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Insight

Eyes on reshaping China: illuminating opportunities for Thai businesses

Contributors:

Sutapa Amornvivat, Ph.D.
Thanapol Srithanpong, Ph.D.
Pitsinee Thitisomboon
Veerawan Chayanon
Teerin Ratanapinyowong
Issarasan Kantaumong
Piyakorn Chonlaworn
Vorada Tantisunthorn

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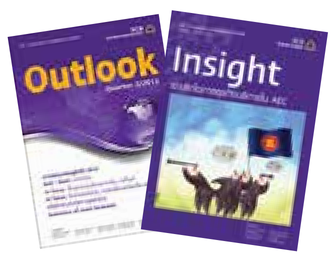

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Eyes on reshaping China: illuminating opportunities for Thai businesses

Executive Summary

China is undergoing a major restructuring of its economic strategy that will create a "new normal" of somewhat slower but more sustainable GDP growth. Under the new approach, consumption and the service sector will become the economy's key engine, displacing the leading role of investment, which helped generate a growth rate of more than 9% per year during the past decade. Because China has the world's second largest economy, with the most trade and largest population, the ongoing change will have ramifications throughout the world. This includes implications for the Thai economy, which depends heavily on trade and investment with China. Thai businesses should stay well informed about the new developments in China and adapt their strategies and tactics according to the emerging dynamics.

Despite China's GDP slowdown, EIC expects that the economy's global role will rise as a result of the ongoing reforms, led by President Xi Jinping, which aim to ensure quality of growth. There are three aspects of the transformation: 1) increasing China's role in global capital markets, 2) changing from production of basic goods toward creation of technology and innovation, and 3) expansion of the middle class, which will boost tourism and imports of consumer goods.

In this issue of Insight, EIC discusses the reform measures outlined in the 5th Plenum and identifies the related opportunities and challenges for Thai companies.

First, China is influencing global flows of capital, as it transforms from a major capital recipient to a giant capital exporter of the world. China's capital exports in the past concentrated on investment in the energy sector. The goal then was to secure resources necessary as the world's "factory." Going forward, China's overseas investment will be distributed across several sectors, including infrastructure, technology and services. Chinese policymakers aim to build a new "Silk Road," increase investment in high technology, and grow consumption. EIC expects China to invest expansively throughout the world.

Second, China aims to become a "technological innovation hub" by 2025 through policies to upgrade its capacities in science, technology and innovation. This will greatly boost the nation's competitiveness. China has already moved from simply obtaining technology transfers to become adept at further advancing existing technology using its own R&D. A good example is the development of high-speed trains. China has created the fastest high-speed trains in the world, with the longest track. In online businesses, several Chinese companies have succeeded leading roles at the global level with R&D support from both the private and public sectors. For instance, Alibaba and Tencent are among the world's leading creators of new business models. China will clearly become an innovator: the highest level of innovation development. Thai businesses should adapt to the new opportunities and also prepare for Chinese competition that will spread into Thailand quickly and aggressively.

Finally, China's enormous consumer market, with high spending power of the middle class, will drive demand for goods and services from around the world, including tourism and international real estate. Despite China's economic slowdown, domestic consumption continues to grow steadily, especially for nonessentials and luxuries.

This stems from rapid expansion of the Chinese middle class, thanks to fast income growth throughout the past decade. Products for the young and elderly will be in high demand because China is becoming an aging society on the one hand, while abolition of the One-Child policy may lead to a new boom in babies. Chinese consumers tend to be sophisticated and demanding in choosing goods and services. Thai companies that want their business must establish a clear strategy and do research on consumer preferences to tailor their products and marketing plan. Beyond China's rising domestic consumption, EIC views that tourism and real estate in Thailand have strong potential to capture demand from China. Businesses in these industries should prepare to develop their competitiveness to meet global standards and establish strategies to attract high-quality Chinese tourists and investors, because Thailand will not be alone in eyeing this group.

China has stepped up its role on the world's stage in the past few years and is overcoming the so-called middle-income trap. The economy will turn toward domestic consumption as its key growth engine. Its reforms are reversing the net direction of its international capital flows, as it transits from importing capital to exporting it for investment abroad. China's technological competitiveness is climbing, as it aims to become the world's tech leader by 2025. Thai businesses should speed up in adapting to the new business environment in China, which is Thailand's major trading partner. We must look for new opportunities to offer products and services that meet the emerging demands of modern Chinese consumers. Businesses must develop new technology and gear up for an influx of Chinese investment in various industries, so that Thailand can become a part of China's global value chain and grow sustainably with the Chinese economy in the future.

China economic reforms toward sustainable growth under 5th PLENUM

What is a PLENUM?

Plenum or plenary session is the biggest annual meeting of Chinese Communist Party, lead by president Xi Jinping. The latest one was the 5th plenum which discussing the new 5-year development plan (2016-2020).

2012 2013 2014 2015 2016 2018

NOV 2012

1st PLENUM

Xi Jinping was elected as the General Secretary of the communist party of China

FEB 2013

2nd PLENUM

National People's Congress approved Xi Jinping as the latest president of China

NOV 2013

3rd PLENUM

Xi Jinping announced economic and social reform policies
"Reduced GDP target to around 7.5%"

OCT 2014

4th PLENUM

"Rule of Law" a major reform in legal area to target corruption
"Reduced GDP target to around 7%"

Oct 2015

5th PLENUM

Announced China's 13th 5-year development plan (2016-2020) **"GDP reduce target for 2016 to 6.5-7%"**

Business opportunities
arises from China economic reform

China economic restructuring rewards sustainable growth will enhance China potential to become one of the leading economic in the world

1. China's emergence as a world source of capital

2. China's step toward innovative and high-technology sector

3. Increasing numbers of China's upper-middle class income population

Source: EIC analysis as of 2016 based on data from Bloomberg

1

How will the 5th Plenum plan change China?

During the past decades, China drove economic growth through policies and measures that centered on ramping up investment. In recent years, however, investment grew too fast in terms of pace and volume, resulting in widespread misallocations of capital that generated losses and project inefficiencies. With these problems in view, the government under the leadership of President Xi Jinping has been pushing forward a series of structural reforms of the Chinese economy. The most recent meeting of the Communist Party's Central Committee, its Fifth Plenary Session, or 5th Plenum ,which took place in October last year, laid out the plans for China's development over the next five years, from 2016 through 2020. The plans encompass economic, financial sector and social reforms that aim to sustain China's growth during a time of global economic volatility.

What were the consequences of China's past strategy to drive economic growth, and how have reform policies under 5th Plenum tried to address the problems?

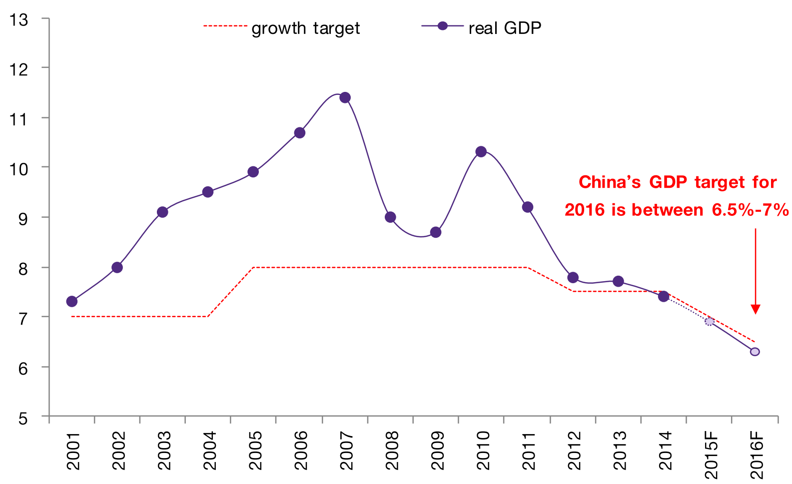
During the past 10 years, China's economy expanded at an average pace of more than 9% per annum, propelled mostly by investment (Figure 1). Throughout this period, the central government, local governments and state-owned enterprises invested heavily in infrastructure and real estate to speed up the nation's process of urbanization. But the rush to invest created numerous economically inefficient and unprofitable projects. This is especially true of investments by local governments and state-owned enterprises, which could borrow cheaply and easily from state-owned banks. As a consequence of its investment spree, China has accumulated public debts that totaled 160% of GDP.

Since 2012 investment has slowed, and several industries that have long relied on demand generated by capital spending have become afflicted by overcapacity and oversupply in the marketplace. Most of the affected industries are heavy manufacturers such as makers of steel and construction materials. This negative consequence shows that high dependence on investment is not a sustainable solution for growth. When China's investment slows, the economy quickly decelerates because private consumption and the service sector still account for a small share of economic activity. China cannot rely on investment alone as in the past, because overcapacity makes capital spending less effective in generating economic returns and government debt is reaching a critical level.

1 China's economic growth continues to decline

GDP target and real GDP growth

Unit: %YOY



Source: EIC analysis based on data from Bloomberg

President Xi thus decided to push ahead with structural reforms so that the economy can grow sustainably. The government first announced its reform plans in its 3rd Plenum meeting. One of the goals then was to double GDP per capita by 2020 compared to the level in 2010. This would make China a "moderately prosperous society," as the policy statement describes it. The reforms aim to increase the role of markets in allocating capital, thereby increasing economic efficiency. The government reduced price controls on public utilities and opened up previously state-controlled industries to the private sector. Beijing also increased the role of the financial sector and domestic capital markets to curb growth of "shadow banking." Policymakers wanted to reduce investment by local governments and state-owned enterprises, shifting toward a more consumption-oriented economy.

Under the 4th Plenum , the government introduced the "Rule of Law" policy, a major reform targeting corruption. It pursued policies to crack down on malfeasance among high-ranking local officials and management of state enterprises. Legal reforms increased penalties for those convicted of corruption. But one side effect of the crackdown was a slowing of public investment by local governments, which became more cautious about spending amid closer scrutiny.

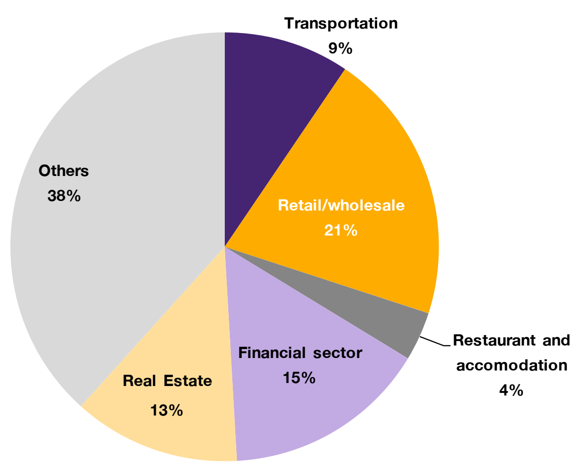
In the 5th Plenum meeting held last year, the government laid out its latest five-year plan for social and economic development. China's 13th development plan stated that China economy should grow on averaged of 6.5% per year for 2016-2020, so that GDP per capita will remain on track to double by 2020. The full plan will be officially announced in March 2016, and will include six areas of reform:

1. Financial markets and capital markets This set of reforms will allow the financial services sector to grow sustainably. A strong financial sector will attract foreigners as well as Chinese to invest more in the equity and bond markets. This will, in turn, boost growth of the overall services sector because 15% of that sector in China comprises the financial and capital markets (Figure 2). Moreover, development of new financial products will enhance opportunities for Chinese investors and open up new sources of funding for private companies. All of these changes should ultimately boost the overall economy.

2 The financial and capital markets account for more than 15% of the service sector in China

Shares to total services sector- by business type

Unit: %



Source: EIC analysis based on data from CEIC

1.1 The government plans to liberalize capital flows through the Qualified Financial Institutional Investors (QFII) program and the RMB Qualified Financial Institutional Investors (RQFII) program. Under these two programs, the People's Bank of China (PBOC) allows qualified foreign institutional investors to invest in Chinese domestic assets such as stocks, bonds and derivatives. In addition, the China Securities Regulatory Commission (CSRC) plans to improve the IPO process by introducing a registration system. IPOs issuance will be oversee by the Shanghai and Shenzhen stock exchanges, instead of CSRC. The new process will increase transparency and end government influence on IPOs issuance, so that bigger corporations do not have an unfair advantage over smaller players. Following the launch of the Shanghai-Hong Kong Stock Connect in 2014, the CSRC will introduce the Shenzhen-Hong Kong Stock Connect in 2016, to further increase investment options for domestic and international investors.

1.2 The yuan will be incorporated into the IMF's Special Drawing Rights (SDRs) basket in 2016. This means that other central banks will be able to hold yuan as their international reserves. The yuan's inclusion in SDRs allows the Chinese government to issue bonds in a wider market and encourages the use of yuan in international trade transactions. It also sets the stage for China to fully liberalize its capital account when ready.

2. State-owned enterprises and local governments The ongoing reforms of state-owned enterprises and local governments are the major cause of the slowdown in China's domestic investment. More rigorous scrutiny has made it more difficult for local government and SOEs to borrow. Yet this reform will increase the economic efficiency of SOEs and government projects in the long-term. The initial plan has several aspects:

2.1 The initial SOEs reform outline has divide state-owned enterprises into two main groups: for-profit organizations and social-development organizations. The government will encourage private parties to share ownership from the state-owned, especially in the telecommunication and banking industries. Moreover, a new committee will be formed to monitor and manage the operations of the state-owned enterprises. The plan will also make sure that SOE employees and management executives to receive pay that appropriately reflects a company's performance.

2.2 Another set of reforms is pushing local governments to issue municipal bonds as an alternative source of investment funding. The government also plans to restructure local governments' existing debts through a debt-swap program that allows localities to exchange their loans from banks and trusts for municipal bonds. This will extend loan maturity and reduce the interest burden on local governments because the majority of their credit now comes from local government financing vehicles (LGFVs) that charge high interest rates.

3. Social welfare development Social security and other social welfare systems will be reformed to be more inclusive and better cover migrant workers. At the heart of this reform is the revamp of the "Hukou system", China's household registration system, so that all citizens can receive fair benefits regardless of where they live. The existing system only provides welfare services to an individual in his or her hometown. Now migrants who move to urban areas will gain access to benefits. The reform will also strengthen land rights for farmers, allowing them to own land they use for the purpose of farming. This reform will prevent local governments from seizing farmers' land (often to generate revenues from property development). Furthermore, the government will expand investment and development into rural areas to increase the nation's rate of urbanization, especially in Tier-3 and Tier-4third- and four-tier cities.

4. Increasing innovation in industry The government plans to promote R&D and provide financial support to selected business sectors to shift industry away from labor-intensive activities toward technology-led businesses. The reform will encourage innovation in the agricultural sector and the use of digital technology throughout all types of business operations. The move to high-technology industries that employ skilled labor will sustain the income growth of companies as well as wage growth, help expanding domestic consumption in the future (Figure 3).

3 Rising wages in China will boost domestic spending in the future

Average wages in private and state-owned enterprises

Unit: thousand yuan/person/year

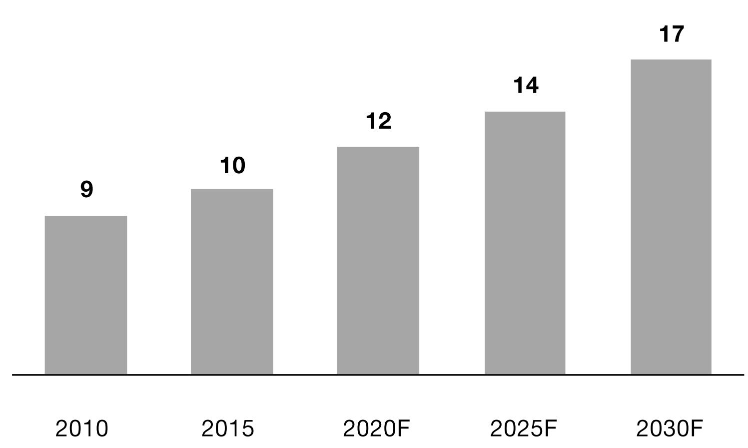
Source: EIC analysis based on data from Bloomberg

5. Demographics The law that has long limited parents to have only one child has been abolished to increase the birth rate. This will help remedy a decline in the size of the working-age population and counterbalance the growing numbers of aging population (Figure 4). The age of retirement will be extended to help reduce labor shortages. Pension funds may be reformed so as to cover a longer period of retirement, as life expectancy rises. However, these demographic reforms will take time to produce results.

4 The share of aging population in China has increased

Shares of aging population in China (over 65)

Unit: % of total population



Source: EIC analysis based on data from US Census Bureau

6. Environmental regulations China did not focus much on environmental issues in previously announced reforms. In the 5th Plenum , however, more measures aim to address these problems. There may be regulations to reduce the industrial sector's emissions of CO_2 . Newer technology will be promoted to reduce pollution. Use of alternative energy will be emphasized. The government plans to increase the share of energy consumption from sources other than fossil fuels to around 20% of total energy consumption by 2030. It aims to reduce greenhouse gas emissions per unit of GDP by 60% - 65% from the level of 2005.

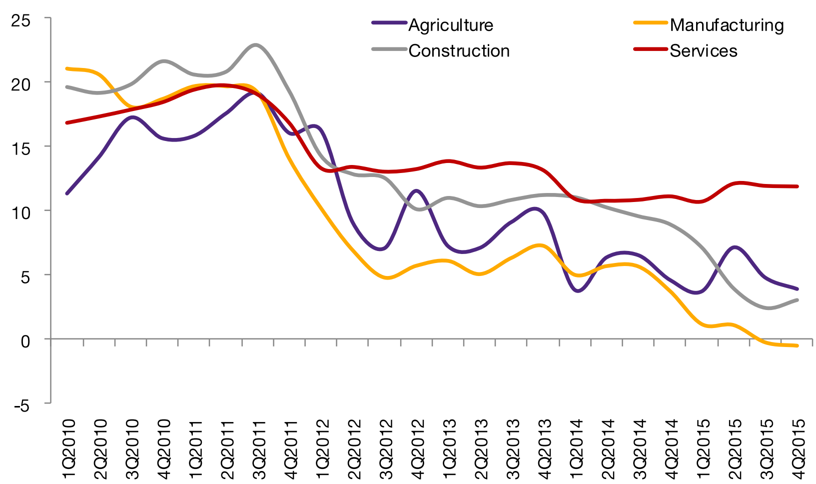
What will China's economy be like under the 5th Plenum reforms?

China's GDP growth will slow to a "new normal" of below 7% per year as the economy becomes oriented toward consumption and services. Growth trends in China differ across sectors. In particular, the manufacturing sector and construction sector are slowing, while the service sector continues to expand at a fast pace (Figure 5).

5 China's service sector continues to grow rapidly, while the industrial sector is shrinking

China economic growth-by sector

Unit:%YOY



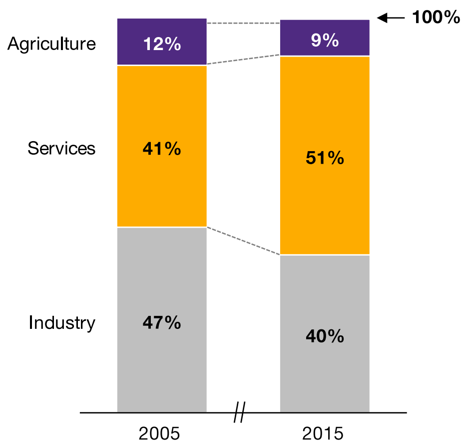
Source: EIC analysis based on data from CEIC and Bloomberg

Going forward, consumption and services will become the main economic drivers that help sustain growth in China, similar to the pattern in advanced economies. China's ratio of services to GDP has been on the rise (Figure 6). It is projected to reach over 70%, the same level as in other developed economies. Reforming financial sector so that it becomes more stable and liberalizing investment will increase household incomes and allow the yuan to play a more prominent role in international trade. Allowing the private sector to participate in previously state-controlled industries will improve efficiency and strengthen private companies, which now tend to be overshadowed by SOEs. The efforts to make social security and welfare more inclusive will reduce households' propensity to maintain high precautionary savings. This will allow families to spend more on consumption. Wages will also increase as the labor market shifts toward high-skill jobs. Rising employment in the high-technology industry and the service sector will lift more households into the middle- and upper-income groups, expanding urbanization into third- and fourth-tier cities all over the country. This will fuel higher demand for modern consumer products such as electronics, plastic products and processed food (Figure 7).

6 The share of the service sector to GDP has been rising

Shares to GDP-by sector

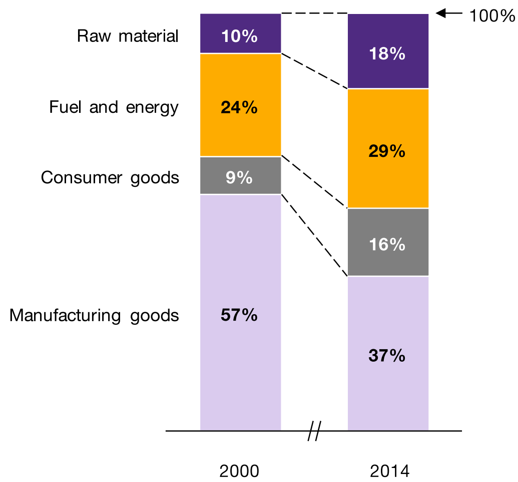
Unit: %



7 China is importing a larger share of consumer products

China import structure-by sector

Unit: % to total import



Source: EIC analysis based on data from CEIC

Although investment will slow, the government policy to allow markets to allocate financial resources will improve efficiency. The government has allowed in more foreign players, especially in the banking sector. It has eliminated the ceiling on deposit interest rates so that small banks can set a higher rate to compete with state-owned banks. Development of the financial sector will allow private companies to more easily access capital through IPOs and bond issuances. Restructuring local governments and state-owned enterprises will improve the efficiency of their investment projects. Nevertheless, the reforms may not go smoothly, and it will take time for China to become the world's leading economy.

Despite the continuing economic slowdown, the reforms under the leadership of President Xi Jinping will build a strong foundation for China to become the world's top economy. EIC expects that new policies under the 5th Plenum will open up business opportunities, as the service sector becomes a major growth engine, similar to advanced economies. Rising personal incomes will drive the economy to be more consumption-oriented, increasing demand for consumer products and tourism. Under the reforms of industry, China will shift toward greater production of innovative and high technology products. These changes will create new opportunities for businesses around the world.

BOX: China's economic climb follows footsteps of Japan

During the years after World War II, Japan transformed its industries, emerging as an economic powerhouse within a few decades. Japan's three key success factors were: abolishing the old business oligopolies to promote competition in the market, establishing efficient public policies to facilitate domestic and international investment in building up a production network, and last but not least, developing well-rounded human capital to promote domestic innovation and research. Japan's decades of economic reform can be divided into two major periods as follows:

1) Postwar occupation by the U.S. army: 1945 - 1953 (postwar occupation: 1945-1953) During this period, Japan followed an economic recovery plan set by the U.S., which featured three key policies. First, it eliminated the old zaibatsu, the large corporations that monopolized many industries, and it liberalized commerce, trade and investment. Reform of land rights created fair distribution of farm land, promoting a more efficient allocation of productive resources. Labor reforms established labor unions and developed a working environment that provided fair pay and increased productivity.

2) Economic "miracle": 1953 - 1970 Japan focused on domestic investment to improve the economy's potential during its "miracle" years. During this time, the private sector played the leading role in investment, but with support from the government. Japan imported new foreign technology that rapidly became a platform for domestic innovation. The important industries during this time were steel, shipbuilding, chemicals, machinery and automotives. The economic development plan emphasized generating steady income for Japanese households, contributing to high growth in domestic consumption and investment. The government also raised education standards nationwide, invested continuously in R&D and built several research centers all over the country. Japanese companies started to invest abroad during this period.

China's process of major economic reform began in 1978, when the government led by Deng Xiaoping opened the way for market principles and for the private sector to play a rising role in an economy long monopolized by the state. China's strategy for introducing market forces was to designate special economic zones in key cities and gradually expand those areas. This differed from the strategy taken in Japan, whose island geography and smaller population made it possible to implement reforms nationwide. Nevertheless, Japan's similar cultural roots and close proximity have influenced China's approach to reform. Japan's success in becoming an economic powerhouse derived from having high levels of domestic investment and consumption and also the ability to create new technology and high value-added innovations. After opening up the country to capitalism, China turned to investment and international trade as key growth drivers. During 1990-2008, foreign direct investment flooded in, establishing China as the so-called "factory of the world," and putting lots of foreign technology in place. After 2008, China began to emphasize the economic role of domestic consumption as well as outbound direct investment, as Japan had done decades before. Policymakers also paid more attention to local development and ownership of technology. During the past four years, a large economic and industrial restructuring program took place. Investment in R&D, which was previously small and limited to government initiatives, has continued to grow, increasingly led by the private sector. Chinese innovations and brands are becoming known to consumers around the world.

EIC sees China's development path as similar to Japan's in three important ways:

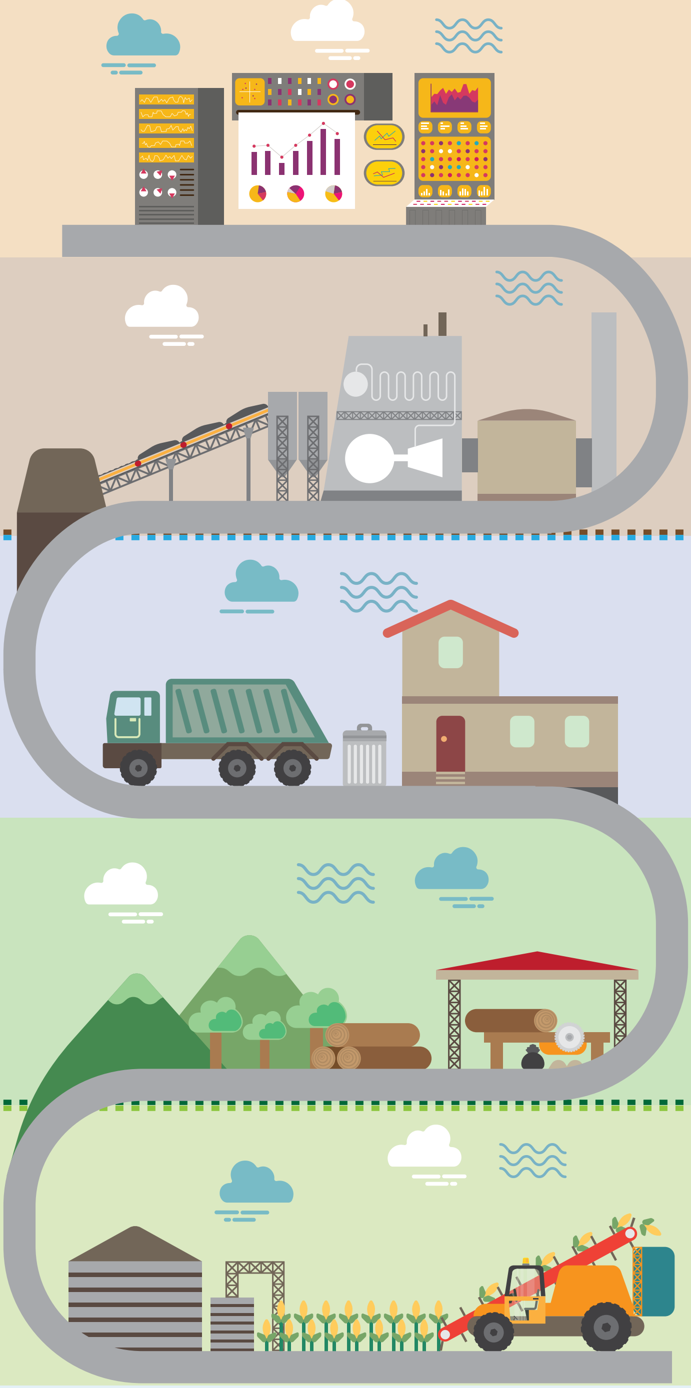
1) Development of well-rounded human resources and technology Today, Chinese companies are building their own brands to capture global markets. Chinese industry is transiting from its past role as an original equipment manufacturer (OEM) toward becoming an original brand manufacturer (OBM), as Japan did from the 1960s onward.

2) Improvement of the economic environment In the past, all economic activity in China was heavily controlled by the central government and local governments. Today, Chinese policymakers are relaxing controls at all levels and encouraging the private sector to drive industrial development, as Japan previously did.

3) Emphasis on exporting capital and outbound FDI Japanese companies overwhelmingly dominate investment in the domestic economy, and they also have a large share of investment around the world. They have established vast production networks outside of Japan. China, on the other hand, has mostly been a recipient of FDI, not a source. Now the Chinese government is trying to curb domestic investment and promote outbound investment instead. This includes both acquisitions and portfolio investment in foreign capital markets.

China's economic reforms and quest to become the world's top economy are still in progress, and they face an uphill climb. Two key reasons are: 1. Development and maintenance of human resources Even though China's number of researchers and scientists ranks among the highest of any country in the world, not all of them are working to create new innovations to improve the country's own economic potential. Many of these professionals work abroad or for foreign companies at home. Meanwhile, Chinese-owned technology still lacks a unique identity. 2. Liberalization of the private sector needs to better align with globalization by reducing the government's control, encouraging competition as in market-led economies. Furthermore, China needs to prioritize several institutional changes. For example, even though the household registration system, or hukou, is being liberalized to better distribute social welfare, it still contributes to inequality, and it remains an obstacle for workers in finding work outside their hometowns. The obstacles to reform need to be monitored. Nevertheless, EIC views that China will continue to follow a pattern of industrial and economic advancement similar to Japan's past successful example, despite some differences in detail. China will thus assume an ever more important role on the global stage.

Industrial Development and Industrialization Process



STAGE 5

Innovation-driven Manufacturing

i.e. Manufacturers with full capability in innovation as the global leaders such as US, Japan and Germany

Japan is in stage 5

Usage of complex technology and in-depth knowledge

STAGE 4

High-technology Manufacturing

i.e. Manufacturers with high technology and management as the regional leader such as South Korea and Taiwan

Technology absorption

China is in between stage 3 and stage 4

STAGE 3

Cluster Manufacturing

i.e. Manufacturer in industrial clusters in the ASEAN-4 (Thailand, Indonesia, Malaysia, the Philippines)

FDI Agglomeration

STAGE 2

Simple Manufacturing

i.e. Simple assemblers in the CLMV (Cambodia, Laos, Myanmar and Vietnam)

Industrial Revolution

STAGE 1

Agriculture

Every country in Asia starts at the same point from the 1930s being an agro-based country. Over the past 80 years, each country has been situated and participated in different points of the global value chain in the world manufacturing industry

Focus on OBM* (stages 4–5)

Focus on OEM* (stages 2–3)

Evolution of Japanese and Chinese Economy during 1978-2015

	Japan	China
Economic Policy	has focused on investment and domestic consumption	focused on international trade and domestic investment, and has now shifted towards domestic consumption
Outward FDI	has been high and the main policy for economic growth	has been increasing rapidly in recent years with support from the government
R&D Policy	private companies as the main leader with high R&D budget	was primarily led by the government and has later associated by privated companies
Government Sector	policy planner (all markets are free and highly open)	policy autocrat (not all markets are free and some are still not open)
Private Sector	has been the global leader in technological development	had to conform to the government's rule, but can now develop own ideas

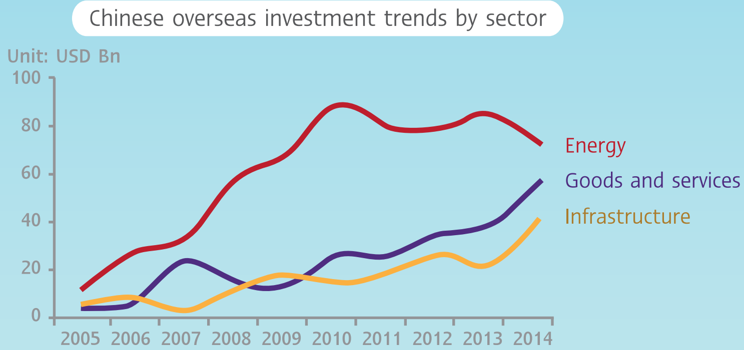
*OEM (Original Equipment Manufacturing) product is a product which is made and then sold to other companies to resell and rebrand.
OBM (Original Brand Manufacturing) product is a product which is built with its own brand by a company that retails their own branded products that are either the entire products or component parts produced by a second company.

Source: EIC analysis as of January 2016

China's emergence as a world source of capital

China is stepping up its role as an investor aboard, becoming a net capital exporter

- China outward investment has expanded globally and is likely to continue to increase especially in infrastructure development, goods and services.



Drivers for Chinese overseas investment	1 Development of the new silk road projects	2 China's growing outbound tourism	3 Rise of China's middle class and domestic consumption	4 Enhance technological readiness of Chinese corporations
Direct business opportunities	• Logistics • Building materials • Construction	• Tourism related businesses ie. hotel, airline, marina and cruises • Real estate ie. condominium, vacation houses	• Food and beverages • Agro-industry • Consumer goods • Electronics and electronical appliances	• Inclusion into China's technological value chain
Indirect business opportunities	Financial services, business and strategy consulting services, legal services, accounting and financial services, asset appraisal services, middleman services and services for Chinese expats.			

Thai businesses should quickly adapt to changes in competition and in the global market by:

- Enhance skills necessry for cross-border buiness, such as cultural awareness and language sills.
- Upgrade technological competitiveness to be able to join Chinese production chains.
- Build and foster business relationships with Chinese companies that might invest overseas.
- Employ a proactive market strategy, such as targeting wealthy Chinese with high spending power in the tourism and real estate sectors.

Source: EIC analysis as of January 2016 based on data from Bloomberg

2

China's emergence as a world source of capital

China has recently become one of the world's largest exporters of capital. Its rise as an international investor means that China's economic growth is no longer confined to trade and the domestic economy. Outward investment from China takes various forms including direct investment, merger and acquisitions, and outward contracted projects. Chinese overseas investment will multiply and become more geographically dispersed. China's rise as a global investor will present many business opportunities for Thai businesses; therefore, Thai businesses should prepare to benefit from this trend and geared up to compete against more Chinese-invested companies in global markets.

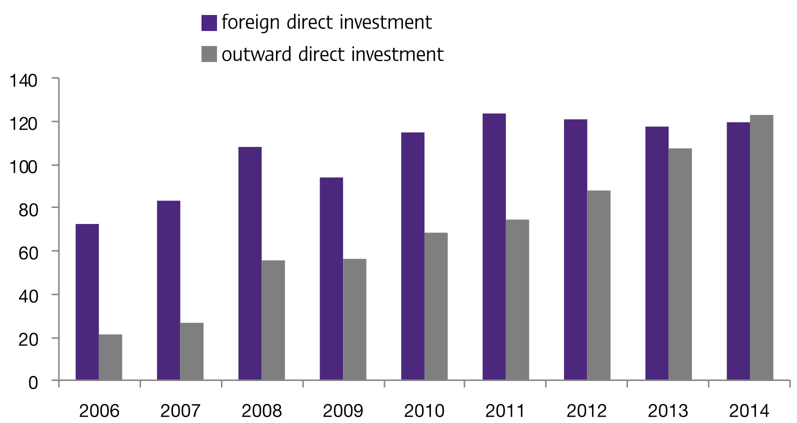
What are the current trends in China’s overseas investment?

After decades of being a net recipient of capital, China is stepping up its role as an investor abroad, becoming a net capital exporter. China’s capital outflows via direct investment and mergers and acquisitions have become increasingly prominent. Data from China's Ministry of Commerce reveal that China’s outward direct investment (ODI) has steadily risen, surpassing the amount of foreign direct investment (FDI) coming into China for the first time in 2014 (Figure 8).

8 The year 2014 marked the first time Chinese outward direct investment surpassed foreign direct investment

Chinese outward direct investment and foreign direct investment

Unit: USD Bn



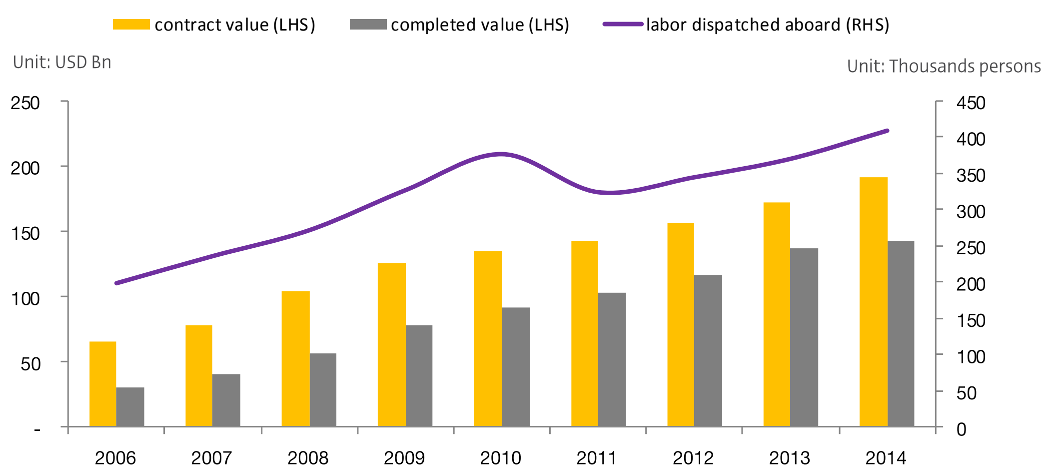
Source: EIC analysis based on data from China’s Ministry of Commerce

Chinese companies have become increasingly focused on mergers and acquisitions overseas. During the first 10 months of 2015, the value of overseas M&As by Chinese companies increased 55%YOY, with the number of transactions shot up by 40%YOY from 2014.

Another form of outbound investment is outward contracted projects. Data from China's Ministry of Commerce show that the value of China's contracted projects abroad has been rising, especially since 2010. These projects are now estimated to total more than USD100 billion per year (Figure 9). The contracted projects include planning and consulting services as well as labor sourcing by Chinese companies.

9 Outward contracted projects by Chinese companies have rapidly increased

Outward contracted projects by Chinese companies



Source: EIC analysis based on data from China's Ministry of Commerce

Which overseas industries do Chinese investors target?

China's investment is widely distributed in many regions around the world. Data from the American Enterprise Institute show that the combined value of Chinese direct investment, mergers and acquisitions, and contracted projects is highest in the United States, followed by Australia and Canada.

During the past seven years, Chinese FDI concentrated most in the commercial services especially in megaprojects and drilling and mining projects. China's next most targeted industries are financial intermediaries, wholesale and retail, manufacturing, logistics, real estate and construction, respectively. The fastest growth in China's ODI is in information technology, growing at 63% per year in the past five years. Next is construction, growing at 57% and real estate at 48% per year, respectively.

China's top players in overseas investment are mostly state-owned enterprises in the energy and construction sectors that are supported by the Chinese government to pioneer outbound FDI. Examples are China National Petroleum Corporation (CNPC) and the Sinopec Group. Two other interesting cases are China Investment Corporation (CIC) and the State Administration of Foreign Exchange (SAFE). The two companies use China's international reserves to invest abroad, comparable to a sovereign wealth fund like Singapore's Temasek Holdings.

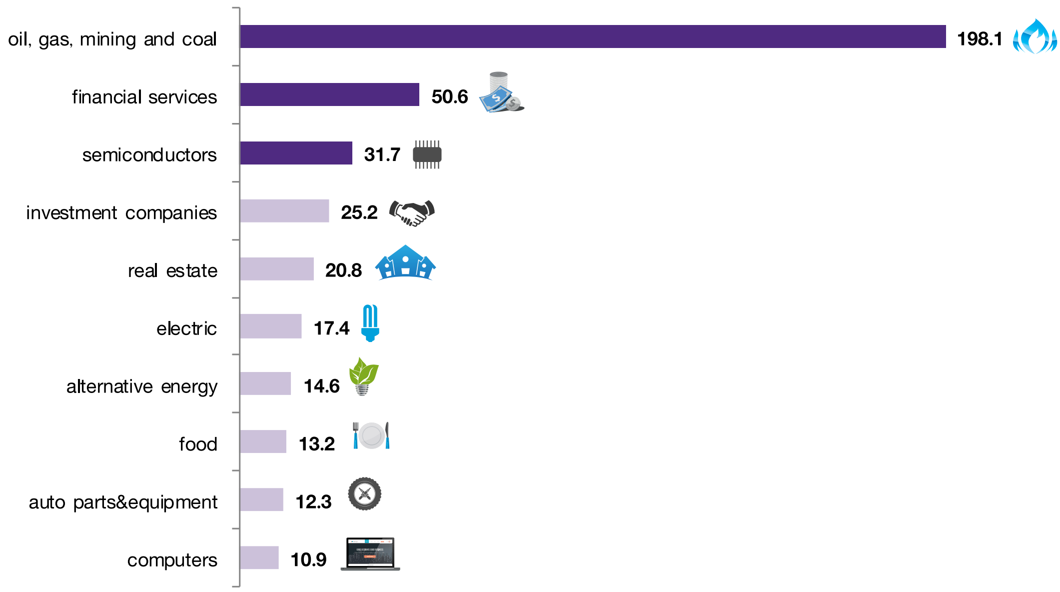
The industry with the highest value of overseas M&A activity is in energy industry, including oil, natural gas, mining and coal. In particular, Chinese firms focus on companies in North America, Western Europe and developed Asia-Pacific countries like Australia and Singapore. One example is China National Offshore Oil Corporation's purchase of USD15-billion of stock in a Canadian energy company, Nexen. Another is China National Chemical Corporation's purchase of 26% of an Italian tire manufacturing company, Pirelli, for USD7.96 billion in 2015.

The targets of most of China's international M&As are listed companies in the advanced economies. In particular, Chinese firms focus on companies in North America, Western Europe and developed Asia-Pacific countries like Australia and Singapore. One example is China National Offshore Oil Corporation's purchase of USD15-billion of stock in a Canadian energy company, Nexen. Another is China National Chemical Corporation's purchase of 26% of an Italian tire manufacturing company, Pirelli, for USD7.96 billion in 2015.

10 Most Chinese M&A activities concentrate in energy-related industries.

Mergers and acquisitions of foreign businesses by industry (accumulated value from 2005 to August 2015)

Unit: USD Bn



Source: EIC analysis based on data from Bloomberg

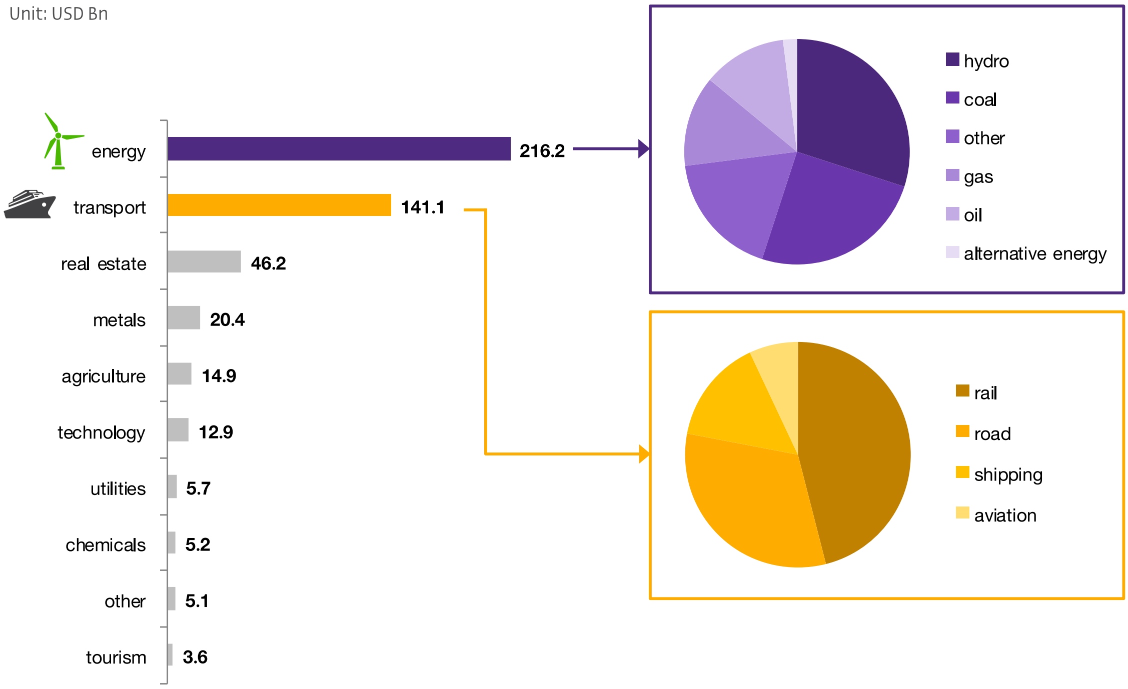
The majority of Chinese contracted projects abroad are mostly construction in energy transport infrastructure. In the energy sector, Chinese firms take on construction projects for hydropower plants the most, followed by coal power plants, natural gas power plants and oil power plants. In the transport sector, the biggest projects by value are rail projects, followed by road, water and air transportation projects.

Most projects are mega-infrastructure projects in developing countries For example, Chinese firms are responsible for a rail project in Nigeria worth USD8 billion, a rail project in Venezuela worth USD7.5 billion, and a nuclear power plant project in Pakistan worth USD6.2 billion. Companies that take on these high-value projects are generally stated-owned, such as China Communications Construction and China Railway Construction (Figure 11).

11 Industries with the largest share of Chinese outward contracted projects are energy-related and transportation construction

Chinese overseas contracted projects' value by industry (accumulative value from 2005 to August 2015)

Unit: USD Bn



Top 10 Chinese companies with outward contracted projects (accumulative value from 2005 to August 2015)

contractors	industries	contract value (USD Bn)
China Communications Construction	transport	50.1
Sinomach	real estate	49.6
China Railway Construction	transport	45.7
State Construction Engineering	real estate	25.8
Sinohydro	transport	24.1
Power Construction Corporation	energy	23.9
China National Petroleum Corporation	energy	22.9
China Railway Engineering	transport	16.7
China Energy Engineering	energy	14.6
Sinopec	chemicals	11.2

Source: EIC analysis based on data from American Enterprise Institute

What will be the future direction of Chinese investment?

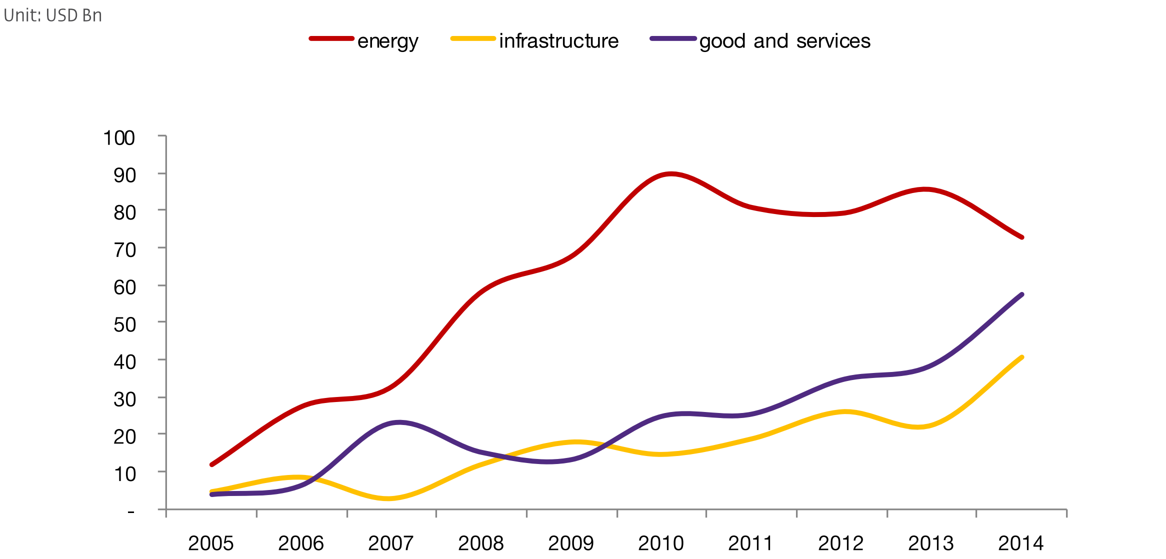
China's outward investment has high growth potential. EIC believes that China's global investment spree has only just begun. Within the next 5 to 10 years, several catalysts will prompt Chinese firms to invest more abroad. In particular, the continual expansion of Chinese exports has pumped revenues and profits into Chinese firms. The money paid for China's exports is exchanged into yuan, causing China's international reserves to balloon. When the Chinese economy stalls, domestic companies turn to invest abroad to expand their markets and increase their revenues. Moreover, the gradual liberalization of China's capital account will make it easier for the private sector to invest overseas, acquire foreign companies and establish overseas operations. Chinese individuals, who have a high rate of savings and high purchasing power, will find it easier to buy foreign assets like stocks, bonds and real estate.

China wants to increase its role in the global market. In an effort to do so, China has founded the Asian Infrastructure Investment Bank (AIIB) as an institution that provides financial support for development of infrastructure and key industries in Asia. Its function is similar to that of the long-established Asian Development Bank (ADB). As of October 2014, 22 Asian countries have signed a Memorandum of Understanding (MOU) to co-establish the bank.

Even though past Chinese overseas investment has focused on acquiring resources, especially energy that are lacking in China, the next stage will likely focus on infrastructure, providers of goods and services as well as technology. In the past, the energy sector, which is crucial to the domestic economy, received the largest share of China's investment abroad. But as oil prices decline, the value of investment in energy has stalled. On the other hand, the value of investment in goods and services businesses and infrastructure has begun to rise substantially (Figure 12).

12 Chinese overseas investment in the energy and industrial sectors is on a decline, while investment in infrastructure and goods and services is rising.

Chinese overseas investment trends by sector



Source: EIC analysis based on data from Bloomberg

What will drive the next stage of Chinese overseas investment? And what are the targeted industries?

1. Development of distribution networks by building the New Silk Road Economic Belt (or One Belt One Road) will lead to a rise in China's investment in infrastructure abroad. The One Belt, One Road framework is China's economic policy to connect China and its trading partners in Asia, Africa and Europe by land and sea. More than 40 countries will be part of China's plan **(See details in Box: The 21st-century Silk Road, China's Path to Global Power)** Apart from One Belt One Road plan, China is pushing for rail projects, especially high-speed trains, to establish an expansive distribution network in the Greater Mekong Sub-Region (GMS, which is Thailand, Laos, Myanmar, Cambodia, and Vietnam). Chinese government plans to invest USD1 trillion in this scheme to facilitate its USD2.5 trillion in annual trade with the GMS. The network will also increase collaboration on other facilities, such as industrial estates and special economic zones. Consequently, we expect to see much more investment from China, including FDI from the government and the private sector as well as contracts for rail, road and seaport projects overseas.

2. China's growing outbound tourism will attract Chinese companies to invest in travel and real estate businesses overseas Chinese companies have started to look for investment opportunities in the tourism sector, such as hotels, yachts and cruises. Anbang Insurance, for example, bought the Waldorf Astoria building in New York City from Hilton Worldwide. Jinjiang International Hotels bought Louvre Hotels in 2014. Moreover, wealthy Chinese individuals are migrating abroad and buying real estate outside of China. This incentivizes Chinese companies to invest in property businesses overseas, including office buildings and condominiums in metropolitan areas, as well as vacation houses.

3. Chinese investment in foreign consumer goods companies is growing. The rise of China's middle class and higher domestic consumption are prompting Chinese businesses to look abroad to obtain goods and services to sell. This has led to an investment in the food industry, agribusiness and makers of electronics such as smartphones; for example, Shuanghui Group bought a big U.S. food company, Smithfield Foods, for USD7.1 billion in 2013.

4. Chinese companies will increase investment in advanced technology, especially via M&As, to jump-start technological growth. China's official policy is to become a global leader in science and technology, including information technology, biotechnology, medical technology, aviation and space. M&As give China access to these advanced technologies faster than investing in R&D alone. EIC predicts that the number of transactions and the value of overseas M&As by Chinese companies in technology-related businesses will grow. This trend was seen in 2015 when Tsinghua Unigroup invested USD3.1 billion for a 15% share of Western Digital, the U.S. hard disk drive maker. A Chinese joint venture spent USD1.9 billion for a stake in OmniVision Technologies, an American developer of digital imaging technology.

The huge expansion of China's overseas investment will increase the importance of the yuan in global capital markets. The portion of yuan used in trade settlement is likely to increase. At the same time, international investors are paying more attention to Chinese capital and securities markets **(See details in Box: RMB Internationalization).**

BOX: RMB Internationalization

As China plays a bigger role in the global economy, the Chinese government will continue to push to internationalize use of the yuan , soon making the yuan a major world currency. China's plan has three aspects:

1) International trade transactions

Using the yuan for trade transactions will help reduce costs for China's importers and exporters and increase the volume of trade between China and other countries. In 2009, the Chinese government rolled out a pilot scheme for settlement of cross-border trade using yuan. The project allowed traders to use the yuan to pay for goods and services from Hong Kong, Macau and ASEAN countries, including Thailand. In 2010, the pilot scheme expanded to cover every country in the world. In addition, the PBOC let foreign central banks and commercial banks register as offshore clearing banks and as participants to conduct yuan transactions in the Chinese interbank market. Meanwhile, the volume of RMB transactions outside of China has been growing. Currently, there are several RMB clearing banks overseas, including in Thailand. In 2015, the Industrial and Commercial Bank of China (ICBC) was designated as a RMB clearing bank to provide services for local banks and entrepreneurs in Thailand.

The use of the yuan in the international trade will likely grow. In 2015, 18% of China's cross-border trade was in yuan, compared to only 3% in 2010. This is equivalent to 500 billion yuan per month. Compared with the size of China's economy and international trade, however, the portion of RMB settlement is still small. But it will continue to grow.

2) Role of the yuan in global capital markets

The government plans to increase investment channels and the raising of capital using yuan. Financial institutions in Hong Kong started to offer RMB deposit-taking services for retail clients in 2004. Deposits in RMB have grown rapidly in many countries, including Hong Kong, Singapore and Taiwan. As for RMB funding, so-called dim sum bonds, or bonds issued offshore but denominated in yuan, have also grown at a fast pace. EIC expects that offshore yuan assets will continue to increase as more Chinese and foreign companies opt for funding in yuan to expand their business in China and abroad.

As for the onshore markets, China began to allow some foreign investors to trade in A-share stock market[1] under the Qualified Foreign Institutional Investors (QFII) program starting in 2003. In 2011, China initiated the RMB Qualified Foreign Institutional Investor Program (RQFII) allowing foreign investment in yuan. The Chinese government has continued to relax rules and restrictions and to expand quotas under the QFII and RQFII programs, attracting more and more investment from foreign institutions, especially for A-share stocks. The foreign proportion of holdings and transaction volume in the Shanghai and Shenzhen stock exchanges remains low, however. Another important development is the debt swap program that will help increase transparency in domestic bond markets.

3) Role of the yuan in international reserves.

As of November 2015, the IMF decided to add the yuan to its Special Drawing Rights (SDRs) basket, which include the U.S. dollar, Euro, British pound and Japanese yen. This is a big leap for China in its effort to internationalize the yuan, and it will increase demand for yuan as a reserve currency on the part of international central banks.

During the next 3-5 years, China is likely to liberalize its capital account. China's capital flows are not yet fully liberalized, because policymakers are still concerned about the nation's international reserves. The government has been gradually opening up its capital account, starting with the domestic financial system and banking industry reforms. This is happening alongside the gradual reform of capital markets, which is progressing as a step-by-step easing of rules and restrictions. For example, the government has been expanding the QFII and RQFII quotas for foreign financial institutions to invest in domestic stock and bond markets. It has also increased the Qualified Domestic Institutional Investor (QDII) quotas for Chinese financial institutions to invest in financial assets overseas. Eventually, the quota system will be abandoned entirely.

[1] There are two major stock markets in China: the Shanghai Stock Exchange and the Shenzhen Stock Exchange. The type of stocks traded in these two markets is A-shares, which are traded in yuan among local investors. Institutional investors must receive permission from the government to trade according to their assigned quotas. Another type of stocks is B-shares, which foreign investors are allowed to trade based on the quotas assigned them by the Chinese government. B-share stocks are traded in U.S. dollars on the Shanghai Stock Exchange and in Hong Kong dollars on the Shenzhen Stock Exchange. Finally, H-share stocks are equities of Chinese companies listed on the Hong Kong Stock Exchange. They are traded in Hong Kong dollars and are open to any investor.

What are opportunities for Thai businesses as China ramps up its outward investment?

The Thai economy will benefit from China's overseas investment. The factors that are driving Chinese businesses to invest abroad present opportunities for Thai businesses. For instance, infrastructure construction to support the One Belt One Road plan will provide opportunities for businesses in the construction materials, engineering and construction sectors; while increasing outbound tourists will benefit Thai tourism and property businesses.

There are also several indirect benefits, especially for service companies that can help facilitate Chinese investments and business operations. Such companies include financial services, business and strategy consulting services, legal services, accounting and financial services, asset appraisal services, middleman services and services for Chinese expats. These opportunities could take on different forms. For example, Thai businesses could provide goods and raw materials, join in joint ventures, sell or rent assets, serve as subcontractors, or become targets for M&As by Chinese companies.

Nonetheless, Thai businesses should quickly adapt to changes in competition and in the global market. China does not target any particular region to invest. This creates competition among countries and companies that want to attract China's capital and spending power. There are several ways in which Thailand's business sector can prepare to compete:

1. Enhance skills necessary for cross-border business, such as cultural awareness and language skills.

2. Acquire expertise in international business, such as international laws, rules for cross-border fund transfers, international trade settlement and investment, and cross-border contracts.

3. Build and foster business relationships with Chinese companies that might invest overseas. For instance, upgrade technological competitiveness to be able to join Chinese production chains.

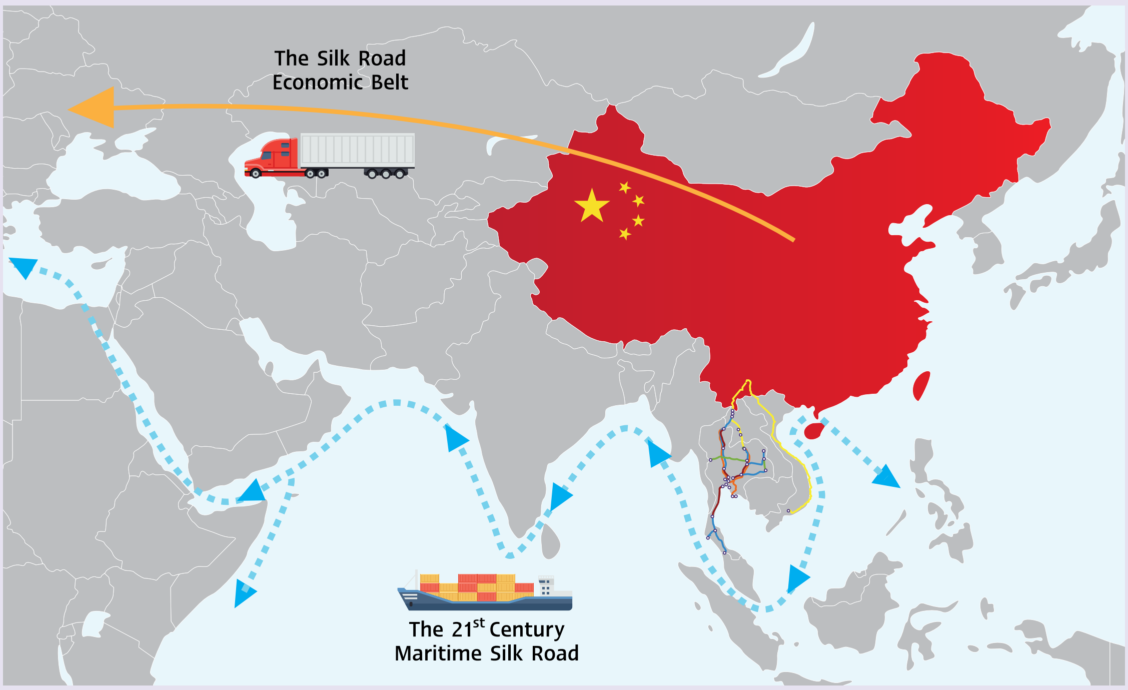
4. Employ a proactive market strategy, such as targeting wealthy Chinese with high spending power in the tourism and real estate sectors.

The Thai government, too, can help attract Chinese investment into Thailand. In particular, concrete policies that improve Thailand as a regional logistics and services hub would increase Thailand's attractiveness as an investment destination. The government could revise laws and regulations related to cross-border business, such as customs and dispute resolution processes.

Despite its slowdown in economic growth, China has just begun its global investment phrase. The rising outflow of Chinese capital presents opportunities for Thai businesses. It will also help boost growth in Thailand as well as other countries in the region. Yet, to fully benefit, both the Thai government and the private sector must upgrade capabilities to gear up for intensifying competition and to cope with changes in the business landscape at home and abroad.

BOX: New Silk Road: China's path to global power

China has invoked the legacy of the ancient Silk Road in announcing its "One Belt, One Road" plan to develop infrastructure and connectivity to create the world's largest trade and transportation route, linking Asia, Africa and Europe. President Xi Jinping announced the One Belt, One Road initiative in 2013. Extending some 6,000 kilometers, the scheme has two parts, covering different modes of transportation. The Silk Road Economic Belt is a land-based network of roads and rails linking China, Central Asia, the Middle East and Europe. The Maritime Silk Road will connect China's seaports to those in Southeast Asia, South Asia, the Middle East, Africa and Europe.



The plan will not only help improve infrastructure and connectivity but also advance China's economy and financial sector. On one hand, One Belt, One Road will make transportation between China and other countries more convenient. For example, the Thai-Chinese rail project, both the Bangkok-Nakhon Ratchasima-Nong Khai section and the Bangkok-Map Ta Phut section, together with its potential link to the Laotian-Chinese rail project in the future, will reduce the travel time between China and Thailand by 30-40% and decrease transportation costs by 20-30% compared to travel by road.

EIC expects that the initiative will benefit China's economy in three major ways:

1) It will increase importance of the yuan. China has established a Silk Road Fund with USD40 billion in capital to help fund infrastructure projects in developing countries. In addition to expanding physical infrastructure, the fund will encourage the use of yuan for cross-border trade settlements, helping internationalize the Chinese currency.

2) It will expand China's exports. Construction projects along the route will generate high demand for construction materials. EIC estimates that demand for steel and cement in the next five years to rise to 270 million tons per year and 580 million tons per year respectively. This presents a golden opportunity for China to export construction materials that are currently in oversupply, helping a domestic industry plagued by overcapacity.

3) The plan will boost employment and China's economic growth. The Asian Development Bank (ADB) estimates that every USD1 billion invested in infrastructure creates 720,000 jobs. One Belt, One Road will substantially increase employment and help generate income for Chinese workers at every level. This will help Chinese economic growth to gain pace again.

Overall, the result of the One Belt, One Road plan is likely to be much more than just new infrastructure. The policy will help boost the Chinese economy and internationalize the yuan. To benefit most from this Chinese initiative, Thailand should speed up megaprojects related to transport connectivity and create a national competitive edge as the region's trade and transportation hub.

China and its
Technological Innovation Hub

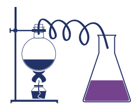
China promotes 2 policies to drive business sectors

What drive success of China's rapid advancement in science and technology?

1 Technology transfer policy

- Merger & Acquisition
- Joint venture

2 Tech start-up policy



- R&D budget
- Key technology cities i.e. China's Silicon Valley in Beijing, FinTech in Shanghai etc.

Tracing the development and progress of China's innovation

1 Adopter
Manufacture exactly as the original

2 Adapter
Adapt the original to be own pattern/ style

Go Pro
Huawei

3 Applier
Digest from original and innovate the addition

4 Innovator
Truly innovate from scratch

A challenge for China regarding intellectual property rights violations

China increases its efforts to provide the legal environment needed to support local innovation and to enhance the enforcability of agencies.

SIPO
monitoring IP rights violations

SAIC
protecting trade secrets and trademarks

MOST
regulating exports of technology and R&D

MOFCOM
regulating imported foreign technology

NRDC
setting the strategies and policies for developing high-tech industries

EIC's view

As China is pushing its domestic enterprises toward high value-added technology and innovation in order to become the leader of the world, Thailand as one of its trading partners should seek opportunities to develop technology in their own industries to gain global shares by improving technological and innovative competencies, answering the various needs, finally, be able to become part of China value chain.

Interested investor should:

- Examining a potential partner through SAIC
- The legal documents should state clearly in written format of ownership rights

Source: EIC analysis as of January 2016

3

China aims to become technological innovation hub

The nations whose companies, universities and governments are most recognized as leading the world's development of technology today are the U.S., Germany and Japan. But in the future they will be rivaled by China, as it moves up the ladder from low-cost manufacturing toward innovation. China is pursuing policies that support technology transfer and start-ups. It is also investing heavily in research and development. Becoming innovative will increase China's importance in global trade and investment. Businesses that want to stay competitive in a changing global environment need to be well informed about China's progress toward becoming a world leader in innovations for consumers, enhancement of efficiency in business process, and engineering and technology.

How will China kick-start technological and innovative development?

China's large economy has grown fast and changed in structure from an agrarian basis toward industry. The country now aims to become a superpower in science, technology and product innovation. In the past, China's development fell behind the West because of outdated research methodologies that were based on trial and error rather than modern scientific methods. To catch up in science and technology, China pursued three main policies during the last century: 1) developing modern knowledge and ability to replicate Western technology by sending a total of 40,000 scientists and technicians to study and train in Russia during the early 1920s, 2) investing in development of human resources by establishing new technical schools and universities using a western curriculum to teach modern science and mathematics, and 3) prioritizing science, technology and research by setting up over 100 specialized research institutions under the guidance of the Chinese Academy of Science (CAS), the country's think tank for science and technology.

China's ongoing advancement in science and technology derives from policies that support tech transfer and tech start-ups Mergers and acquisitions (M&As) and joint ventures with foreign investors have been the main channels used to promote technology transfer. For example, Lenovo's acquisition of IBM's ThinkPad laptop PC business and of Google's Motorola mobile phone business gave access to patents, know-how and branding.

Leveno also collaborated with Japan's NEC by setting up Lenovo NEC Holdings to tap into new tablet production technology and over 3,800 international patents for 3G and LTE technology. A more recent example is Haier, the appliance maker that has a 30% market share in China. At the start of 2016, the company acquired an American company, GE Appliance, in order to expand Haier's overseas reach and obtain technology and high quality staff.

China has supported tech start-ups by providing funding and tax privileges. Many Chinese tech start-ups have had rapid growth, becoming recognized as global successes. An example is Baidu, which started out as a search engine business that received a government research grant and access to useful government databases. By 2015, Baidu was earning more than USD10 billion per year and expanding its business into a variety of applications and software. In January 2016, Baidu launched a new cutting-edge application called AskADoctor. The application, which links its search system with a health analysis program, forms diagnoses with an accuracy rate of 75% and can recommend preliminary treatment. Going forward, Baidu plans to use government health records of each user to increase the accuracy of its diagnostics.

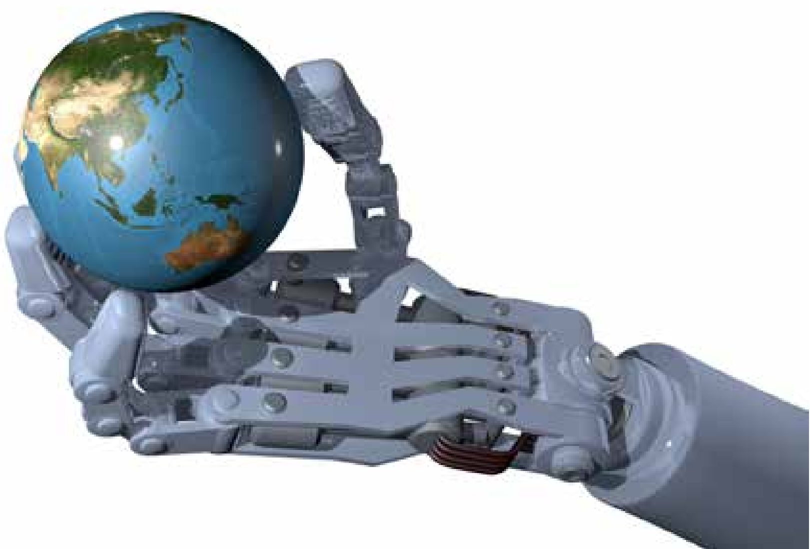
What is China's current capacity in developing technology and innovation? And in which fields of technology will development be prioritized?

China is now at the stage of being able to digest and innovate existing technology, and it is on path to become a innovator of original, new technology. China has long been seen as "the world's factory," using foreign technology to capitalize on its abundant natural resources and low cost-labor. The capacity to "adopt and manufacture" was China's first step of technological development. In the second stage, the country learned to "adopt and adapt," especially in industries like textiles, packaging, automobile parts and cameras. Today, China has progressed to the third stage of technology development, whereby it can "digest and innovate," which is the capacity to build on existing technology and innovate further. An example of technology at this stage is Chinese enhancements of drones, the unmanned aerial vehicles. Drones, which were first invented by an Austrian in 1849, began in the form of a balloon and were later adapted into various formats in the U.S. for military use. In January 2016, China launched a newly developed drone that can carry a passenger. This shows how China is likely to advance its capacity in technology and become an innovator in future.

Chinese innovations from the third stage of development, "digest and innovate," are concentrated in innovations for consumers, efficiency enhancements, and engineering and technology. Scientific innovation, however, is in the early stage of development in China.

Innovations for consumers have grown significantly due to China's large consumer base and diverse consumer needs. The middle-income population in China has grown substantially and is expected to exceed 200 million by the year 2025. This part of the population will continue to increase its consumption of luxury goods and high-tech products and services. This huge source of demand will bring big profits to innovators that can come up with products that improve everyday life and respond to consumer needs. This is especially true for companies and products taking advantage of the intermediation efficiencies of the internet.

Indeed, this kind of innovation is already abundant. An example is the Alibaba Group, which has multiple online services including Taobao.com, an internet platform for sales between consumers (C2C), with an average online sales volume of USD20 billion per month during the first nine months of 2015. It also operates Tmail.com, a website that connects business owners and consumers (B2C), with an average monthly sales volume of USD12 billion. The company also owns Juhuasuan.com, a website that caters to consumers searching for discounted products.



Another Chinese innovator is Xiaomi, the smartphone maker, which sold 70 million phones in 2015. The company, which began as a start-up in 2011, offers smartphones that have functions comparable to those of top brands like Apple and Samsung, but at half the price. Xiaomi markets via social media. The company uses consumer feedback from online questionnaires to design new models that are slimmer, faster and lighter.

One factor driving creation of efficiency innovations is the large supply chains in China, which will continue to grow. Companies that want to create competitive advantages will demand improved systems for production and distribution that are faster and more cost-effective as they expand. The Alibaba group, for example, has developed a logistics system for goods transport called the China Smart Logistics Network (CSN). The system is able to manage delivery of goods to any area in China within 24 hours, while also offering comprehensive services in packaging, storage and delivery of goods. The system, which uses software to analyze and process information, supports a daily volume of USD4.6 billion in online sales and 13.7 million domestic deliveries, for a total annual volume of USD1.5 trillion. Demand for such services will continue to increase. The CSN aims to achieve a total delivery of 100 million packages per day in the future.

Another example is Everstar, a clothing producer that has developed a laser-cutting technology, known as a “Smart Tailor.” The technology can tailor clothing to a customer’s size in just 20 seconds, enabling Everstar to manage a total of 40,000 orders with just 490 staff members and two factories in 2014. Everstar customers can even design their own clothes and make online purchases that will arrive within just 72 hours, cutting short the previous delivery time of two weeks. Since launching this innovation, the company has increased its profits by six-fold compared to its previous business model as a B2B supplier.

Although development of science and technology has largely depended on policies to support foreign technology transfers, other elements such as legal requirements to use locally produced parts, as well as R&D investments are also key factors. The Chinese are quick to learn new technology and are good at reverse engineering. This is the process of doing research to identify the components of a technology or product and understand its functioning so that one can replicate it. When foreign companies build a new production base in China or co-invest with a local company, locals use this as an opportunity to learn the technology themselves. In some cases, a Chinese business then sets up its own operation to compete directly with foreign firms, as in the case of the Wind Power Concession Project (WPCP), which relies on transferred technology but manufactures products that are 70% built from locally produced components.

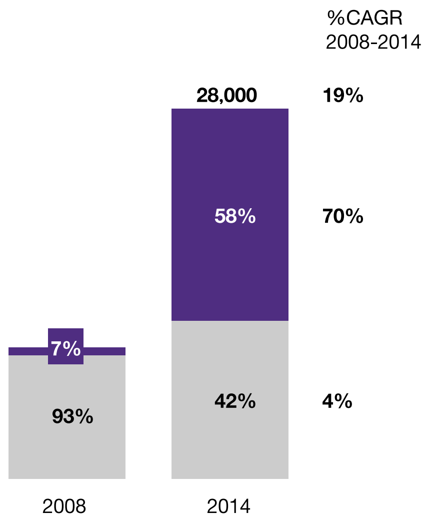
After obtaining knowledge transfers, Chinese businesses generally build on the technology by investing in R&D. For example, Huawei, a leading telecommunication products maker and services provider, began its business by reverse-engineering a foreign technology and then using R&D to create its own version. The company allocates up to 19% of its income to research, and owns a total of 19 joint innovation centers in Europe and currently has the most international patent applications in the world, totaling 3,342 patents as of Q12015.

Another successful innovation that stemmed from heavy R&D support is China's high-speed trains. In 2010, the China South Locomotive & Rolling Stock Corporation (CSR) launched its high-speed train, model CRH380. The train, which is modeled after the Japanese shinkansen, can run at 380 kilometers per hour. It is currently the fastest train, running on the longest high-spped track in the world. The company's success is the result of its 1:3 policy, whereby it spends USD3 on technology development for every USD1 it spends on foreign patents. Today, China is the leading producer of high-speed trains. At least 28 countries, including Thailand, have expressed interest in buying high-speed trains from China. (Figure 13)

13 China has been by far the largest global investor in high-speed rail

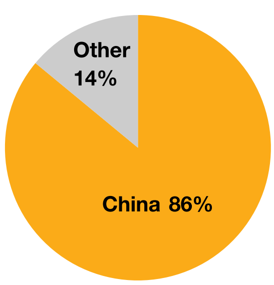
High-speed rail lines

Unit: kilometers

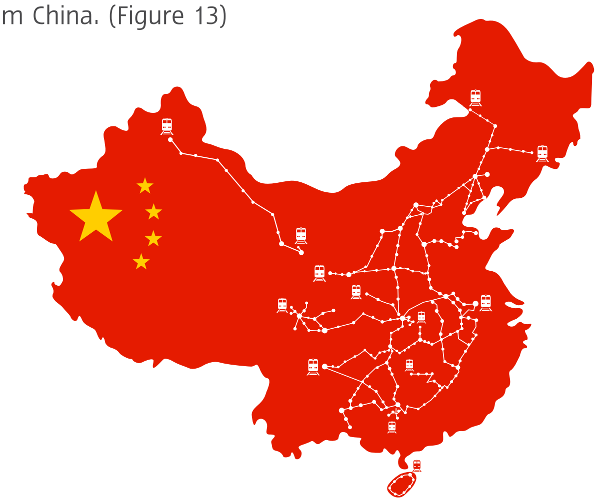


Build since 2008

Unit: %



Source: EIC analysis based on data from International Union of Railways, National Railway Administration, China Statistical Yearbook และ McKinsey Global Institute



Scientific research is also making progress with support from the government and various institutions, despite being at an early stage of development. Key scientific research in China, such as in biotechnology, pharmaceuticals, and semiconductor technology, is still in the early stages of development owing to limited funding. From an annual funding of USD200 billion, only 5% is allocated for basic research and 11% for applied research, a small portion compared to developed countries for instance, United Kingdom whose 16% is contributed to basic research and another 47% for applied research, according to McKinsey Global Institute. Nevertheless, progress has been achieved recently. For instance, China has trimmed the authorization processes and regulations in pharmaceutical development by allowing local authorities to approve the use of new drugs without having to wait for a national decision. Furthermore, the government also strengthened protection of intellectual property, which led to an increase in patent applications from 1,786 in 2008 to 24,479 in 2014. Large companies in China have started to emphasize the need for doctoral researchers in the field of STEM (science, technology, engineering, mathematics), the numbers of which have increased by several thousand so far. This is to drive the development of new technology. Compensation for such researchers in China now starts to exceed the levels in developed countries by 20-40%. EIC believes that China will continue to progress, with excellent prospects going forward.

What is China's strategy to become a tech innovation hub in the future?

Existing factors that drive technological advancement in China are its large consumer base and availability of capital. Such factors have been beneficial because local manufacturers can expand production and gain from their economies of scale. Furthermore, given sales growth and ample available investment capital, manufacturers are keen to develop their engineering and production capacities as well as invest in development of innovations and business integration.

Another important supporting factor is the government's development policies targeting four major cities to lead China in becoming an all-in-one center for technological innovation by 2025.

First, China will position Beijing as a world center for information technology The Zhongguancun Science Park has been set up in the north west of Beijing as a center of a new industrial area called China's Silicon Valley. The area will be used as a pilot project to develop high technology and new product innovations. It houses a research and development center for telecommunication and information technology, similar to Silicon Valley in the U.S. and Taiwan's Hsinchu Science and Industrial Park. It hosts some 20,000 tech companies, including Baidu, the first Chinese company ever listed on the NASDAQ-100 stock exchange. Many other leading tech companies such as Google, Intel, AMD, Oracle and Microsoft have also set up offices and research centers in this area.

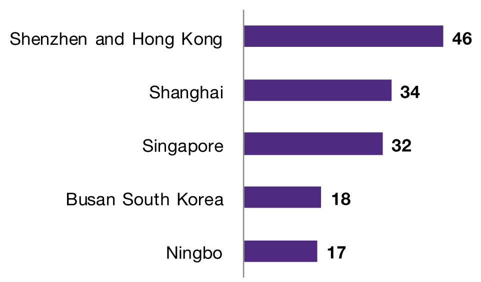
Shanghai will become the center for financial technology (FinTech) Shanghai is recognized as one of Asia's centers of financial innovation, trailing Hong Kong. Each year, over 1,500 attendees from over 150 institutions gather at the city's financial-innovation exhibition, making it a good opportunity for businesses in the sector to find new partners. The most notable company at the event is Alibaba, a group now consisting of 20 companies. The company started its business in Hangzhou, providing all-round services for B2B and B2C businesses. It later went on to develop its online payment system, AliPay, as well as an online money-market mutual fund, Yu'e Bao, which was a great success in 2014. Other companies under the group include Ant Financial Services Group, which started Zhao Cai Bao, a platform to advertise and promote financial products to small businesses and individuals.

Meanwhile, Shenzhen and Guangzhou utilize advantages as centers of manufacturing to drive further innovation in high-tech appliances and services. A giant animation studio, ACM, and Intel, the micro-processor manufacturer, have both expanded their businesses into Shenzhen to set up integrated production bases. In addition, over 1,000 manufacturers of electronic parts have moved their production into this city and the surrounding area to shorten travel time to each other to less than two hours. Furthermore, with its modern seaport and airport, Shenzhen is now among the cities that transport the highest volume of goods in the world. As for Guangzhou, sales of its high-tech products grow 8% in 2015, reaching USD130 billion. In 2017, given production technology advancements like the development of industrial robots, sales of high-tech products is expected to reach USD170 billion. (Figure 14)

14 Shenzhen and Shanghai are among cities that handle the world's largest volume of goods

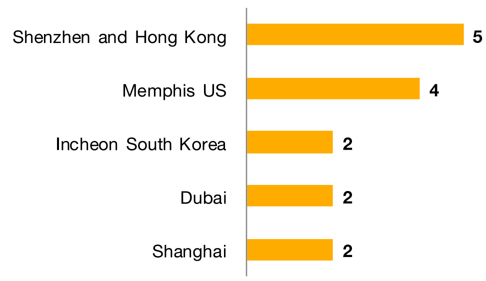
Volume of goods handled in major sea ports around the world

Million TEUs/year



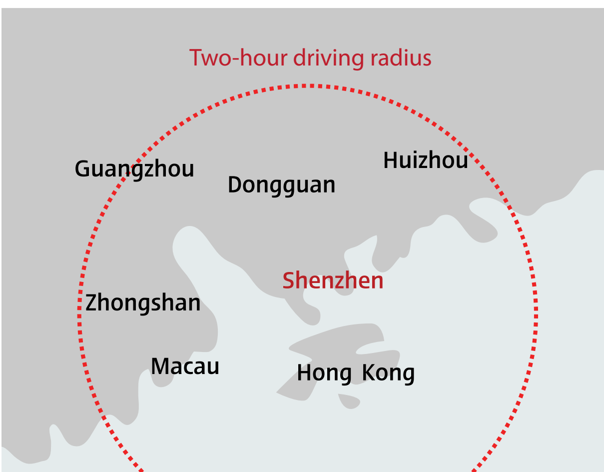
Volume of goods handled in major airports around the world

Million Tonnes/year



Source: EIC analysis based on data from Drewry Container Market and Airport Council International

Map of cities within 2 hour radius of Shenzhen



1,000+
electrical equipment manufacturers

300+
apparel manufacturers

2,000+
electronics manufacturers

1,300+
materials manufacturers

9 million
labor force, average age 33 years

Source: EIC analysis based on data from Shenzhen Statistical Yearbook 2014

A challenge for China is improving compliance with laws on technology transfer and intellectual property rights (IPR). How will other countries cope with this problem in China?

The international community has long pressed China to upgrade and better enforce laws and regulations that protect intellectual property rights. One problem, for example, is that China permits local recipients of foreign technology transfers to modify and develop existing technology without having to ask for legal consent. EIC notes that loopholes in the Chinese legal system make technology owners fear that their technology may be stolen and adapted for new patents. Technology owners risk having their intellectual property rights violated and their technology being revealed to unrelated parties. Unfavorable changes in government regulations are a risk. An example is the case of Danish and German companies that own wind turbine production technology. They agreed to transfer technology to Goldwind, a Chinese manufacturer, by importing parts from Europe. Afterward, however, the Chinese government announced a new regulation forcing bidders on government projects to use 70% local content. This change in regulations caused the technology owners to lose revenue from exporting parts to China and forced them to invest in setting up a new production base in China.

EIC predicts that disputes over IPR violations will likely subside, as China increases its efforts to provide the legal environment needed to support local innovation and to enhance the enforcement capacity of agencies. The agencies involved in IPR protection are: 1) a newly established State Intellectual Property Office (SIPO), which is responsible for registering patents and monitoring intellectual property rights violations, 2) the State Administration of Industry and Commerce (SAIC), which is the law enforcement agency protecting trade secrets and trademarks, 3) the Ministry of Science and Technology (MOST), which regulates exports of technology and coordinates high-tech research and development in China, 4) the Ministry of Commerce of the People's Republic of China (MOFCOM), which is responsible for regulating imported foreign technology and recommending types of technology to be imported, and, 5) the National Reform and Development Commission (NRDC), which sets the strategies and policies for developing high-tech industries.

Nevertheless, foreign technology owners should examine the reliability of any contract partner and demand co-ownership of patents as well as the rights to use new technology and research that are jointly developed. These terms need to be put in writing to be legally enforceable. Foreign firms should start by examining a potential partner's reputation, legal status and foreign trading rights through SAIC.
Additionally, there are two main issues foreign technology owners should be aware of. First, in choosing the legal framework to resolve a dispute with a Chinese counterpart, foreign firms should be aware that certain judicial orders by foreign courts are not binding in China. Therefore, foreign technology owners may be better off using Chinese law for legal proceedings, in which case, the foreign firm can seek advice from the China International Economic and Trade Arbitration Commission (CIETAC) in Beijing, which is a respected agency that has experience in handling disputes for foreigners. Secondly, the legal documents should state clearly which party will have the right to apply for any patent covering the new technology being developed, which depends on the type of contract. For instance, in a commissioned development contract, the researcher should own the right to file a patent, but the employer should be able to use the technology at no cost. On the other hand, under a cooperative development contract, such rights are co-owned. China has a reasonably clear framework and law enforcement agencies that offer help to foreign firms. For example, in a dispute between Canada 1246854 and Nanjing Shisheng in 2007, their contract for joint development of a new technology stated that Canada 1246854 solely owns the right to file patents. When Nanjing Shisheng filed a patent without legal consent, the Nanjing Court ruled in favor of Canada 1246854 and ordered the patent ownership to be transferred.

Although the legal framework for intellectual property rights in China is improving, the most urgent need is for stricter, clearer regulations and greater awareness of proper business practices among young operators. This will be crucial to repairing China's reputation in the international community.

How will China's rising innovation affect Thailand?

China's progress toward becoming an innovator will allow it to escape the so-called middle-income trap. Yet the transition will take time and cannot solely rely on foreign support. China's development sets a good example for the Thai government and Thai businesses to work together in developing the nation's technological capacity. As a starting point, Thailand can focus on building on existing technology or the "digest and innovate" stage. Due to limited funding for science and technology and R&D as well as insufficient human resources here today, the Thai government should start by promoting education in science and technology. It also needs to improve the capacity of the government agencies involved and to set up research institutions to expand employment opportunities in science and technology. Additionally, science and technology should be an integral part of the national development plan. Strong local R&D can help the government address national agendas and improve efficiency in resource allocation. At the same time, Thai businesses should seek opportunities to develop technology in their own industries and form clusters to foster cooperation. Businesses can collaborate with academic institutions to develop research having commercial applications. This is also a practical starting point in attracting and developing more human capital in the field of science and technology in Thailand.

As China becomes a major international investor and expands its capacity for innovation, Thailand must be agile in adapting to its neighbor's greater influence on global investment, manufacturing and distribution. In the past, China was a low-cost manufacturer that generally exported cheaper products, especially appliances, in direct competition with Thailand. Thai goods were long in demand in many markets due to superior quality. In the future, however, China will begin to export more of its own technology under well-accepted Chinese brands and with higher quality than before. China's advantage from economies of scale will make the pricing of Chinese products highly competitive. As a result, businesses of all sizes in Thailand need to adapt by identifying specific markets and consumer groups in which they can maintain an advantage over Chinese competitors. They can also look for opportunities to become part of the Chinese value chain. Thai SMEs that serve as OEMs will have difficulty expanding due to rising competition from neighboring countries that are evolving into industrial producers with cheaper labor costs. Going forward, SMEs in Thailand therefore will need to start innovating unique new products and technologies.

EIC believes that the success of China's rapid advancement in science and technology owes to its clear policy to support development of this field. The government's initiatives to promote various technologies through the use of regulations, to screen imported technology and to invest in R&D and tech start-ups contribute greatly to the country's success. The next step is to work on improving consumers' perceptions of Chinese product standards, which is crucial to becoming a top global competitor in innovation.

BOX: Lessons for Thailand from Tencent

Tencent started in 1998 as an online provider of value-added services (VAS). Examples of its services are the WeChat application, QQ search engine, Soso online store and PaiPai website, which is a direct competitor of Alibaba. It has its own payment system called Tenpay. Today, Tencent is the fastest-growing company in China, with revenues growing by 95% in 2015, and is rated the most valuable brand in China. (Alibaba is ranked second, Baidu fifth, and Haier 30th). Overall, the company is considered one of the top online service providers in the world.

Success factors

One of Tencent's strengths is its understanding of the evolving demands of consumers and the power of social networks. Tencent started its business offering instant messaging and chat services and later went on to develop an internet browser called Tencent Traveler, a social media application called QZone with features similar to Facebook, and an online weblog diary called Tencent Weibo. Over time, as consumers demanded faster access to information, Tencent collaborated with Google to develop Soso and a cloud storage system called Tencent Weiyun to provide data storage via the internet. Tencent also developed an online taxi booking application called Didi Dache. Accessible on mobile phones, the app informs the customer of the expected wait time and travel cost as well as driver's name and license number. Customers can pay for their taxi service using Tencent's online payment system called Tenpay Wallet.

Tencent is able to innovate at its dedicated research center "Tencent Technology". The research center, which is situated in the high-tech park in Shenzhen, primarily emphasizes development of software. Renowned products from the center include Tencent Traveler, a new version of the QQ instant messenger and various mobile apps. The research center owns a large number of patents related to instant messenging and online games.

Tencent's investment strategy focuses on finding business partners to strengthen and expand its service coverage in online social networks. For example, Tencent connects its online and offline services through a partnership with Wanda, a huge property developer and cinema operator. The combined service allows customers to pay for shopping and services at Wanda malls and cinemas via Tenpay or Wechat. In 2014, Tencent acquired a 15% stake in JD.com and 20% of the 58.com websites in order to link its social media services with e-commerce systems to enable Tencent to compete with major players like Alibaba. In the future, Tencent plans to continue expanding this business sector by co-investing with China South City Holdings. Together, they plan to develop a logistics and storage system needed for the company's expanding e-commerce system. Tencent also signed a contract with HBO and the U.S. National Basketball Association for the rights to broadcast on Tencent television in China.

Tencent's three core strategies enable the company to grow rapidly. Its key success factor is understanding consumers as well as its capacity to research and develop new products. Tencent's partnerships with firms in other business sectors allow the company to promptly respond to consumers' evolving needs and lifestyles.


TICKET
SALE!
Welcome to
THAILAND

4

With smart strategy, Thai businesses can win big in China's huge consumer markets

Despite China's economic slowdown, its consumer demand has not declined. Middle- and high-income consumers continue to seek new products, travel abroad and buy properties overseas. In EIC's view, Thai entrepreneurs should not miss today's golden opportunity to capture this market. But it will not be easy. China's consumer market is sophisticated, and foreign firms from all over the world are entering it. In this issue of Insight, EIC has handpicked some important trends and offers recommendations on how Thai businesses can prepare to succeed in the world's largest consumer market.

What are the tendencies of Chinese consumers? How should businesses cope with the recent changes?

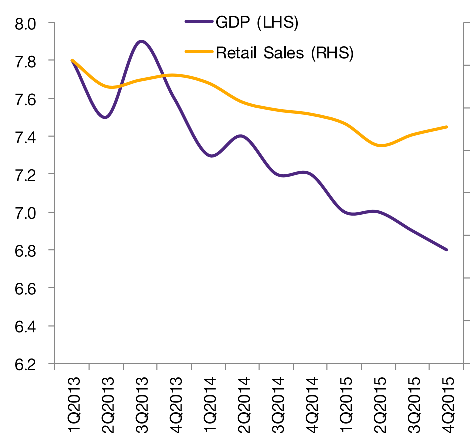
China's consumer sector is largely influenced by middle-income consumers with high purchasing power, who are spread out in many different parts of the nation. Domestic consumption has not decelerated despite the slowing of industry. Retail sales growth increased in the second half of 2015, consistent with higher income per capita (Figure 15). The growth in China's domestic consumption is driven by the rise of the middle-income class, which now includes 109 million individuals, the largest middle class of any country in the world, now surpassing the 92 million people in the middle class in the U.S.

15 Despite the slowing Chinese economy, the retail sector is growing, consistent with rising income per capita

Growth of GDP and retail sales in China

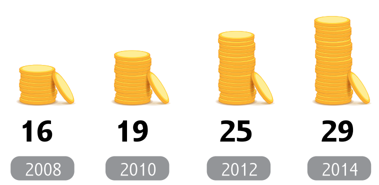
Unit: %YOY

Unit: %YOY



Urban disposable income per capita

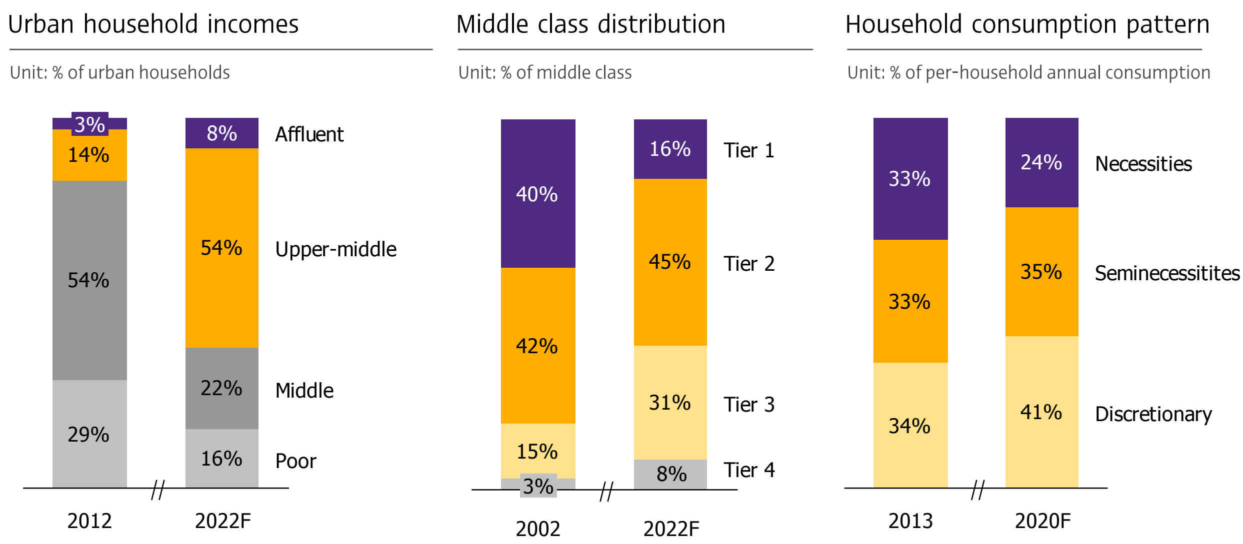
Unit: RMB Thounsand/person/year



Source: EIC analysis based on data from the World Bank and the National Bureau of Statistics of China (via CEIC)

In the future, this group will progress toward becoming upper-middle income, and eventually the nation's main group of consumers. Moreover, economic development in western China has generated the emergence and growth of the middle-income group in new areas in the country (Figure 16). Business opportunities are therefore no longer limited to big cities like Shanghai, Beijing, Guangzhou and Shenzhen.

16 Income of the Chinese households are rising and spreading to various areas in the country, triggering demand for semi-necessary and luxurious goods



Remark: Income classes are classified by annual disposable income per urban household; Poor (less than 60,000 RMB), Middle (60,000-106,000 RMB), Upper-middle (106,001 – 229,000 RMB), Affluent (more than 229,000 RMB)
Source: EIC analysis based on data from McKinsey

The young generation is particularly interested in high-tech products, making consumer electronics increasingly popular in China. Digital cameras, computers and new cellphone models are in high demand. The world's leading smartphone and tablet companies indicate that their sales growth in China declined during October-December in 2015, as compared to the prior year. But China remains Apple's fastest-growing market, as global growth slackens. Apple is still China's favorite brand in terms of quality, technological sophistication, luxury and desired functions and design. Moreover, Apple has equipped additional components in their products in order to technically support the Chinese telecommunication system.

The online market is another business opportunity that should not be overlooked, as Chinese consumers like to look up information and shop on the Internet. Along with rising spending in convenience stores, supermarkets and hypermarkets, sales through e-commerce grew on average 50% per year during 2012-2015 (Figure 3). In 2015, China's e-commerce transactions amounted to USD672 billion, the highest in the world. The main driver for the upsurge is the rising numbers of internet and smartphone users, who are 50% and 40% of total population, respectively. E-commerce is especially popular among buyers of clothing, cosmetics, jewelry and children's products. Most payments are made via Alipay, on websites like the Alibaba Group's Tmall.com and Taobao.com, Tencent's JD.com as well as Haitao.com, which compiles a variety of products from overseas. Moreover, Chinese consumers like to do research via websites and social media like WeChat, Weibo, Tianya.cn and Douban.com before making online purchases. Businesses should rely on the online channel as a powerful tool to increase sales. Coca-Cola, for example, had a campaign to prompt customers to buy beverages with customized labels via online channels, and then share their photos via social media. The campaign was well received, and Coca-Cola is continuing to rely on online marketing strategies.

17 E-commerce in China has become increasingly popular during the past few years

Source: EIC analysis based on data from eMarketer and KPMG

How do Chinese consumers choose their imported products? What are good strategies for Thai entrepreneurs?

While Chinese consumers generally believe that imported products are high in quality, not all foreign brands are successful when first entering the Chinese market. For instance, when Mattel, the toy company, opened a Barbie doll shop in Shanghai in 2009, the store was unsuccessful. It closed in 2011 mostly because the company made mistakes in marketing and product selection. Their Barbie doll model wore fashionable clothing and looked highly self-confident, which contradicted China's conservative parenting culture. In addition, the dolls were too expensive for most Chinese consumers. The products did not stand out from any other toys because the Chinese did not grow up knowing the Barbie story. The store targeted children as its doll customers, not parents, but it also had promotional offers to attract women aged 20-30 years old and extras like food service, a spa and drink corner. This confusing approach failed in China.

Brands that make a good first impression on Chinese customers still need to keep adjusting their strategies, because consumers' behavior continues to evolve. KFC, the American fast-food restaurant chain, has been successful with their branches in China for almost 30 years. But today's young generation is more concerned about health and looks for quality nutrition. KFC encountered negative news reports like the avian flu outbreak, overuse of antibiotics in poultry farming, and unhygienic practices among chicken meat suppliers. They also came up against fierce competition from local burgers and fried chicken franchises, Hua Lai Shi and Dicos, which are becoming popular. KFC's revenue steadily declined, and Yum decided to restructure the company in late 2015. The new branding tries to resolve the problem of ingredient quality and transforms the stores' fast-food atmosphere into a western-style café format for meet ups. KFC also deployed various marketing strategies to boost consumer confidence, such as promotions by Chinese celebrities.

Some western luxury brands are encountering a drop in sales as consumers turn to even more upscale names. Yet, this is an opportunity to develop products to meet the need for higher perceived quality. A prime example is Louis Vuitton (LV), a long-popular French brand of clothing and accessories. The brand long represented luxury and high social status, but has lost some of its cachet in recent years. In late 2015, LV closed three branches in China and will gradually close more. There are a total 50 branches in China, making it seem less exclusive. Chinese consumers have turned to other brands perceived as more luxurious and distinctive, such as Chanel and Hermès. Apple saw this trend as an opportunity and collaborated to release a limited edition of the Apple Watch having Hermès leather wristband. When existing products fail to fully meet consumers' needs, businesses can form alliances to develop new products and expand their customer base.

Entrepreneurs should study local consumers' behavior to improve products and design consistent marketing strategies to succeed in China. In response to consumers increasing focus on health, PepsiCo released drinks based on natural and caffeine-free ingredients. Starbucks is successful in China, with more than 1,800 branches, the second largest number in the world after the U.S. Their success factor is product adaptation to match the tastes of Chinese consumers. For example, the menu includes green tea and red bean snacks as well as colorful packaging. They make souvenirs and products for local festivals and holidays such as moon cakes, sticky rice dumplings (zongzi) and gift cards with the year's Chinese zodiacal emblem. Their marketing strategy also extends to various social media including WeChat and Weibo. Having learned an expensive lesson, Mattel came back with new strategies tailored to Chinese consumers. They have introduced new Barbie characters that offer good role models for children and designed the dolls to resemble famous Chinese actors and actresses. This helps localize the Barbie dolls and makes them more accessible to consumers.

China will present great opportunities for businesses and products serving the elderly and children. In particular, EIC believes that Thai firms have a strong advantage in the food industry. China's domestic economic stimulus measures have opened doors for Thai businesses to expand exports, especially products for the elderly. China has become an aging society, and 30% of the total population are older than 50. This proportion will rise in the future, increasing demand for products for old people. EIC also sees great potential in healthy foods because Thailand has so many different farm products. Thai food, especially canned fruit, is esteemed by the Chinese. At the same time, the Chinese government is trying to increase the birth rate by abolishing the one-child policy that had been in place since 1979. Therefore products for children, such as milk, toys and children's clothing, will be in high demand in the future. Thai businesses should closely study the behavior of Chinese consumers in order to tailor products to serve the elderly and children.

Nonetheless, entering the Chinese market is still a challenging task, and Thai entrepreneurs should be prepared before introducing their products. Notwithstanding the large market size and the world's largest population of 1,368 million (in 2014), entrepreneurs should not forget that socio-economic development is uneven across the different regions in China. Consumers and consumption behaviors can vastly differ. Firms from other countries are also seeking opportunities in the Chinese market. As competition will be fierce, Thai businesses should be equipped with strong strategies and focus on the right consumer niches and locations. They should bear in mind their marketing and sales channels as well as plans to cope with challenges in the market. They should export products that are difficult to imitate or counterfeit, promote their brands and form alliances for product distribution. More importantly, Thai entrepreneurs cannot rest assured regarding market conditions in China. It is a developing country with a fast changing business environment. Without flexibility in planning, Thai businesses might miss opportunities to make profits or could lose market share, as in the examples described above.

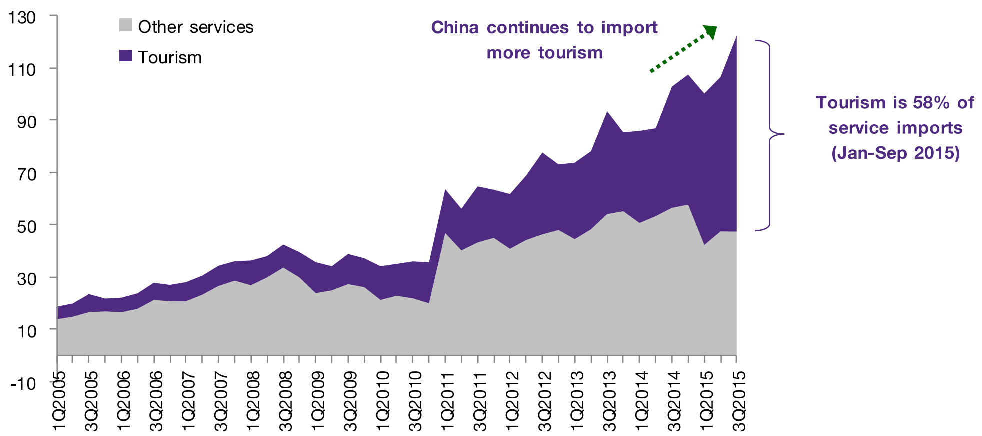
As more and more Chinese travel abroad, how should Thai entrepreneurs tap this golden opportunity?

In addition to rising consumption of goods, Chinese are spending more on tourism and services abroad (so-called import of services), second only to the U.S. China's imports of services grew 16% YOY in 2014, outpacing GDP growth of 7% YOY. The fastest growing imported service is tourism (Figure 18). The growth rate of Chinese travel overseas averages 16% per year during 2005-2014, with the main destinations being Hong Kong, Macau, South Korea, Thailand and Taiwan (Figure 19). EIC believes that Chinese tourists are likely to increase in number in the future due to the large population size. The proportion of outbound tourists to total population is still low in comparison to other developed countries such as the U.S. and Japan (Figure 20).

18 China's import of services increases every year, especially tourism. China's import of services

China's imports of services

Unit: USD Bn

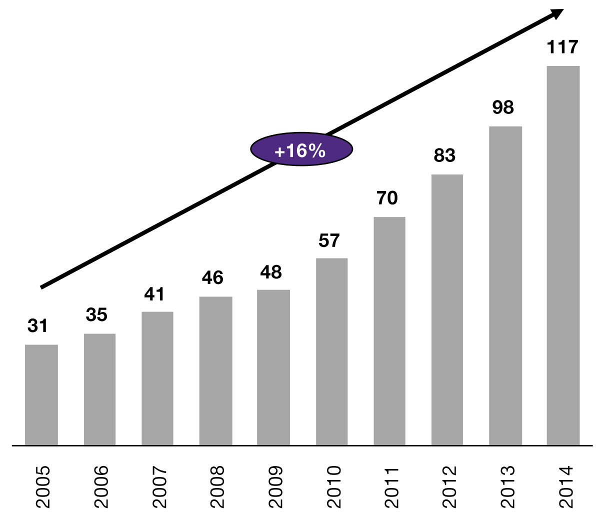


Source: EIC analysis based on data from the State Administration of Foreign Exchange (via CEIC)

19 More Chinese have travelled abroad with Thailand being one of their main destinations

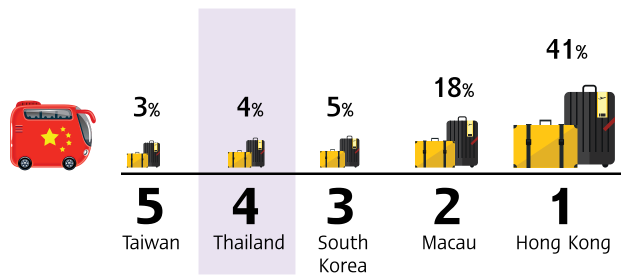
Annual departures of Chinese residents

Unit: Person-time million



Main destinations of Chinese travellers in 2014

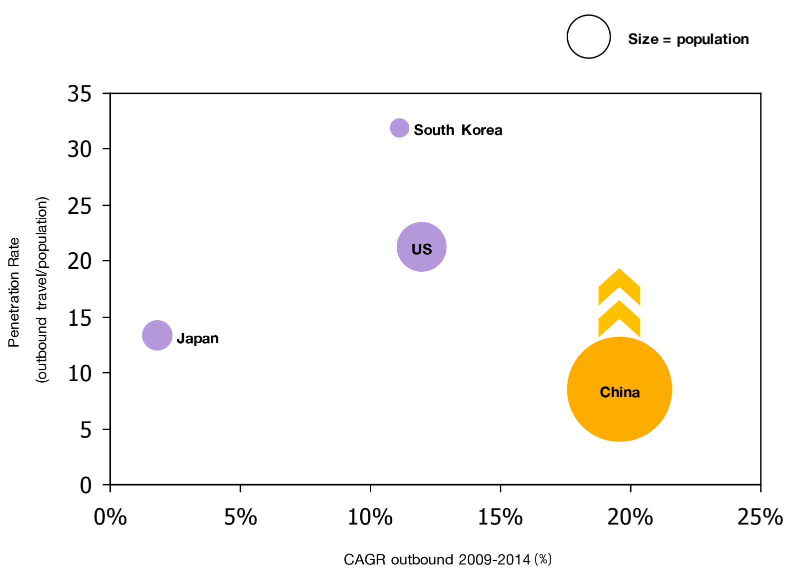
Unit: %



Source: EIC analysis based on data from China National Tourism Administration (via CEIC) and Bank of America

20 Chinese tourists show a great potential as their penetration rate of overseas travel is still lower than other countries

Penetration rate of foreign travel



Source: EIC analysis based on data from Ministry of Tourism and Sports and the Immigration Department

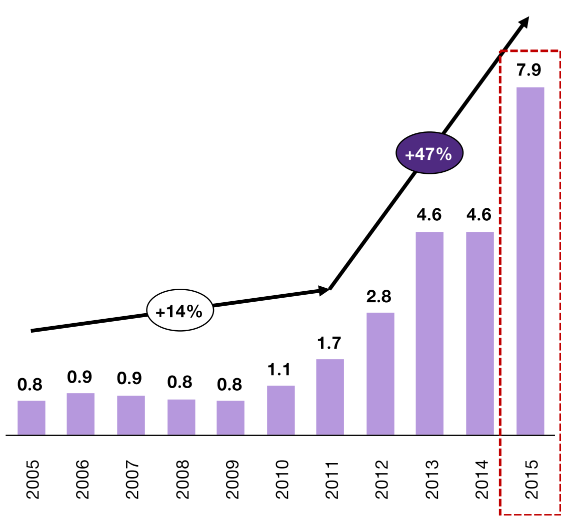
Chinese visitors play an important role in Thailand's tourism industry, and are already ranked first among travellers here. Having increased significantly since 2012, tourists from China account for almost 30% of Thailand's inbound tourists (Figure 21). Thanks to the popularity of "Lost in Thailand," a movie shot in Chiang Mai, Thailand quickly became one of China's favorite travel destinations. Thailand was also pro-active in promoting tourism by organizing a variety of activities, for example, inviting press and bloggers from China's famous websites to experience new travel routes around Bangkok, Chonburi, Rayong, Ayutthaya and Ang Thong. The number of Chinese inbound tourists has constantly increased because Thailand impresses them with local friendliness, a variety of tourist attractions and good food, as well as great value for money. Moreover, flights to Thailand take only four or five hours in the air, and are convenient due to international airports in major destinations such as Bangkok, Chiang Mai, Phuket and Krabi.

While the rising numbers of Chinese tourists open up many opportunities for Thai businesses, entrepreneurs should be prepared to adjust to these visitors' behaviors. Shops, restaurants, hotels and transport businesses should increase their capacity, as their services correspond to the highest expenses paid by the Chinese. Businesses should incorporate the concerns of tourists into their services to improve the quality. That means, for example, putting up signs written in Chinese, hiring Chinese-speaking staff and offering Chinese food. Nonetheless, according to a study by the Tourism Authority of Thailand, Chinese tourists are not completely impressed with Thailand's safety and shopping areas. Thai businesses should be mindful of these preferences and offer diverse shopping experiences, such as duty-free shops offering Chinese's consumers' favorite products and special tourist facilities. For instance, Harrods, the famous department store in the UK, provides VAT refunds for tourists and smartphone applications in Mandarin Chinese.

21 Chinese tourists in Thailand have significantly increased since 2012

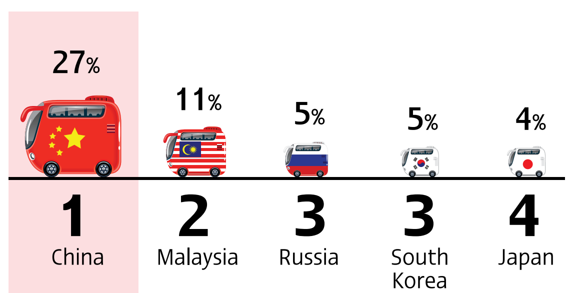
Chinese arrivals in Thailand

Unit: Person-time million



International arrivals to Thailand in 2015, by nationality

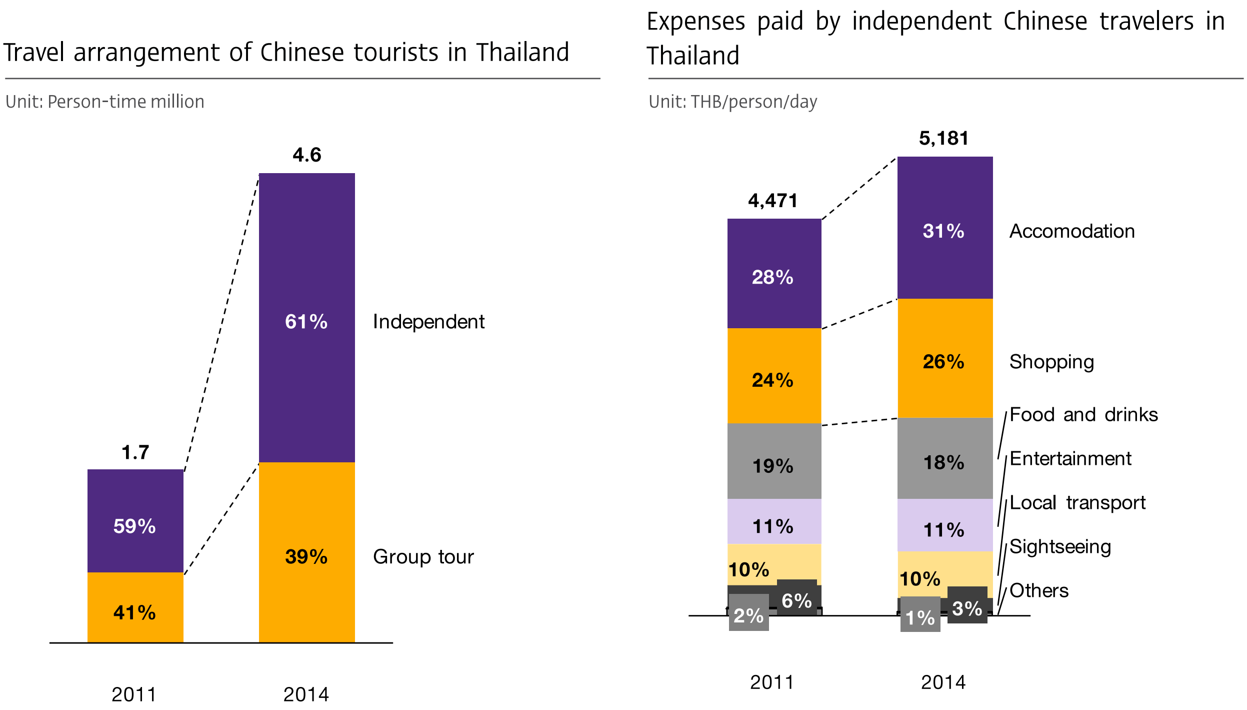
Unit: %



Source: EIC analysis based on data from the Ministry of Tourism and Sports

Businesses that target tourists travelling on their own are likely to be successful but should also bear in mind the risks. Around 60% of inbound Chinese tourists in Thailand make plans by themselves, and this group is likely to expand in the future (Figure 22). This shows a great opportunity for Thai entrepreneurs to offer services that serve the needs of such "free and independent" travelers, or FITs. For example, websites should be in Chinese to allow easy access and should provide customized services. However, Thai entrepreneurs should bear in the mind the risks, especially from competition with Chinese businesses that set up Thai representatives and offer related services such as restaurants, accommodation and transportation. Some also buy products from local producers and sell them to the tourists at high prices. This has shifted the tourism proceeds to Chinese businesses. Therefore, Thai businesses should use a strategy that boosts their business strength such as forming alliances with other entrepreneurs to provide all-in-one services. This can build the strength of Thai business alliances and provide services based on local expertise that is difficult for foreign competitors to access.

22 More Chinese tourists travel on their own.
Most of their expenses are paid on accommodation and shopping



Source: EIC analysis based on data from Ministry of Tourism and Sports

BOX: Tour, Shop and Share: Tourism with Chinese Characteristics

More Chinese tourists travel overseas every year, especially the new generation, who like to travel on their own. Most Chinese tourists are 25-35 years old and from large cities such as Shanghai, Beijing and Guangzhou. Their main purposes in travelling are leisure, business and study abroad. They are often accompanied by family members or friends. More than 70% of them make their own travel arrangements without a tour company. Moreover, Chinese prefer three- and four-star hotels and pick their destinations based on safety, tourist attractions, value for money and convenience. The usual trip length is six to eight days and the main activities are shopping, sightseeing at seaside and historical sites, dining and entertainment like shows and amusement parks.

The Internet has a strong influence on Chinese tourists' decisions prior to travel and remains the main space for sharing their experiences after their trips. In addition to advices given by family, friends and guidebooks, most Chinese trust reviews written on websites and social media, such as Baidu, Sina, Weibo, QQ Kongjian, daodao.com, and flight and hotel booking sites, such as Ctrip and Tuniu. They incorporate this information in their plans. Moreover, Chinese travelers like to share their travel experiences after their trips. They share photos and stories of the accommodations, restaurants and prices on social media. This information can heavily influence other potential travelers. Reviews written by celebrities can even make news headlines. For example, Jay Chou, popular actor and singer in China, posted his wedding photos taken in Selby in the U.K. This little town, which is less well known than others, became popular among Chinese tourists within a couple of weeks. Therefore, social media is proving to be a great marketing channel for the tourism industry, which both the Thai government and private sector should not overlook.

Chinese tourists generated more revenue for the tourism industry than visitors from any other country. Most of their spending is on shopping. According to the World Tourism Organization, tourism spending by the Chinese is the highest in the world, surpassing that of American and German tourists since 2012. In 2014, the total spending by Chinese tourists amounted to USD165 billion, rising on average 32% per year during 2010-2014 (Figure 23). Around 46% of total spending, excluding international transport, was for shopping. Other expenses are for accommodation, food and drink. Most Chinese tourists like to purchase local specialties such as food, snacks, souvenirs, clothes, cosmetics, jewelry and handicrafts. Half of the expenses are paid by credit card in duty-free shops, department stores and franchised shops. This presents an opportunity for Thai entrepreneurs to create a variety of shopping experiences and offer alternative products. In particular, there are a variety of products from the Thai government's One Tambon One Product (OTOP) scheme, such as Thai snacks, Thai textiles, herbal medicine and spa products. With good marketing and distribution channels, these products can generate big revenues for Thai businesses if they become well known. There are also opportunities to export to China if a product catches on.

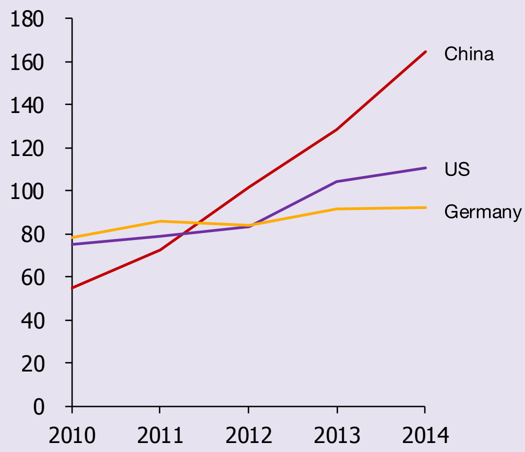
It is no surprise that Chinese tourists are welcome in many countries. One key success in the tourism sector is flexible adaptation to the needs of Chinese tourists as well as constant search for business opportunities. Several governments around the world, such as in the UK, South Korea and Japan, have made the visa process more convenient for Chinese tourists. The private sector, including hotels and shops, has made websites available in Chinese. They often serve Chinese food. Some have hired Chinese-speaking staff to reduce the language barrier. Additionally, Thai entrepreneurs should not limit their Chinese business opportunities by only marketing and selling to them within Thailand. As Chinese tourists research and make travel plans in advance via the Internet, Thai entrepreneurs should offer products and services that help the Chinese plan their trips. This can catch some customers before they even reach Thailand. Fan pages on Chinese social media can be used to provide travel information and discounts for subscribers and referred friends.

Source: EIC analysis based on data from the Tourism Authority of Thailand Intelligence Center (TAT Intelligence Center), World Tourism Organization, World Tourism Cities Federation, EU SME Centre and www.hotels.com

23 Chinese are the world's highest spenders on tourism. Excluding international travels, their expenses on shopping and accommodation account for 80% of total expenses

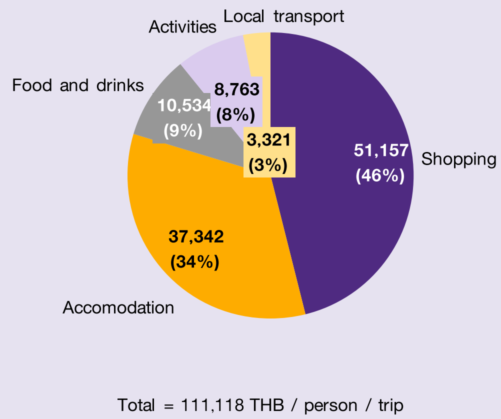
International tourism expenditures by country

Unit: USD Bn



Chinese tourists' expenditures by category

Unit: THB, %



Source: EIC analysis based on data from TAT Intelligence Center and the World Tourism Organization

Golden opportunities arising from Chinese travelers

Inspiring
Search travel information on review websites, blogs and social media

Booking
Book air tickets, accomodations and restaurants buy tour packages and entry tickets

Traveling
Go shopping, taste local food, watch arts and cultural shows stay at hotels

Business opportunities

- **Influencers**: Travel marketing businesses and promotional creators
- **Service facilitaters**: Booking facilitators and intermediaries between traveler and service providers
- **Service providers**: Traveler services

What are popular activities?

1. Shopping 99%
2. Visiting beaches 75%
3. Tasting local food 66% and Vistiing historical sites 66%
4. Watching arts and cultural shows 61%

What do they buy?

1. Local food 63%
2. Souvenirs 62%
3. Clothes 51%
4. Cosmetics 49%
5. Electrical products 42%
6. Jewelry 39%
7. Handicrafts 30%

Where do they shop?

1. Duty-free shops 82%
2. Department stores 70%
3. Franchise stores 51%

How do they make a payment?

1. Credit card 53%
2. Cash 43%
3. Mobile payment 4%

Source: EIC analysis as of January 2016 based on data from TAT Intelligence Center and World Tourism Cities Federations

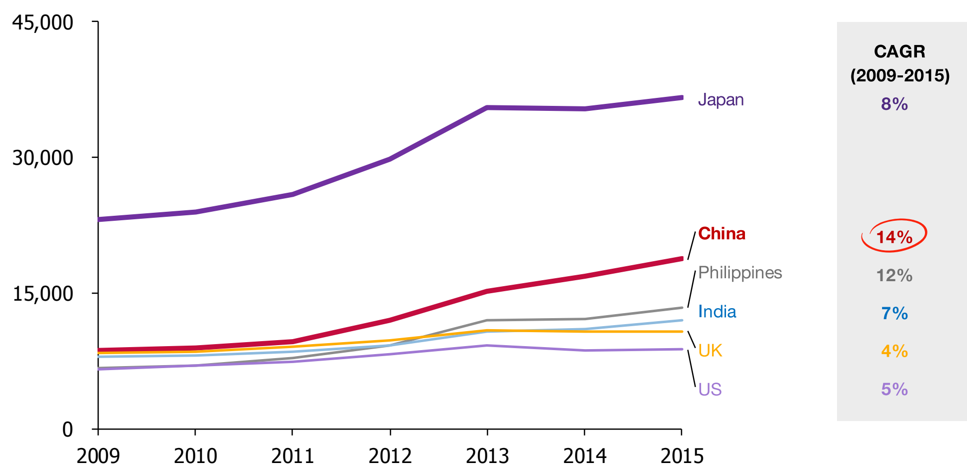
Why do Chinese buy real estate abroad? What does this mean for Thai entrepreneurs?

Chinese are large property buyers in many countries and are likely to invest more in the future. In addition to famous tourist attractions, there are four reasons for Chinese to buy real estate overseas: **First, the yuan's ongoing depreciation** encourages wealthy Chinese to hold real estate overseas, such as in the U.S. and Australia, to maintain wealth. In addition, housing reforms in 1998 allowed many Chinese to obtain homes at low prices. After the value of these residences goes up, the Chinese sell them and invest the money abroad. **Second, liberalization of capital flows,** especially under the Qualified Domestic Individual Investor (QDII2) program, allows individual investors to invest abroad without going through a fund management institution. More Chinese are therefore expected to buy properties abroad. **Third, the desire to own land** is strong because Chinese laws designate the government as the owner of land and Chinese nationals are allowed to reside for only 70 years. This encourages, wealthy Chinese like to buy houses in countries where foreign ownership is allowed. These assets will later be transferred to serve as their children's wealth and inheritance. **Fourth, higher quality of life** available elsewhere has convinced many Chinese to move out of large cities, such as Beijing and Shanghai, that are crowded and polluted. They relocate to places with better environmental conditions and education for the sake of their family members.

24 Chinese are ranked second among those who move to Thailand for work and also increasing

Number of skilled foreign workers with work permits in Thailand

Unit: People



Source: EIC analysis based on data from Office of Foreign Workers Administration, Ministry of Labour

Thai entrepreneurs in the real estate sector can compete in China if they target specific customers and answer their needs; related businesses can also benefit. Thailand is one of China's top picks in the real estate sector due to proximity, low living costs, and the similar climate, culture and people. Thai law states that apartments are the only type of property that foreigners are allowed to own, and no more than 49% of total units in a building. Chinese tend to buy apartments in main tourist destinations such as Bangkok, Pattaya and Chiang Mai. Most real estate developers target middle- to high-income customers. This group is growing in size and buyers willing to spend on properties that are in good locations with great facilities and high-quality management. Real estate developers should adapt to their preferences. Moreover, Chinese in Thailand are the second largest group of skilled workers after the Japanese. They are also increasing constantly, by 14% annually, on average during 2009-2015 (Figure 24). This is an opportunity for house and apartment owners to rent out their properties. Other related businesses, such as shops, health clinics and international schools, are likely to benefit from the presence of Chinese skilled workers and their families here.

However, entrepreneurs should be mindful of risks associated with their businesses, especially with regard to payment, and they should raise their competitiveness to match international levels. Both Thailand and China have regulations regarding international money transfers. For instance, Chinese cannot take more than USD50,000 or the equivalent out of the country per year. While the Thais are not restricted by the amount of money received from abroad; however, transactions of USD50,000 and above must be reported. Therefore, entrepreneurs should provide flexibility for Chinese customers to pay by installment. Moreover, many other countries are attracting the Chinese to invest in real estate. For example, the Malaysia My Second Home Project (MM2H) is targeting well-off foreigners who work, own businesses, study or retire. They are allowed to legally own an unlimited number of assets such as houses, land, apartments and cars. Nonetheless, different conditions apply in different states. Moreover, there are additional incentives such as exemptions of import tax for the first car, unlimited length of stay and number of entries, 10-year visas with a renewable option for spouses and children. Since the project launch in 2002, Chinese have taken up these benefits the most of any group, and the number is still rising. To attract high-spending Chinese customers, Thai businesses should upgrade their services to compete at an international level. They can take care of the visa application and extension processes, medical treatment and education planning and offer 24-hour assistance.

The Chinese market has launched a new period of both opportunities and challenges for Thai businesses. Yet, entrepreneurs may not be able to avoid fierce competition with other players. Chinese consumer behaviors are diverse and constantly changing. To grab the opportunity in the Chinese market, Thai businesses, whether large or small, should devise a focused strategy, get ahead of the game, and adapt quickly. They should constantly stay alert to the opportunities and challenges around them so as not to miss their trade and investment chances in the enormous Chinese market.

Contributors

Sutapa Amornvivat, Ph.D.
Chief Economist and FEVP

Sutapa is Chief Economist and First Executive Vice President at Siam Commercial Bank (SCB), where she leads the Economic Intelligence Center (EIC). She previously served as Head of Credit Risk Analytics Division under Risk Management Group.

Before SCB, Sutapa set up and headed the Risk Analytics and Research Group at TMB Bank during her secondment from ING Group. Prior to joining the banking industry, Sutapa was Economist (EP) at the International Monetary Fund (IMF) in Washington, DC. She had also served as Advisor to the Thai Senate Committee on the Economy, Commerce, and Industry, as well as Director of Macroeconomic Analysis Section at the Thai Ministry of Finance.

Sutapa holds an undergraduate degree in Applied Mathematics from Harvard University and a doctorate degree in Economics, Management, and Policy from Massachusetts Institute of Technology (MIT). She was a recipient of Thailand's most prestigious King's Scholarship. In 2007, Sutapa was honored by the Asia Society as Asia 21 Young Leaders Fellow, selected among a diverse group of professionals under 40 from the Asia-Pacific region.

Teerin Ratanapinyowong
Head of Sectorial Strategy and (acting) Head of Export Cluster

Teerin has over 10 years of management consulting experience working with the Boston Consulting Group and A.T. Kearney. She has advised leading companies across South East Asia in various industries such as banking, insurance, energy, consumer goods, and services. Her areas of expertise include growth strategy, competitive business model development, and business transformation. Prior to consulting, Teerin worked with PTT Plc. in oil business and investment management of PTT's subsidiaries.

Teerin graduated with a Bachelor of Accountancy (First Class Honors with Gold Medal Award) in Accounting Information System from Chulalongkorn University and a Master of Business Administration from Kellogg School of Management, Northwestern University in the United States.

Piyakorn Chonlaworn
Analyst
Area in Charge: Financial Markets

Piyakorn has extensive experiences in the financial industry. Before joining the EIC, he worked in private wealth at a leading securities firm in Thailand, where he provided advisory in asset allocation, derivatives, and structured products investment. In addition, he was a member of the pioneer team to establish the first financial futures exchange in Thailand.

Piyakorn received his Bachelor's degree in Industrial Engineering from Chulalongkorn University and obtained a Master of Science in Financial Engineering from Columbia University. He is also professionally qualified as a Financial Risk Manager (FRM) and a Chartered Financial Analyst (CFA). Besides his role at SCB, Piyakorn serves as a member of the Board of Directors of the CFA Society Thailand.

Contributors

Thanapol Srithanpong, Ph.D.
Senior Economist

Dr. Thanapol has experience in conducting research in the field of international economics and has worked on several empirical studies concerning the Thai economy, especially concerning micro-level analysis. His firm-level studies are related to international trade, foreign direct investment, and firm performance by utilizing applications from microeconometrics and business economics. Apart from academics, he had an internship experience at Siam Commercial Bank Asset Management (SCBAM) and the Bank of Thailand in the Monetary Policy Group during his undergraduate studies. He also worked as an information officer for the Tourism Authority of Thailand (Tokyo Office) during his studies in Japan.

Dr. Thanapol received a Bachelor of Arts (First Class Honors with Gold Medal Award) in Economics from Chulalongkorn University. He was awarded a Japanese Government Scholarship to pursue his graduate studies and received his Master of Arts and Ph.D. in Business and Commerce from Keio University, Japan.

Issarasan Kantaumong
Analyst

Issarasan has prior work experience at the Ministry of Transport, working on the development of the transport infrastructure development plan under the ASEAN and APEC Frameworks. Prior to that, Issarasan had experience working at Proctor & Gamble Manufacturing (Thailand) as a supply and distribution planner. While working at Procter & Gamble, Issarasan received the Star Award, an award given to employee that have achieved distinctive performance improvement.

Issarasan graduated with Bachelor's degree in Environmental Engineering from Chulalongkorn University. He was awarded the Royal Thai Government Scholarship to pursue MSc in Industrial and Systems Engineering at the University of Florida.

Pitsinee Thitisomboon
Analyst

Pitsinee had 2 years experiences working at The Nielsen Company as a Senior Executive providing consultancy to FMCG clients. Then, she joined L'Oreal Thailand as a Product Manager taking care of Maybelline New York brand, she had experiences on branding, marketing, product-related research, and consumer research. Pitsinee passed the internship from Office of Commercial Affairs, Royal Thai Embassy, Paris.

Pitsinee graduated in Bachelor of Economics, International program, Thammasat University (First Class Honors), and she received the scholarship to continue another degree in Bachelor of Business Administration (Honors) from ICN Business School, France. Pitsinee graduated her Master's under Msc. Marketing & Strategy (Merit) from Warwick Business School, University of Warwick, UK.

Contributors

Veerawan Chayanon
Analyst

Veerawan previously worked for Mitsubishi Motors (Thailand) as a product planner in the marketing division where she was responsible for eco-car projects and automotive market analysis. She has also participated in the 'LongD with DTAC' trainee programme at Total Access Communication and the 'New Investor Program' (NIP) held by the Stock Exchange of Thailand.

Veerawan was awarded a Master of Business Administration (MBA) degree with merit from Lancaster University Management School. She received her Bachelor of Arts in Economics with First Class Honors from Thammasat University.

Vorada Tantisunthorn
Analyst

Vorada has experience in economics and financial markets.

Vorada received her Bachelor degree in Economics at Chulalongkorn University (EBA program) with first class honour and Master degree in Finance and Risk at University of Bath with distinction.

Economic Intelligence Center (EIC)

E-mail : eic@scb.co.th Tel : +66 (2) 544 2953

Sutapa Amornvivat, Ph.D.
Chief Economist and FEVP
sutapa.amornvivat@scb.co.th

Economic and Financial Market Research

Phacharaphot Nuntramas, Ph.D.
Economic and Financial Market Research
phacharaphot.nuntramas@scb.co.th

Chutima Tontarawongsa, Ph.D.
chutima.tontarawongsa@scb.co.th

Krasae Rangsipol
krasae.rangsipol@scb.co.th

Piyakorn Chonlaworn
piyakorn.chonlaworn@scb.co.th

Thanapol Srithanpong
thanapol.srithanpong@scb.co.th

Natakorn Visudtiko
natakorn.visudtiko@scb.co.th

Tanakorn Limvittaradol
tanakorn.limvittaradol@scb.co.th

Vorada Tantisunthorn
vorada.tantisunthorn@scb.co.th

Yuwanee Ouinong
yuwanee.ouinong@scb.co.th

Knowledge Management & Networking

Anyarat Boonnithivorakul, Ph.D.
Head of Knowledge Management & Networking
anyarat.boonnithivorakul@scb.co.th

Ekarat Laokulruch
ekarat.laokulruch@scb.co.th

Napat Srichamorn
napat.srichamorn@scb.co.th

Nattida Intaramayoon
Nattida.Intaramayoon@scb.co.th

Sorodda Upamai
sorodda.upamai@scb.co.th

Vipasara Arpaskundait
vipasara.arpaskundait@scb.co.th

Wanitcha Nateesuwan
wanitcha.nateesuwan@scb.co.th

Sectorial Strategy

Teerin Ratanapinyowong
Head of Sectorial Strategy
(Acting) Head of Export Cluster
teerin.ratanapinyowong@scb.co.th

Pitsinee Thitisomboon
pitsinee.thitisomboon@scb.co.th

Pakanun Poolvoralaks
pakanun.poolvoralaks@scb.co.th

Veerawan Chayanon
veerawan.chayanon@scb.co.th

Export Cluster

Chotika Chummee
chotika.chummee@scb.co.th

Konjanart Thueanmunsaen
Konjanart.thueanmunsaen@scb.co.th

Pann Boonyavanich
pann.boonyavanich@scb.co.th

Teerayut Thaiturapaisan
teerayut.thaiturapaisan@scb.co.th

Infrastructure Cluster

Tubkwan Homchampa
Head of Infrastructure Cluster
tubkwan.homchampa@scb.co.th

Sivalai Khantachavana
sivalai.khantachavana@scb.co.th

Supree Srisamran
supree.srisamran@scb.co.th

Alisa Tamprasirt
alisa.tamprasirt@scb.co.th

Issarasan Kantaumong
issarasan.kantaumong@scb.co.th

Lertpong Larpchevasit
lertpong.larpchevasit@scb.co.th

Service Cluster

Vithan Charoenphon
Head of Service Cluster
vithan.charoenphon@scb.co.th

Pavaris Pruedsaradch
pavaris.pruedsaradch@scb.co.th

Pranida Syamananda
pranida.syamananda@scb.co.th

Kanchanok Bunsupaporn
kanchanok.bunsupaporn@scb.co.th

Lapas Akaraphanth
lapas.akaraphanth@scb.co.th

Puripat Sophonkeereerat
puripat.sophonkeereerat@scb.co.th

Vipavadee Srisopa
vipavadee.srisopa@scb.co.th

Siam Commercial Bank, SCB Economic Intelligence Center, 9 Ratchadapisek Rd., Jatujak, Bangkok 10900, E-mail:eic@scb.co.th