TRADE talks

A podcast about the economics of trade & policy

with Chad P. Bown

Episode 174. The incredible rise of Chinese fintech

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Transcript

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Chad Bown: How would you describe Chinese fintech to a non-Chinese audience?

Martin Chorzempa: Chinese fintech is just amazing.

Chad Bown: That is Martin Chorzempa. Martin is my colleague here at the Peterson Institute. He's a scholar. He reads and writes and speaks Chinese, and he has spent part of his life living in China.

Martin has an amazing new book about Chinese fintech called "The Cashless Revolution."

Martin Chorzempa: If you think about fintech, you are thinking about the new generation of technology, like mobile phones and digital payments, blockchain, things which can potentially change the way that finance is done and create new opportunities for finance.

Fintech in China is really about this new model of what they call “super apps,” where you take all of the things that you do with your bank, with Venmo and things that you don't even think are finance, like getting an Uber, booking travel, and putting it all into one single application that has a payment system built in, that stores your data, that know who owns what, what is paid to whom, and then can use that data to help give you credit or sell you good investment products.

Just about your entire life can be encapsulated in this one application, and that's what makes it so powerful.

Chad Bown: You are listening to an episode of *Trade Talks*, a podcast about the economics of trade and policy. I'm your host, Chad Bown, the Reginald Jones Senior Fellow, at the Peterson Institute for International Economics in Washington.

On this week's show, we're going to speak with Martin Chorzempa. We'll explore the incredible rise of a brand new sector of economic activity in China – fintech. This episode is about Chinese policies, the people and firms behind the technology, as well as the implications of fintech for the Chinese people today. It's also a little about trade.

Chad Bown: Hi Martin.

Martin Chorzempa: Hi Chad. Thanks for having me.

FINANCIAL PAYMENTS AT THE TIME OF CHINA'S 2001 WTO ENTRY

Chad Bown: Let's start in 2001. This is the year that China enters into the World Trade Organization. Back then, what was the most advanced form of financial payments *globally*?

Martin Chorzempa: The most advanced would be credit cards. You have a credit card issued by your bank that works on this network, run by Visa, MasterCard, or American Express, underpinned by all these banks. And what that allows you to do is easily make payments anywhere that accepts these cards, which is just about everywhere, all across the country and also around the world.

And as a consumer, you barely even need to think about it. It just works really well. In addition, you're getting about 30 days of free credit. Maybe you're getting rewards points. It's a system that works really, really well for consumers. It is, however, a little bit expensive.

Chad Bown: How about in China? And again, we're in 2001. What was China doing on payments at this time, and what was it supposed to do with respect to its legal commitments for these types of financial payments services when it came into the World Trade Organization?

Martin Chorzempa: At this time, China is basically running on cash. Maybe a few people have a debit card, but it's not very useful yet. Nobody has a credit card.

If you want to issue credit cards, you need somebody to be evaluated for how credit worthy they are to figure out how much credit you want to extend. And in China they didn't really have a system for that.

This was really an urgent need in China at this time because with the entry into the WTO, they were supposed to open up their domestic payment system, and generally their financial system, fully by around 2005.

But China didn't do it.

And that foot dragging led the US companies that were hoping to make a killing in the Chinese market to get so mad that they pushed the US government to launch a WTO case against China, which China lost and where it still refused to comply.

Chad Bown: Why didn't China open up or comply with that WTO dispute settlement ruling?

Martin Chorzempa: China was very nervous about what would happen if it opened up to competition with these powerful, much more experienced global, western payments companies and banks. China was worried that that these foreign financial institutions were going to essentially eat the lunch of the domestic companies, many of which were state owned.

And China's own counterpart – to Visa and MasterCard – which is China Union Pay, was a state backed monopoly that plays a similar role linking together bank cards in China, was only really established in 2002. China Union Pay had a lot of growing to do in order to think that it could compete with the Western companies.

Chad Bown: China Union Pay sounds like the classic infant industry protection story. The Chinese government is trying to create its own national champion. It's worried about competition from the western companies that had a head start in this industry.

Why didn't this particular approach work out?

Martin Chorzempa: There are three main reasons. The first is that nobody was really willing to pay fees on the merchant side or the consumer side to pay in cards because they weren't credit cards.

The second is that China Union Pay was really a state monopolist, without any competitive pressure, that was run by a bunch of former government bureaucrats. So this is not really conducive to an innovative system focused on serving consumers and businesses.

The third is this whole new interesting payment system developing for the Internet that was largely separate and ignored by this big monopolist that was about to disrupt it.

Chad Bown: This "whole new interesting payment system developing for the Internet" – that was a massive source of unexpected domestic competition for China Union Pay – this would become Chinese fintech.

FINTECH'S PEOPLE: JACK MA

Chad Bown: In your new book, you described the creation and evolution of a number of these incredible Chinese fintech companies that are working, through the Internet somehow, to be involved in the financial sector.

But another amazing part of your story really involves a number of individuals. One in particular really stands out. Who is Jack Ma?

Martin Chorzempa: Jack Ma is this fascinating guy who starts off as an English teacher and can't even get a job at Kentucky Fried Chicken. He can't manage to pass the exam that's required for people to go to universities without multiple tries. You look at him as a young person, you don't necessarily see the ingredients of someone who's going to be one of the richest, most innovative, people on earth.

But he then discovers the Internet somehow, through a bunch of crazy situations, and is convinced that the Internet is going to help China connect to the rest of the world.

He starts a company that's trying to link together – say, you are a business in Iowa and you want to order 30,000 t-shirts with your customer logo on them – you're able to order that from Alibaba.com.

He called it Alibaba because he thinks, "This is 1,001 Nights. Everyone around the world knows what this name is." This is someone who is really engaged with technology.

He's very colorful. At one point he makes up quotes from Bill Gates about how important the Internet is to try and convince people in China that the Internet actually exists, and that he's connecting them with a real thing.

He's really one of the most important drivers of the adoption of new technology in finance.

Chad Bown: In running Alibaba.com, what's the key problem Jack Ma needed to solve?

Martin Chorzempa: The first one that brings us to fintech is the looming entry of foreign competition from eBay and PayPal. They are entering the consumer e-commerce market and Jack Ma fears that if they're able to conquer that market, they're going to conquer the whole thing.

So he creates, as a result of this fear, Taobao, which is now the largest e-commerce marketplace in the world, but at the time it was a tiny thing. And he discovers that people transacting online are having trouble because they can't pay with a credit card by just typing their information in, and they don't trust the people that they're that they're transacting with online.

The only transactions people are willing to do are in person, like Craigslist. We chat, we meet up in person. I make sure the goods are legitimate. You make sure my bills aren't counterfeit. We pay in cash and we separate. But then there's not really potential for this to be a new national or international way to transact.

So Jack Ma creates this system called Alipay. Alipay really begins as an escrow system where I, as the person buying something, pay the money to Alipay, so the business knows that I've paid up before they ship me the goods. And I know that Alipay isn't going to give that money to the merchant until I receive the goods and make sure that they're legitimate.

As long as both the merchant and the consumer trust Alipay, this system can work, even if we don't trust each other. But then, of course, to actually make that work, they have to move money around between accounts. So they partner with the banks. And this ends up growing into a fully separate payment system for the Internet.

Chad Bown: Why wasn't Union Pay the answer here?

Martin Chorzempa: This is really the early 2000s, and Union Pay just started in 2002. China Union Pay has to first digitize the entire, offline huge economy of hotels, restaurants, everything else. That's what they're focused on. And when Jack Ma comes to them and says, “I want to work with you, can you help us build a payment system for the Internet?”

They send some low level executive to tell him off and say, “You little pip squeak. We don't care about the internet economy.”

Remember these are government bureaucrats. They're not people who are really trying to get their pulse on innovation. They're trying to build the basics of a system, and this is really just not a priority for them.

So Jack Ma has to do it on his own.

THE CHINESE REGULATORY ENVIRONMENT

Chad Bown: To outsiders, Chinese economic policy has this reputation for being pretty heavy handed. China has this long history of state planning with five-year plans, industrial policy, subsidies, and lots of inefficient state-owned enterprises.

How does Chinese financial regulation fit into this story?

Martin Chorzempa: This is one of the most fascinating paradoxes in the way that China does things. Alongside the state dominated subsidies and five year plans, there's also this side of it, which is extremely friendly to innovation.

And the way this worked in fintech was that they made a specific decision not to impose regulation in 2005 and just to let this thing go and watch how it worked without any clear rules. It's really extraordinary. It's like a libertarian paradise in an authoritarian system of government.

And a lot of this was due to the governor of the Central Bank, Governor Zhou Xiaochuan. This is someone who is absolutely convinced that really new technology and competition is what's going to make China's financial system much better. You can't just order the banks to become innovative. You need to actually force them to become innovative by introducing new competition.

He recognizes that the system that China has at this point is very repressive. It's designed to give consumers limited choice to funnel their money at low interest rates into government priorities, is not what's going to support China's growth going on into the future.

He's this really important protector that allows people like Jack Ma to do this innovation without going to jail.

Chad Bown: This lack of regulation did result in this incredible innovation and creation of Chinese national champions in fintech like Alibaba. Were there any downsides along the way?

Martin Chorzempa: Absolutely. When you open up this kind of space in a usually very regulated industry, all sorts of people will come in and pretend that they're doing innovative fintech things, but really what they're doing is Ponzi schemes and old-fashioned loan sharking.

I'll give you one example: Ding Ning, someone I actually met for tea at one point and thought was one of the most honest people I had met in the entire industry because he was forthcoming about the problems in it. He turned out to be China's version of Sam Bankman-Fried, the Crypto guy, but add in pink diamonds, Singaporean villas, weapons stashes and smuggling gold across the border into Myanmar to ethnic militias where you can launder the money. It's almost an unbelievable story.

This guy gathers $7.6 billion from nearly a million people in China by promising them these wildly high interest rates and saying, "We have all this AI and big data that makes your money safe." And really what he was doing was just making up projects and smuggling the money out of the country.

But it was on the Internet. And really nobody knew who was responsible for checking if any of these claims were real. It slipped through the cracks in China's system.

China really couldn't figure out what to do about this highly fraudulent space until it was well over a $100 billion problem affecting at least tens of millions of people in China, who were about to lose their savings.

Chad Bown: What happened to Ding Ning?

Martin Chorzempa: Ding Ning is in jail.

FINANCING CHINESE FINTECH

Chad Bown: Tell us about the role of the foreign, non-Chinese, financiers during this era.

Martin Chorzempa: These internet companies were copying in many ways the business models that we're familiar with in Silicon Valley. Initially, they don't charge any money for their products, so they can build up user bases and become a large companies.

That means that these companies need a huge amount of money upfront to be able to take these losses and not go bankrupt. The money for this doesn't come from the Chinese state, it doesn't come from subsidies. It comes from foreign investors, which are the ones who are able to recognize the potential of these companies.

Examples are Goldman Sachs, Yahoo!, and SoftBank in Japan, and it's this money from these foreigners, which enables Alibaba to beat eBay in the Chinese market. Jack Ma called it "Cutting a hole in their pocket, even though they have deep pockets." You have these foreigners funding a Chinese domestic company to out-compete other foreigners, and they make a killing off of this, because these companies became extremely successful.

But at the same time, some of them discovered that doing business in China can be very dangerous. At one point, around 2011, Jack Ma transfers the stake in the fintech business, Alipay, to himself without telling the board of Yahoo! or SoftBank, who are supposed to own big shares in this company.

In the end, they come to an agreement that the foreign companies will only get a small share of it. And Jack Ma tells them it's because the Chinese government is not going to give us a license for payments if it's foreign owned. The funny thing is that Tencent, the other main fintech company competing with Alibaba in China, also has foreign ownership, but was able to get the get the license that Ma wants.

It's really not clear, and I don't think we're ever really going to know. Was this actually a demand from the Chinese government to make sure this online payments company was a domestic one? Or was this simply a power grab from Jack Ma who didn't want to share the profits from the fintech boom with American investors like Yahoo!?

CHINESE FINTECH'S NEW PRODUCTS

Chad Bown: How did product offerings for these fintech firms evolve over time?

Martin Chorzempa: When they started out, it was extremely low tech. It's literally faxing copies of your bank transfers and a notebook where somebody writes down the suspicious transactions.

But then it builds into a payment system for the Internet and for e-commerce things. And then around 2013, 2014, they start to go offline. And this is when they begin to compete with the traditional financial system. This is the rise of QR codes. And that starts with taxis. And there's this battle between the two main companies in this space over who's going to get their QR code printed in the taxi.

And they provide massive subsidies to people who scan a QR code to pay instead of using cash, which then creates this flywheel where enough consumers have adopted it that merchants decide that they want to accept it. And within a year or so everywhere is taking QR code payments and cash has pretty much disappeared. And they realize once they have a payment system, they can add all sorts of other financial services to.

This is where the government allowing them to do so becomes so crucial.

These fintech companies get licenses to sell money market funds and other investments. They get licenses to give loans. And they add all of these things into this bundle of services that becomes ultimately the super apps.

If you have the Alipay app, it's essentially like a whole new operating system for your phone, where you don't really care about iOS or Apple anymore. You just care about opening up that Alipay app.

Your Uber on the way to work: you call it through that app. Checking your stocks is through that app. You order your coffee when you arrive at your office, that's going to be done through the app. Booking your travel is through that app, updating your insurance policy is in there, getting a loan to buy a refrigerator. You're going to do that through that app.

Just about your entire life can be encapsulated in this one application, and that's what makes it so powerful.

TRADE? CHINESE FINTECH'S INTERNATIONAL EXPANSION

Chad Bown: By 2017, hundreds of millions of Chinese citizens have this new access to finance. Only a short time earlier they'd been transacting in cash. In your book, you describe how China now has these incredibly dominant and valuable Chinese payment systems like WeChat Pay and Alipay, and these super apps that have a billion users in China that do everything.

Let's talk about trade.

It seems like this would be pretty competitive globally. How did these Chinese firms attempt to expand internationally?

Martin Chorzempa: There are really three models that they've followed.

The first and the most successful is that, because it's such a no-brainer for merchants around the world to accept Chinese payment tools, Chinese tourists can use them to pay for things. Think about a Louis Vuitton store on the Champs Elysée. Someone in the payments industry has likened it to not offering air conditioning in a car. They're now accepted in dozens of countries around the world at thousands, if not millions, of merchants. That's a really successful globalization story.

The other side of it is investing in fintech companies around the world that can be partners for the Chinese fintech companies. They've been decently successful, but many of the companies they've invested in that are trying the Chinese model abroad haven't really worked out as well as it worked in China. Those partnerships are often very controversial from a national security perspective, which limits their ability to merge these companies into a global network.

The third approach of internationalization has been to try and get users abroad for Chinese fintech apps.

They had such a powerful system in China that they assumed that that model would work in other countries. The best example of this is WeChat's attempt to expand in India. They started really through social media, having people chat with each other through WeChat.

What they discovered is that the environment there is different. In India, they didn't have phones with as much memory. It was more expensive to get access to data. And there were other issues. For example, if you shake your phone in China, it's supposed to open you to connect to other people around you. In India, that led to women getting tons of harassing messages from men around them.

In addition to that, the Indian government said that they might ban this app because it was Chinese. And that was a surprise to the users. They said, “This is Chinese? We don't think we can trust a Chinese app with all of our sensitive personal information!” In India, WeChat failed, and instead WhatsApp, now owned by Facebook, completely dominated the chat market.

These companies that failed to really adapt themselves to different situations in other international markets and struggle with this geopolitical baggage from China made it very difficult for them to expand abroad, at least to get people abroad to use their products.

CHINA'S REGULATORY CRACKDOWN ON FINTECH

Chad Bown: What happened in 2019, and what happened to Jack Ma?

Martin Chorzempa: David essentially has become Goliath. We go from these small, scrappy, very popular tech companies, which are empowering small businesses and giving people new access to loans, to becoming these gigantic conglomerates of finance and technology that look like they're unassailable. No one else could compete with them.

We go from, no one has access to credit, to people having credit shoved down their throats. You have too many offers for credit. People are falling into debt. You get a lot of sob stories about these people whose lives have been ruined from clicking, "I'll take that loan," one too many times on their phone.

At the same time, you have global recognition of the downsides of these huge technology companies for competition, for privacy, and for everything else. The popularity and the sense that you're helping the underdog no longer exists for Chinese fintech. Chinese fintech is now this huge thing that if it goes bust could bring down China's entire economy, digital and elsewhere.

But Jack Ma hasn't really adapted to the new reality. He still thinks he has this aura of invincibility. He gives the Bund Summit speech, castigating the government for daring to regulate his massive empire. In a way that's probably what you would want for something that's that large.

And that leads the government to think this guy is not just a threat to financial stability in the country, he threatens our political system. He's not willing to accept the government's decision about how to weigh the risk of innovation versus regulation. And that leads to the massive tech crackdown that you've probably seen in the headlines for the past few years.

There are all these rumors that Jack Ma has been put in jail or somewhere else. Some journalists tracked down his private jet and discovered that he was jetting around in China. Now it appears he's living in Tokyo, trying to safely escape the government net.

But you really never know if someone like that, traveling with their friends, if some of those friends might be inserted there by the Chinese state to keep tabs on him and to make sure he is not going to say anything controversial anymore.

SURVEILLANCE, AUTHORITARIANISM, AND THE DOWNSIDES OF CHINESE FINTECH

Chad Bown: As my last question, I want to ask about one other thing that you also cover extensively in your book, and that's privacy, surveillance, and some of the downsides to the efficiency of fintech, data accumulation, and these Chinese super apps like WeChat and Alipay.

How are these trade-offs – both the promise and the peril – made clear when the Covid pandemic hit?

Martin Chorzempa: When Covid-19 hit China, the whole country went into a strict lockdown. And one of the key questions facing the government was, how can we let some people out so that our economy doesn't collapse? And how can we thus choose who are the people who are safe, who haven't been around anyone infected?

But they didn't know how to do it. So they instead turned to Alipay, they turned to the fintech company to design an algorithm that would give people a health code. And if you got the green code, you could go around and do your grocery shopping, and go back to your relatively normal life. If you had a red code, they might weld your door shut and block off the fire escapes.

This really shows how this power that this company gained through the ubiquity, and through their technical expertise, was at this point a force for liberation for people who were in lockdown.

But then, as the government maintained this system of controls on people, it later became a way for the government to keep tabs on everybody. Anywhere you went in China, until very recently, you had to scan your health code. This not only showed people that you hadn't been exposed to Covid, but it also sent your information and location directly to the police, so they could track you everywhere you went, maybe for a lot more than just contact-tracing.

This technology – which is so powerful and can bring people new freedoms, financial and otherwise – in the hands of an authoritarian government, can very quickly become a tool of control and surveillance.

When all your data is in one place and the government asks to take a look, it's really hard for that company to say no.

Chad Bown: Martin, thank you very much.

Martin Chorzempa: Thanks for having me.

GOODBYE FOR NOW

Chad Bown: And that is all for *Trade Talks*. A huge thanks to Martin Chorzempa, my colleague here at the Peterson Institute. Do check out his amazing new book, “The Cashless Revolution: China's Reinvention of Money, and the End of America's Domination of Finance and Technology.”

Thanks to Melina Kolb, our supervising producer. As always, thanks to Collin Warren, our audio guy.

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We are on @Trade__Talks. That's not one but two underscores @Trade__Talks.

<insert super funny double underscore joke here> . [redacted]

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