't sell their app. They couldn't sell certain books and movies.

So, right, this is the paradox of China. We're happy to have you open a $20 billion theme park and have you make billions of dollars on it, but you're not running your app store in China. That's the healthy skepticism you need.

HEARING CO-CHAIR DORGAN: Commissioner Tobin.

COMMISSIONER TOBIN: Great. Thank you all.

As you said, Vice Chair Shea, a lot of questions are running around in our heads, and Mr. Zakkour, you just touched on what I wanted to ask. If you think on whether or not a cup is half full or half empty, to use that metaphor, which American companies do you think have learned how to effectively compete with e-commerce in China? Is any American company doing a really good job of competing in the PRC with e-commerce?

Mr. Cant, you spoke about one of the barriers being the lack of protection for intellectual property. You said the situation is getting better—but from what base level is it getting better? How much better? What level are we at I ask because that's going to be key for us going forward.

And, then, Ms. Roberson, and perhaps Mr. Zakkour, you'll have something on this as well, concerning President Xi Jinping's vision for China, the One Belt, One Road, and the integration and movement of products and services and resources. Can you each comment on how that vision plays and where American companies, if at all, can effectively participate in Road or Belt opportunities?

So I'll start with Mr. Cant.

MR. CANT: Okay. I'll just briefly talk about the IP situation. We've all heard all the stories. We've seen the counterfeits. The situation came from very low base, I think, and it's only recently that China became serious I suppose about IP. The law has always been there, but it's about the regulation and the protection.

They are becoming serious. There's still a problem in the sense that if you are not already registered--if a Western brand or trademark is not already registered in China by now, then it's been taken by someone else. And China uses what's called a "first to register" system. So whoever gets there first gets the trademark.

And, of course, most Western brands and trademarks have already been taken either by the owners or the cyber squatter, the trademark squatters. So it's a problem, and in fact many U.S. companies still have a lot of problems when they try--Apple had the biggest problem just recently, and you've basically got to buy your way out of it in that sense. It was a business expense.

As Chinese brands get bigger, then of course the interest in ownership of those brands becomes bigger also. So, yes, it's getting better. Is there a problem still? Yes. Is counterfeit still a problem? Yes. Brands like Alibaba, JD.com are trying desperately to clean up their sites to make them sort of counterfeit free.

One of the reasons they give for making the barriers so high for smaller Western companies is they want to make sure that you are the brand owner and the brand is strong and feasible. So I think, yeah, it is getting better. It is a work in progress, I think, you know.

COMMISSIONER TOBIN: Do you see them from your years of experience as being serious about that getting--

MR. CANT: Now yes. Yeah. Previously not so.

COMMISSIONER TOBIN: Okay. One Belt One Road comments?

MS. ROBERSON: Okay. From a logistics perspective, it's fascinating for sure. In fact, you've got UPS and you've got several other U.S. logistics providers already offering services along this. UPS, in particular, is offering less than container loads, full container loads, onto the Chinese rail system, and having it move all the way into Europe, and from there, the UPS trucking is picking it up from there and doing that last mile delivery within Europe. So there is some hope there.

There's little political questions that's usually raised with the One Belt One Road situation. You know what is the Chinese government's ultimate reasons for doing this? And who knows? You know I'm not a politician so I'm not going to go down that road.

COMMISSIONER TOBIN: One point I know, I'll just name one company--Hewlett Packard--

MS. ROBERSON: Yes.

COMMISSIONER TOBIN: --was thinking of moving its products from more middle of China versus going across the seas and around, products that didn't have to move in 24 hours like lobsters.

MS. ROBERSON: Exactly. They had had, they had--

COMMISSIONER TOBIN: But I think they pulled back.

MS. ROBERSON: Oh, really.

COMMISSIONER TOBIN: But I'm not 100 percent sure on that.

MS. ROBERSON: Okay. I know they were testing the rail for awhile. The rail system offers less time versus ocean freight and less costly than airplanes.

COMMISSIONER TOBIN: Right.

MS. ROBERSON: So that was the whole perspective there. However, when you move from country to country, or even sometimes province to province, that rail gauge is going to change.

COMMISSIONER TOBIN: Right.

MS. ROBERSON: So it's going to require all the containers coming off the train and then having to be reloaded. So, you know, there's pros and cons on that. But logistics providers are jumping on the bandwagon, so to speak, from a logistics--

COMMISSIONER TOBIN: American ones?

MS. ROBERSON: American, European, you name it, they're all there.

COMMISSIONER TOBIN: Keep us posted if you hear more on that in the coming months.

MS. ROBERSON: Definitely. Definitely.

COMMISSIONER TOBIN: Anybody else on One Belt One Road?

MR. ZAKKOUR: Yeah. So, and just for everyone's edification, the Belt part is the land-based trade routes.

COMMISSIONER TOBIN: Yes, yes, we know.

MR. ZAKKOUR: And the Road ironically is the sea part. That's very Chinese. So on Tuesday, I'm actually giving a talk at the Confucius Institute of Business in New York City entitled "China Using Diplomacy, Steel and Tech to Enhance Global Power." And actually the One Belt, One Road is a perfect example of the diplomatic intentions, and the steel, right, so diplomacy, steel and technology.

So they're looking at that Belt and Road Initiative as a way to, you know, gather that part of the world in its sphere of influence certainly by deploying steel and logistics and infrastructure projects throughout Asia, all the way into Europe, and so certainly technology. So really that Belt and Road Initiative is their in a sense Marshall Plan, I think. It's the Chinese version of the Marshall Plan where they're going in and they're going to build infrastructure and, you know, make friends along the way.

COMMISSIONER TOBIN: We're very versed in it, but have you heard from where you sit on American companies--

MR. ZAKKOUR: Right now I mean for the most part American companies have chosen to stay out of it. I mean there's almost--and I've tried to get the word out, you know, through my appearances on stages and in front of cameras to get the word because there are opportunities for American companies, and this could end up being, despite what the ulterior motives may or may not be in doing it, you know, there's $6 trillion worth of investment that's going to happen through this initiative, and I think it would really be foolhardy for American companies and the government not to look more closely at where we can participate.

COMMISSIONER TOBIN: I agree. The system, several of us have noted, is not fair, but if we want to compete, we've got to be smart, and that may be one of the avenues.

Thank you.

HEARING CO-CHAIR DORGAN: Commissioner Talent.

COMMISSIONER TALENT: Mr. Cant, can you explain, because I'm just a little bit unclear on it, your fourth model of the cross-border? Go through what that entails, and the difference between that and the third model? I mean is it simply that there are certain like cities that are declared more free trade zones and that?

And then if you--I was fascinated by all of your discussions of Alibaba and the way they have gained market share in part by aggregating in one device so many things that people want to experience in the course of a day. But as my understanding of business, aggregation can often work and produce economies, the problem being that, you know, competitors can disaggregate particular things and get so good at that that they're able to compete effectively against you in that area.

And if the Chinese consumers are as discriminating as you all say, and I have no doubt that they are, how likely is it do you think that avenues of purchase are going to develop where other companies are going to be able to undercut Alibaba in particular areas?

You know once the consumer becomes sufficiently knowledgeable about Gucci, let's say, I mean if they're like the consumers in my family, they don't care where they get it from, as long as they get a Gucci bag, and then it's all price; right?

So is Alibaba going to continue being able to compete on price against, you know, maybe direct sales or other methods? Just speculate a little bit on that.

MR. CANT: I'll just clarify that model four, the fourth method, as it were, and that really is direct sales. That's really the Chinese shopper seeking out a product from overseas, but one of the problems in the early days when you had a product coming from overseas into China, there were problems with logistics, there were problems with customs, there were problems with tax, there were problems with delivery, you know, there were problems with payment systems. So it didn't really work quite frankly.

What we have now though is because of the success of e-commerce generally, the Chinese government is promoting cross-border e-commerce by designating a bunch of cities, you know, some major cities, as pilot e-commerce free zones where they can guarantee automatic customs clearance, great logistics, a reduced tax rate, and basically take all that hassle off the hand of the Chinese consumer.

COMMISSIONER TALENT: Would I be correct if I thought of that in terms of they're just declaring some cities where they're actually going to allow free trade?

MR. CANT: Basically.

[Laughter.]

COMMISSIONER TALENT: They're actually in those cities doing what they promised to do 15 years ago in the whole country so that you can just sell products in those cities; right?

MR. ZAKKOUR: Let's be clear though. It's not the cities. They're setting up free trade zones adjacent to the cities.

COMMISSIONER TALENT: Okay.

MR. ZAKKOUR: So Shanghai doesn't become a universal free trade zone.

COMMISSIONER TALENT: Okay.

MR. ZAKKOUR: But to clarify on cross-border real quick, the three ways you can ship is you ship direct, right, so somebody buys from your website in China and you ship it from your warehouse in the U.S. to the Chinese consumer. And there are certain levels if it's purchased under, it's duty free. So, in some cases, categories 800 RMB or under, it's free.

Or you can put your goods in a consolidated warehouse here in the U.S., and if a Chinese consumer buys it on Alibaba, it gets sent from there.

The most common method now though, my clients, certainly in retail, is you ship the goods to the free trade zone in China; it goes into a bonded warehouse. When somebody buys it on JD.com or Alibaba.com, the 3PL picks and packs the product, writes out a single customs form, and has it to the consumer in less than 24 to 48 hours. That's the most common and fastest growing model for cross-border.

COMMISSIONER TALENT: Okay.

MR. ZAKKOUR: Sorry, Richard. I just wanted to make sure we were clear on that.

MR. CANT: And just a word on the free trade zones. I mean I was in Shanghai when

Shanghai free trade zone was touted in 2013 as being the place where everything was going to be regulated. It was going to become the new growth area. And of course, it didn't happen, you know, for various reasons.

I mean it's starting to get to work in a few other areas. What they've done now is they've extended the concept of the Shanghai free trade to a number of other cities, and then they've tacked on these other pilot e-commerce free trade zones around.

So there is movement here. It's still very much a work in a progress. As I said, it caused a lot of distortions in the market because goods were coming in from overseas, you know, in a tax free manner in certain ways.

One of the other problems, the other methods of selling into China is what we call the parallel importing, which is basically Chinese nationals in let's say the USA go down to the local Amazon here and buy products and then ship them personally to someone in China, and it's basically done under the counter. It's a gray market, and again distorting a lot of areas, particularly in health foods and so forth, infant powder, milk powders and things like that.

So there's a problem there that the Chinese are trying to stop also so all these areas are in play at the moment. Very interesting area. Set to boom, you know.

HEARING CO-CHAIR DORGAN: Commissioner Stivers.

COMMISSIONER STIVERS: One of you mentioned in your testimony, I believe it was Ms. Roberson, that exports drive growth. I think that was one of your headings.

The key question and a focus for U.S. policymakers is how can we help sell U.S. manufactured products to a growing number of Chinese consumers, but in a way that can really boost middle income wages here in the United States?

So my question would be is there any hope for any small and medium-sized businesses competing in China through e-commerce? And what are your best ideas for the U.S. government to help with that? I think Mr. Cant mentioned strengthening the U.S. Commercial Service as one of his recommendations, and that seemed like a strong recommendation.

What can the U.S. government do to help small and medium enterprises and businesses compete in China?

MR. CANT: I'll just speak to that then. I think there is a great future potentially for small and medium enterprises in the U.S. to sell products to China. It's a matter of getting all of the pieces moving in the right way and so on and so forth. A number of different factors. There's regulatory factors, there's cultural issues, and maybe there's issues concerning assistance for exporters also.

I worked closely with the U.S. Commercial Service for a number of years and have seen how they've helped U.S. businesses try to export more, set up businesses in China and so forth, and I think there's a great opportunity for them to take the lead in maybe, in conjunction with private, private business also in really schooling and targeting SMEs in the U.S. as to how to do it.

I think there's a lot of misinformation around. There's a lot of confusion, and there's a lot of snake oil salesmen going around. And I think that really someone needs to take the lead.

I've personally seen the Australian and New Zealand governments take a real lead in this area. They both have free trade agreements which, of course, helps, but they've really targeted their small and medium enterprises, particularly for export, and mainly in the e-commerce area, and it's been very successful quite frankly.

The Canadians also have done this, and so there's a couple of models out there where--we're not talking about overall subsidies. We're talking about education programs more, and basically going around the country, telling people this is what you can do, this is how you can do it, so on and so forth.

I see a lot of smaller U.S. businesses don't have that information at hand. Although there's a lot around, there's still a lot of confusion, there's a lot of ambiguity, and people frankly put their hands up and say it's too hard. And I think that would be a great start.

MS. ROBERSON: If I may just agree with you wholeheartedly. The Alibaba conference, there was over 3,000 people there, small to medium-sized entrepreneurs there, looking to learn more and that, it struck me last night, you know, our small to medium-sized businesses need this information. They need to know what the difference is between an Alibaba type of platform versus an Amazon platform.

Walmart has a platform. You know, which is better, you know? And if you could have an unbiased system, you know, someplace for them to go to, to type into, then I think that would be a great help to these people because, yeah, e-commerce levels the playing field for small and medium-sized businesses. I'm competing outside, you know, in my house against a Fortune 500 company. Nobody knows, you know, online.

So I think there's great opportunity. It's just the need for that information.

HEARING CO-CHAIR DORGAN: The--yes? Go ahead. I'm sorry.

MR. ZAKKOUR: I think it's really, it's my favorite question. I think it's actually going back to the roots of America. It's actually in the world we live in today that people need to take control of their own careers and their own lives; right. You can't necessarily depend on government, you can't depend on big corporations, that we're seeing the freelance economy; right?

And this doesn't, and I'm often offended when people think that only means for the creative class. It's not. So I think there's a movement here where we can empower people to be farmers again, to be merchants again, to be artisans again, to be small business owners again. And the way we support the middle class is to give them the tools and the information to empower them to build their own small businesses.

I really believe what we're coming up to here is the age of the small and medium-sized enterprise of the independent striver, of the entrepreneur. I think we're heading into a golden age in that.

And so I actually agree with everything Richard and Cathy said. I mean I think, you know, one just touching on WTO real quick and its discontents, and there are many, I think we need to initiate at the very highest level some new rounds of negotiation that are e-commerce and digital transformation specific between China and the U.S. because I don't think the previous agreements in WTO cover these issues that didn't exist 15 years ago. That would be number one.

Number two, educate and empower national, state, and local chambers of commerce to provide education, resources, maybe grants, whatever these things might be, the tools to empower these small businesses.

I don't know if you guys follow James Fallows at The Atlantic, but for the last two years, he's been flying across America and reporting on when he goes to these small towns, everybody is happy. Businesses are thriving, and there's such a disconnect between our national narrative and what's happening at the local levels across America, and I follow that closely, and I know

James, and I think we can tap into that here.

You know how do we bring these small strivers across America back to the roots of the country? Farmers, merchants, artisans, take control of your lives. It's not just about big corporations and that's how we can make globalization work for them; right?

So globalization has been great for urbanites, for the creative class, for big corporations, but a lot of little guys get left behind, and we've been--

HEARING CO-CHAIR DORGAN: Mr. Zakkour--

MR. ZAKKOUR: I'm sorry. So that would be my recommendation.

HEARING CO-CHAIR DORGAN: Let me--I deferred my questions at the start, not understanding I would run out of time.

[Laughter.]

HEARING CO-CHAIR DORGAN: No, no. I'm just kidding. I'm just kidding. But I've chaired a lot of hearings over the years, and I think the testimony here has been really, really interesting. I mean because you know your subjects, and you have lived them, and so I really appreciate what you have told us today.

I want to make just a couple of observations, and if you have a comment on it, we'll take that before we leave for lunch. Mr. Cant, you described that this is all a work in progress, and I'm thinking of the political disaffection in our country. There's a lot of it, and you know some of the press calls it populist. It's not populist. It's just disaffection. People are angry because their lot in life has changed.

It used to be the answer to do I have a good job, does my job pay well, do I have job security and so on? Around the family table at night, having dinner or supper, they ask those questions, and they answered in the affirmative. Now they can't answer it in quite so affirmative a way.

And they understand if they used to have a job with Huffy Bicycles and don't any longer because all those bicycles are made in China that they themselves can't affect all of this. They try. They're angry, but they can't affect it themselves. There are larger forces at work, and when someone says, well, it's a work in progress, you know, it's been a work in progress for a long, long, long time, but it's not progressing very well.

And I started by describing these numbers and goods. Now, in 2016, the Chinese sent us $462 billion worth of goods. We sent them $115 billion worth of goods. That's about a $350 billion imbalance. And that imbalance does relate to jobs and opportunity and so on.

And I was sitting here thinking about the movies. The Chinese have I think 25,000 movie screens or so, and they allow 34 movies into their country on very significant revenue sharing; right?

And so now this year there's going to be a renegotiation, and we went from 20 to 34 five years ago. So maybe we get a few more movies into China. That's a really big deal; right? So all of this describes to me that we have a strategy in which China runs a managed trade system. They know exactly what they want to do. They make it happen.

When I've visited with AmCham in Beijing to hear how American businesses see their situation there, they grumble and they complain and they said yeah, we face lots of--but they can't say it there because saying it there means somebody there might decide, you know what, you're out of here. We'll do something that you won't quite understand, but as soon as it's implemented, you're gone. So my point is they run a managed trade system, and we're pretty open over here, and we're running very large trade imbalances.

And so, you know, a work in progress. It better start progressing pretty soon because the American people are running out of patience.

Your description, however--let me just summarize by saying your description today about these pieces was--a lot of it was new to me and really interesting to me. The e-commerce, the logistics, finance and so on, we have not had this kind of a hearing before, and I think the discussion of all of this is very, very helpful, helpful for us as we prepare to think through a report, and you might have, as you leave this table, you recognize just from our questions that we have different perspectives, but all of us have a pretty healthy skepticism about whether this is fair open competition between two systems that allow each other's businesses to have equivalent opportunities in the other country.

There's a lot of skepticism of that because we think the evidence suggests not. You make a point that I think is accurate: there has been progress. I mean I was in China a long, long time ago and saw a very different China than I see today. But this progress needs to move much, much more quickly from the standpoint of Americans who want jobs, businesses who want opportunities, in a country that wants to grow its economy.

So with that, it's time for lunch, and we're a few minutes over, but let me on behalf of all of the commissioners thank you. I think your testimony is extraordinary. Thank you very much.

HEARING CO-CHAIR HUBBARD: Thank you all.

[Whereupon, at 11:48 a.m., the hearing recessed, to reconvene at 12:47 p.m., this same day.]

PANEL II INTRODUCTION BY COMMISSIONER GLENN HUBBARD

HEARING CO-CHAIR HUBBARD: Good afternoon, everyone. I would now like to introduce the second panel of experts and, of course, thank them in advance for their testimony.

We will beginwith Michael Hirson, who is Asia Director at the Eurasia Group, where he leads the firm's coverage of China. Previously he served as the Treasury Department's Chief Representative in Beijing. In addition to his time in Beijing, he has worked on a range of international economic issues for the Treasury Department and the Federal Reserve Bank of New York, and he will provide an overview of the current state of China's financial sector reforms and discuss some opportunities and market access barriers for U.S. firms in China.

Next, we will hear from Anne Stevenson-Yang. Ms. Stevenson-Yang is the cofounder and research director at J Capital Research. Previously, she was a managing director at the U.S. Information Technology Office and led China operations for the U.S.-China Business Council.

She will testify on opportunities and market access challenges for U.S. financial firms in China.

Then we will hear from Zennon Kapron, the founder and director of Kapronasia. Prior to that, he was the Asia Pacific Financial Industry Manager and Global Banking Industry Manager for Intel. Prior to his work for Intel, he served as the Chief Information Officer for Citigroup in Portugal.

He will provide testimony on developments in China's financial technology sector and identify opportunities and challenges for U.S. firms.

Finally, Christine Bliss, who is the President of the Coalition of Services Industry, has provided a written testimony for the record, which is available on the website.

For the panelists, let me just offer a quick reminder to keep remarks to seven minutes, so that we'll have plenty of time for question and answers. Thank you, again, in advance, for your testimony.

Mr. Hirson, over to you.

OPENING STATEMENT OF MR. MICHAEL HIRSON, ASIA DIRECTOR, EURASIA GROUP

MR. HIRSON: Thank you very much. Co-chairs, members of the Commission, thank you for the opportunity to testify today.

Let me start by putting the issues that we'll be discussing in a broader context of China's financial sector reforms. China's financial sector has, of course, been long attractive to U.S. firms, and there was no question that the potential opportunities are particularly significant for services marketed to Chinese households.

China's middle class is, by some measures, already the largest in the world and is growing quickly but has traditionally been poorly served by the financial system. Households still lack wide availability of many important financial products that are mainstays in the U.S., such as reliable vehicles for long-term retirement savings.

Chinese households are also increasingly looking to diversify their wealth by moving some of it overseas, which is a role that U.S. firms are well placed to fill.

And yet, foreign firms have faced major challenges cracking China's financial sector due, in part, to significant market access restrictions and other impediments, formal and informal, imposed by China's government. Foreign firms account for less than two percent of China's commercial banking assets and have less than a six percent market share in insurance, for example, rates that are significantly below that of the United States and also China's peers among middle income countries.

Of course, the fact that China's financial sector assets have been growing at double-digit annual rates means that even with the flat market share many foreign firms are doing reasonably well in China and remain committed for the long-term. But it is clear that the role of foreign firms in China is far smaller than most people expected when China joined the WTO in 2001.

In terms of China's financial sector reforms, I think there are a number of areas that are helpful for understanding where we are today. Banks continue to dominate the financial sector in China, with a growing but still much smaller role for equity and bond markets. State-owned firms dominate the financial sector, particularly in banking. In recent years, the government has expanded some pilot programs that allow domestic private investors to set up new banks, but their market share remains very small.

Even throughout much of the reform period that started in the late 1970s, the Chinese government has administered the financial system with the core purpose of providing low cost funding to the corporate sector and, in particular, to state-owned enterprises.

There were two main losers in this system: households, who earned meager returns on their bank deposits, as the government mandated low interest rates in order to keep funding costs cheap for banks and their corporate customers; and private firms, particularly small and medium-sized enterprises, who have had a much harder time obtaining capital from the financial system than state-owned firms.

More broadly, the emphasis on financing state-owned enterprises and the implicit guarantee that state-owned firms still receive from the government has contributed to the weak efficiency of capital allocation in China. State firms are less efficient than the more dynamic private sector. With credit continuing to favor state-owned firms, China's economy has become reliant on ever-greater amounts of credit to achieve a given unit of economic growth.

Improving the efficiency of the financial system is essential if China is to successfully address its growing debt problems and maintain relatively high rates of growth in the future.

While financial reforms have been very gradual, there are several important financial reform efforts underway. These include: interest rate liberalization; broadening the availability of consumer finance; deepening the financial markets, equity and bond markets; and liberalizing the capital account.

And I think the important thing to keep in mind here is that foreign financial firms have much at stake in China's overall financial reforms, and this point really underscores the need for the U.S. government to continue to engage with China on the broad financial sector reform agenda, in addition to more specific market access barriers.

Now let me just say a word on those market access barriers. I think these fall into two main categories: ownership restrictions and then the more specific licensing and regulatory barriers that financial firms face in their specific sectors.

In terms of ownership restrictions, even more than 15 years after its WTO accession, China maintains major restrictions on foreign participation in the financial sector. According to the OECD, China has the second-most restrictive regime for foreign investment in the service sector of any economy in the G-20 and the most restrictive regime in the G-20 for financial services.

The most significant of these are ceilings on the share of equity that U.S. and other foreign firms can hold in their China operations. This is 20 percent for banks although banks have the option of operating as wholly foreign-owned banks. In securities and asset management, foreign investment is limited to a 49 percent share, and then life insurance, the limit is 50 percent.

In addition to ownership restrictions, foreign financial firms face a host of limits imposed by the specific regulators in their sectors. The key challenge in this area is distinguishing between requirements that arise from legitimate regulatory concerns and those that are arbitrarily directed at foreign firms and are intended, at least in part, to give domestic competitors an advantage.

Another restrictive area related to specific regulations is China's Cybersecurity Law, which I've outlined in my written testimony, and I'm sure we'll be discussing further.

Let me just turn to a few key recommendations that I would put to Congress and the administration in terms of how to maximize opportunities for U.S. financial firms in China.

The first is to deepen high-level engagement on China's broader financial sector reforms. In other words, the conversation shouldn't be just about market access. China's continued financial reforms are critical to the ability of U.S. financial firms to capture opportunities in China.

U.S. firms will do best in a financial system that rewards well-run firms that are efficient in deploying capital and managing risks. U.S. firms will struggle in an environment where regulations are opaque and capital is allocated based on political criteria.

The second is to use negotiations on a bilateral investment treaty to push for broad lifting of equity caps and other investment impediments, and in the meantime to push for incremental progress.

I believe the BIT, the Bilateral Investment Treaty, is very important to putting the U.S.-

China investment relationship, which is increasingly a political and economic flashpoint, on a fair and sustainable footing. The BIT is also the United States' best source of leverage for pushing for opening in finance and other services.

However, the United States must continue to make it clear to China that all progress on financial services opening cannot wait for the conclusion of BIT negotiations which still may be some years away.

My third recommendation is to engage China at the highest levels to ensure that the Cybersecurity Law and other technology policies that are implemented are done so without discrimination towards foreign firms. Again, we'll be discussing the Cybersecurity Law, but I think, suffice it to say, this is a top level agenda, even at the level of President Xi, and so it requires engagement really at the very highest levels of our system in order to make progress in this area.

And then, finally, the last recommendation is the United States should urge China to cease the use of regulatory measures as market access restrictions. In essence, we should be putting China on watch that we're also monitoring for how they implement regulatory restrictions and to ensure that those are not done in a discriminatory way.

Let me close there and turn it over to the other speakers and for questions.

HEARING CO-CHAIR HUBBARD: Thank you very much for your testimony.

PREPARED STATEMENT OF MS. MICHAEL HIRSON, ASIA DIRECTOR, EURASIA GROUP

U.S. ACCESS TO CHINA'S CONSUMER MARKET

Testimony before
The U.S.-China Economic and Security Review Commission
June 22, 2017

Co-chairs, members of the Commission: thank you for the opportunity to testify today.

Since December 2016, I have been the Director for China at Eurasia Group, an advisory and consulting firm based in New York City. In this capacity, I advise our clients on the policy environment in China and how it will impact their business. Our clients include many of the country's leading financial firms, and I spend much of my time each day on issues that pertain to the focus of today's hearing.

My view on these issues is informed by my previous career in the federal government. For the prior three years (2013-2016), I served as the US Department of Treasury's financial attaché to China, based at the US Embassy in Beijing. In this capacity and in earlier roles at US Treasury based in Washington, D.C., I was deeply involved in the US government's efforts to expand market access for U.S. financial services firms in China, promote China's broader financial sector reforms, and strengthen financial regulatory cooperation between the United States and China.

Part I. China's Financial Sector Opportunities in Context

Ia. Overview

China's financial sector has long been attractive to U.S. firms, and there is no question that the potential opportunities are particularly significant for services marketed to Chinese households. China's middle class is by some measures already the largest in the world and is growing quickly, but has traditionally been poorly served by the financial system. Households still lack wide availability of many important financial products that are mainstays in the United States, such as reliable vehicles for long-term retirement savings. Chinese households are also increasingly looking to diversify their wealth by moving some of it overseas, a role that U.S. firms are well-placed to fill.

And yet, foreign firms have faced major challenges cracking China's financial sector, due in significant part to market access restrictions and other impediments -- formal and informal -- imposed by China's government. Foreign firms account for less than two percent of China's commercial banking assets and have less than a six percent market share in insurance, for example, rates that are significantly below that of the United States and China's peers among middle income countries. Of course, the fact that China's financial sector assets have generally been growing at double-digit annual rates means that even with flat market share, many foreign firms are doing reasonably well in China and remain committed for the long term. But it is clear that the role of foreign firms in China today is far smaller than most expected when China joined the WTO in 2001.

My remarks will highlight some of the opportunities for US financial firms in China, and place these in the context of China's overall financial sector reforms. I will then discuss the major impediments facing foreign firms, which fall into the two main categories of ownership restrictions and broader business environment issues such as discriminatory licensing procedures. I will close with a few policy recommendations.

Ib. China's Financial Sector Reform Agenda

China's ongoing financial reforms provide important context for where the financial system is today and how it is likely to evolve.

Banks dominate China's financial sector, with a growing but still much smaller role for equity and bond markets; this is in contrast to the United States, where the equity and bond markets are far larger than the banking system. State-owned firms dominate the financial sector, particularly in banking. In recent years, the government has expanded pilot programs that allow domestic private investors to set up new banks, but their market share remains very small. Private firms are more prominent in sectors such as insurance, trusts, securities and asset management.

Even throughout much of the reform period that began in the late 1970s, the government has administered the financial system with the core purpose of providing low-cost funding to the corporate sector, and in particularly state-owned enterprises (SOEs). There were two main losers in this system:

(1) Households, who earned meager returns on their bank deposits as the government mandated low interest rates in order to keep funding costs cheap for banks and their corporate customers (a situation economists refer to as "financial repression"); and

(2) Private firms, particularly small and medium-sized enterprises, who have had a much harder time obtaining capital from the financial system than state-owned firms. Anecdotal evidence suggests that while access to finance for private firms has improved over the last decade, it remains significantly more difficult than for SOEs.

More broadly, the emphasis on financing state-owned enterprises, and the implicit guarantee that state-owned firms still receive from the government, has contributed to weak efficiency of capital allocation in China. State firms are less efficient than the more dynamic private sector. With credit continuing to favor state-owned firms, China's economy has become reliant on ever-greater amounts of credit to achieve a given unit of economic growth. Improving the efficiency of the financial system is essential if China is to successfully address its growing debt problems and maintain relatively high rates of growth in the future.

While financial reforms have generally been very gradual, several important reform efforts are underway:

Interest rate liberalization: China's government removed the final formal limits on interest rates in 2015, though it still uses informal "window guidance" to order banks to keep deposit rates within 1.5 times the benchmark rate. Going forward, the full removal of interest rate controls will help promote the efficiency of the financial sector by allowing the most competitive banks to offer higher interest rates to depositors and thus grab market share from less efficient peers.

Availability of consumer finance: In line with China's efforts to promote consumption growth, the government has encouraged broader availability of consumer financial products such as mortgages, which have grown very quickly in recent years. Chinese "fin tech" companies, including leading e-commerce firms such as Alibaba and Tencent, have exploited new technology platforms -- and, in some cases, regulatory gray areas -- to move aggressively into consumer-focused financial services, largely at the expense of less nimble state-owned competitors. Several additional policy efforts would help improve the market for consumer finance in China, including licensing third-party credit bureaus.

Deepening of financial markets: China's government has sought to reduce reliance on the banking system by further developing the financial markets. China's equity and bond markets are already among the largest in the world, but require deeper reforms to serve as stable sources of long-term financing and investment. Priorities include expanding the role of long-term institutional investors (including foreign investors), broadening the array of financial products, and improving investor protection and corporate governance.

Capital account liberalization: China's government continues to exercise strict control over cross-border capital transactions, particularly portfolio investment. The pace of capital account liberalization intensified between 2012 and late 2015 through initiatives such as the Shanghai-Hong Kong Connect Program. Capital account reforms have slowed, and informal controls on outward flows have even tightened, since China's mishandled exchange rate reform in August 2015 set in motion a cycle of exchange rate depreciation and large capital outflows. But over the long-term, China will further liberalize both inflows and outflows; this will likely be one of the most important trends in global finance over the next ten years and a key opportunity for foreign firms.

One key take-away from the above discussion is that foreign financial firms have much at stake in China's overall financial sector reforms. This point underscores the need for the US government to continue to engage with China on the broad financial sector reform agenda, in addition to more specific market access barriers.

Ic. Structural Opportunities for US Firms

The broad strength of the U.S. financial services industry means that there are few areas in which China does not represent a major growth opportunity, ranging from car loans to bond and equity underwriting. With the focus of this hearing on the household sector, two structural themes in China's economy are worth highlighting as examples -- by no means exhaustive -- of how U.S. financial firms can play an important role in China:

Funding Retirement: China is facing a daunting demographic challenge, the result of increased longevity and lower birth rates, with the latter exacerbated by the one-child policy. UN estimates show the number of people aged 65 and above growing from 131 million in 2015 to 371 million by 2050. As the median age of the population rises, China's dependency ratio (the population aged 65 and over relative to the working age population) will rise from 0.13 to 0.47. This will put an enormous strain on both the public social safety net and household finances to fund the retirement years, including rising health care costs.

Chinese households traditionally lack access to, or confidence in, investment vehicles that would help them meet these future needs, and frequently turn instead to property investment, or stowing money away in low-yielding banks deposits. U.S. firms stand to benefit by creating solutions in areas including mutual fund management, life insurance and insurance-linked investment products, private pensions, and private health insurance. U.S. firms are already active in many of these areas in China, most of which are still at a relatively early stage of development.

The lack of tax benefits for retirement savings is a key limit holding back growth of this sector. The United States should encourage progress in this area as part of China's ongoing tax reform efforts, as it will spur development of what could be an important part of households' financial safety net.

Outward Investment: Lack of capital convertibility has meant that Chinese households and firms have their wealth overwhelmingly invested within China. Particularly as China's economy continues to slow from peak rates, and with the currency no longer a safe one-way bet to appreciate, both households and firms have already sought to diversify their wealth by moving it more of it overseas. This trend has very far to run: by one estimate, non-government outward securities investment and direct investment accounts for only 13% of China's GDP, compared to an average of 90% of GDP for the United States, EU and Japan[31].

China has introduced several programs in recent years to gradually allow households to access foreign markets in a controlled manner, such as through the Qualified Domestic Institutional Investor (QDII) program and the Mutual Fund Recognition program with Hong Kong. The further expansion of such programs will be very gradual for at least the next 1-2 years, given China's concerns that outward capital flows could jeopardize the stability of the exchange rate and broader financial system. Over the long-term, however, China's government will almost certainly create more windows for households to access external financial markets, aware that blocking such

[31] Source: DBS Group Research, "China: Outbound Investments Intact", May 5, 2016

efforts would be difficult and counter-productive. Chinese households will need investment services from firms that can serve as bridge to U.S. and global financial markets.

Part II. Market Access Barriers for U.S. Firms in China

IIa. Ownership Restrictions

Even more than 15 years after its WTO accession, China maintains major restrictions on foreign participation in the financial sector. According to the OECD[32], China has the second-most restrictive regime for foreign investment in the service sector (behind Indonesia) of any economy in the G-20, and the most restrictive regime in the G-20 for financial services [Table I].

The most significant of these restrictions are ceilings on the share of equity that U.S. and other foreign firms can hold in their China operations. China has been gradually lifting these "equity caps" across different parts of the financial sector, due in significant part to sustained engagement by the U.S. government through bilateral dialogues. Nonetheless, within the main areas of the financial sector, foreign firms are still not permitted to control a majority share of a joint venture. In commercial banking, a single foreign firm can hold no more than 20% of a joint venture, although it also has the option of operating as wholly foreign-owned bank. In securities and in asset management, foreign investment is limited to a 49% share, and in life insurance the limit is 50%.

The restrictions on foreign firms' ability to exercise control over their China business is a major barrier. This is particularly the case for foreign firms that are seeking to invest and grow their China operations; they are often contributing most of the financial and human capital in the business, while the joint venture partner receives the majority of the profits and exercises management control.

Lifting and eventually removing equity caps in financial services and other sectors has been a key rationale for the United States to negotiate a Bilateral Investment Treaty (BIT) with China. While talks have been underway for many years, they intensified in 2013 after China agreed to negotiate under the principle of national treatment and through a so-called "negative list" approach. The two sides made substantial -- though still insufficient -- headway on key issues in the final year of the Obama Administration. Public comments by US officials suggest that the Trump Administration is still formulating a position on whether it wants to take the BIT forward.

My view is that as long as the United States can secure a suitably ambitious offer from China, the BIT remains the most effective vehicle to make progress in lifting equity caps. For one, the comprehensiveness of the agreement is more likely to lead to broad opening than a series of one-off commitments on market opening under annual bilateral dialogues. Just as importantly, China's leadership has made clear that signing the BIT is one of its major priorities, giving the United

[32] OECD FDI Regulatory Restrictiveness Index (http://www.oecd.org/investment/fdiindex.htm)

States important leverage in pushing for significant liberalization in financial services and other areas.

However, the U.S. should not allow BIT talks to stymie progress on market opening altogether, particularly if prospects for reaching final agreement seem several years away. The United States should continue to push China to lift equity caps in financial services through bilateral dialogues such as the upcoming Comprehensive Economic Dialogue. Chinese officials and even Chinese firms increasingly recognize that further liberalization will benefit China by attracting additional capital and know-how to China's financial sector.

Outside of the bilateral context, China's State Council announced in January 2017 its intention to further liberalize foreign investment in a variety of sectors, including financial services. Such commitments are welcome, but there are few details and similar announcements by China in the past have failed to produce significant market opening without an external push from the United States or China's other major trade partners.

It is worth noting that in mid-May, China announced several market access measures in the financial sector as part of the 100-day action plan now under negotiation with the Trump Administration. These include a commitment to allow wholly foreign-owned financial services firms in China to provide credit rating services, and a commitment to issue remaining guidelines for U.S.-owned suppliers of electronic payment services (EPS) to begin the process to receive licenses in China. These commitments are not breakthroughs -- the commitment on EPS comes a full five years after China lost a WTO dispute brought by the United States in this sector -- but they are at least positive signals towards potential further opening in financial services.

IIb. Licensing and Regulatory Barriers to Market Access

In addition to ownership restrictions, foreign financial firms face a host of limits imposed by the specific regulators in their sectors. The key challenge in this area is distinguishing between requirements that arise from legitimate regulatory concerns and those that are arbitrarily directed at foreign firms and are intended at least in part to give domestic competitors an advantage.

This distinction is often difficult to make in practice. China's financial regulators lack political independence, and have at least an informal mandate to promote growth of the domestic market and domestic firms in addition to traditional regulatory objectives like financial sector soundness. China will frequently use the granting of licenses to specific foreign firms as a bargaining chip in bilateral negotiations. China's self-regulatory organizations (SROs) in the financial sector also present a challenge when it comes to the awarding of specific licenses under their remit: the SROs are comprised of Chinese firms, who are essentially deciding whether they want to allow market access for foreign competitors -- and the answer is often that they do not.

This blurring of regulatory and market access discussions is exceptionally challenging for foreign firms since the guidelines and criteria are often opaque. It also a challenge for the US government in acting on behalf of firms, since US agencies -- particularly independent regulators --

appropriately seek to avoid pushing foreign counterparts to lower or regulatory standards for foreign firms.

Consistent engagement by the US government has been effective at addressing many problematic areas. Through the Strategic and Economic Dialogue, for example, the US won agreements by China to shorten a needlessly long three-year waiting period by which foreign banks were required to wait before engaging in RMB-denominated business. And in the last twelve months, China has agreed to issue several important licenses for the bond market to qualified US firms.

Nonetheless, arbitrary and discriminatory regulatory restrictions will remain a challenge for the foreseeable future. There are few easy solutions to addressing these issues other than persistent pressure from the United States for China not to treat regulatory matters as intentional barriers to foreign firms.

I do not believe it is inappropriate for the United States to warn China that such behavior will ultimately lead to a less welcoming attitude towards similar Chinese investment in our markets. However, the United States should avoid reciprocal treatment, in the sense of a similar blurring of regulatory and market access issues, as that would undermine the effectiveness and transparency of both U.S. financial regulation and our investment regime.

IIc. Restrictive Technology Policies

Cybersecurity Law

China's Cybersecurity Law, which became effective on June 1, is a significant source of concern for foreign financial firms and other information technology companies. Much will depend on how China implements the law and accompanying regulations. At least on paper, the law raises two key issues for foreign financial firms:

Provision on cross-border data flows. As drafted, the law and accompanying draft measures require companies to conduct a review of data protection processes before transiting customer data across borders. Beijing has postponed compliance with these measures until the end of 2018, giving financial firms time to understand how to implement processes to comply with requirements. Since foreign firms operate much of their underlying IT infrastructure outside China, elements of the new regulation could hamper their ability to serve customers within China. Chinese officials have indicated that data transfers involved in normal business operations may not be subject to the reviews, and regulators in different sectors may interpret the measures differently. Adding to the confusion are questions about data definitions used in the measures and what the final language will look like.

"Secure and controllable" procurement. The law requires "critical information infrastructure" operators, which includes the financial services sector, to use products that meet China's standards of "secure and controllable" technology. To qualify as secure and controllable, products must undergo a cybersecurity review process whose full parameters are still unclear. A number of factors suggest that some foreign IT firms will find it challenging to pass this new review process, which early indications suggest may require access to source code and details about supply chains.

While China claims the review process does not discriminate against foreign products—and some foreign network products have passed informal reviews—implementation of the reviews could favor Chinese technology firms and put Western firms at a disadvantage. For foreign financial services firms, the danger is that firms will be unable to use significant parts of their global IT infrastructure in China, and forced to use domestic substitutes. Depending on how China implements its regulations in practice, this could result in anything from an irritation to a major business impediment.

China has focused on commercial banks and insurance firms as the two focal points to date for cybersecurity in the financial sector, but the broad sweep of China's cybersecurity efforts indicate it will reach across financial services (draft cybersecurity regulations for the securities industry came out earlier this year). Fin tech firms will face particularly steep challenges navigating not only the Cybersecurity Law, but China's increasingly restrictive policies in the technology sector more broadly.

Part III. Key Recommendations for Congress and the Administration

Below are recommendations for the Congress and the Administration with respect to engaging China on market access issues and broader reforms in the financial sector. Over the next nine months, China will undergo a significant reshuffling of the leadership of the Communist Party and the government. This transition may somewhat complicate the process of engagement on these issues in the short term, though it also provides an opportunity to start fresh with a new round of senior officials as they take up their posts.

(1) Deepen high-level engagement on China's broader financial sector reforms. The conversation shouldn't just be about market access. China's continued financial reforms are critical to the ability of U.S. financial services firms to capture opportunities in China. U.S. firms will do best in a financial system that rewards well-run firms that are the most efficient in deploying capital and managing risks. U.S. firms will struggle in an environment where regulations are opaque and capital is allocated based on political criteria.

There are two other enormously important reasons for the United States to maintain a robust dialogue on financial regulatory issues: (1) to help China deal effectively with mounting financial risks, which pose a threat to China's economic stability and hence to U.S. and global growth; and (2) to strengthen cooperation between U.S. and Chinese agencies on cross-border regulatory issues, which are already important and will become even more so as China's financial sector continues to open up and integrate with global financial markets.

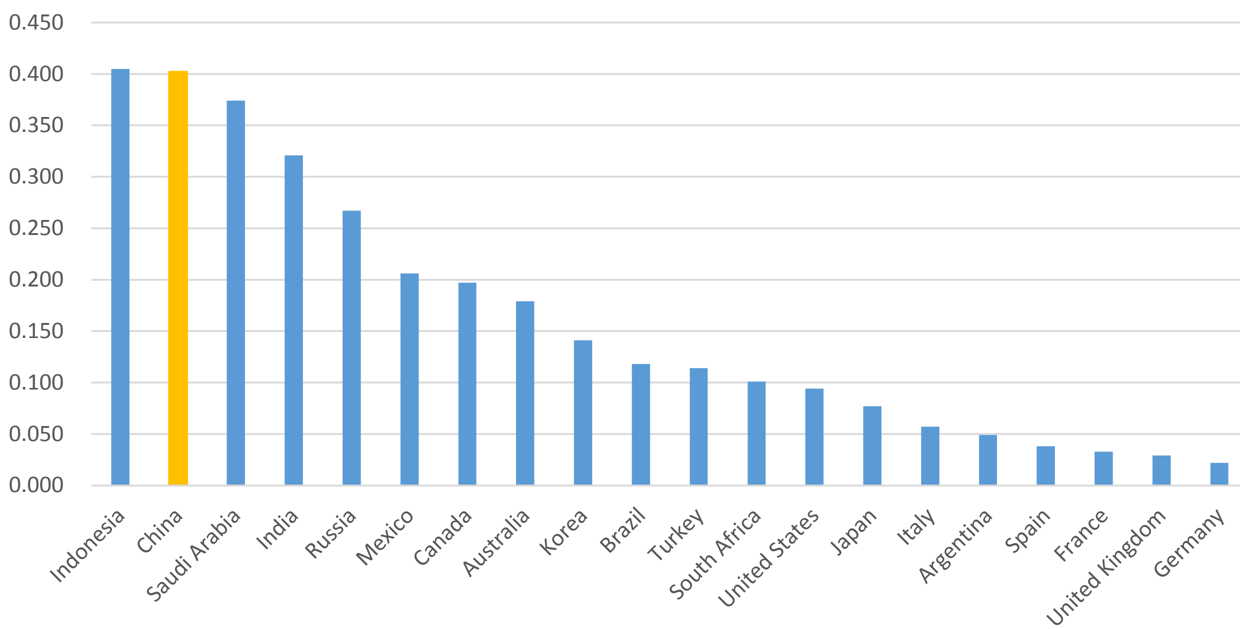
(2) Use the BIT to push for broad lifting of equity caps and other investment impediments, but push for incremental progress in the meantime. I believe the BIT is very important to putting the U.S.-China investment relationship -- which is increasingly a political and economic flashpoint -- on a fair and sustainable footing. The BIT is also the United States' best source of leverage for pushing for broad opening in finance and other services. However, the United States must continue to make it clear to China that all progress on financial services opening cannot wait on the conclusion of BIT negotiations, which may still be years away. The United States should use the Comprehensive Economic Dialogue and other bilateral tools to encourage China to announce at least incremental market opening in the meantime.

(3) Engage China at the highest levels to ensure that the Cybersecurity Law and other technology policies are implemented without discrimination towards foreign firms. The challenges posed to U.S. financial firms show that China's increasingly restrictive technology policies are not only a detriment to U.S. technology firms, but have a much broader impact. China's technology policies are a core aspect of President Xi Jinping's policy agenda. The United States will only be effective engaging on these issues if concerns come are conveyed to China by the very highest levels of the Administration. Congress should also continue to make its concerns known, noting to senior Chinese leaders that China's discriminatory technology policies are detrimental to the broader bilateral relationship.

(4) Urge China to cease the use of regulatory measures as market access restrictions. The United States should monitor China's broad use of regulatory measures as market access restrictions, keeping in mind that such distinctions are often difficult to make with respect to individual measures. The goal should be to convey to China that the United States is on the watch for discriminatory practices, and for evidence that China may use informal market access restrictions to impede foreign firms even as it seeks to liberalize formal investment measures such as equity caps.

Appendix:

Table I. Restrictiveness toward FDI in services among G-20 economies (2016)



Source: OECD FDI Regulatory Restrictiveness Index
(http://www.oecd.org/investment/fdiindex.htm)

OPENING STATEMENT OF ANNE STEVENSON-YANG, RESEARCH DIRECTOR, J CAPITAL RESEARCH

HEARING CO-CHAIR HUBBARD: Ms. Stevenson-Yang.

MS. STEVENSON-YANG: I was hoping to give you a couple of my minutes there. But thank you to the Commission for listening to my testimony, and I make no attempt here to be comprehensive.

I'm just trying to give an overall view of what I think the core impediment is to U.S. market access, and I already gave you my written statement. So let me just summarize.

I think that market access for foreign financial services has declined in China since the entry to the WTO even as China's financial markets have sort of exploded. China's bank assets are around US$23 trillion. Including non-banking financial service assets, financial services sector assets, they're around $37 trillion. This is up from about five just after the time of WTO entry.

And U.S. bank assets in China, I'm not sure what the number is, but certainly in the tens of billions. So a very, very small portion and a smaller portion than was represented at the start of the WTO. So why is this? It's essentially because Chinese regulatory authorities want political and not only regulatory control of the financial sector.

They need this in order to fend off defaults, direct capital to favored sectors and companies, keep capital from companies that they consider to be too risky, and otherwise sort of micromanage the economy, and as more problems emerge in China's economy, this tendency becomes more pronounced than it used to be.

In other words, the Chinese system is fundamentally antagonistic to rule-based governance, and financial institutions one might say are the beating heart of the Chinese economic system. So one can understand why there's a sort of political reluctance to allow broad market access.

So a philosophic difference between the U.S. and China in trade and investment philosophies is inevitable, but U.S. negotiators can make progress by focusing on some achievable goals. So some of those might include, number one, ending the foot-dragging and high investment requirements for regional licensing of both bank branches and insurance companies, and seeking an end to the 20 percent cap on equity holdings in Chinese banks.

Also I think much neglected in the market access dialogue is the importance of a healthy support system for financial institutions. China's markets are bedeviled with scarce and often frankly false economic data and with poorly informed analysis.

This situation would be immediately and materially improved with some of the following changes:

One would be to require corporate disclosure of basic ownership data and financial statements. This disclosure has gone dramatically backward since March of 2016 or 2015--I forget which it was--when China made the disclosure of financial data optional. And also require disclosure of corporate tax payments. This would significantly help the U.S. investor who needs to assess the validity of the statements of Chinese companies that are listing in the U.S. and gathering tens of billions of dollars from U.S. investors.

Second, make these statements unambiguously public and make them available to foreign and domestic credit bureaus and economic research companies for collation and publication.

Third, allow international brokerages and independent research providers unfettered access to this financial data and allow them to establish wholly foreign-owned subsidiaries that would be governed by the CSRC and can issue reports within China.

Then allow the PCAOB to audit its own member firms, accredit U.S. audit firms in China, and then grant third-party payments providers foreign third-party payment provider licenses. This is a very important impediment to the development of not only to the U.S. financial sector but to U.S. e-commerce and some other aspects of commercial companies. The third-party payment's license would be key to allowing a company like Amazon or eBay to compete on equal footing with Chinese companies.

And finally I think engage China at a very high level on the Cybersecurity Law. The secrecy surrounding financial and other data is a key impediment to the development of financial services, both foreign and Chinese, and the Cybersecurity Law creates a new framework, a new more--let's say these practices have been in place for quite a long time in China, but the Cybersecurity Law elevates it to a higher level in the government, creates a framework that many different bureaucracies are engaging with, and allows an access point for our own negotiators to discuss.

So there was the minute-and-a-half I wanted to give to you.

[Laughter.]

HEARING CO-CHAIR HUBBARD: Thank you very much.

PREPARED STATEMENT OF ANNE STEVENSON-YANG, RESEARCH DIRECTOR, J CAPITAL RESEARCH

U.S. ACCESS TO CHINA'S CONSUMER MARKET

Testimony before
The U.S.-China Economic and Security Review Commission
June 22, 2017

In the 16 years since China entered the WTO, the incremental growth in its financial system has exceeded the total size of the U.S. financial system (see Chart 1). And yet the participation of U.S. financial institutions in the market has proportionately diminished. In many ways, the explosion of credit in China has been a family affair: China's government has force-fed credit to property developers and local governments for capital construction and then enabled the general securitization of debt, allowing it to move like a river among regions and institutions until it becomes impossible to distinguish sound assets from unsound or to isolate bad debt by region and type. It is not necessarily bad that U.S. institutions have largely been kept out of this market.

Market Access for Banks

When China signed on to the WTO in 2001, its government promised foreign banks "full national treatment" within five years. Instead, the foreign banks that do operate in China have been increasingly marginalized. Since the stimulus program of 2008, foreign bank assets in China have sharply diminished as a proportion of the total.[33] Foreign market share in terms of assets is about 1.5%. This compares with an average of 20% share for foreign banks in emerging markets, according to the OECD.[34] By contrast, there are 13 Chinese banks among the world's largest 100.

Rules ensure that foreign banks cannot compete: foreign banks are limited to acquiring 20% of equity in Chinese banks and 49% in brokerages and various types of financial service companies. Their regional and branch expansion is dramatically curtailed by the withholding of licenses. Without branches, they cannot collect deposits, and without deposits, they cannot extend loans, because loans are strictly limited to a proportion of deposits. Foreign banks also face restrictions

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[33] See "European Business in China Position Paper 2015-16": http://www.europeanchamber.com.cn/en/publications-position-paper

[34] See "Foreign Banks: Trends, Impact and Financial Stability," https://www.imf.org/en/Publications/WP/Issues/2016/12/31/Foreign-Banks-Trends-Impact-and-Financial-Stability-25618

on their investment activities that Chinese banks do not and consequently cannot easily expand their balance sheets by partnering with non-banking financial institutions, something that is routine fore Chinese banks. So the market is open, technically, but closed in practice via the regulator's control of partnering activities and approval process over branch expansion and other commercial processes.

The deeper and more intractable problem impeding market access for foreign banks is the unease felt by Chinese regulators with their lesser political control of foreign banks. Chinese regulators frequently issue verbal instructions to banks. Some examples are "window guidance" indicating how much foreign currency may be remitted in a given month or instructions to borrow or lend money in the interbank market at a given rate. Foreign banks, which must answer to their own regulators and to shareholders, are less inclined than Chinese banks to follow these verbal instructions, and regulators tend to be unwilling to grant them broader licenses.

As a consequence of these restrictions, foreign banks in China essentially exist to serve their foreign clientele with trade financing.

The Chinese financial system would be much healthier, and foreign financial institutions in China much larger, if China allowed the market access it promised in 2001:

- End restrictions on foreign bank branch licenses
- End minimum set-up staffing and capital requirements and simplify branch closing rules
- End caps on foreign ownership of brokerages and funds
- Allow foreign banks, brokerages, and fund managers exactly the same license scope as that available to Chinese institutions.

Securities Markets

China's securities market consciously operates as a roach motel for hard money: incoming investment is warmly welcomed. Profit repatriation and fund redemption are fought tooth and nail. The goal of Chinese financial regulators is not transparency or best practices; it is a net influx of capital. While China's currency was appreciating and its domestic rates of return high, this was acceptable to foreign institutions. That is starting to change. In the next couple of years, foreign financial investors are likely to become much more demanding.

Some of the market rules that tend to trap money invested by foreign securities firms include:

- Periodic "window guidance" that limits Chinese banks' willingness or ability to approve foreign remittances
- Low quotas for Qualified Domestic Institutional Investors and Qualified Foreign Institutional Investors (QDII and QFII). The former are domestic institutions that may invest in overseas securities markets, and the latter are foreign institutions that receive a RMB quota for investing in Chinese securities.
- A limit on capital repatriation of 20% per month
- Lack of clarity on the tax treatment of trading gains realized by foreign funds in China
- Internal guidelines that direct underwriting deals to domestic institutions.
- Quotas on foreign debt permitted to domestic investors that limit shareholder loans
- Pre-approval requirements for funds investing in Chinese securities

Insurance

Foreign insurers are hampered by the limitations on regional expansion that beset foreign banks. After 25 years' operating in China, for example, American insurer AIA, the first foreign insurer in the Chinese market, is permitted to operate only in three cities and one province in China, while its domestic competitors operate nationally.

Foreign insurers are also restricted from investing in the assets that have enabled Chinese insurers to sell high-return universal policies and bancassurance products. While a typical Chinese insurer sells universal products that yield 4-6%, American companies can generally offer only about 2%, making them uncompetitive. These rules may, ironically, have kept the foreign insurers' balance sheets clean, but that is an issue for management to decide.

More insidiously, Chinese government authorities frequently intervene in the settlement of claims without permitting adequate investigation and discovery. Some major accidents are classified by the government, ad hoc, as state secrets, and the settlement of insurance claims is then directed by authorities without adequate disclosure.

These practices have undermined not only the profitability and scope of American insurers but the health of the Chinese market.

Fintech

Fintech is among the more promising areas of financial services for U.S. companies but also one of the most closed to foreign participation.

The two major categories of fintech are payments and virtual currencies, with payments being much larger and more economically significant.

The first problem for foreign investors is that a “third party payment provider” license is required in order to operate a payment system like Stripe or PayPal and no such licenses have been issued to foreign companies. Current regulations do not prohibit foreign investment in this segment, but they anticipate specific foreign investment rules, which have not been issued.

The second problem is that Chinese regulations make payments fundamentally unprofitable. Regulators in September 2016 limited interchange fees to 65 basis points for most types of transactions. This compares with total fees in the U.S. market of between 1.4-3.5% and often higher. These interchange fees are split among an issuing bank, which issues the customer’s credit or debit card, an acquiring bank, which holds the merchant’s account, a card scheme like Visa or Mastercard, and the interbank payments system. Often these parties use technology providers as subcontractors

Chinese third party payments companies are often willing to lose money on payments to achieve other objectives. It is also an open secret that many of them invest the float they carry before remitting cash to all parties, even though this is not technically permitted. Foreign companies would be unlikely to do that, i.e. operate in compliance gray areas, which is the modus operandi of most Chinese firms across many sectors, and a soft access barrier in effect for foreign companies.

These two sets of regulations mean that foreign payments providers and card schemes face highly circumscribed and generally money-losing markets, if they can play in the China market at all. The payments restrictions are also a key impediment to U.S. e-commerce, since a proprietary payments system is a key competitive advantage.

Virtual currencies were the predecessor or third-party payments systems; it is no coincidence that Tencent, which has the second most popular payments system after Alipay, was the issuer of the biggest virtual currency in China, the QQ coin. Because of their role in money laundering, virtual currencies and newer cryptocurrencies are now being closely monitored by Chinese regulators whether managed by foreign or Chinese companies, but Chinese companies have so far enjoyed some advantages:

- Direct government subsidies and access to below-market prices for the electric power needed to mine Bitcoin, Ethereum, and other virtual currencies
- Right to operate exchanges within certain limits
- The right to retain mined Bitcoin and Ethereum for investment

Data Protection, Data Privacy, Encryption Regulatory Structure Evolving

China has always maintained a complex and opaque information regime whose hallmark is the ability to sanction virtually any use of information that is ex post facto determined to be politically threatening. The definitional scope of "national security" provides the bulwark, technically within the confines of WTO rules.

Elements of this regime include regulations prohibiting encryption that is not transparent to Chinese authorities, restrictions on access to certain types of financial data, and much more. With the official entry into effect of the Cybersecurity Law on June 1 this year, authorities have finally developed a national legal structure for implementing rules and regulations governing personal data, corporate data, and data deemed important to the state ("important data"). Chinese officials claim that these new regulations will not place restrictions on corporate operational data transfers across China's borders, but have defined "important data" broadly, and it is unclear how specific cross border data flow measures will be implemented and enforced. Beijing has postponed compliance with the measures until the end of 2018 to provide time for companies to understand how compliance will work. Chinese officials claim that the measures are "convergent" with international practices, such as the EU General Data Protection Regulation (GDPR), but there are many areas that will require further clarification.

Financial sector data have long been a sensitive issue in China, and the potential inclusion of e-commerce companies under the critical information infrastructure provisions of the new cybersecurity law is likely to further complicate financial data flows. Ways in which the regulatory system already inhibits foreign activity in the financial services industry include:

- Classification of audit records as secret. This makes it impossible for U.S. regulatory bodies to review the audits conducted on firms that are publicly traded in the United States.

- Internet information services licensing rules: These make it practically impossible for U.S. financial news services to operate in China.
- Personal information protection standards: A revision of these standards is expected in the near future. Currently, the standards make it difficult for U.S. data-analysis companies to access consumer databases and provide intelligence. The play space is gray, creating in effect a compliance barrier to entry – and foreign companies are prohibited from housing data, much less owning it. Foreign companies are prohibited from engaging in the aggregation and management of credit records. Among other things, this forces banks into unhealthy collateral-based lending.
- Alleged national security issues justifying Chinese government constraints on sharing and examination of working papers, Mainland tax filings and registration information, and other information sources relevant to regulatory assessment of the accuracy and integrity of financial reports.
- Rules on surveys: Current rules, observed in the breach, require that all surveys be conducted in conjunction with the National Bureau of Statistics, which has the right of review and must receive payment. This is a key impediment to market research to support a range of financial services.
- Arbitrary designation of information as secret: Every foreign organization that deals with data in China must be concerned that collecting newspaper reports, conducting phone interviews, and maintaining databases may at some future time be designated a violation of state secrets. Penalties for violating state secrets are draconian.

U.S. Regulatory Tools

While the U.S. government concerns itself with baby steps toward market access in China, it ignores the risks being imposed on U.S. investors by wide access to our own equities markets.

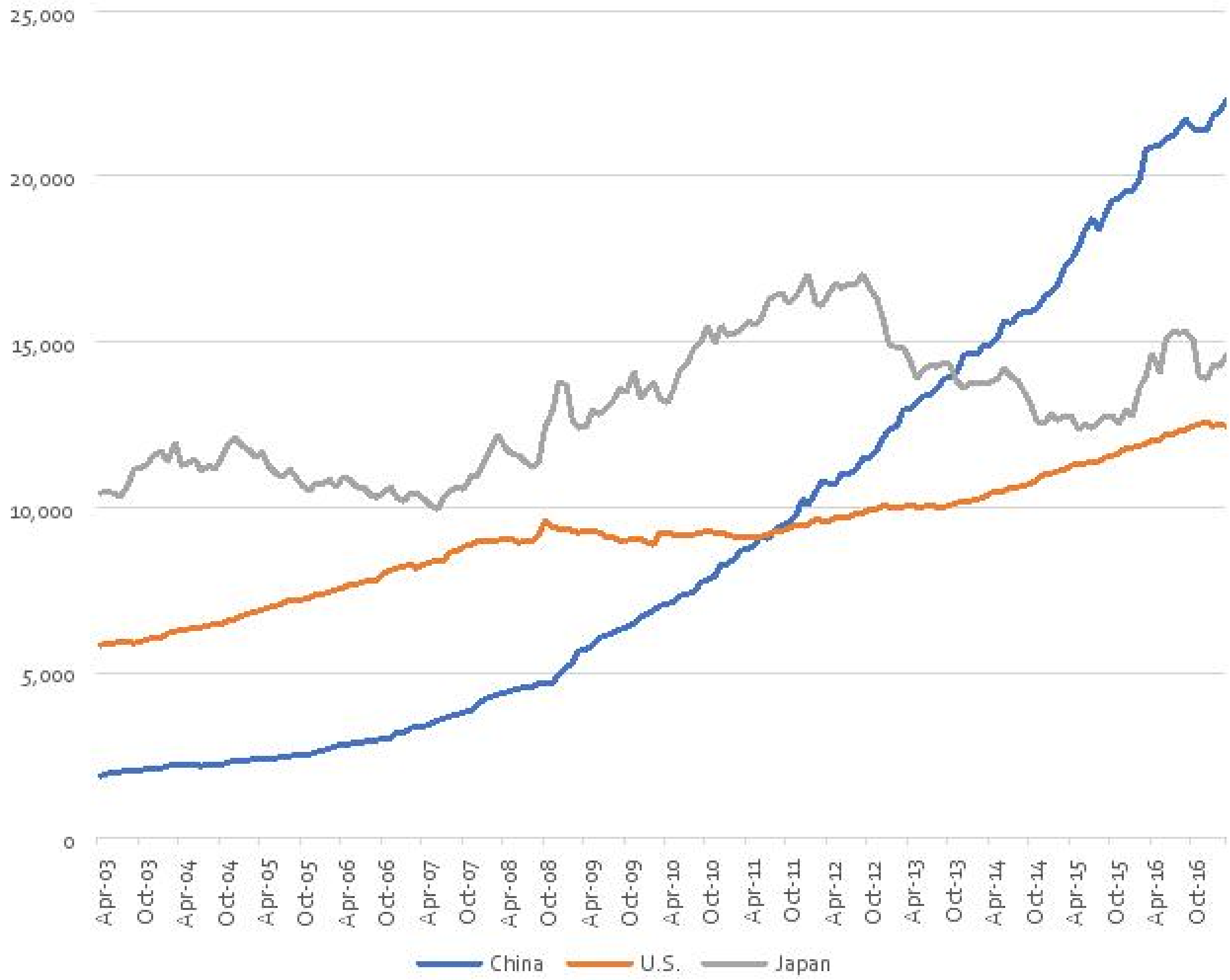
Organizations in the U.S. responsible for assuring the integrity of our capital markets were unprepared and understaffed to deal with the scale and unique characteristics of the Chinese inrush to U.S. capital markets, and many marginal or outright fraudulent Chinese entities have extracted substantial resources from investors, while those investors have been left with limited or immaterial remedies.

Among the unique characteristics that have challenged the regulators, unique in scale if not basic nature:

- The wide use of reverse mergers to achieve backdoor listings involving totally unrelated industries, primarily to avoid the normal listing disclosure and reporting requirements.
- Where basic data like domestic tax filings has been accessible, major discrepancies between those declarations and formal filings with the SEC are commonplace.
- There is a dense curtain obscuring ultimate ownership, making it difficult to map related-party activities in both pre and post IPO investment flows and the resultant impact on calculated market capitalization, use of proceeds, material M&A activities, and the like.
- Undisclosed insider buying and selling campaigns in the open markets themselves, fueling substantial price moves by entities domiciled in China but of indeterminate ownership and hence relationship to the listcos themselves, resulting in insider profiteering and manipulation that is extremely difficult for the regulators to identify and control.

While these issues do not affect U.S. market access to the Chinese market, they suggest that the U.S. government has powerful regulatory tools with which to impel Chinese entities that want to continue to access U.S. investment to improve disclosure, lobby for market participation by respected international auditors, brokers, lenders, research companies, credit bureaus, and the like, and playing according to international rules.

Chart 1: Bank Assets, U.S., Japan, and China



Source: People's Bank of China, Federal Reserve, Bank of Japan. Exchange rates: YTCI.com, Chinamoney

OPENING STATEMENT OF ZENNON KAPRON, DIRECTOR, KAPRONASIA

HEARING CO-CHAIR HUBBARD: Mr. Kapron.

MR. KAPRON: I'll take your minute-and-a-half.

HEARING CO-CHAIR HUBBARD: Okay.

MR. KAPRON: I'd like to start out by giving an anecdote. We did a research paper with the U.N. a couple of months ago and interviewed Kaiyu Ma. Kaiyu Ma is a young mother in the city of Ordos in Inner Mongolia in northern China. She lives far away from the hustle and bustle of China's major cities but still has managed to find a place in China's growing digital ecosystem.

Ma is an active user of digital payment services and finds them indispensable for many of her daily activities. She uses the Alibaba Taobao and Tmall e-commerce platforms to shop for her 18-month-old daughter, often ordering from merchants located a considerable distance away from Ordos.

Ordos was once considered one of China's "ghost cities," the term that was given to cities that were purposely constructed to bring development into second-tier, third-tier regions of the country. A cottage industry in Ordos has developed of young mothers selling clothing, accessories, shoes and bags online to supplement income. This is especially important as Ordos was heavily hit as the natural resource decline. Ordos was heavily reliant on coal production and was hit by the slowdown in China's energy sector.

Ma is part of this group. She runs a small store selling used clothing on Taobao and she says it's a great way to earn money for her family and her daughter and to feel that she's contributing economically to the family.

In many ways, Kaiyu's embrace of digital payments and digital e-commerce is emblematic of the country as a whole. Everyday across China, hundreds of millions of consumers and businesses use digital platforms, digital payments, mobile payments, to conduct their daily financial lives.

At a micro level, digital finance allows individuals like Kaiyu to improve their own or families' lives. At a macro level, digital payments have the potential to dramatically improve living standards for large sections of the population, especially in developing areas of the country, through increased transparency, security and lower costs.

Internet finance, as fintech is commonly known in China, has enabled financial inclusion and economic empowerment in a way that was previously impossible in China, largely because of the geographical, cultural and economic diversity of the country itself.

China's Internet boom started with digital payments but has since expanded to include all aspects of the financial industry. On a mobile app, I can buy wealth management products; I can split the bill with my friend; I can book a ridesharing, either on a bicycle or on a Uber-like service.

While all of this has been good for the financial industry and the economy as a whole, risks remain. In 2016, more than 1,700 of China's peer-to-peer lending platforms, online lending platforms, closed, leading to huge losses for investors and borrowers. Many, in addition, claimed that China's $9 trillion in wealth management products is largely a ticking time bomb. Traditional players also struggle to compete in the new digital finance landscape.

This innovation and stability paradox that fintech poses is a challenge for governments globally, but is even more so the case in China, where the financial industry is relatively undeveloped yet remains a critical part of the nation's economic growth in terms of infrastructure and lending.

Even as China's government and regulators seek to cross the river by feeling the stones and allow the growth of new platforms and services like digital payments and peer-to-peer lending, they are also very cautious about creating potential risks to economic growth.

Arguably, as was discussed this morning, many of China's 2001 WTO Agreement commitments were approached with much the same intent. Industry reform was often delayed to protect the stability and growth of the domestic market. If the market had opened up immediately to foreign banks in 2001, as per the WTO commitment, the sector itself would have likely collapsed along with the economy itself.

Some WTO commitments still remain outstanding such as allowing foreign payment schemes like Visa and Mastercard to operate renminbi businesses in China. Therefore, trying to influence the Chinese regulators to make changes on a schedule that does not match their own is a fool's errand.

Regardless of the comments, threats or negotiating tactics used by foreign governments, China's regulators will move forward at their own pace. That is not to say that the U.S. government should not be engaging China to further open up its financial industry. I would argue the opposite.

The U.S. government will be more successful through three recommendations that I have put forth in the testimony. The first, as mentioned before by Michael, is a deeper engagement on regulatory issues. One of the aspects of the WTO commitment was opening up the payment markets to Visa and Mastercard, companies like this.

From what we've heard talking to them, the challenge is not getting the license or the government telling them, yes, you can come into the market, but is the detail about implementation. One of those companies set up all of their IT systems. There was an audit by one of the regulators. They were told that they needed to redo the entire system leading to a nine-month delay.

Although the talk about the 100 Day Plan, the WTO commitments, is great, and it's good to see that the current administration is engaging with China around this, a deeper level of engagement is critical to ensure that we move beyond good PR talking points to actually things that matter to the companies on the ground.

The second point is refocus on the finance of the future. We were discussing payment cards. Payment cards--I am obviously not Chinese, but I've lived in China for 13 years. Alibaba every year does a summary of your spend using mobile payments. In 2016, I spent $65,000 in mobile payments. Now some of that was for company expenses like buying laptops and things, but arguably my engagement with these digital platforms mirrors many of the people in China. I have not touched my debit card in the past three weeks nor handled cash in the past week.

We need to refocus on the financial products of the future. Stop worrying about the payment cards and credit rating. Start worrying about the digital credit rating. Start worrying about digital payments.

Thirdly, we need to start paying more attention to the global expansion of the tech giants internationally. Companies like Ant Financial, the finance arm of Alibaba, and Tencent have expanded rapidly globally here in the states with the partnership with First Data and with the potential acquisition of MoneyGram. What we sometimes fail to realize in this is that these expansions could be a direct threat to America's national security globally.

As they have access to payment systems, payment systems, especially in developing countries, are very critical for the growth of those countries. As was discussed in the panel this morning, although the government may not have set up Alibaba, it definitely has influence in that and investment in that. There are political relations between the companies.

We need to pay attention too as these countries are expanding internationally because it could affect the influence that the American government has as we look beyond our borders.

Finally, not all the answers are in China. Some of the answers are here in the United States as well. On one aspect, companies like PayPal are forbidden from operating in China. On the flip side, we have companies like Alipay that have now signed agreements to be accepted in the U.S. and presumably entering the market more.

So as we look forward, I would encourage the Commission and government in general look beyond the traditional financial services play because the future in China has gone digital.

Thank you.

PREPARED STATEMENT OF ZENNON KAPRON, DIRECTOR, KAPRONASIA

U.S. ACCESS TO CHINA'S CONSUMER MARKET

Testimony before
The U.S.-China Economic and Security Review Commission
June 22, 2017

Introduction

Near our previous office in Shanghai, there was an elder craftsman named Mr. Wang. Every morning, he would setup his modest sidewalk stand, which was nothing more than a few milk crates with a piece of wood and cloth on top, and gradually bend long strands of wire into the shape of small bicycles – the kind of model that you would put on your desk or dresser.

Each bicycle model took him about an hour to make, which Mr. Wang then sold for about $4 each. On an average day, he sold about 10 of the wire bicycles, netting him, about $8,000 a year. Not a bad salary in a country where the average yearly income in 2015 was $7,925.[35] After walking by his stand numerous times, I finally bought one of the models. A month later, Mr. Wang wasn't at his usual spot and I did not see him again over the next month.

Shortly after, we moved to a new office in a different area of Shanghai, a few miles from where Mr. Wang's street-side shop was situated. One day, I had a meeting near our old office, and much to my surprise, he was there.

It turned out that Mr. Wang had gone digital. In his absence from his road-side stand, a friend had helped him start selling his small model bikes on Taobao & Tmall, China's largest C2C and B2C e-commerce platforms, where $449 billion in merchandise changed hands in 2016. Selling both online and offline had dramatically increased his sales and now he was selling 30-40 a day and had some of his friends helping to shape the bicycles.

Beyond stopping to say 'hi,' I also wanted to buy one of the small wire bikes for a friend, but when I went to hand the money to him, he waved me off and pointed to two large printed QR ('quick response') codes, and asked me to pay using Alipay or WeChat Pay, China's two leading mobile payment providers. I unlocked my mobile phone, scanned the Alipay code and a few seconds later, I had paid and was on my way.

In many ways, Mr. Wang's shift to digital is emblematic of the country as a whole. Every day across China, hundreds of millions of consumers and businesses use digital payments and digital finance for social and commercial uses. At a micro level, digital finance allows individuals like Mr. Wang to improve their own or their family's lives. At a macro level, digital payments have the potential to dramatically improve living standards for large sections of the population,

[35] World Bank

especially in developing areas of the country, through increased transparency, security, and lower cost.

'Internet finance,' as 'fintech' is commonly known in China, has enabled financial inclusion and economic empowerment in a way that had previously not been possible in China, largely because of its geographic, cultural, and economic diversity. China's internet finance boom started with digital payments, but has since expanded to include wealth management, credit, and lending. Digital finance has brought many people like Mr. Wang, into the financial fold.

While this has been good for the financial industry and the economy as a whole, risks remain. In 2016, more than 1,700 of China's P2P (peer-to-peer) lending platforms closed, leading to huge losses for investors and borrowers. Many claim that China's $9 trillion in wealth-management products, which are now largely sold through digital platforms, are also a ticking time bomb.[36] Traditional players also struggle to compete in the new digital finance landscape.

This innovation and stability paradox that fintech poses is a challenge for governments globally, but even more so in China where the financial industry is still relatively underdeveloped, yet remains a critical part of the nation's economic growth in terms of infrastructure and lending. Even as China's government and regulators continue "to cross the river by feeling the stones," and allow growth of new platforms and services like digital payments and P2P lending, they are also very cautious about creating any potential risks to continued economic growth.

Arguably, many of China's 2001 WTO agreement commitments were approached with the same intent. Industry reform was often delayed to protect the stability and growth of the domestic market. If the market had immediately opened to foreign banks in 2001 as per the WTO commitment, the sector would have likely collapsed along with the economy itself. Some WTO commitments still remain outstanding such as allowing foreign payment schemes like Visa and MasterCard to operate domestic RMB businesses.

Therefore, trying to influence the Chinese regulators to make changes on a schedule that does not match their own, is a fool's errand. Regardless of the comments, threats or negotiating tactics of foreign governments, China's regulators will reform at their own pace.

That is not to say that that the U.S. should give up trying to influence China to further open its financial industry. I will argue the opposite, the U.S. government will be more successful through **deeper engagement** including setting up financial industry focused working groups with industry players from both sides**,** and a **refocus on the financial products of the future** like mobile payments rather than those of the past, like payment cards. In addition, the government should be **paying greater attention to the expansion of China's tech giants internationally**, which poses, among others, a specific challenge to America's national security.

[36] "China is playing a $9 trillion game of chicken with savers," April 11th, 2017, Bloomberg

Finally, although the discussion is centered on the openness of China's financial industry, that is not where all of the answers lie. The **U.S.'s internal regulations also limit the U.S.'s industry growth and development**, while at the same time providing foreign companies relatively unfettered access the U.S. domestic fintech market.

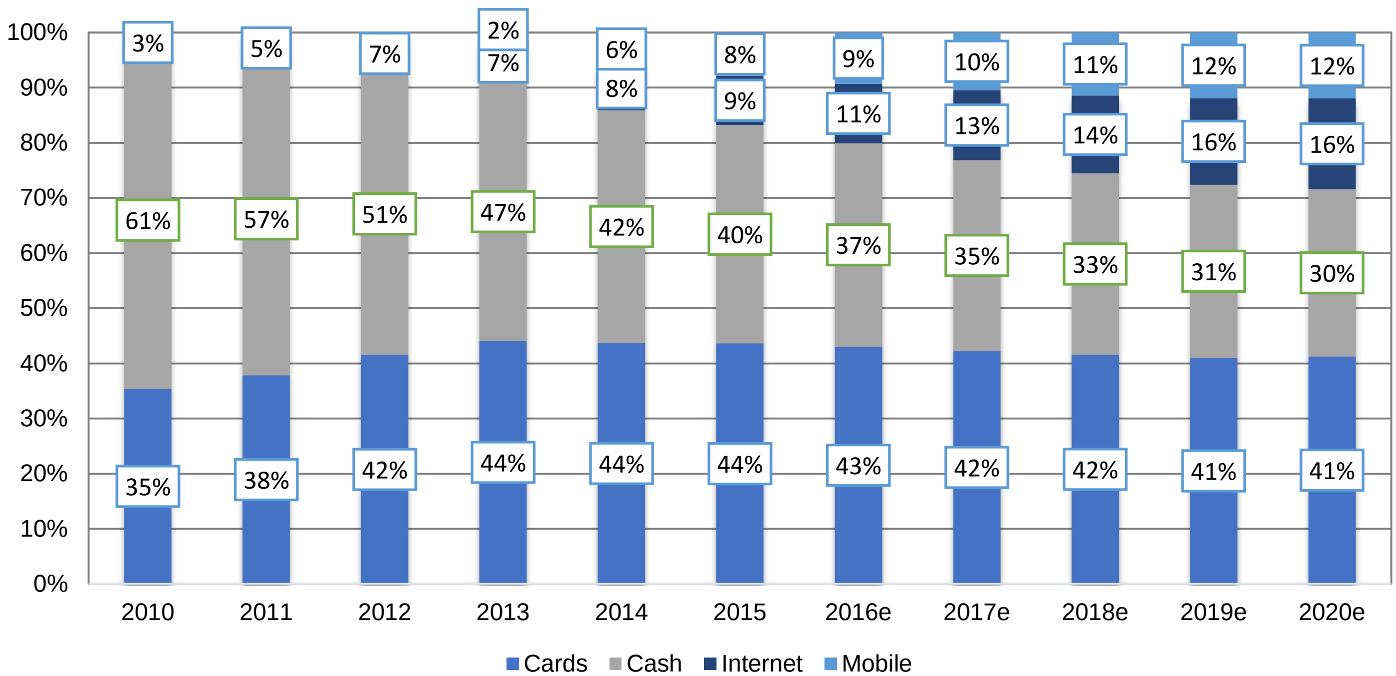
Setting the context – China's shift from cash to digital

China's history of physical currency is a long one. The country's first use of cash can be traced back to as early as 770 BC where "coins" in the shape of cowrie shells were used to settle trade. These were replaced around 350 BC by actual metal coins that had either a round or square hole in the middle to allow them to be strung and carried. But carrying around strings of coins could be quite heavy for merchants, so eventually, by the 7th century AD, China pioneered the first use of paper money.

Until recently, China remained a heavily cash-based society. In 2010, nearly 61% of China's retail consumption was still transacted in cash, even as debit card penetration reached about 1.8 cards per person.[37] A number of factors account for this reliance on cash, including high levels of perceived trust and convenience for cash, and habit.[38] However, the payment landscape is changing rapidly as cards and digital payments have grown in importance, with the proportion of retail consumption transacted in cash falling to 40% in 2015.[39] Compare this to the UK where in 2016, cash accounted for 45% of all transactions.[40] During that same 2010-2015 period, mobile and internet payments grew from 3% of retail consumption to 17% in China.

[37] Kapronasia Analysis, Euromonitor, World Bank
[38] David Barboza, "Chinese Way of Doing Business: In Cash We Trust", New York Times, May 1st, 2013
[39] Kapronasia Analysis
[40] Paul Hastings, Centre for Economics & Business Research (Cebr), YouGov, "The Future of Payments," Dec 2016.

Figure 1 - China Retail Consumption by Payment type
(% of total payments)



Source: Kapronasia Analysis

Traditional Financial Services

Since the 1970s, China's financial sector has played a major role in the country's economic development. China's "Big Four" banks are predominantly government-owned and serve as an essential tool for the government to allocate resources to public and private sector projects. Initially, because there were only four large banks and interest rates were government- controlled rather than market driven, industry competition was limited.

However, shortly after China's accession to the World Trade Organization in 2001, new segments of domestic banks started to appear, including "city commercial" banks like the Bank of Shanghai, and "joint-stock commercial banks" (also known as "shareholding banks"), as well as foreign entrants, such as HSBC and Citi. The increased competition pushed Chinese banks to adapt their business models, products, and service offerings, yet improvements to the overall customer experience were modest. The competitive size advantages enjoyed by these traditional players created an environment in which innovation and differentiation were not a high priority. Even if the new "traditional" competition pushed the industry forward a small step, it was by no means a giant leap.

Despite a lack of competition and product diversity in China's financial industry, the underlying technology is quite robust. Most of China's big banks employ modern core-banking software and many are embracing cloud computing to reduce costs and increase agility. In addition, China has a domestic real-time payments system for both retail and commercial payments and, in 2015, launched the China Interbank Payments System (commonly referred to as CIPS) which supports the development of the renminbi (RMB) as an international trade currency.

China's retail, non-cash payments market is also quite well developed. China UnionPay is the country's main domestic payment card clearing and settlement system, enabling the use of UnionPay-branded credit or debit cards at the estimated 26.7 million merchants that have electronic point- of-sale devices installed to accept card payments.[41] Debit card penetration stands at 3.1 cards per person and is increasing. In addition, every new point-of-sale device sold in China must come equipped with Near-Field Communication (NFC) technology to enable mobile payments.

Similarly, China's internet and mobile infrastructure is very robust.

Internet and Mobile Phone penetration

As of January 2016, China had 688 million internet users,[42] which is more than twice the size of the entire population of the United States. Even with such a large pool of users, China's internet penetration rate is just over 50% of the population. This compares with the US rate of 84%.[43] There is massive potential for future growth.

Relatively cheap, full-function smartphones are also widely available in China through many Chinese manufacturers. The result is a significant difference in average selling prices, which are at least $50 less in China than globally.[44] Lower prices have spurred the adoption of smartphones in China, where penetration is about 20% higher than the global average.

[41] Kapronasia Analysis
[42] China Internet Network Information Center, "Statistical Report on Internet Development in China," January 2016, http://cnnic.com.cn/IDR/ReportDownloads/201604/P020160419390562421055.pdf
[43] Americans' Internet Access 2000-2015, Pew Research Center, June 26, 2015, http://www.pewinternet.org/2015/06/26/americans-internet-access-2000-2015/
[44] This gap has narrowed in 2014 and 2015 with the popularity of the iPhone which raised average sale prices.

Figure 2 - Major shift towards smartphones in the last five years

Smartphone as % of all phones in China vs Globally

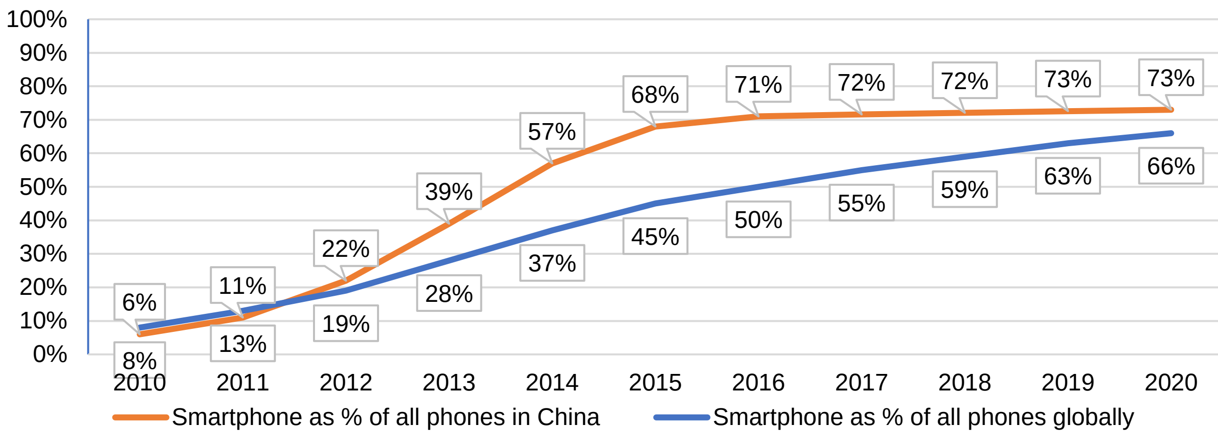
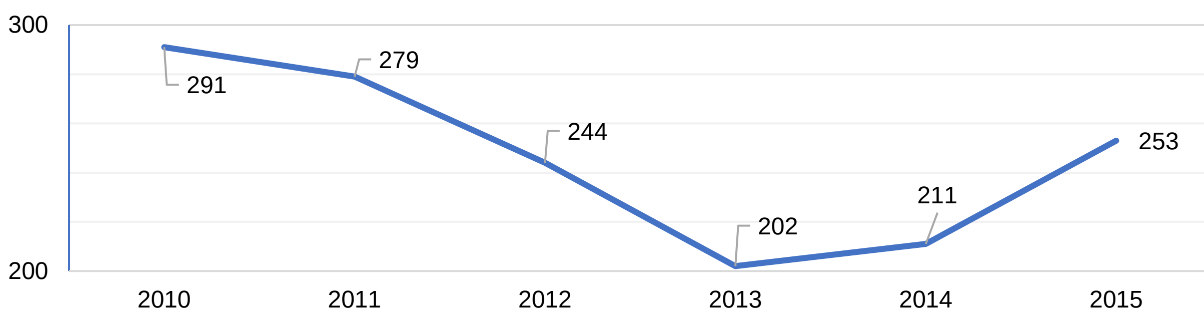


Figure 3 - Average smartphone price rebounded in 2014 as consumers were ready to spend more on their devices

Average smartphone price (USD)



Mobile data in China is also cheaper than other countries. For instance, a pay-as-you-go 2 gigabyte data package from China Mobile is 120 RMB (US$17.40). A similar data package from T-Mobile in the US would cost US$20.50.[45] These smartphones are able to use a 4G telecommunications network that covers 76% of the population, which is comparable to the US where 4G coverage is 81%.[46]

Finally, China's millennials are particularly active users of mobile phones. For many of them, their smartphone is their first, and often only, avenue for accessing the internet. Smartphones are cheap and provide easy access. In 2015, only about 49.6% of China's households had a personal computer,[47] this contrasts with the United States where household computer ownership stands at

[45] China Mobile and T-Mobile websites
[46] Opensignal.com
[47] The World Bank, World Development Indicators, "States & Markets: The Information Society, Table 5.12," http://wdi.worldbank.org/table/5.12

87.3%.[48] This characteristic is another one that China may have in common with other geographies where mobile penetration is high and computer penetration is low.

With relatively little competition in the traditional financial industry, and very good technology infrastructure, the sector was ripe for disruption. Digital finance just lacked one thing: trust.

[48] Ibid.

Digital Payment Development

Alipay

Alibaba Group’s first e-commerce platform, Alibaba.com, was launched in 1998 in Hangzhou, China. The site was originally designed as a business-to- business (B2B) platform to match foreign buyers with Chinese sellers. In 2003, the company launched Taobao, a consumer-to-consumer (C2C) platform, which proved highly successful.

Taobao is a multi-merchant e-commerce platform where individuals or small merchants can set up a storefront and sell products. Alibaba does not actually sell products directly, but provides the marketplace infrastructure for the merchants on the platform, including the technology, payments, and logistics, like an eBay in the U.S. or Amazon Marketplace.

Five years later, in 2008, Alibaba launched Taobao Mall (now known as Tmall), a business-to-consumer (B2C) platform that achieved similar growth and popularity. The two platforms quickly became China’s largest e-commerce sites.

Most of the transactions in the early days of Taobao and Tmall were cash on delivery, where the customer would pay the courier when the product was delivered. This approach worked, but it was not the most efficient. Many internet payment services were available, but they were primarily used for paying bills or charging phones. None were not designed with e-commerce in mind. A consumer could make a payment online, but there was no recourse if the transaction was fraudulent; the money would have been transferred instantly, with no built-in chargeback mechanism typically found in a credit card or PayPal-like transaction today.

As a result, Alibaba decided to create its own payments mechanism, Alipay, in 2004. Using Alipay, users can hold money in a digital wallet that can be topped up using debit cards, physical prepaid cards, or by receiving money from others in a P2P or B2C transaction.

Alibaba then introduced Alipay into Taobao, its already well-established, e-commerce platform. Shoppers on Taobao were given the option of setting up and using Alipay instead of cash during the checkout process, although “cash on delivery” remained an option. To address the challenge of building trust among users and potential users, Alipay was designed as an escrow system so that the merchant would not be paid until the customer was satisfied with the purchase.

In doing this, Alibaba addressed the key payment challenges of trust and scale, giving consumers more confidence to make transactions with vendors that may have been thousands of miles away. The payments service rapidly gained in popularity thanks to its use on Taobao, and in 2015, Alipay accounted for nearly 50% of all internet payments in China.

The initial Alipay service launched in 2004 was internet-based. The company introduced a mobile version in 2009. By 2016, Alipay was processing 175 million transactions per day, 60% of which were completed through a mobile phone.

Still, its market share in internet payments has since been eroded slightly by a similar product from rival Tencent Holdings.

Tencent: WeChat Pay

China's other popular mobile payments service was established by Tencent, founded in the Southern Chinese city of Shenzhen in 1998. Tencent has two major social apps, QQ and Weixin, or WeChat as it is known in English, which had a combined monthly active user rate of 846 million as of Q3 2016.[49]

WeChat is similar in some respects to Facebook and WhatsApp, two popular social networks launched several years before WeChat. WeChat allows users to chat with contacts one-on-one via messaging, audio, or video, facilitates communication among large groups, and has a functionality called "Moments" that is like Facebook's "Timeline." Moments allows subscribers to post images, thoughts, popular news articles, and other material that can be viewed by selected members of the user's contact list. Most of its users spend a considerable amount of time in the app, logging into it multiple times per day to keep up with their friends and to post and review messages, thoughts, and pictures.

In 2005, Tencent had developed a digital payment platform called Tenpay, which was launched nine months after the initial internet version of Alipay was released. Tenpay allowed users to pay for Tencent's products and services, such as its online gaming and music offerings, and was also interoperable with many e-commerce platforms (except for Taobao or Tmall, the two Alibaba e-commerce properties).

In 2013, Tencent integrated the Tenpay payment app into WeChat. This function, known as "WeChat Pay", allowed users to setup a digital wallet contained within the WeChat app and access a variety of products and services on WeChat. Linking the wallet to a debit card or credit card enabled the user to transfer value over to the WeChat Pay wallet and store it there for later use.

It was less obvious then, but in no time, digital payments pushed Tencent and Alibaba into the financial industry. Such payments created the basis for a much larger business opportunity: for the two companies to leverage data collected to offer additional products and services to consumers and small businesses, and create one-stop financial service ecosystems.

[49] 56. Press Release, "Tencent Announces 2016 Third Quarter Results," Tencent Holdings, November 16, 2016, http://www.tencent.com/en-us/content/ir/ news/2016/attachments/20161116.pdf

Figure 6 - Comparison of Key Mobile Functionalities

Platform	Functions					
	Launched	**Video Calls**	**Voice Calls**	**Payments**	**Monthly Active Users (Millions 2015)**	**Mobile Payments Processed (US$ Billions 2015)**
WeChat	January 2011	July 2012	July 2012	August 2013	697	396
PayPal	1998	None	None	1998	180	50 (est.)
Alipay	2004	None	None	2004	450	1,316
WhatsApp	2009	April 2015	November 2016	None	1,000	Not Applicable
Facebook Messenger	August 2011	April 2013	April 2015	March 2015	1,000	Not Available

Wealth Management

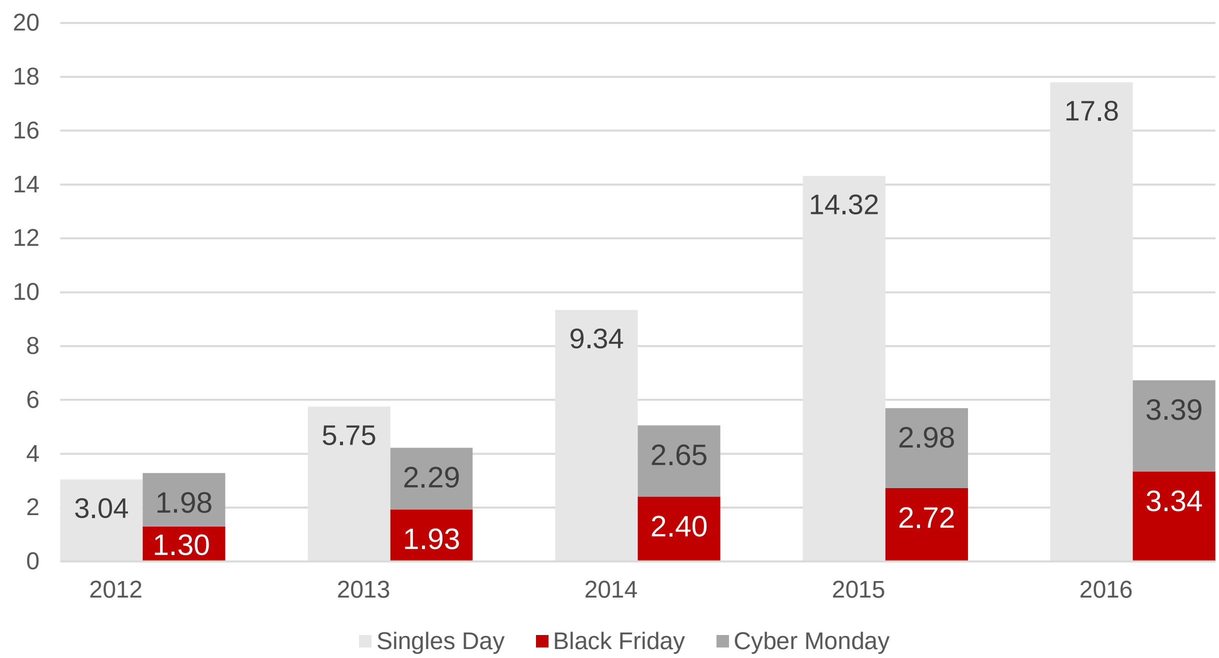
As Alipay grew, the company realized that customers were leaving money in their Alipay wallets. In 2013, liquidity was tight in the banking market, so interbank deposits were in high demand. To capitalize on this, Alibaba worked with Tianhong Asset Management and launched the Yu'e bao (meaning "leftover treasure") product, a low-risk money market account like a bank savings account.

The idea was simple: Customers could take the money "sitting" in their digital wallets and invest it on the Yu'e bao product. Consumers could invest in the Yu'e bao product, which at the time paid a high interest of between 6-7% annually as it was based on interbank lending, and have the freedom to withdraw their funds at any time. This was a significant change from the rules of typical time-bound deposit products offered by banks, where there are early withdrawal penalties.

Although it seemed as if Alipay was acting as a fund manager in providing this product, from a regulatory perspective Alipay was a distribution service, while Tianhong was treated as the fund manager, making it easier for Alipay to offer Yu'e bao.

Yu’e bao was a hit, with customers valuing the ease with which they could shop online, pay bills, and now, easily and flexibly invest their savings. Yu’e bao grew from 0.2 billion RMB (US$29 million) in assets under management (AUM) in the second quarter of 2013 to more than 810 billion RMB (US$117 billion) with more than 152 million customers three years later. Consumers are also allowed to use funds on Yu’e bao to complete e-commerce transactions directly. On November 11th, 2016, known as “Singles’ Day” and also the biggest online shopping day of the year, 11% of all Alipay transactions were made using Yu’e bao.[50] All of this has made Tianhong Asset Management one of the largest money market funds in the world.

Figure 4 - Comparison of China's Singles Day Spending to America's Black Friday and Cyber Monday (US $ Billion)



In January 2014, about seven months after Yu’e bao was launched, Tencent launched a nearly identical product called Licaitong. Within one year, the Licaitong product had over 10 million users and AUM had reached RMB 100 billion (US$14.5 billion).

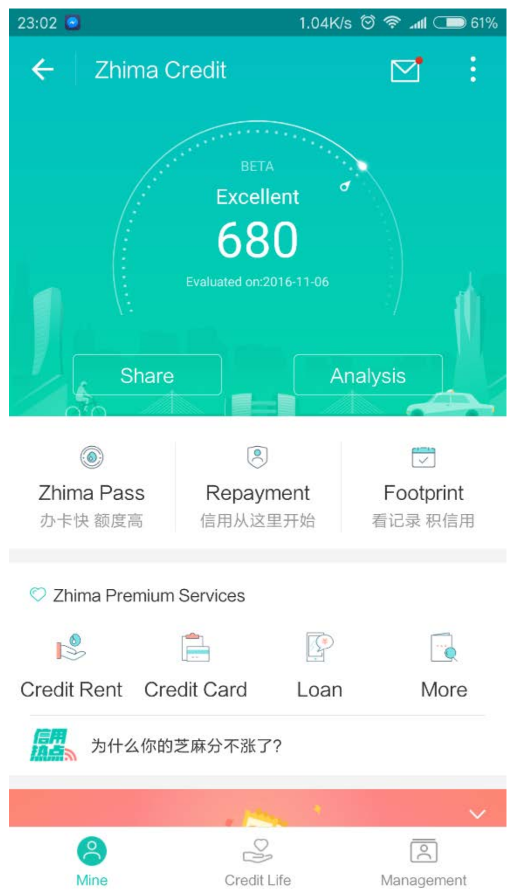
Prior to these two offerings, wealth management products (WMPs) in China were only available to those with significant assets. For instance, most WMP required a minimum investment of RMB 10,000 (US$1,450), which was out of reach for many of China’s consumers. Yu’e bao and

[50] Ant Financial, January 2017 Ant Financial Data Sheet.

Licaitong, however, needed only a minimum investment of one RMB. This helped to "democratize" wealth management, making it more inclusive and accessible to more sections of the population. Indeed, China's banks have followed suit and now have a range of WMPs that can be purchased for as little as one RMB.

Digital Credit Rating

One of the challenges China's financial industry has faced is a lack of accurate and complete credit information. According to World Bank estimates, although 79% of China's adults have had a bank account at some point, only 10% of these have ever borrowed in the formal financial system,[51] which means that there is little information available on potential borrowers' credit histories. In addition, China only established a nationwide commercial credit database in 2005 and a consumer credit database in 2006.[52] As a result, as of 2015, the PBOC had data on 880 million people, about two-thirds of the total population, but only maintained credit histories on 380 million people, less than one-third of the adult population. In comparison, 89% of Americans have a credit score.[53]



This situation has made it difficult for lenders to accurately assess credit risk and make lending decisions for either retail or commercial lending, a problem further exacerbated by the fact that China's government has so far been reluctant to allow international credit reporting companies to set up their businesses in China.

In January 2015, the People's Bank of China (PBOC) selected eight technology companies to set up consumer credit scoring businesses including the Alibaba affiliate Ant Financial. Shortly after that, Ant Financial launched its Sesame Credit product, which now has 190 million users.[54]

Sesame Credit assesses user creditworthiness through five metrics: the credit history of the user, financial behavior, contractual capacity, identity, and their social network. The service also looks at consistency and preferences in their history for shopping, money transfer, and wealth management. They can tap into over 350 million real-name registered users and 37 million small businesses that buy and sell on Alibaba Group

[51] World Bank, Financial Inclusion Index
[52] Credit Reference Center, Peoples Bank of China
[53] "Credit in China: Just Spend", The Economist, November 19th, 2016
[54] Ibid

marketplaces, including Taobao Marketplace and Tmall.com and reportedly use over 100 million data sources.[55]

When users sign up for Sesame Credit they agree to terms and conditions that allow Ant Financial to use their transaction data to assess their credit worthiness and use it to come up with a credit score. This score is also shared with Ant Financial's partners. For instance, a program was set up in June 2015 with the Luxembourg Government to allow Sesame Credit scores to be used in place of bank records in securing a visa for the Schengen travel area in Europe. Also, third-party non-bank financial companies like China's many peer-to-peer (P2P) lending companies are not allowed to access the PBOC's credit databases, so many have chosen to integrate Sesame Credit into their credit rating systems. At the Hangzhou train station, if your credit score is above 600, you can even borrow an umbrella.

Sesame Credit can also play a constructive role in terms of financial inclusion in China. One of the biggest challenges for financial institutions is lending in second- or third-tier cities. Firms like Sesame Credit that provide reliable credit scoring services, could potentially help lenders to provide financing to people who otherwise may be deemed ineligible.

In July 2016, Sesame Credit launched a similar credit checking and rating system for SMEs called "Ling'Zhi" – which means "Smart Sesame" in Chinese. The system is designed to better assess the credit of SMEs and could potentially open new funding channels for a segment of the market that has been, until recently, starved of bank credit.

Lending

Before launching Sesame Credit, Alibaba had been providing micro-credit to merchants on the Taobao and Tmall platforms since 2010. Because Taobao and Tmall work on the escrow model, being able to borrow small amounts to cover short-term financing needs is useful for a merchant who would otherwise potentially need to wait up to two weeks to receive payment for a product they have already shipped.

In addition to lending to companies, In December 2014, Ant Financial started lending to individual consumers through a service called Huabei or "Just Spend." Tied into the Taobao and Tmall e-commerce platforms, shoppers can take out month-to-month loans of up to RMB 30,000 (US$4,300) and are expected to repay loans one month after receiving the product. The option to use Huabei to pay for purchases is available at check-out and advertised throughout the site. On Single's Day 2016, Taobao and Tmall consumers spent a total of RMB 26.8 billion (US$3.9 billion) using the Huabei platform.[56]

In many cases, Alibaba was lending its own money as part of its lending arm, which is now part of Ant Financial. In 2016, Ant Financial even went so far as to underwrite its consumer lending

[55] Sesame Credit, "芝麻信用大数据实践", 08/2016, http://wenku. baidu.com/link?url=o33srR3T5xQ4nSr-oNFkYs4RFUxM1e2uzDJb8- 7-WbSfDZvS3BGC1ms_nzKzsn6WDnMiT7-M5_j7K-22XeA- 3Fl6ZB0cEAjD9YZZHwHnGAa
[56] Ant Financial January 2017, Ant Financial fact sheet.

by selling asset-backed securities (ABS) against the loans. Institutional investors could purchase the ABS through Chongqing Alibaba Small Loan, which provided the underlying loans themselves.[57] Effectively, people were "investing in Singles' Day" and Ant Financial was able to tap a large source of funding for its loans.

[57] "You Can Now Officially Invest in Alibaba's Singles' Day," Reuters, November 28, 2016, http://fortune.com/2016/11/28/alibaba-singles-day-securities/

A Brief on Quick Response (QR) codes

Although mobile payments have existed in China since 2009, the mobile payment industry faced many of the same teething challenges in China that it faced elsewhere around the world: poor device interoperability, conflicting technology standards, and unclear customer / data ownership. By 2010, all three of China's telecommunication companies (China Mobile, China Telecom, and China Unicom) were pursuing mobile payment pilots.

In early 2010, a wave of quick-response of "QR" code startups emerged in China. A QR code consists of black squares of varying sizes and positions arranged in a square grid on a white background. The code can be read by an imaging device such as a phone camera or a simple hand scanner.

Although Alipay and Tenpay were making inroads in online payments, they had yet to break into proximity offline payments because of the monopolistic control of China UnionPay and the mobile operators, but QR codes offered a viable solution. QR codes were secure, easy to use, and were already familiar to customers.

Yet, the key advantage is that they are hardware agnostic. To get UnionPay or a handset manufacturer to embed an Alipay technology would have been incredibly difficult and costly, as would attempting to penetrate the NFC payments market. However, with an app-based QR code, Alipay and Tencent only needed consumers to download the app to their smartphone to gain access to the payment functionality.

Alipay was actually the first to use QR codes for payments when it launched QR payment in December 2011. WeChat followed in September 2012 with QR codes for both exchanging contact details and for payment. By May 2016, Alipay QR code payment acceptance reached 600,000 brick-and-mortar merchants across China. Each has their own set of QR codes that users can scan with their phone and pay, or by using 'quick-pay' functionality, a user can display a dynamic (changes every 30 seconds) QR code to a merchant who scans the code with a device to complete the transaction.

QR-code based mobile payments seem to have caught on in China for a number of reasons:

- Platform agnostic - Both the Alipay and WeChat pay app work across the Android and Apple iOS platforms, which account for 99.3% of China's smartphone market in urban areas.
- Easy to use - Users unlock their phone and click on an icon to show an auto-refreshing QR code that can be scanned by the merchant.
- Inexpensive - Users make transactions for free and receive points that can be exchanged for gifts or credit. On average, merchants pay 0.6% to process digital payment transactions through WeChat Pay or Alipay.
- Ubiquitous - Over 600,000 merchants accept Alipay payments. On a promotional day where WeChat charged no merchant fees for using its network, 700,000 accepted WeChat Pay in China.

Today, millions of stores across China accept QR-code based Alipay and WeChat Pay mobile payments and the technology is being trialed in many other countries across Asia.

China Fintech Today

The breadth and depth of the digital financial products and services available in China today is impressive. As detailed above, mobile payments provided the basic foundation on which many of the subsequent products and services were built including wealth management, credit rating and lending.

In addition to Ant Financial and Tencent, many other players have gotten into finance including Xiaomi, one of China's largest smartphone manufacturers, JD.com, another e-commerce platform and Baidu, China's largest search engine. Xiaomi itself has payment, wealth management and lending platforms.

New industry segments have grown rapidly as well. P2P lending started in China in about 2007 and has since grown to be a $60 billion industry.[58] In fact, China now boasts 4 of the world's top-5 fintech unicorns.[59]

Functional Comparison of Key Digital Finance Functionalities

Functionality	Participants					
	Alibaba	**Tencent**	**Baidu**	**PingAn**	**JD.com**	**Xiaomi**
Payment	Alipay	Tenpay, WeChat Pay	Baidu Wallet	1qianbao	JD Payment	Xiaomi Pay
Lending	Ant Micro Loan, Huabei	Weilidai, Renrendai	Baiduxiaodai	Chengyi, Puhui	JD IOU	
Bank	MyBank	WeBank	Baixin Bank	PingAn Bank		
Insurance	ZhongAn Insurance, Cathay Insurance	ZhongAn Insurance	BaiAn Insurance	PingAn Insurance, ZhongAn Insurance	JD Insurance	
Securities	Tebon Securities	Futu, Huatai		PingAn Securities		Tiger Securities
Wealth Management and Distribution	Tinahong, Yu'E Bao, Ant Jubao, Shumi, Taojin 100 Index	Howbuy.com, Licaitong	Baifa, Baizhuan	Lufax	JD Xiaojinku	Jijinbao, Huoqibao
Credit Score	Sesame Credit	Tencent Credit		Qianhai Credit		
Crowdfunding	Taobao Crowdfunding, Antsdaq	Tencent Lejuan		PingAn Haofang	JD Crowdsourcing	Duocaito

58 "A Brief Look at the current state of China's P2P industry," March 10th, 2017, Technode
59 Defined as a private company with a valuation over US$1 billion

Platform Ecosystem

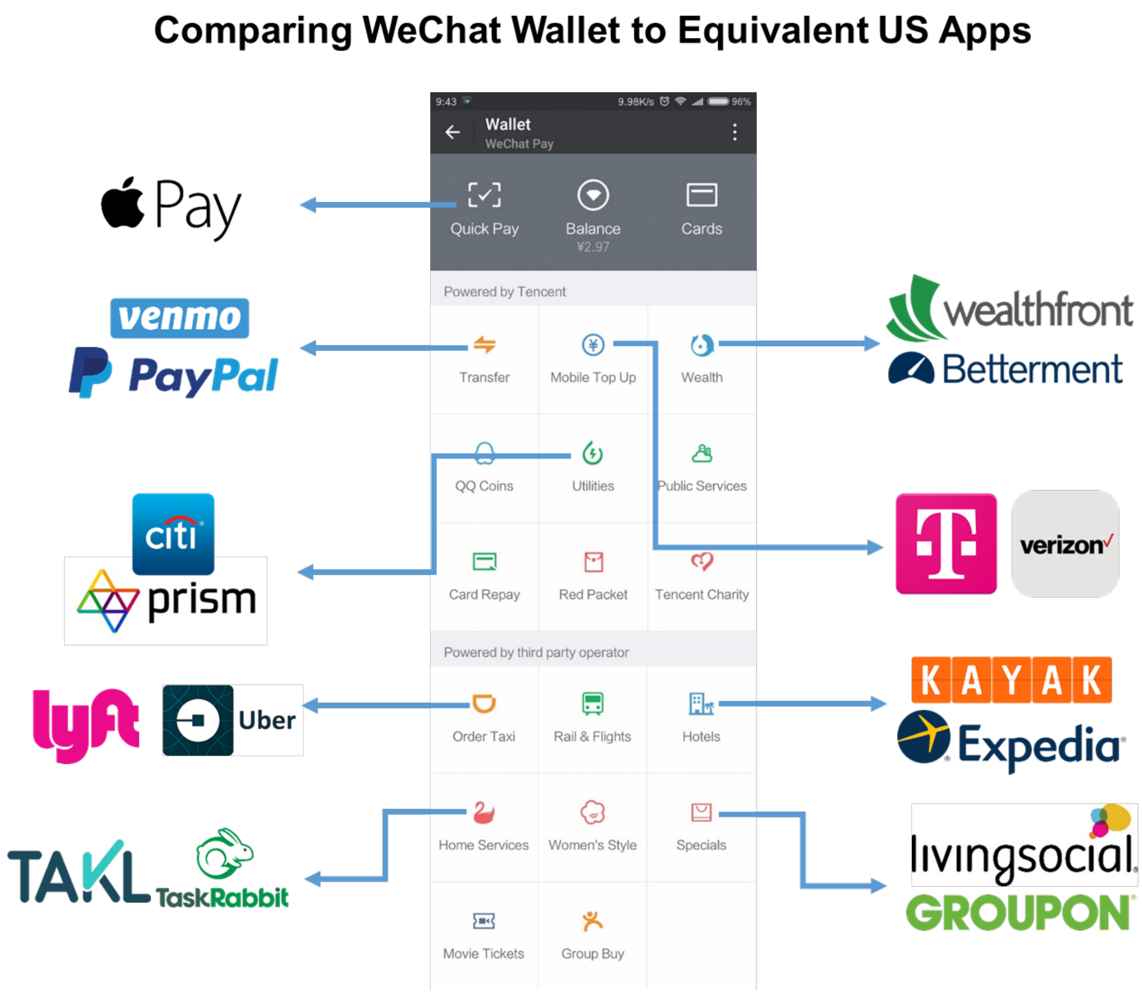
Since their launch, both the Alipay and WeChat products have become what could essentially be considered lifestyle platforms, allowing users to buy anything from movie tickets to taxi rides and flights, to wealth management products.

This distinction between similar products and services in the U.S. is important one when trying to understand China's fintech market and market dynamics. Although WeChat at its core is very similar to WhatsApp: they both are chat apps, the similarities end there.

When you open the mobile wallet, the true breadth of the WeChat ecosystem is apparent. A user can execute many functions on one app, something that would take several apps in the US to do. As an example, from within the WeChat app, you can:

- Book a card or taxi, similar to Uber
- Invest in wealth management products, like WealthFront or Betterment
- Pay utilities like you would with Citi or Prism

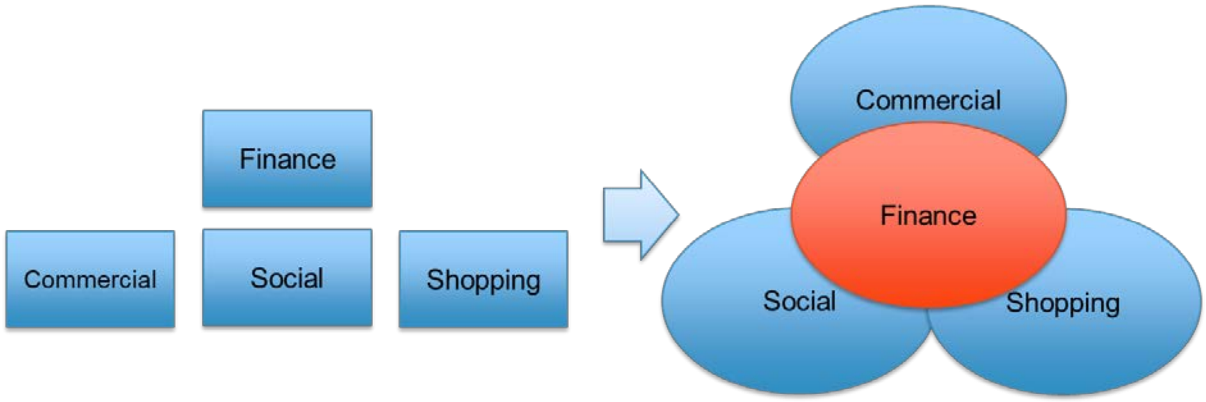
Figure 7



So, although mobile payments were the entry point for China's large technology companies into enter the Chinese fintech market, they have now become the plumbing to a wide variety of other products and services which allows a significant amount of cross-selling. When everything is contained on one app, why do you need to look elsewhere?

More importantly, the platform approach leads to an incredible amount of transactional data. Knowing what consumers are purchasing, where they are taking taxis, etc., allows you to move closer to the idea of 'situational finance' where financial providers can provide the right product at the right time to the right person.

Figure 8 - Situational Finance



This combination of payments, platforms and data have put China's big tech companies in a very strong market position, both in the context of tech companies in general as well as the financial industry.

This is having an impact. Banks' traditional business of payments and investment products is decreasing and they are scrambling to find a response. In 2016 alone, over $30 billion in payment fees were lost to the mobile payment platforms of Alipay and WeChat Pay.[60]

[60] Kapronasia Analysis

The Response of the Traditional Financial Industry

China's traditional financial industry including banks, asset managers, payment providers and payment networks (e.g. UnionPay), have struggled to respond to the growing threat of digital finance. One bank manager that we spoke to told us: "Forget about payments, that battle is lost. Help us with the rest of our businesses." There are few reasons for this:

- **Lack of Agility –** China's Industrial Commercial Bank of China (ICBC) is the largest bank in the world with 22,000 branches and over 400,000 staff. That is not only a huge organizational footprint, but also technology. Making changes to the core systems is challenging and has prevented many banks like ICBC from competing effectively with the tech giants.
- **Business focus –** Alibaba and Tencent are technology companies and are judged by the market and as such are measured by gross-merchandise value and other metrics related to payments and digital businesses. Traditional banks are measured by return on assets or equity, which hinders their ability to engage in 'moonshot' projects or activities.
- **Technical ability –** Although running a technology platform that can support millions of customers is impressive, many of the big banks have IT teams that are geared towards operational stability and efficiency rather than innovation. They also struggle find the right talent. Ten years ago, top college graduates would have eagerly jumped at a job in banking. Today, they are more likely interested in an Alibaba, Tencent, or one of the millions of start-ups in China.
- **Regulations –** Regulation on domestic banks is just as onerous as regulation on foreign banks. Even for using online banking, USB-keys and multiple maker/checker accounts are required. China's tech firms have enjoyed access to what could be considered as the world's biggest fintech sandbox.

There are some traditional players that have managed to position themselves well. Ping An Group is known to be at the forefront of fintech in China and has done a good job in making technology and innovation a key part of their business strategy. Where allowed, data is shared across the organization that can help to cross-sell products and leverage data analytics to improve the customer experience.

Banks are also setting up centers and groups within their organization to foster innovation, mimicking many of the initiatives of other banks like Singaporean lender DBS, which was one of the first banks globally to hire a Chief Innovation Officer.

Despite these efforts, China's traditional financial institutions are unlikely to be able to catch-up with the digital giants at this point, not without some help from the regulators, which they are starting to get.

The Role of China's regulators

As China's financial services industry is less developed than that of many other countries and is a key lever for the country's economic development, industry regulators have always focused on maintaining stable industry growth. This has so far meant relatively slow and measured reform, and openness to foreign firms than many had hoped.

As an example, as part of the 2001 WTO commitment, China agreed to open the domestic banking industry to foreign banks, but much to the chagrin of foreign players, it was only in 2006 that they finally accepted applications for local licenses. HSBC was one the first to receive a license in 2007. Up until a few years ago, if a foreign bank opened a branch in a rich city, they had to do so in a poorer one. Also until a few years ago, foreign banks establishing branches in China could do foreign currency (USD) business but were prohibited for 3 years to do local RMB business.[61] Imagine a Chinese bank coming to the US and being told they could not do USD business.

Although they were technically committed to the WTO agreement, realistically, if China had immediately fully opened the financial industry to foreign players in 2001, or even shortly after, the sector would have collapsed along with the economy itself. The measured approach allowed both the regulators and the existing players to prepare for the entrance of foreign competitors.

Wait and See

Despite the relatively closed industry, China has become the world's biggest fintech sandbox as home-grown 3rd-party players like Ant Financial and Tencent have been allowed to thrive.

These players grew in industry segments that were previously very lightly regulated. Mobile payment companies were licensed in 2011, but regulations on business scope and operations were promulgated in 2015-2016. So, licenses were needed a full eight years after the platforms were launched in 2003-2004, and specific regulations only came 4-5 years after that. Similarly, the first P2P lending platform launched in China in 2007. The government then did not regulate the industry until 2016.

This "wait and see" regulatory approach allowed various segments of China's fintech industry to grow and develop within limits. As mentioned previously, mobile payments in China have helped to drive financial inclusion and economic empowerment across the country, a net benefit for the industry and the economy. It was only when the industry reached a substantial size that regulators started to ring-fence the behavior of the mobile payment companies.

Similarly with P2P lending. Shadow finance and lending has been a challenge for regulators in China. While shadow finance has helped borrowers that are not able to access traditional sources of funding, it is very risky as the loans are not tremendously transparent and often come with usurious interest rates. Yet, if the government seriously cracked down on shadow finance, there would be a significant dent to China's economic growth as the segment is so large.

[61] This has now been shortened to a one year period.

P2P, although not a complete replacement for shadow finance, did help slow the industry growth. As borrowers realized they could access capital on the P2P lending platforms, some of the historically shadow-funded borrowing, moved onto the P2P platforms. Yet again, in 2016, after a number of P2P lenders closed down, the regulators issued regulations which will be in effect this August controlling the operational practices of the P2P platforms (e.g. usage of custodial banks) as well as the amounts that can be borrowed.

Future fintech regulation

Although the regulators and government have been very supportive of fintech's growth in China, they are starting to gradually take back some control in certain segments.

As an example, the market leaders Alipay and WeChat Pay currently run across their own 'payment rails' meaning that the transactions do not go across the China UnionPay or bank networks. Although this has resulted in a loss of fees for the banks and China UnionPay, the bigger issue is the data, which is becoming increasingly important as mentioned previously.

Earlier in 2017, the PBOC launched the 'WangLian' platform, which can be thought of as a China UnionPay network for digital payments. Whereas previously a mobile payment would have gone through just the Alipay network, it is expected that at the end of the 2017, most mobile and online payments will be required to go through the WangLian network.

While the WangLian platform should provider interoperability between payment platforms and may help to ensure the industry growth continues unabated, realistically it is an attempt by regulators to take back control of an industry that has gotten away from them. It may also be a saving grace to the banks, who have largely been left out of China fintech's development so far.

Previously the government has been very open to fintech's growth in China, but the regulations over the past few years as well as the setup of the WangLIan platform may mean that the heady days of fintech growth are behind us. Should the government continue to regulator the industry, certainly some of the power will go back to the incumbent players from the disruptors.

Barriers to Entry for Foreign Fintech Players

Over the past decade, China's financial industry has developed rapidly and has gradually opened up to foreign players. Most of the large multinational banks, insurers, and asset managers have operations in China.

Still, there are some barriers to entry across the financial industry in all the sub-segments. For example, foreign companies have not been allowed to IPO on domestic Chinese markets and only a handful of foreign brokerages have been given licenses to operate in mainland China, and even then, mainly through JVs. Most well-known is likely the fact that Visa, MasterCard and their competitors are unable to operate domestic businesses in China. [See Appendix A. for more details.]

Within the fintech space, there are very few successful foreign companies. This lack of success typically comes from one of two reasons: operational mistakes by the fintech company or explicit regulations preventing foreign companies from operating in a segment.

PayPal originally entered China in the early 2000s. Its failure initially was due to a series of well-known and acknowledged missteps, and it was never able to capture significant domestic market share. PayPal was then not one of the 270 companies awarded a payments license in 2011-2012. In fact, to date, only two foreign companies were given payments licenses: Edenred and Sodexo, which both received pre-paid card licenses.

Beyond payments, there are some successful 3rd party foreign players in China's fintech industry, although they are mainly foreign entrepreneurs who have setup domestic businesses in China. Saul Hilte, one of the founders of Lending Club in the U.S., set up Dianrong, Shanghai's largest P2P platform. Greg Gibbs was part of the original management team at Lufax, which is set for an IPO later this year.

The other avenue of entry is through infrastructure. Companies like Intel, IBM, FIS, FirstData and Microsoft have been in China for years providing software and hardware to the financial industry. Yet foreign companies are not allowed to directly provide cloud services, so Amazon, Microsoft and others have joint-ventures in China.

China's 2017 Cyber-security ruling

In June 2017, China's new cyber-security regulation will go live. The regulations cover a number of items around Chinese customer data, code escrow and other topics that China has indicated they feel are important for internal security.

There have been numerous legal firms that have analyzed the rules in more detail. For the financial industry and fintech, the rules are not entirely new as for many years Chinese customer data was required to stay in China and code escrow was often a requirement in contract negotiations.

Recommendations

Despite the challenges in and around China's financial industry, the correct tactic is continued engagement, but with a slightly different approach. There are a four key elements of engagement around China and fintech that are critical for the U.S. government to focus on going forward:

1. Apply a more rigorous approach to bi/multi-lateral agreements
2. Focus on the new financial industry battlegrounds
3. Examine the implications China fintech's international expansion
4. Implement reciprocal domestic U.S. regulations on foreign fintech participants

1. Apply a more rigorous approach to bi/multi-lateral agreements

From all of the reporting and news, it would appear that the new U.S. administration has ramped up its engagement with China after the meeting at Mar-a-Lago and efforts since, and at least it appears a dialogue has started. Although this is positive, the details will be critical. For many of these agreements to move beyond talking points and PR exercises, the negotiations and agreements need additional detail to be effective as there are several examples of high-level agreements with China that did not lead to actual implementation.

The first example is domestic China market access for the card clearing and settlement systems of Visa, MasterCard and similar card schemes. Although China has agreed at a high-level to allow payment players to come in and launch RMB businesses, the reality on the ground is that they could be allowed to operate, but the operational requirements are challenging.

We were told by one of the card networks that the Chinese regulators told them they had the green light to setup the domestic core-systems needed for processing payments. The company implemented the required domestic core-systems and infrastructure, but then one of the regulators audited the system and found an issue around security. The finding was not entirely clear in the initial guidelines, but nevertheless, the card network was told to re-design significant parts of the system, costing them about 9 months and presumably a significant amount of money. The detail of the core-systems would have been a minute detail had it been included in the overall WTO agreement, but it needed to be included.

Similarly, although foreign banks are now operating in China relatively unencumbered, had the details around business requirements been defined from the outset, the time to market could have been shortened.

That is not to say that in either case the Chinese government was not justified in the regulations that they promulgated. They do have a vested interest in seeing the continued development in the industry, but had the details been discussed earlier, these situations could have potentially been mitigated.

Because of this, any future regulatory efforts need to 1. be very detailed, 2. have a team in-place to ensure both all of the details are covered in the text as well as correctly implemented, and 3. define consequences if guidelines are not met. It cannot just be assumed that if something happens at a high-level, it will be possible on an operational level. That level of detail, although tedious to implement, is critical.

The challenge with this approach is that most Chinese regulation, even purely domestic, is very high-level and somewhat grey, leaving a lot of interpretation around implementation. Further, the Chinese government typically does not like foreign intervention in markets, but it should be considered if the U.S. government wants to make more than just noise around agreements with China.

2. Focus on the new financial industry battlegrounds

Most of the financial industry engagement with China has centered on traditional segments of the financial industry. The WTO agreement in 2001 focused heavily on the banking and payments industry and the more recent 100 day plan, on credit rating and electronic payments.

Although it is important to focus on these segments, the direction of the financial industry in China has shifted. Mobile payments through QR-codes, are already accepted at millions of shops and stores across China, rapidly replacing debit and credit card transactions. Similarly, companies like Ant Finance are redefining credit rating and reporting.

Engagement with China on access to the financial industry needs to look forward. The old battles around payments and credit rating are no longer as critical as those segments lose relevance to the future of the financial industry in China. Yes, there is huge market potential for Visa and MasterCard in China, but regulations and engagement needs to be more forward looking and including things like P2P lending, mobile payments and wealth management. Even if the card companies are allowed to set up, they may not be the future of finance in China.

3. Examine the implications China fintech's international expansion

As part of their overall strategy, we have seen a serious push from Alibaba, Ant Financial and Tencent to expand internationally and according to the latest numbers we have, over 300,000 merchants outside of China accept WeChat Pay and 80,000 accept Alipay.[62]

The first countries that the tech giants focused on were the countries where the Chinese tourists go, so Thailand, HK, Singapore, etc. The second wave has included Europe and now the U.S.

This expansion has come in a few different forms: the first is investment into or acquisition of an existing player, as is the case with Alibaba's investment in PayTM in India and potentially MoneyGram in the U.S. The second is through partnership, as is the case with First Data in the U.S. and Ingenico in several European countries. Finally, they have also gone alone into particular countries like Alipay in Hong Kong.

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[62] Kane Wu and Juro Osawa, "Alipay Mobilizes for Worldwide Expansion", WSJ November 1st, 2016

Although the expansion into these countries opens up new opportunities for the tech giants to expand their userbase and revenue opportunity, it is also having a critical impact on the payment systems in those target countries.

In some cases, such as Hong Kong, there is very little mobile payment activity, so launching a mobile payment product augments the existing payments infrastructure. In many cases however, the payment infrastructure is not as robust as in other countries, or completely non-existent. Because of this, in places like India and Africa, Alibaba and Tencent are having an outsized impact as an increasingly large segment of the population is going digital and using mobile payments.

Given that payment systems are so critical to the development and growth of countries, having influence and sway over the payment system in a foreign country could potentially include political influence, especially in those countries with underdeveloped payment systems. As Ant Financial and Tencent are heavily Chinese government supported (formally through investment and informally through political networks), it also means that the Chinese government, by proxy, has a potentially outsized influence in those countries.

As the U.S. evaluates its foreign policy, this cannot be understated: the expansion of China's fintech giants into other markets' payment systems gives them, and the Chinese government, outsized influence on financial industry regulation and policy, and potentially, overall political policy. This in many cases will help the target countries as China continues to fund overseas development, but it also raises a potential challenge to the U.S.'s national security interests which may be weakened through this expansion. Particular attention needs to be focused on this market segment to ensure that the U.S. government is aware of and comfortable with the implications.

4. **Reciprocal domestic US regulations on foreign participants**

One of the advantages of the U.S. financial industry and specifically fintech, is the openness of the market. Not only does the U.S. have excellent home-grown fintech companies like Lending Club, Lemonade, and Prosper, the market structure is such that foreign companies can also enter the U.S. market. This applies across the board: the U.S. has one of the most advance and robust financial industries in the world, populated by banks, brokers, asset managers and more from all over the world.

Although this has worked previously, it needs to be re-thought, specifically in the context of fintech for two reasons:

Firstly, for reasons mentioned previously, access to payment systems and the correspondent influence of the Chinese government in the tech giants represents a special case and affects national security and policy.

Secondly, even as there are few limitations on what Chinese firms can do in the U.S., American firms are very much limited in what they can do in China. I do not typically support tit for tat reciprocal regulations, but believe this to be a special case, where it should certainly be on the table for consideration: there is no reason why products like Alipay are allowed to expand and grow in the U.S. while U.S. firms, like PayPal, struggle to gain market access in China.

This review of reciprocal regulations and restrictions should apply not just to China, but any markets where this is happening.

Conclusion

Although the fintech industry globally is relatively young, the impact is nowhere greater than it is in China. By any measure, China's fintech industry dwarfs any market globally whether it is by assets under management, volume of transactions or valuation of the companies.

This has helped drive economic empowerment and financial inclusion in China as digital-finance becomes a way of life for Chinese individuals. Although there are risks, the benefits certainly outweigh any drawbacks, especially as the regulators walk the fine line of maintaining industry stability, while at the same time fostering innovation.

As these platforms expand internationally, it is a critical time for the U.S. government and regulators to re-evaluate their approach to fintech regulation, especially for China's fintech companies. The game has shifted and so have the players, a new approach is not just recommended, but required for the U.S. to maintain its position of importance on the global stage.

Appendix A: Financial Industry Foreign Barriers to Entry by segment

	Banking	
	Investment Banking	**Retail/Commercial Banking**
Is the market open to foreign companies?	Yes	Yes
Are there restrictions on foreign companies?	Yes	Yes
What restrictions?	Foreign investment banks currently must partner with local brokerages in a joint venture to do business in China, permits are required for trading	Foreign banks have a foreign debt quota, required loans to deposits ratios, limited access to bond underwriting market, withholding taxes on offshore funding, and liquidity requirements, ceiling of ownership of foreign banks in domestic banks, waiting periods for RMB
U.S. Companies that have entered Chinese market	JP Morgan, Goldman Sachs, Bank of America Merrill Lynch	Citibank, JPMorgan Chase, Morgan Stanley, Bank of America, BNY Mellon, Wells Fargo, SDP Silicon Valley

	Capital Markets	
	Bond Underwriting/Brokerage	**Offshore Bond Trading (Dim Sum)**
Is the market open to foreign companies?	Yes	For synthetic bonds, not retail bonds
Are there restrictions on foreign companies?	Yes	No
What restrictions?	Licenses required	
U.S. Companies that have entered Chinese market	JPMorgan, Citibank	

	Capital Markets	
	Onshore Bond Trading (Panda)	**Equity Trading**
Is the market open to foreign companies?	Yes	Yes
Are there restrictions on foreign companies?	Yes - file paperwork with PBOC	Yes
What restrictions?	Medium to long-term investors allowed, incl. foreign central banks, international orgs, foreign commercial banks, insurance companies, securities firms, fund management companies, etc.	Foreign investors can trade through Shenzhen exchange, can also trade equity for Chinese companies listed on NYSE

	Capital Markets	
	Derivative Trading	**Asset Management**
Is the market open to foreign companies?	Yes	Yes
Are there restrictions on foreign companies?	Yes	Yes
What restrictions?	Foreign companies are allowed to conduct forwards, FX trading, options trading, but most other forms of derivative trading are limited even for Chinese companies	Gov. approval/permits required, WFOE has to be created
U.S. Companies that have entered Chinese market		Fidelity Investments

	Capital Markets	
	Listing equity on Chinese exchanges	**Commodities Trading**
Is the market open to foreign companies?	No	Yes
Are there restrictions on foreign companies?	-	Yes
What restrictions?	Foreign companies not yet allowed to list equity on Chinese exchanges, although discussions/planning have occurred and exchanges are expected to be opened at some point in the future	Futures are slowly being opened up for trade

	Infrastructure	
	Cloud Computing, Software as a Service (SaaS), Platform as a Service (Paas)	**Network Products**
Is the market open to foreign companies?	Yes	Yes
Are there restrictions on foreign companies?	Yes	Yes
What restrictions?	Foreign companies must partner with Chinese companies in order to provide cloud computing/storage services in China or obtain a license if they have server hardware located within Chinese borders	Foreign companies must partner with Chinese companies in order to provide network products in China
U.S. Companies that have entered Chinese market	IBM, Amazon, Microsoft, Oracle, Zoho	Cisco

	Infrastructure	
	Hardware	**Software**
Is the market open to foreign companies?	Yes	Yes
Are there restrictions on foreign companies?	Certain cases	Certain cases

What restrictions?	Foreign companies that supply hardware to Chinese banks/gov/military must turn over code, submit to audits, and build backdoors into hardware. Otherwise, companies may need approval from government to sell hardware.	Foreign companies that supply hardware to Chinese banks/gov/military must turn over code, submit to audits, and build backdoors into hardware. Otherwise, software must comply with Chinese data/software laws.
U.S. Companies that have entered Chinese market	Apple, Samsung, Dell, Intel, Qualcomm, etc.	Apple, Microsoft, Adobe, etc.

PANEL II QUESTION AND ANSWER

HEARING CO-CHAIR HUBBARD: Okay. Thank you.

Let me start with one question before turning it over to my colleagues. You all have talked about a variety of political concerns that make financial services a bit special in the regulatory process, and I agree, and many of those political concerns relate to the allocation of credit, which is a point Mr. Hirson made.

But there are segments of financial services-- mobile payments and insurance also come to mind--that may be a little bit less sensitive. Should we be focusing more of our efforts there because American insurance firms have not done very well or in the mobile payments? It is a question for anyone on the panel.

MS. STEVENSON-YANG: Well, shall I take the first crack at that? I think so, yes. It's not possible for the United States to attack the whole ball of wax, which is the Chinese financial and political system.

Finance is-like water. It rolls downhill; right? Money rolls downhill. And so in this environment that China has been in, especially since 2009, in which the money system has been expanding so dramatically, you have money just pouring into investment, into very dodgy investment, and many of them pyramid schemes.

And this has been occurring through the banks and through the insurance firms and through the payment systems as well. Foreign companies don't want to participate in this, but are disadvantaged by not participating.

The Chinese insurance companies now are, many of them are almost exclusively offering one-year products that return four to as much as eight percent. of the, one of the insurance firms, Evergrande Insurance, has 97 percent of its products in one-year investment schemes. So this is not something--and then if you're, you know, little AIA, and you're trying to compete with that, you offer two percent in your investment scheme, and then you offer real life insurance, very difficult to compete.

Why am I going into all of that? I say that we just don't touch many of those investment issues but focus on branch expansion for both insurance and banks. It's not that hard. The barriers are too high. The investment requirements are too high. The close-up requirements are too great, and it's a gateway to collecting the deposits that you need to make more loans.

MR. HIRSON: Just to riff off a point that Anne made in terms of the somewhat risky short-term investment products that Chinese households invest in through the insurance sector and through other sectors.

In my written testimony, I discuss what I think is a really important opportunity for U.S. firms, which is long-term retirement savings. And this is an area where we've seen more traction from the Chinese government in terms of understanding the role that foreign firms can play, and there's two reasons for that.

One, China's leadership has made it a key goal to rebalance the economy towards consumption, which is something that's very important for the health of the global economy and also the sustainability of the Chinese economy. And having households enjoy economic security from the ability to rely on mutual funds, insurance products, other sectors, to care for their long-term retirement needs is an important part of that.

The other reason is because China's government is increasingly looking to develop healthy capital markets. The equity market meltdown that China experienced in 2015 was really another reflection of the fact that the stock market is largely retail. It doesn't have the large institutional investors, the pension funds, the mutual funds that in our system create a lot of the stability and a platform for long-term investment.

So I think that this is an area where there are structural economic opportunities for U.S. firms and an open door by relative standards to the role that foreign firms can play.

MR. KAPRON: Just one last point on that. I think one of the challenges for foreign firms is the e-channels by which consumers are purchasing these products are changing. When you look at where somebody would buy a wealth management product ten years ago, it would be going to the bank, and indeed the asset managers when they wanted to have a mutual fund with a bank would have to go branch by branch to get that product stocked.

Increasingly, all of this is moving online to online platforms and mobile platforms as well. And so, whilst it's nice, I think it's realistic that probably the point to engage on is around the traditional banking or insurance sectors. That's a nice short-term fix, but in the long-term as things move away from banks, it's a losing game for them.

We talked to a number of banks, and one of them said forget about payments. We've lost. We've lost the battle in payments. Help us protect the rest of our business.

In 2016, the digital payment providers took $13 billion in fees away from the traditional hard payments industry. The impact is huge on that, and it's shifting increasingly digital.

HEARING CO-CHAIR HUBBARD: Okay. Commissioner Wessel.

COMMISSIONER WESSEL: Thank you, Mr. Chairman, and thank you all for being here.

It seems to me that China gets to have their cake and eat ours too in this field; right? You know if you look back, and I was just reading an article, pulled it back up from the Wall Street Journal: In the year that has already produced--this was last year--$81.5 billion of foreign acquisitions by Chinese companies, blowing away the pace in any prior year, not a single Wall Street bank is among the top three buy side advisors.

The article goes on to say, and as we've seen in other acquisitions, that U.S. firms that had previously--law firms, investment banks, buy side, et cetera, had been participating, and now China is excluding them.

A Chinese entity is trying to buy the Chicago Stock Exchange, which was cleared by the CFIUS in December, but is still undergoing SEC scrutiny. We have, as you mentioned, the MoneyGram transaction, which is still out there.

It seems to me, and you mentioned the BIT, Mr. Hirson, it seems to me that I don't know that China really needs a BIT. They're getting pretty much what they want right now. Understand they'd like a little more political certainty, et cetera, but under the President's 100 Day Plan, the Secretary of Commerce indicated that, they were going to give greater access for Chinese banks to the U.S.

So China is gaining more and more access to the U.S. financial system. They are closing us out at an increasing rate in some of the areas we were in. And that doesn't seem to be reciprocity. It doesn't seem to be a positive outcome or a positive track, and, you know, why are we giving them the kind of access, which I agree, Mr. Kapron, is somewhat of a national security issue here in terms of MoneyGram, why are we giving them access when we're not getting anything in return?

Mr. Hirson, do you want to start?

MR. HIRSON: Sure. I mean I completely agree. Reciprocity is a key element of fairness obviously and is stoking a lot of the darkening mood towards China in the U.S. business community, and you just see a profound asymmetry with China's ability to invest in the U.S. versus the ability of the U.S. firms to invest and sell and operate in China.

I think in terms of the Bilateral Investment Treaty, I would just make a few points. One is that the Chinese firms and the Chinese government is, to some extent, worried about new barriers, rightfully so, that the U.S. might be--and other markets. And there's a very similar conversation happening in Europe right now. So the Bilateral Investment Treaty is viewed as something that would provide assurances to Chinese investors when investing in the U.S. So there is an incentive there.

COMMISSIONER WESSEL: Thank you.

But let me interject. With China's history on the WTO and other agreements, MOUs, going back years and years, do you have confidence that if we did reach a BIT, that actually China would live up to their promises? I don't have any confidence in that.

MR. HIRSON: Well, I think it would, I mean it would depend on how it's crafted, and I think it's fair to ask that question. Ultimately behind a lot of these conversations has to be some notion of what the U.S. response will be. Are we going to be erecting barriers? And I think that's certainly an appropriate conversation to have.

My point would just be that I think we should be careful and clear about how we go about that. If it's concerns that we're raising for national security reasons, I think that should be done in that national security context.

But I'm not a particular supporter of the same kind of blurring of regulatory and investment restrictions that we face in China. So I think, again, it's a very appropriate conversation to have, but I just think it should be done with the right tools, and that might require Congress to give the administration more tools to act on these, you know, concerns of reciprocity.

COMMISSIONER WESSEL: And I think there is legislation currently being drafted, bipartisan, that's going to look at that, but again on the MoneyGram, just as it relates to national security, there were concerns about remittances to China, and access to all the data that could have human rights and other implications as well as broader platform access to financial information.

So I understand the sort of traditional national security, but when it gets into the integrity of our financial markets, my view is that is a national security issue.

MR. HIRSON: Absolutely. Just one other quick point, with the BIT, I think it's also important, too, to the extent that we can, to stay on the side of reformers within the Chinese system.

And there are a lot of supporters for the BIT in China, precisely because they view it as an external anchor to open up financial services and other services, which aren't just closed to foreign firms. They're closed to even private firms in China, and really this is one of the key macro concerns to China right now. It's a service sector that's still dominated by state-owned enterprises, and it's really hurting China's economy.

So to the extent that we can use the BIT to help make that broader opening, I think it benefits us and benefits the health of China's economy.

COMMISSIONER WESSEL: Okay. Thank you.

HEARING CO-CHAIR HUBBARD: Senator Dorgan.

HEARING CO-CHAIR DORGAN: You mentioned Chinese firms, Chinese governments, or the Chinese government, and we've had hearings and testimony, including the first panel this morning, that talks about the role of the Party so we have a Communist Party, a ruling structure of the Party, the government run by the Party, an economy, and I wonder, is there much daylight? You know, those of you who watch and evaluate what's happening in China relative to trade between the Chinese and the United States, should we view China as having much daylight between the Party and the economy?

We're talking about financial systems and financial services here. My guess is that the decisions about this are decisions that come from the Communist Party; right? I mean, and then you just talked about state-owned enterprises. We've had some discussions about state-controlled enterprises, which are not state-owned but still state-controlled. And so it appears to me, just my observation, is that it looks like almost all of the apparatus that's developed in China either to boost or support or protect what they want for their economic future comes from the Party, implemented through the government, and abided by the individual enterprises. Is that a fair evaluation, do you think?

MS. STEVENSON-YANG: Yes, I think the question is for which purpose are you evaluating? So as to the daylight between the Party system, the bureaucracy and even quasi-private companies, such as Tencent and Alibaba, there is none. So one should expect a total unity of communication and purpose--not total but as much as there is within the bureaucracy between those companies and the Party.

Nevertheless, I think that foreign countries, and particularly the United States, attribute more geostrategic purpose to China than exists. I think actually there is no international geostrategic goal or a plan. The plans are all internal facing.

So I don't think that there's, for example, a Party-driven motive to access foreign data through MoneyGram or one of the other acquisitions. However, I do think that allowing a company like Alibaba to own foreign financial data and names and identifiers is a national security concern because that data will therefore be able to be accessed by the government.

HEARING CO-CHAIR DORGAN: So it's kind of a China-first policy, isn't it?

MS. STEVENSON-YANG: Yeah. I mean as to the first question, you know, why does China seem to get a lot and we don't get a lot, I mean I think the answer to that is because that's what our system is. And it's a good thing and an appropriate thing that for the most part we don't conduct our negotiations on a transactional tit-for-tat basis, whereas China actually does.

And what the problem has more been, our failure to use some of the systems and strengths that we have. My particular stomping ground is the SEC and financial regulation in the U.S. and China. And I think that our systems here--obviously this is not a matter of bilateral investment, but still a broader concern and broader leverage--it would be our ability to cause Chinese companies to provide more disclosure before they list and gather money from U.S. investors, for example.

MR. HIRSON: I would just add one point, which is I mean I agree, and it gets very complicated to figure out where the lines of the Party, and particularly when we get into private business, because that's exercised not through direct ownership but through maybe a Party committee that the largest private companies have.

But the Party doesn't just have one objective, which I think we sometimes all lose sight of. There are multiple objectives. They're sitting on an enormous governance challenge. So if you look, for example, in the financial sector at the degree to which China's financial regulators have allowed these fintech firms to challenge the very slow-moving dinosaur state-owned banks, it's been pretty impressive, and it's because they view it partly as a solution to some of the challenges they face.

So there are, I think, nuances in terms of, what the Party wants. It's not always one team. It's multiple teams and the Party acting to some extent as a referee at times.

HEARING CO-CHAIR DORGAN: Thank you.

HEARING CO-CHAIR HUBBARD: Commissioner Wortzel.

COMMISSIONER WORTZEL: I have really three short questions I'll throw out. For Ms. Stevenson-Yang, what Chinese banks operate in the United States, and are there ways to make U.S. rules reciprocal? In other words, a little tit-for-tat here.

For Mr. Hirson, on page seven in your written testimony, you put the words "critical information infrastructure" in quotes. Why?

And on page eight, you seem to be quite an advocate for a bilateral investment treaty. If, as Ms. Stevenson-Yang and Mr. Kapron point out, China hasn't complied with its WTO commitments, why would we expect them to comply with any BIT commitments?

MS. STEVENSON-YANG: Want me to take that first? That's a pretty complex question condensed into a little question.

[Laughter.]

MS. STEVENSON-YANG: All the big Chinese banks operate here--ICBC, Bank of China, Bank of Communications, and so forth. Their businesses are more focused than generally speaking our banks abroad on serving Chinese Americans and Chinese corporations within the United States.

I think that those banks are focused to a degree on creating dedicated systems that will be nontransparent to both their own regulators and to international and U.S. regulators. One good example is the payment system that China has launched as an alternative to the Swift System. Not many people use it these days, but their banks are compelled to use it for a portion of trade payments. This payment system is more or less nontransparent. In fact, totally nontransparent.

And the PBOC, the Central Bank, is working on its own version of bitcoin and blockchain trans--a system for blockchain that will allow it to have its own encryption system that governs international payments and contracts. I think those are things. One doesn't want to say, oh, you can't use these systems, but one does want to engage with them in creating transparent international systems and not using these dedicated Chinese systems.

For me, that also extends to the Asian Infrastructure Bank, which is China's sort of proposed alternative to the World Bank. There are many, many bilateral international institutions, multilateral institutions, that provide financing to the Third World for infrastructure projects. Another one that's governed by China is really not needed. So the question is why do we have it?

MR. HIRSON: Good questions on both those topics. In terms of quotes around "critical information infrastructure," it's to denote that that's a Chinese term, a Chinese concept, and of course this is subjective.

Different governments have different descriptions, but I think in China one thing that we've seen over the last several years is that regulations that deal with security or some aspect of national security are--the term is quite expansive. So national security really is a term that in China has come to mean economic security, food security, energy security in different contexts.

And so I think it's one of the more challenging aspects of engaging with China on some of these issues, is what we might not consider to be "critical information infrastructure," in China, it is. And there are sometimes market access reasons for that.

In terms of the BIT and the WTO, I think it's a completely fair point. I wouldn't say that the WTO has been a complete failure in terms of addressing China's trade concerns. I think there are many successes with WTO, and some of the existing ownership caps that we discussed are not necessarily in violation of WTO. It's just that we thought China would be making more progress than they have made.

So, one, I don't think the WTO has been a failure. I don't think we should be so quick to throw it out in terms of a dispute mechanism.

And two, we're talking about a bilateral investment agreement. The WTO is a large multilateral organization. It has its own challenges dealing with the politics of that, but we should keep in mind that the BIT would be a bilateral agreement, and thus to some extent may give us some more flexibility and some more control over how these kind of disputes are managed with China.

HEARING CO-CHAIR HUBBARD: Commissioner Shea.

VICE CHAIRMAN SHEA: Thank you very much for your interesting testimony.

Thinking about this question of lack of market access, and appreciate your bringing those issues to the forefront, made me think that there might be a silver lining here, and that's the fact that U.S. financial exposure to China may be more limited than it otherwise would be. And our staff, Michelle Ker, who you probably know, put out a paper by the Commission earlier this year pointing out how the U.S. financial exposure to China is, in fact, limited.

So I'm hearing, you know, stuff, about $9 trillion in wealth management products, a ticking time bomb. I've heard about pyramid schemes through the banks. We've heard about the stock market meltdown. Explosion of debt in China, particularly corporate debt.

Is there, in fact, a silver lining I mean in this lack of market access? So my question is really what do you think of the stability of the financial system in China? That's basically what my question is.

MS. STEVENSON-YANG: Yeah, there's definitely a silver lining. I mean look at what happened with Standard Chartered, which is a very conservative British bank. It was exposed to a hypothecations scandal for copper, copper loans in Qingdao, where all of these, all of these people brokering loans were faking warehouse certificates and saying I have a warehouse full of copper when in fact they didn't, lost up to US$500 billion all together among institutions on that scandal. And Standard Chartered sucked up a piece of it, and its share price suffered concomitantly.

There are all sorts of ways in which the U.S. institutions would have been, as I say, money flows downhill, and they would have been brought into some of those financial, risky financial schemes if they had been allowed to play.

I still think--and by the way, we have a little bit of disagreement around the payment schemes, but one of the reasons that the payments, that third-party payments have been so successful in China, but so prohibitive to foreign participation, is that the rates that are, that are required to be charged, the top rates, are too low for anybody actually to make money off the payments and companies like Ant Financial and WeChat Pay lose buckets and buckets of money on the payments themselves, but it's sort of an open secret that they invest the float.

That's a very, very dangerous thing to do. In other words, he pays me today; I pay him three days from now. In the meantime, I take the money and invest it in the short-term market. Imagine how dangerous that is, and all of this money, which is now more than 16 trillion renminbi a year, I guess, is bypassing the inter-bank system so nobody sees it--these dark rivers of cash.

So it's good that U.S. institutions have not been able to play in here. However, how about banks? How about insurance companies? We do have some examples of U.S. institutions. I keep saying AIA, but they're few and far between that are extremely successful. So let's let them expand.

MR. KAPRON: I would agree with what the other two panelists have said around this topic. I think the ability to play, certainly from a macro perspective, the overall exposure is low, so maybe that is positive. But the Chinese market is so huge in multiple different industries, including the financial industry, that these banks have run into trouble before in other countries, and they have gotten out of it in some form or another or been able to handle it in some way.

I think the question is really do they have the opportunity to play at the table, which is the real question in this?

MR. HIRSON: Just to make a quick point, I think, to pick up off a point that Anne made earlier, I think when we look at the financial vulnerabilities in China, really I completely agree with her point that we need to be putting a big emphasis on things that are sort of softer infrastructure, like information disclosure, rule of law, creditor rights, investor protections, and this is an area where foreign firms as they enter the Chinese market can actually play a constructive role.

So I'm sure you saw that China has now been included in the MSCI global benchmark. That is, I think, potentially, if used right by China and by the investment community, you know, a healthy way of exerting some pressure of raising the bar in terms of corporate governance, information disclosure, investor protection, which will help China get through this set of challenges it faces.

VICE CHAIRMAN SHEA: Thank you.

HEARING CO-CHAIR HUBBARD: Commissioner Tobin.

COMMISSIONER TOBIN: Thank you, Mr. Chairman.

I have to swing over with this chair so I can see each of you. My question relates to Hong Kong and where it plays in this system. Several of us this year went to Hong Kong, and, as we all know, the regulation is stronger there than in the Mainland; the banking system is more akin to how we're used to doing business, and yet we learned that the share of their economy that Hong Kong banks play now is significantly reduced percentage-wise than it was 20 years ago.

So as we think about liberal reform, as we think about the potential value of the BIT and how we the U.S. can play that, do you as experts in banking see Hong Kong playing a smaller role over time that is one that helps the PRC economy liberalize?

I'd be interested in all of your opinions on that, please.

MR. KAPRON: I think, in my opinion, Hong Kong remains successful because it's always been one step ahead of mainland in terms of market openness. So if you look at many of the things that are there, that Hong Kong was always the financial jumping off point for mainland China for many years. I think as we've seen the mainland market open up, as you rightly point out, the importance of Hong Kong has decreased over time, and we see other things like the Shanghai-Hong Kong connect, the Shenzhen-Hong Kong connect, that are opening up equity markets. You know, that openness will only continue going forward.

I think the challenge for Hong Kong is more of an internal challenge. Anecdotally, it's very difficult to open up a bank account in Hong Kong as a company if you're--if you have any American ownership or board members, the Hong Kong banks won't touch you in that case. There's been criticism on the fintech side that Hong Kong as compared to a place like Singapore in terms of fintech is not as innovative around that.

So longer term, I think the importance of Hong Kong, certainly as compared to the historical significance of it, will decrease, but that's kind of natural as the mainland markets open up. The question will be can they stay one step ahead to provide that bridge and still provide a valuable bridge into mainland markets?

COMMISSIONER TOBIN: Yes, and can their practices, if at all, move over into mainland?

MR. KAPRON: I think in many cases Hong Kong is a sandbox for mainland China. You know, I think they test a lot of the things in Hong Kong or they, since the handover, it's been allowed to test in those markets, and so they can try it there and then see what works on the mainland.

But fundamentally the economics of both the region and the country as a whole are completely different. So even though it may work in Hong Kong, it doesn't necessarily mean that it makes sense for mainland.

COMMISSIONER TOBIN: Thank you.

MS. STEVENSON-YANG: Well, I think it's a persistent misconception in the United States and outside of China generally that China has an agenda to become more liberal, to become more open and transparent, and to become sort of a really huge Jeffersonian democracy but on its own timeline. It really isn't that way at all. And there's no agenda to learn from Hong Kong.

China does have many hundreds--let's say hundreds of years of history of maintaining partition cities, or separate cities, that serve a function, sort of a window on the outside and allow certain aspects of foreign things to come into China without sort of polluting China too much, as Deng Xiaoping said.

So Hong Kong is one of those. I think we may possibly look forward in the future to seeing that role move toward Shenzhen or maybe Xiamen, which is across the strait from Taiwan. I can imagine a time when the Hong Kong peg breaks and the Hong Kong dollar becomes--I don't think they'll dissolve the Hong Kong dollar, but I imagine that the Hong Kong dollar in some time in the future may become more akin to the Scottish pound where the mainland ships over money and says print this much.

And so I think that the only possible direction for Hong Kong finance and economy is more an alliance with the mainland and less independent, but that doesn't mean that it won't still be called Hong Kong and given the perception of independence.

COMMISSIONER TOBIN: Almost as if it has a brand.

MS. STEVENSON-YANG: Yeah.

COMMISSIONER TOBIN: Yes.

MR. HIRSON: I would just say Hong Kong faces a number of challenges from rival financial centers in China--Shanghai, Shenzhen--from other financial centers like Singapore, but plays a really important role in terms of rule of law and information, freedom of information.

I find it striking that China has ambitions for Shanghai to become a global financial center, but still in Shanghai, unless you have a virtual private network, you're not able to read the New York Times, the FTe, Bloomberg, Wall Street Journal. Well, maybe the FTe now you're able to read, but for, you know, for a global financial center to not have that access to information is pretty striking, and so that's one reason why Hong Kong I think will remain important and is a limiting factor for the ability of Shanghai and other Chinese financial centers to become truly global financial centers.

COMMISSIONER TOBIN: Thank you, all.

HEARING CO-CHAIR HUBBARD: Senator Goodwin.

COMMISSIONER GOODWIN: Thank you, Dean, and my appreciation to the panel for your testimony today.

I want to follow up on Commissioner Shea's question and try to explore a little bit of how silver that silver lining actually is. Again, to use the phrasing that we heard here today about a ticking time bomb, and, Mr. Hirson, in your testimony, you talk about mounting financial risks, which are a threat to Chinese economic stability, which by extension, of course, are a threat to our own economic stability and Chinese political stability and therefore the geopolitical stability of the entire international community.

What are those risks? Do they flow directly from these ownership caps and restriction on access irrespective of whether our banks are able to participate fully in a financial sector and the unintentional benefits that may flow from that in terms of limited exposure? What are the risks to our economy writ large from these restrictions?

MS. STEVENSON-YANG: You want to take that or do you want me to take that? Want me to take the first part?

MR. HIRSON: You start and then I'll follow.

MS. STEVENSON-YANG: All right. The lack of participation by international financial institutions plays a very, very small part, if any part, in the risks that are mounting in the Chinese system. The risks are created by, I mean they're really sort of political risks. So, on one hand, you have, you have massive, massive debt in the Chinese economy that most conservative analysts would put it about 350 percent of GDP.

And this debt, you also have the Chinese rule, for reasons I could go into, that nothing can default because if things default, then it will be systemic, and banks will fall on their faces and so forth. So nothing can default, which means you have to keep on refinancing all of these loans that are coming to term.

On the other hand, you have the Chinese government's determination that the exchange rate not depreciate too much. So you can't, it's just a supply-demand thing. You can't just keep on supplying more renminbi and make it go whew, whew, whew, whew, you know, get that big, and the supply of dollars is still like this without having the renminbi be inherently less valuable.

That's the fundamental problem for the Chinese system. If they were to allow the renminbi to float, then they wouldn't have a problem anymore. It's just that Chinese people would no longer be able to buy BMWs and real estate in New York. But they're determined not to do that, at least this year, and therefore they're constantly running the risk of not supplying enough capital to these loans that are rolling over.

Ultimately, what will happen is the renminbi will devaluate a lot. The value of real estate and other assets in China will drop by 50 percent or more. People's bank accounts won't be worth a whole lot, and Chinese people will--the effects on the U.S. will be, number one, there will be defaults on international debt so there's bonds outstanding by the property companies, by the Internet companies, and so forth. Sorry to hog the time, but it's a complicated issue.

Secondly, imports will drop. That will have very significant impact on the commodities exporting countries--Australia, Canada, Brazil, and so forth. Secondarily, on the United States.

And thirdly, the value of the Chinese equities floated in the U.S. markets will drop a lot. That's to start.

MR. HIRSON: That's a good start. I mean it's obviously a complicated question. I mean fundamentally I think it gets down to a few factors. One, China's economy is still very credit-intensive. China gets most of its fixed investment, you know, building infrastructure, building factories, as opposed to, say, household consumption. It's still a very, very important part of China's economy--almost unprecedented for an economy as large as China's.

That requires a lot of credit. To build a bridge, to build a factory, requires debt. And so there's that factor, and then that credit is not being allocated efficiently. And really what that means is a lot of it is politically directed or, you know, it's flowing to state-owned enterprises that may not be as efficient as private firms but are able to rely on state-owned banks to direct that credit. So absolutely agree there's a real political economy problem there.

And then there's just the challenges of effective regulation, and I think those are something that China is really wrestling with right now, particularly within the financial market where there is a lot of very worrying behavior.

I would just say in terms of how serious this is, I think it is serious. We absolutely have to keep our eyes on it. I personally do not feel that China is at high risk of a financial crisis in the next couple of years, and there's some reasons for that that we can go into. But I think that it is very serious, and the issues--this is not a long-term problem. It's certainly a medium-term problem, and if they make a policy mistake, it could be a short-term problem.

But I don't think that in my base case scenario that we should be too worried about a financial risk in the short-term.

COMMISSIONER GOODWIN: Thank you. Thank you, Mr. Chairman.

HEARING CO-CHAIR HUBBARD: If I could interject something on that very point before I recognize Senator Dorgan. You know, in economics, whenever you teach students the short run and the long run, invariably some pesky student raises his hand or her hand and says so what exactly is the difference between the short run and the long run? And, of course, we don't really know.

So I want to come back at you on the two years. Why are you so sure no crisis within two years? Why is the line so cleanly drawn?

MR. HIRSON: I don't want to seem overconfident, and I'm not by any means dismissing the risk of a financial crisis, but I think that the challenges really grow over the medium term as we look at the levels of debt that cease to become sustainable. And there's no, I mean economists can argue about at what point that comes, but I think my concern, and it actually gets to the point that Senator Dorgan made earlier, which is the Party control.

I mean this is what China's fundamentally wrestling with right now in the financial system. On the one hand, China's leadership has been more focused this year about financial risks than we've ever seen before. President Xi described financial stability as a matter of national security in April.

We've never heard that kind of seriousness, which should be encouraging to us, that they're being serious about it. But at the same time, there is still a real emphasis on the financial system financing the initiatives that the Party and the government feel are important, including China's Belt and Road Initiative, some domestic projects as well.

So at the same time that they're addressing the short-term risks, it's almost as though China is right now addressing the heart attack, but they're not as worried about the cancer, and the cancer is the low efficiency of credit, and that is not sustainable.

I tend to think that this becomes more of an issue in the next three to five years, and that will be the point of another political transition in China, and the combination of the fact that debt issues are likely to remain serious and that another political transition is coming up I think makes that especially complicated. So that's one reason why I think it's that time frame that we should be focused on.

HEARING CO-CHAIR HUBBARD: Senator Dorgan.

HEARING CO-CHAIR DORGAN: Mr. Hirson, you'll be a very wealthy man if you are determined on that time frame and make a wager on it actually.

[Laughter.]

HEARING CO-CHAIR DORGAN: I think we forget sometimes the Warren Buffett law of bubbles. Every bubble bursts, and the question isn't whether, it's when, and when I hear, Ms. Stevenson-Yang, your description of the--what did you say--350 percent--conservative economist--350 percent debt level of GDP in China, so I think of bubbles.

But I was curious. After your comments about where you think this is heading, I have just finished reading Ambassador Graham Allison's new book, Destined for War, and actually I was with him a week or so ago and heard him give his book talk pitch. Very interesting. He talks about hundreds and hundreds of years of history of ascending powers crossing paths with descending powers, and he describes in his book in a very profound way the ascending power of China.

As I listen to this discussion, there doesn't seem to be very much ascending about it, at least in the intermediate term, because there has to be adjustment in their economy that's going to be painful and difficult.

So have you had a chance to take a look at that book, any of you?

MS. STEVENSON-YANG: I actually debated Dr. Allison a couple of weeks ago at the Council on Foreign Relations. I thought I did fabulously, but everybody lined up for him and nobody paid me the smallest mind.

[Laughter.]

HEARING CO-CHAIR DORGAN: They still bought the book; did they?

MS. STEVENSON-YANG: Yeah. I have lots of objections to his analysis. One of them is just plain his view of Thucydides. But, fine, that was college, which is many decades ago.

Another is his, is the definition of who's rising and who's falling and who's challenging whom? I think the whole idea of this contention is very open to debate. But more saliently, I lived in China for 25 years. I have a big set of in-laws who are Chinese. I think I'm pretty familiar with the place and the psychology that we're in, you know, the politics.

And I really do not think that there is a geopolitical goal. I think that the goal of the Chinese system is aggregation of cash. That's what it is. And there is a certain need to project gloriousness to the people because there was an era in which financial opportunity, economic opportunity was growing all the time.

That era is over, and the degree of wealth and comfort that people can aspire to now is much less than the degree they could aspire to ten years ago. It needs to be compensated for somehow. So the message being provided to the Chinese people now, from the end of the Jiang Zemin administration though this one, is, well, you can't have a Jaguar, but you might have a Volkswagen or a Geely, and even though you can't have a really nice house, well, Chinese people are glorious. The glory of China is returning. Everybody respects us, and you can use your renminbi to fly to Milan and buy stuff.

So I think it's a key message to the Chinese people that you don't have to be that rich, but you can be okay, and respect is really important, and also the renminbi.

If they would give up the renminbi, I think it would be much, much easier to manage the economy, and as for the two years, I have a view of that, but let's let you talk.

HEARING CO-CHAIR DORGAN: Let me just say thanks. I would have enjoyed that debate, by the way. I have some of the same mis--

MS. STEVENSON-YANG: I'm sure you would have lined up for him, too.

HEARING CO-CHAIR DORGAN: No, no, not necessarily, because I think he has a fascinating elevator pitch, but I, as I read the book, I think you have to assume a lot in order to believe the premise of the book, but I would have enjoyed hearing the debate.

Thank you for the answer.

MS. STEVENSON-YANG: Agree. And also he's got this thing that so many Chinese analysts have done for 20 years, which is list all the quantity achievements. You know, how much steel they've produced, and it honestly, you know, how much GDP, for example.

HEARING CO-CHAIR DORGAN: Right.

MS. STEVENSON-YANG: So I pointed out, which I thought was a good point, but he didn't, that you could also tax every American citizen $10,000, raise $3 trillion, build a wall all the way around the borders, and it would boost GDP by around ten, 12 percent next year. Would that be a value to the American people? So same thing with steel production.

HEARING CO-CHAIR HUBBARD: We might wind up trying.

[Laughter.]

MS. STEVENSON-YANG: Don't get me started.

MR. HIRSON: I think it's a great point, and just to add to that, I mean this notion of China's strength versus China's vulnerabilities, I mean when we look at China from outside of the country, we see the whole pie, the numerator of the size of China's economy.

When China's leaders look at the challenges they face, they're looking at that big pie divided by 1.3, 1.4 billion people. So it's important for us to keep in mind that China is increasingly powerful and influential on the global stage, no question about that, but they have very serious challenges, and it's really those challenges that I think China's leaders are most focused on. So even the foreign policy issues, at heart, are more motivated by domestic stability concerns.

HEARING CO-CHAIR DORGAN: And even the measurements in China and here with respect to growth, I mean heart attacks and car accidents increase GDP, as you know.

[Laughter.]

HEARING CO-CHAIR DORGAN: So all of that is suspect. But anyway thank you very much. I'm sorry to take us off to that side.

HEARING CO-CHAIR HUBBARD: Any other questions from commissioners? I have one, an attempt to join Commissioner Shea in looking for silver linings, about fintech and mobile payments.

In many respects, what one sees in China superior to what one sees in the United States, are there things that American firms can learn on the distribution side? Let's put aside investments and capital--whether it's insurance payments, fintech generally.

Let me start with you, Mr. Kapron, but anyone's views.

MR. KAPRON: Yeah. I think the, I mean this, I was on a moderating panel with the CFO from Lufax, which is one of the fintech unicorns worth in valuation one of the top five in the world basically at the moment, and he made the comment, and he said there is no fintech, there is only China fintech.

And his point on that was that by any measure what's happening in China in terms of the value of transactions, the number of transactions, the assets under management, the valuation of these companies dwarfs any sector around the world.

There has been a bit of a perfect storm in this shift to mobile. I mean if you look at PC ownership, PC ownership in China is about 50 percent household PC ownership. Here it's about 90 percent. Smartphone penetration in China is about 72 percent as compared to a global average that's about 55 to 60 percent. So there were a lot of things that were in place to assist this transition, certainly within fintech.

That being said, one of the key elements of the regulatory approach, and Michael hinted to this earlier on, was solving the issues within the financial industry. The regulators have taken very much a wait-and-see approach on a lot of the regulation. If you look at peer-to-peer lending, peer-to-peer lending first launched 2007-2008 online in China. It was only regulated last year.

Why is that? Well, to a certain extent, peer-to-peer lending helped solve the issue around shadow finance. So it doesn't completely alleviate that issue, but it brings a little bit more of that lending into a transparent environment. So I think the wait-and-see approach by regulators has been very productive.

You know, I don't follow the regulations, particularly here in the U.S., to know exactly what they're grappling with, but one of the things that shocks me is that the tech companies here beyond Apple who have Apple Pay have not really gotten into the financial industry as much as we think or as they should as compared to China.

I mean in China, Baidu has a financial product that takes search data, amalgamated and anonymized search data, and has created a financial wealth management product that sold out in two days in China, and that's a search engine. I mean obviously Alibaba, and Tencent, and Ant Financial, what they've done within this space, it's almost not fintech but tech fin. It's technology moving into financial services rather than financial services moving into technology.

So I think there are a number of elements that have made this possible in China. It's certainly "horses for courses." I mean we've seen certain things like in Australia. Australia is heavily driven by contact lists so cards. You just put down your card and you go, and that's the way it works there. In China now, QR codes.

So there's a certain amount of consumer adoption for that and certain things that were unique to the environment, but I think there are things around regulation, around product offering, and understanding a consumer that China has done very well that could be replicable here in the U.S. or in any other markets certainly.

MS. STEVENSON-YANG: Well, Alibaba, Tencent, and the payments world internationally are things--and Lufax--are companies and sectors that I follow very closely.

I have somewhat jaded opinions on them, perhaps too much like the rest of my opinions, but let's say, I would say that the lack of participation of international payments companies and payments market is, is fortunate and one of those silver linings that we should think about.

It's telling that the truly competent international finance companies like Visa are not able to make money at third-party or mobile payments. The only example of a company we have making money from mobile payments is M-Pesa in Kenya, and that's serving a very, very special population, and the durability of that model is much in question.

So, yes, I think that foreign companies should have access to the market. Are we lagging miserably behind? No. We don't all dominate. We don't have one platform that dominates because we have Facebook Messenger and Instagram and WhatsApp and WeChat, and, you know, a zillion different platforms rather than a single one in China.

I don't think it's an unhealthy environment, but I do think that we should be allowed to play in China.

MR. HIRSON: Yeah. I think we would be dumb to not study what China is doing and those companies. I mean they are innovating clearly, but, and I think to echo previous points, you have to view it in context. One reason why fintech has exploded in China is because these very savvy firms like Alibaba were exploiting inefficiencies in the system that were largely the result of government policies.

So the reason why Alibaba was able to take its payment system and turn it into now the world's largest money market fund is because caps on interest rates meant that banks weren't able to charge competitive rates. Alibaba came in and really exploited kind of a regulatory loophole as well as their technology to use their equivalent of PayPal and take that money that was parked in those accounts to become now the world's largest money market fund.

Similar dynamic taking place now with the way that Alibaba and other firms are lending to SMEs. They're answering the solution that the larger banks in China haven't been able to crack, in part because there aren't third-party credit bureaus in China and some other infrastructure that serve as the basis for sustainable consumer finance in the U.S.

So Alibaba is using its big data to do credit ratings and lend to private individuals and SMEs. In the U.S., that space doesn't exist to the same extent because we have credit rating, we have credit bureaus. So there's a degree to which these firms, yes, they're very innovative, but they're also exploiting some very particular vacuum spaces that exist in a peculiar way within China's economy.

HEARING CO-CHAIR HUBBARD: Well, if there are no further questions from commissioners, I'd like to thank the panelists. The size of the opportunity for finance in China is huge for us, but getting it right is critical for China, too, and thank you for shedding light on all that and the occasional silver lining to boot.

Senator Dorgan, I'll give you the last word.

HEARING CO-CHAIR DORGAN: Let me join you and thank the panel. I thought both panels today were really exceptional. I think we learned a great deal, and the source material, the written material, you've provided us is very much appreciated. So we thank you for being here, and we will adjourn the hearing.

[Whereupon, at 2:01 p.m., the hearing was adjourned.]

WRITTEN STATEMENT CHRISTINE BLISS, PRESIDENT, COALITION OF SERVICES INDUSTRIES

U.S. ACCESS TO CHINA'S CONSUMER MARKET

Testimony before
The U.S.-China Economic and Security Review Commission
June 22, 2017

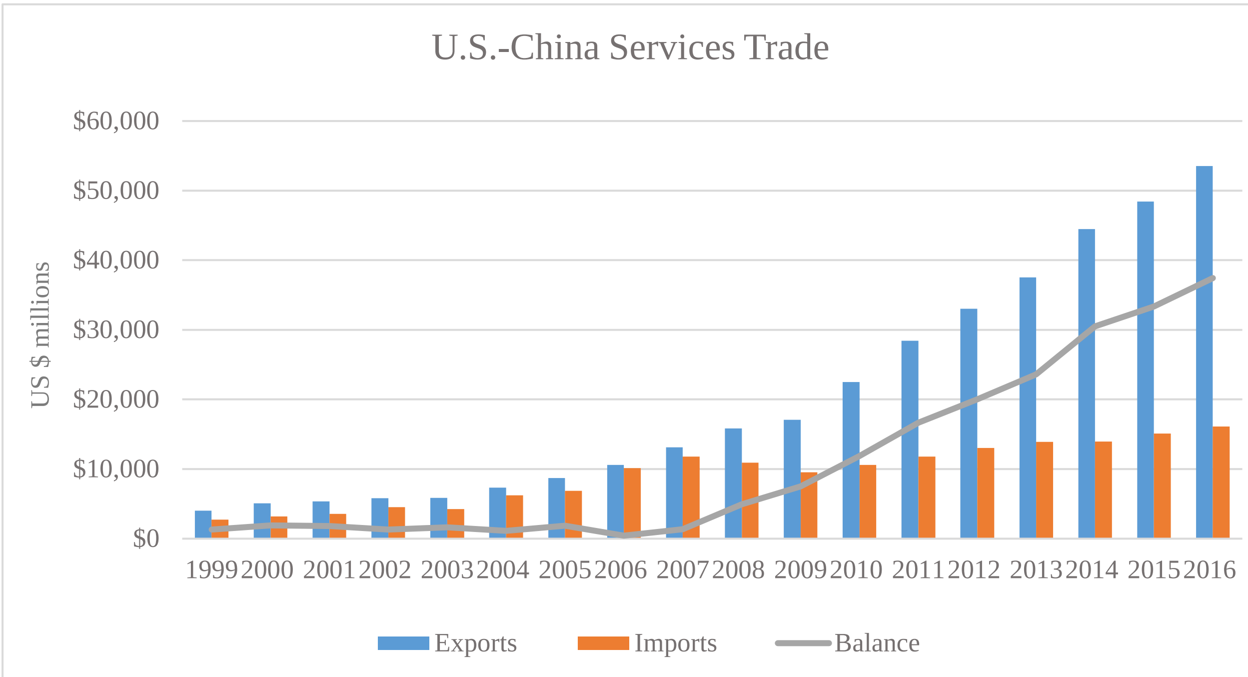
The Coalition of Services Industries (CSI) appreciates the opportunity to submit testimony to the U.S.-China Economic and Security Review Commission for its hearing on "U.S. Access to China's Consumer Market: E-Commerce, Logistics and Financial Services." As requested, this testimony will cover U.S. access to China's financial services market.

CSI, established in 1982, is the leading industry association devoted exclusively to helping America's services businesses, increasingly digitally enabled services, and workers compete in world markets. CSI member companies represent a broad spectrum of the U.S. services sector, including distribution services, express delivery, financial services, media and entertainment, telecommunications, information and communication technology (ICT) services, and professional services. These services are a critical enabler for U.S. economic growth.

Current State of Play in China

China was the second largest services export market for U.S. services providers in 2016, with $53.5 billion in U.S. services exports, and a $37.4 billion services trade surplus.[63] From 1999 to 2007, the United States maintained a services bilateral trade surplus with China of around $1 billion. Since then, U.S. services exports have more than quadrupled, resulting in the U.S. services trade surplus with China growing from $1.3 billion in 2007 to $37.4 billion in 2016.[64] This growth over the last decade in U.S. services exports to China and the bilateral services trade surplus exceeds the growth in total U.S. services exports, which have grown by 54 percent, and the increase in the global U.S. services trade surplus, which has risen by 115 percent.[65] China has thus become one of the fastest growing markets for U.S. services.

[63] "Table 3.2. U.S. International Trade in Services by Area and Country, Seasonally Adjusted Detail, China," Bureau of Economic Analysis, U.S. Department of Commerce, March 21, 2017, https://www.bea.gov/itable/.
[64] "Table 3.2. U.S. International Trade in Services by Area and Country, Seasonally Adjusted Detail, China," Bureau of Economic Analysis, U.S. Department of Commerce, March 21, 2017, https://www.bea.gov/itable/.
[65] "Table 3.2. U.S. International Trade in Services by Area and Country, Seasonally Adjusted Detail," Bureau of Economic Analysis, U.S. Department of Commerce, March 21, 2017, https://www.bea.gov/itable/; "Table 2.3. U.S. Trade in Services, by Country or Affiliation and by Type of Service," Bureau of Economic Analysis, U.S. Department of Commerce, December 19, 2016, https://www.bea.gov/itable/.



The financial services sector has been an area of great strength for U.S. services providers. Over the last decade, the United States has increased its financial services exports to China by 347

percent, totaling over $3 billion in 2015.[66] This growth rate is the second highest among all U.S. trade partners and nearly triple the average global financial services export growth rate.[67]

Despite the growth of U.S. financial services exports and China's stated intent to provide greater services market access, significant market access barriers remain, including existing and proposed discriminatory regulations in areas such as restrictions on data flows, information technologies, equity cap limitations, licensing restrictions, and outright bans on foreign investment.

China has long insisted that it is an open market with clear rules. Unfortunately, this position does not match reality. While China continues to increase its investments abroad and engage in more trade with its partners, U.S. firms have an increasingly difficult time competing on a fair playing field in China. At a time when China's economy is growing exponentially and its population is aging at arguably the fastest rate in the world, China needs U.S. services, especially those in the financial services sector. U.S. firms have considerable experience that could prove beneficial to China as its economy develops further, but this requires that U.S. companies have non-discriminatory access to the Chinese market. China's current short-sighted approach means that China risks losing the significant benefits and expertise of U.S. financial services firms.

China's Treatment of Data and Technology

The free flow of data across borders is critical in every business sector as it is necessary for businesses to operate globally in an efficient and secure manner. In addition to the free flow of data, businesses also need ICT services, platforms, and other infrastructure, to provide their services, which are increasingly digitally enabled. This is especially true in the financial services sector, where U.S. financial services firms are employing digital services and technologies to access and operate in the Chinese consumer market.

The free flow of data means that these companies can easily integrate staff around the world, maintain their customer networks as well as their supply chain, and ultimately build their competitiveness. Financial services companies rely on the ability to transfer data quickly and easily across the globe to provide better service to their clients at lower cost. This means that consumers can access their accounts from any location, whether they are performing a simple bank transfer or more complex transactions. Further, cross-border data flows increase access to capital for start-ups and allow small businesses, through digital marketplaces, to tap into foreign markets and receive payment from customers.

Over the last decade, China has taken wide-ranging steps to restrict data flows, including through requirements to localize data and servers in China. Because of the widespread use of and reliance on customer data by many financial services firms, these practices have significant impacts,

[66] "Table 2.3. U.S. Trade in Services, by Country or Affiliation and by Type of Service, China," Bureau of Economic Analysis, U.S. Department of Commerce, December 19, 2016, https://www.bea.gov/itable/.
[67] "Table 2.3. U.S. Trade in Services, by Country or Affiliation and by Type of Service, China," Bureau of Economic Analysis, U.S. Department of Commerce, December 19, 2016, https://www.bea.gov/itable/.

including in insurance, banking, and cloud computing, among other areas.[68] These data-restrictive policies impede the ability of U.S. financial services firms to supply cross-border services to and make investments in China. The inability to operate cross-border, the loss of efficiency, and increase in costs, among other impediments to operating in China, reduce U.S. competitiveness.

Moreover, as noted in the letter to China's Cybersecurity Administration signed by a global coalition of industry associations, including CSI, it appears that China's Cyber Security Law (CSL), along with other current and proposed regulations, has the potential to create additional, discriminatory barriers and impose significant compliance burdens, especially for financial services companies, due to its broad and vaguely defined scope. Particularly concerning is China's proposed requirement that all Chinese personal data must be stored domestically. The CSL also potentially subjects U.S. companies to security reviews. This includes the proposed requirements to review companies' proprietary source code and allow the government to review and approve encryption measures. The industry association letter called on China to delay implementation of the CSL along with other recent ICT regulatory and legislative actions, to allow sufficient time to work with U.S. industry and government experts to revise implementing measures that create technical barriers to trade, hinder market access, and/or diminish cybersecurity.[69] While China recently announced that some aspects of the implementation would be delayed, the data flow and storage restrictions mandated by the CSL, as well as other discriminatory aspects, remain unaddressed.

In addition, China has proposed new draft regulations regarding cloud computing services which, if implemented, combined with existing Chinese laws, would force U.S. cloud service providers to transfer valuable U.S. intellectual property, surrender use of their brand names, and hand over operation and control of their business to a Chinese company in order to operate in China. These proposed regulations are of concern to financial services companies. Cloud services provide an effective and secure way for financial services companies to provide their services cross-border as well as within China. To address this, the United States should secure China's commitment that it will allow U.S. cloud service providers to obtain and hold all necessary licenses for the operation and provision of cloud services in China, including those related to software, hardware, facilities, and infrastructure; allow foreign investment in Chinese companies established to provide cloud services in China; and allow U.S. cloud service providers to sign contracts for the provision of cloud services in China and use their trademarks and brands to market their cloud services. China should also allow U.S. cloud service providers to procure telecommunication services (including bandwidth) for the provision of cloud services on the same terms available to Chinese companies.

China has cited concerns over national security as the justification for these restrictions, but in September 2015 and June 2016, China committed to the United States that measures it has taken to enhance cybersecurity in commercial sectors would be non-discriminatory and would not

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[68] Nigel Cory, "Cross-Border Data Flows: Where Are the Barriers, and What Do They Cost," Information Technology & Innovation Foundation, May 1, 2017, https://itif.org/publications/2017/05/01/cross-border-data-flows-where-are-barriers-and-what-do-they-cost.
[69] "May 2017 Association Letter on Cybersecurity Law Implementation," The U.S.-China Business Council, May 2017, https://www.uschina.org/advocacy/regulatory-comments-on-china/may-2017-association-letter-cybersecurity-law-implementation.

impose nationality-based conditions or restrictions. These restrictions are in direct contradiction of these commitments.

Insurance Markets in China

U.S. access to China's insurance and retirement securities markets remains difficult as a result of restrictive Chinese measures. Foreign insurers have less than a 5 percent cumulative market share in what is the third-largest insurance and pensions market in the world.[70] Given the size and future growth of China's insurance markets, and the relatively small market share of foreign firms, the economic opportunity for foreign insurers, absent the discriminatory equity cap and prohibition on U.S. companies in the enterprise annuities sector (401k), is exponential and would deliver significant commercial benefits to U.S. industry. Profits generated from overseas operations would help fund long-term infrastructure investments in the United States, creating jobs, and supporting high-paying service jobs.

Current Chinese regulation places a 50 percent cap on foreign equity in life, health, and pension companies, a restriction that has been in place since China's accession to the World Trade Organization (WTO) in 2001. While U.S. industry and the U.S. government have worked for years across different fora and platforms to eliminate this barrier to the Chinese insurance market, China has been unwilling to budge. In fact, a revised 2017 draft of the "Catalogue for the Guidance of Foreign Investment Industries" shows that China will maintain the 50 percent cap on foreign equity for life insurance companies. Removing this equity cap has been a top priority for the U.S. financial services industry for over a decade, and liberalization in this area would send a strong signal that the U.S.-China bilateral trade and investment relationship is entering a new, more balanced era.

China has made some progress in liberalizing the non-life insurance sector. In 2013, China removed all restrictions on foreign non-life insurers. In January 2017, China's State Council issued the "Circular on Several Measures to Expand the Opening-up and Actively Utilize Foreign Investment," which committed to lower entry restrictions on foreign investment in several service sectors, including insurance, banking, and securities.[71] Further action is needed. The elimination of the equity cap aligns well with China's domestic policy goals and economic reform agenda, which emphasizes the need to grow the services sector, deepen financial inclusion, and enhance the participation of foreign financial services firms in China. Liberalization in the life insurance sector would benefit Chinese consumers who need greater access to insurance and more stable protection and investment options in light of China's recent market volatility.

China has not yet authorized any U.S. investment in the enterprise annuities industry, which is China's 401k. Further to equity restrictions in China, there is a 33 percent cap in the securities sector. There is also a recent proposal for new regulations to restrict domestic shareholding in foreign-invested insurance companies (both life and property casualty), which will diminish the value of existing investments. The United States should seek confirmation from China's insurance

[70] "The 13th Five-Year Plan – China's transformation and integration with the world economy," KPMG, October 2016, https://assets.kpmg.com/content/dam/kpmg/cn/pdf/en/2016/10/13fyp-opportunities-analysis-for-chinese-and-foreign-businesses.pdf.
[71] "Circular on Several Measures to Expand the Opening-up and Actively Utilize Foreign Investment," State Council of China, January 17, 2017, http://www.gov.cn/zhengce/content/2017-01/17/content_5160624.htm.

regulator that the existing "Foreign-Invested Measures" will continue to govern, with respect to foreign equity and all other issues involving insurers, with at least 25 percent foreign investment. It should also seek confirmation that the proposed regulations will not be applied retroactively to foreign-invested insurance companies.

China has made several commitments on insurance at the WTO. This includes allowing 100 percent foreign equity in property insurance and reinsurance, as well as prohibitions on creating conditions of ownership for existing foreign suppliers of insurance services that are more restrictive than they were on the date of China's accession to the WTO. Both of these commitments are formalized in the 2004 "Detailed Rules on the Measures for the Administration of Foreign-Invested Insurance Companies."

However, questions remain on how well these commitments have been followed. In short, explicit and implicit barriers in China's insurance sector mean that U.S. firms are unable to fully tap into this critical market.

Banking and Securities Barriers

China has exercised great caution in opening its banking sector to the United States. In particular, China has imposed capital requirements and other rules that that have made it more difficult for foreign banks to establish and expand their market presence in China. It is then unsurprising that foreign banks' collective market share in 2013 was below 2 percent.[72]

U.S. banks, securities, and other bodies are unable to compete on an equal footing with domestic institutions. U.S. banks are subject to a 20 percent investment ceiling (for single foreign shareholders) and a 25 percent investment limit (for multiple foreign shareholders) in local Chinese banks. Further, once a foreign-funded business in the banking sector is established, it is limited in its activity for two years. Following this waiting period, a business can expand the scope of the business, assuming it has met certain conditions, which includes holding over $10 billion in total assets.[73] There are also other restrictive regulations, including stipulations that foreign banks in China must work through branches, as opposed to subsidiaries, which have legal and economic impacts.

Equity caps on foreign ownership of securities joint ventures have not been lifted in China since 2012, and remain at 49 percent, despite the commitment to "gradually raise" the equity caps from the 2016 Strategic & Economic Dialogue (S&ED).[74] A commitment to ensuring that a foreign firm can establish a wholly-owned company in its market is a bedrock free market principle that the U.S. and a significant number of other countries committed themselves to many years ago. It is time for China to make the same positive step by allowing U.S. securities firms to establish wholly-owned subsidiaries without subjecting them to additional requirements that would hamper their

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[72] "Future Directions for Foreign Banks in China 2014," Ernst & Young, 2014, http://www.ey.com/Publication/vwLUAssets/EY-foreign-bank-china-report-2014/$FILE/EY-foreign-bank-china-report-2014.pdf.

[73] "2017 National Trade Estimate," China, Officer of the United States Trade Representative, Executive Office of the President, March 2017, https://ustr.gov/about-us/policy-offices/press-office/reports-and-publications/2017/2017-national-trade-estimate, 87-88.

[74] "2016 U.S.-China Strategic and Economic Dialogue Joint U.S.-China Fact Sheet – Economic Track," U.S. Department of Treasury, June 7, 2016, https://www.treasury.gov/press-center/press-releases/Pages/jl0484.aspx.

ability to conduct business onshore on the same terms as domestic players. Lifting equity caps only nominally, while imposing additional onerous requirements that effectively impede the business of foreign securities firms, would not be a commercially meaningful outcome.

China has also committed to expand opportunities for U.S. financial services firms to acquire settlement and underwriting licenses as part of the 2016 S&ED.[75] CSI's member companies look forward to working with the U.S. and Chinese governments to ensure proper and effective implementation of these licenses is underway.

Electronic Payment Services (EPS)

China has placed restrictions on foreign companies that provide EPS, only allowing a Chinese entity to process a payment that handles renminbi. The United States brought this dispute to the WTO in September 2010, where the dispute panel ruled in the United States' favor in 2012. The following year, China announced it had implemented the WTO's ruling, but the United States disagreed with that assessment, noting that further corrective action is needed.[76] The People's Bank of China is effectively further restricting U.S. companies' already-limited market access in the cross-border/international space at a time when it should be moving to open China's domestic market. China had previously allowed cards with the logos of both UnionPay and a foreign payment company to be issued, but the People's Bank of China pressured banks in fall 2016 to stop issuing these "dual-branded, dual currency" (DBDC) cards, and many Chinese banks followed suit. By restricting the issuance of new DBDC cards, U.S. payments companies have already experienced declines in their reported DBDC volumes; this negative trend is expected to continue.

The 100-Day Action Plan announced that U.S. EPS firms would be licensed.[77][78] While EPS licensing is a positive step, the real impact will be unclear until licenses are actually approved and banks are issuing foreign brand cards for domestic use.

A Path Forward Through Continued Bilateral Engagement

The U.S.-China Comprehensive Economic Dialogue (CED) launched this year will host four bilateral talks throughout the remainder of 2017 on a variety of issues, including on security, the economy, trade, and investment.[79] We look forward to the implementation of the initial commitments that China made as part of the 100-Day Action Plan, particularly on EPS and bond

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[75] "2016 U.S.-China Strategic and Economic Dialogue Joint U.S.-China Fact Sheet – Economic Track," U.S. Department of Treasury, June 7, 2016, https://www.treasury.gov/press-center/press-releases/Pages/jl0484.aspx.

[76] "China — Certain Measures Affecting Electronic Payment Services," World Trade Organization, https://www.wto.org/english/tratop_e/dispu_e/cases_e/ds413_e.htm.

[77] "JOINT RELEASE: Initial Results of the 100-Day Action Plan of the U.S. - China Comprehensive Economic Dialogue," U.S. Department of Commerce, May 11, 2017, https://www.commerce.gov/news/press-releases/2017/05/joint-release-initial-results-100-day-action-plan-us-china-comprehensive.

[78] Don Weinland and Gabriel Wildau, "China's fight with Visa and MasterCard goes global," Financial Times. April 23, 2017, https://www.ft.com/content/a67350fa-1f6f-11e7-a454-ab04428977f9; Alun John, "China orders banks to stop issuing dual-currency credit cards to stem capital flight," South China Morning Post, November 25, 2016, http://www.scmp.com/business/china-business/article/2049280/china-orders-banks-stop-issuing-dual-currency-credit-cards.

[79] "Briefing by Secretary Tillerson, Secretary Mnuchin, and Secretary Ross on President Trump's Meetings with President Xi of China," The White House, Office of the Press Secretary, April 7, 2017, https://www.whitehouse.gov/the-press-office/2017/04/07/briefing-secretary-tillerson-secretary-mnuchin-and-secretary-ross.

and settlement licensing, and further commitments to address other concerns in financial, cloud, and other key services sectors. Outside of this forum, the U.S.-China Bilateral Investment Treaty (BIT) would create rules for foreign investment, allowing U.S. investors better access, and on fairer terms, to China. While the BIT would not address the full scope of industry concerns with China, this negotiation would represent another outlet for continued engagement with China. These venues remain viable options to continue pressing China to address U.S. services industry concerns, but must produce tangible results that would provide greater market access for U.S. services firms.

Conclusion

Significant market access barriers remain for U.S. financial services companies in China. China continues to impose restrictions on foreign financial services firms, including equity cap limitations, licensing restrictions, and outright bans on foreign investment. Further, because of the important role that data plays in a modern, competitive economy, China's restrictions on data flows, ICT, cloud technologies, and services also obstruct U.S. financial services firms from effectively accessing the Chinese market. While China has announced, as part of recent bilateral discussions with the Administration, some initial steps in the right direction, problem areas remain. These barriers ultimately make the Chinese consumer market still largely untapped for U.S. financial services firms.