

The Domestic Travel Sector in China

by

Jeff Anders

Bachelor of Commerce, McGill University, Canada 1999

Submitted to the MIT Sloan School of Management in Partial Fulfillment of the
Requirements for the Degree of

Master of Business Administration

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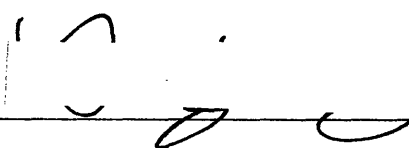
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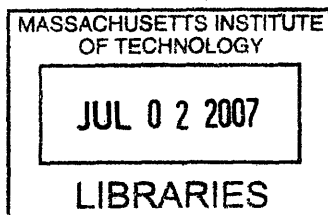
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ABSTRACT

China is already the largest domestic tourism market in the world. Chinese citizens made as many as 800 million overnight domestic trips in 2005. While travel is not a new concept in China, the disposable income they wield, the range of options becoming available and individual tastes are changing every day.

This paper has two main objectives: (1) to detail the characteristics of the domestic Chinese traveler and, to a lesser extent, foreign inbound and Chinese outbound tourists; and (2) to explore the different drivers of tourism development and growth in China. Both sections are targeted at businesspeople and governments thinking about tourism-related business ventures, and at policymakers considering how best to stimulate tourism, consumption and economic gain.

The Chinese people are eager to explore China – they will travel at home before going abroad. Tourism is not the exclusive purview of cosmopolitan urbanites; rural Chinese travel too. Chinese domestic tourists want overwhelmingly to visit natural landscapes when they travel. They also want more specialized and less visited destinations. They pay for lodging and spend as much on retail purchases as on lodging or food. Domestic Chinese business is the main driver of business travel in China

The major drivers of tourism growth in China are: the rise of the middle class, expansion of business and trade, government policy, public infrastructure, private industry, Cooperative Tourism Zones, mega-events and conventions, and increased leisure time.

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Summary Insights and Recommendations

Domestic Tourists

- Chinese people are eager to explore China – they will travel at home before going abroad. Thus, domestic tourist trips far exceed the number of inbound or outbound tourist trips.
- Chinese domestic tourists want overwhelmingly to visit natural landscapes when they travel. They also want more specialized and less visited destinations. Although there are an infinite number of scenic locations in China, few have been developed. Local and regional tourism authorities and private entrepreneurs could explore tourism clusters in currently undeveloped areas for massive financial gain.
- Chinese tourists rank shopping at the bottom of the list of things they want from a trip, but they spend as much on retail purchases as on lodging or food. This suggests a pattern of consumption that will only grow with disposable income available for discretionary items. Tourism destinations that boast “good” shopping and tour operators that develop shopping tour packages will reap extraordinary gains.
- Chinese domestic tourists pay for lodging when they travel. In fact, a Chinese tourist is as likely to stay in rented accommodations when traveling in China as an American tourist traveling in the United States. Moreover, a Chinese domestic tourist will spend an equivalent share of trip budget on lodging as an American domestic tourist.
- Chinese domestic tourists spend more money when traveling abroad than when traveling at home. Price differentials account for much of this difference. But it implies an opportunity for local tour operators to create higher-priced packages for domestic travel. This is still relatively untapped and early movers that can establish a brand will reap long-term benefits.
- Rural Chinese travel too; tourism is not the exclusive purview of cosmopolitan urbanites. Low-cost travel options targeted at the Chinese heartland is a major opportunity. There is a small segment of rural tourists, approximately 20%, who spend as much per trip as the average urbanite.
- Chinese get their tourism information mostly from newspapers and TV broadcasting. Internet is slowly on the rise.

Foreign Tourists

- The number of inbound tourists is tiny compared to the number of domestic tourists. This is more a function of the size of the domestic market than any impediments to foreign arrivals. In fact, China is the fourth most visited country, ahead of tourism behemoths UK, Mexico and Italy. Moderate obstacles include state-owned tour operators, visas, ADS and language.
- Foreign tourists are 2/3 male and 50% are aged 25-44 years old.
- Foreign tourists stay in China for an average of three nights. Taiwanese stay almost as long. Visitors from Hong Kong make day trips.
- Foreign arrivals are evenly split between business and leisure. Business is overrepresented relative to global averages. The global averages show leisure trips are twice as numerous as business trips. This suggests that foreigners visiting China for leisure is an under-developed market.
- Foreign tourists move around a fair bit once they arrive. Domestic transportation accounts for the largest share of spend.

- Foreign tourists love to shop in China. They spend as much on shopping as on accommodation and food combined.

Outbound Tourists

- The number of outbound tourists is even smaller than inbound: approximately 10 million trips were taken to non-SAR countries in 2005.
- Outbound tourists travel to nearby countries.
- Outbound tourists are not very adventurous yet. They stay in Chinese run hotels, eat Chinese food, travel in Chinese groups.
- Outbound tourists spend vigorously on shopping, but stay in meager accommodations far from the city center and eat inexpensive food.

Business Travel

- Domestic Chinese business is the main driver of business travel in China
- These travelers work for small and medium sized indigenous Chinese companies
- They are price sensitive; they are not yet brand loyal
- The hotel they want provides comfort, cleanliness and breakfast but no frills.
- They minimize transportation costs by staying within 5km of clients or suppliers
- Data shows growth

- Foreign business travelers account for almost half of all inbound tourists
- Foreign business travelers stay in 4 or 5-star hotels
- They shop while in China
- Can be expected to grow as the domestic consumer market attracts foreign products and as Chinese suppliers gain market share abroad.

Drivers

Rise of the middle class

- Middle class discretionary spending will increase as (1) the number of middle class households increases, (2) the average after-tax disposable income per household increases and as (3) the percent of disposable income available for discretionary spending increases.
- Spend on recreation is expected to increase 9% per year through 2025
- The number of cars in China is growing rapidly and will change the way people think about travel, where they go, and what they do.
- Consumer credit is on the rise and will increase discretionary spending

Expansion of business and trade

- Domestic business and foreign trade are major drivers of tourism in China
- The maturation of indigenous Chinese businesses that serve the domestic market will lead to domestic travel for business.
- Liberalized trade practices and the introduction of foreign competition will stimulate inbound tourism

Government Policy

- Current Chinese government policy encourages domestic and inbound tourism.
- The government has impeded outbound tourism through bureaucratic delays and the ADS regime. Changed policy on outbound will stimulate more inbound.

Public Infrastructure

- Government support for tourism has manifested itself in the building of infrastructure large projects. The Chinese government is very good at infrastructure development

- and has integrated tourism projects into general plans. Smaller developments are critical and the government should turn its attention to those more aggressively.
- Airport development has allowed the introduction of additional air carriers, which has brought capacity and competition that are driving down prices, and further increasing consumption. This paper supports the government policy changes on foreign investment in air carriers.
 - The road network has been massively expanded, which, along with the introduction of more cars, will probably be the single biggest driver of budget travel growth. Road trips will allow to lower income people to travel without the high fixed cost of air travel.
 - Welcome Centers are a gap in the tourism infrastructure today. Studies of welcome centers in the US have shown that their presence increases both the number of nights stayed and dollars spent.

Private Industry

- All classes of hotels are growing rapidly. The budget hotel sector is growing to serve domestic tourists, predominantly domestic business people. As with airports, the additional capacity will bring down costs and make travel more amenable to the average Joe. But the hotel sector faces challenges of its own, which may limit the growth in the short to medium term.
- Large travel agencies are owned by the government, which does not have the same profit incentive and which has been slow to adopt western marketing practices. The introduction of foreign competition has spurred consolidation and more competition.

Cooperative Tourism Zones

- Cooperative tourism zones, including the GMS and Tumen River, have been very successful at stimulating tourism and reducing poverty.

Mega Events and Conventions

- The government has participated in attracting mega-events like the 2008 Olympics. Industry experts believe these events will establish China as destination for foreign tourists and will awaken the traveler in domestic tourists as well.

Increased Leisure Time

- China has a government mandated 5-day work week
- Golden Weeks are massive travel and shopping weeks

Introduction

A video advertisement for Kingfisher Airlines in India illustrates the tourism revolution taking place in Asia. The film features a young boy whose father gives him a toy airplane that captures the boy's imagination. Thirty years later, the boy is grown and prospering and he reciprocates by giving his father the opportunity to fly in a real airplane. The advertisement positions tourism in the context of broader changes taking place: poverty alleviation, global competitiveness and technological leadership. Nowhere are these factors more real than in China, a nation that is rapidly emerging as a global power house in all respects.

As a result, national pride in China is high. People are eager to explore their country and to introduce foreigners to its beauty. China is already the largest domestic tourism market in the world and it continues to grow. Of course, travel is not a new concept in China, but the distance people can now travel, the disposable income they will soon wield, the range of options available and individual tastes are changing every day.

The paper has two main objectives: (1) to detail the characteristics of the domestic Chinese traveler and, to a lesser extent, foreign inbound and Chinese outbound tourists; and (2) to explore the different drivers of tourism development and growth in China. Both sections are targeted at businesspeople and governments thinking about tourism-related business ventures, and at policymakers considering how best to stimulate tourism, consumption and economic gain.

The first section, *New Journeymen: The Traveling Public Segmented*, gives a detailed overview of the demographic nature and consumer behavior of domestic, inbound and outbound tourists, and a sub-section on business travelers, who span all three groups. The second section, *Drivers of Tourism Growth*, identifies and explores the factors impacting the

tourism growth to date and future performance. Those factors include the rise of the middle class, economic and trade growth, public and private infrastructure development, government policies, cooperative tourism zones, mega-events and conferences, and increased leisure time.

New Journeymen: The Traveling Public Segmented

Travel as a leisure activity in China is growing by leaps and bounds. Millions of people who could never afford to travel before are packing bags, boarding planes and exploring China, Asia and the world.

The traveling public in China can effectively be segmented into three groups: (1) domestic tourists, (2) foreign inbound travelers and (3) outbound Chinese tourists. A fourth segment that spans all three is the business traveler, which will be covered separately. Who are these tourists? Where do they come from? Where do they go? What mode of transportation do they use? What accommodations do they choose? How do they purchase travel products? What is the purpose of their travel? How much do they spend? What do they buy? These and other questions will be answered in detail in this section.

This paper will focus primarily on the first segment, native Chinese people traveling within China. This market is the largest and fastest growing. Inbound tourism from foreign countries and outbound trips taken by Chinese citizens are beyond the scope of this paper, so only a brief overview of the topics will be covered here.

Domestic Tourists

The Chinese domestic tourist market is the largest such market in the world. Chinese Government statistics report that domestic tourists took 1.2 billion trips¹ in 2005. By 2010, the number of domestic tourists is forecast to soar to about 1.8 billion². The number of domestic trips was ten times larger than the number of foreign arrivals in 2005. Excluding the number of “foreign” visitors from Hong Kong, Taiwan and Macau, the number of domestic trips is closer to sixty times larger than the number of foreign visitors. That domestic tourism

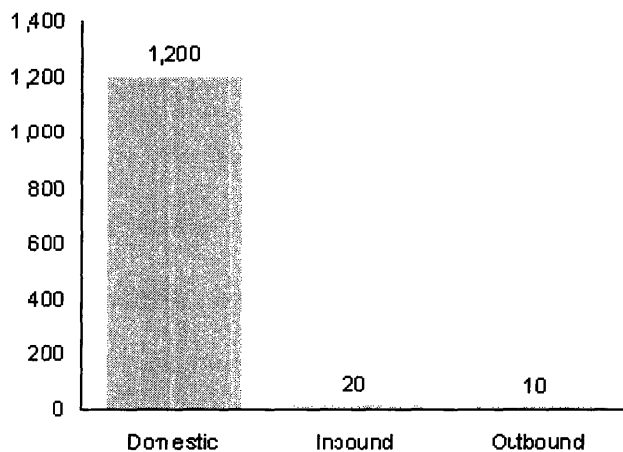
¹ <http://www.cnto.org/chinastats.asp>

² <http://www.time.com/time/asia/magazine/article/0,13673,503060807-1207866,00.html>

is larger than foreign tourism seems intuitively to be correct. China is a vast country with a diverse geography and rich history. The Chinese people want to explore their own country before heading to more exotic and costly destinations.

The total trip numbers are astounding, especially when put in a global context. The World Tourist Organization estimates that international tourist arrivals worldwide were approximately 0.8 billion. So the number of domestic tourist trips in China was equal to 150% of all foreign tourism worldwide.

Total trips
(2005, million trips)



Note: Inbound excludes visits from Hong Kong, Taiwan and Macao; Outbound excludes visits to Hong Kong, Taiwan and Macao

But as with all statistics there are some issues with these numbers that should be identified at this point. A domestic trip qualifies if the person traveled more than 6 hours or more than 10km and was not remunerated for the travel. This could include trips made within a single city; one could travel 20km in Beijing and never leave the city proper and inner suburbs.³ The data also include same-day trips, which represent at least one third of the 1.2 billion trip total. According to Wang & Qu, daytrips account for 33% of domestic tourist trips. Prof. Dr. Wolfgang Georg Arlt of the China Outbound Tourism Research Project believes the

³ <http://en.wikipedia.org/wiki/Beijing>

daytrips are a greater percentage, representing at least 48% of total. One might argue that day trips are not tourist trips at all. But what is significant is that as many as 800 million visitors stay at least one night.

Chinese people are eager to explore China and they will travel at home before going abroad. Leisure is the major travel segment in China. According to a 1999 study by Wang & Qu, the preferred travel activity of domestic Chinese tourists is “visiting outdoor natural scenery”, which 73% percent of respondents listed as among their favorites. This signals a significant preference compared to the other options, which were Relics / Historical sites (32%), Fitness/Sports (27%), recreation/leisure (23%) and Shopping (17%).⁴

Chinese tourists rank shopping at the bottom of the list of things they want from a trip, but they spend a huge share of trip budget on retail expenditures. It is interesting to compare the results from this study to those from a similar survey given to domestic tourists in the United States. The big difference that jumps out is the preference for shopping, which ranked first in the US survey, garnering 33% of the votes, and last in the Chinese survey. One might conclude that Americans like to shop when they travel and the Chinese do not. But the data suggests otherwise. Chinese travelers spend as much on retail purchases (16%) as they spend on lodging (17%) and food (16%). Entertainment accounts for only 7% of total budget. On the other hand, US domestic tourists rank shopping as the #1 reason to travel and they only spend 8% of total budget on shopping! The aggressive spending and relatively modest excitement about shopping suggests enormous growth potential for the travel shopping sector. Outbound Chinese tourists have already demonstrated a propensity to shop. Mainlanders spend more per person in Hong Kong than any other tourists.⁵ Tourism destinations that boast “good” shopping and tour operators that develop shopping tour packages will find a captive market for these kinds of trips. Entrepreneurs exploring this market segment should consider

⁴ Wang, Suosheng and Qu, Hailin. “A Comparison Study of Chinese Domestic Tourism: China vs the USA”, *International Journal of Contemporary Hospitality Management*, Volume 16, Number 2, March 2004.

⁵ http://www.economist.com/business/displaystory.cfm?story_id=2771531

government partnerships. The government is eager to develop tourism as an engine of consumption to spur economic growth. Shopping as a tourism activity will only grow with increases in disposable income available for discretionary items.

Chinese domestic tourists want overwhelmingly to visit natural landscapes when they travel. They also want more specialized and less visited destinations. A study by Wu and Zhu highlighted that in the year 2000, domestic travel preferences were already beginning to shift. As income levels rose, preference “shifted from historic and cultural areas (e.g. Beijing, ... Hangzhou, Zhejiang province) with large carrying capacity to natural landscape areas with smaller carrying capacity (e.g. mountain resorts far away from cities); from traditional national parks (e.g. Huangshan Mountain, Anhui province, and Guilin, Guangxi Autonomous Region) to newly developed areas (e.g. Jiuzhaigou, Sichuan province, and Zhangjiajie, Hunan province)”⁶. Although there are an infinite number of scenic locations in China, few have been developed. Local and regional tourism authorities and private entrepreneurs could explore tourism clusters in currently undeveloped areas for massive financial gain.

It is generally understood that the where people go when they travel and what they do depends on how they get their tourism information. In the United States and most developed countries, tourists get most of their information about different travel destinations from friends, family and co-workers and from the Internet. Chinese tourists, in comparison, get most of their information from newspapers and TV broadcasting. As more people gain travel experience and as Internet penetration increases, these information sources will become more important. But for the foreseeable future, the official media sources will continue to play a primary role in this regard. Tourism industry players that can generate word-of-mouth buzz or target internet savvy travelers should gain a competitive and cost advantage over competitors advertising through traditional channels.

⁶ Bihu Wu, Hong Zhu, Xiaohuan Xu. “Trends in China's domestic tourism development at the turn of the century”, *International Journal of Contemporary Hospitality Management*. Bradford: 2000. Vol.12, Iss. 5; pg. 296.

Researchers have been surprised to find that rural residents travel too. The domestic tourism market is split between rural (60%) and urban (40%) residents. Tourism is not the exclusive purview of cosmopolitan urbanites. Rural dwellers are eager to explore the country and visit family and friends, and they too are prepared to pay for it. Rural dwellers do differ from urban dwellers in the number of trips they take annually on average. Rural residents make 0.76 trips per year, compared to 1.35 trips per urban resident⁷. Put differently, the average urban dweller will take almost twice the number of trips as a rural dweller. Income disparities- rural income is estimated to be 1/3 of urban income⁸- probably accounts for most of this difference.

Data showing urban dwellers spend more per trip than rural dwellers supports the income disparity hypothesis. The average urban dweller will spend \$90 per trip, compared to only \$30 for the rural dweller. What is most interesting about the rural dwellers is they segment into two groups: the first, which accounts for 80% of rural travelers, spends only \$12 per trip. These people are making day trips, staying with family or in inexpensive Luguan, not shopping and generally not consuming very much. The travelers in the second group, the other 20% of rural dwellers, behave like their urban counterparts and spend close to \$100 per trip. This suggest two opportunities. The first is low-cost travel options targeted at people from the Chinese heartland. This is still a nascent industry and budget tour operators and should aim to establish brand equity immediately. A second opportunity is to offer higher-end trips for rural residents that are prepared to spend as much as urban travelers. Regional brands that understand local tastes and preferences are likely to emerge.

Domestic travelers spent a total of \$66 billion in 2005. What did they spend it on? The largest chunk was spent on transportation (30%), presumably on bus or rail. Food (17%),

⁷ <http://www.cnto.org/chinastats.asp>

⁸ <http://www.zmag.org/content/showarticle.cfm?ItemID=10273>

Lodging (16%) and Retail Purchases (16%) accounted for equivalent shares and made up the bulk of the remaining spend.

The length of stay for domestic tourists is an important question in quantifying their financial impact on the local economies. Those who stay longer spend more and are more likely to return. Wang & Qu study showed that non-day trips were evenly split between 1-2 nights (28%) and 3-7 nights (27%).⁹ These results would be particularly heartening for hotel operators and owners in China, for whom longer term stays are most profitable, if it could be shown that domestic travelers pay to stay in rented rooms when they travel.

Chinese domestic tourists do in fact pay for lodging when they travel. Half the traveling population stays with relatives or friends, a result that would be expected. But a significant share stays in some form of commercial dwelling. The most prominent choice is Luguan reception houses (28%), and hotels constitute a respectable share (18%)¹⁰.

These results are somewhat surprising. China is still a developing market for domestic tourism, but when it comes to lodging Chinese tourists behave like their counterparts in developed countries. Nearly half of Chinese tourists pay to stay when they travel, which is approximately equivalent to the percent of American domestic tourists that pay to stay (43% in hotel or motel). That such a high proportion of travelers pay for lodging at this early stage of the development of the tourism industry suggests real growth potential for the budget hotel industry in China. The budget hotel chains and private developers agree and are pursuing aggressive development plans to meet the expected demand surge.

Chinese tourists spend more money when traveling abroad than when traveling at home. Price differentials account for much of this difference. But it implies an opportunity for local tour operators to create higher-priced packages for domestic travel. This is still relatively untapped and early movers that can establish a brand will reap long-term benefits.

⁹ Wang, Suosheng and Qu, Hailin. "A Comparison Study of Chinese Domestic Tourism: China vs the USA", *International Journal of Contemporary Hospitality Management*, Volume 16, Number 2, March 2004.

¹⁰ Ibid.

Profile – Foreign Tourists

Foreign visitors to China are a small group when compared to the domestic tourists. There were 120 million¹¹ foreign arrivals in 2005, 1/10 the number of domestic visitors. The 120 million is itself somewhat nuanced; 100 million of those came from Hong Kong (75 million), Macau (26 million), and Taiwan (4 million).¹² So the number of *foreign* visitors was closer to 20 million¹³. The relatively small number of foreigners who did visit China in 2005 came from other Asian countries and Russia. Japan and South Korea accounted for 3.5 million visitors each and Russia added another 2.2 million, together accounting for approximately half of all foreign arrivals. Europeans travelers accounted for 25% of total foreigners, a significant share when compared to the Americas, which was the origin for only 10% of total visitors.¹⁴ Most of the inbound tourists came from China's immediate neighbors, 2/3 were male and 50% were aged 25-44 years old.

It is clear from the data above that number of inbound tourists is tiny compared to the number of domestic tourists. This is more a function of the size of the domestic market than any impediments to foreign arrivals. In fact, China is the fourth most visited country in the world, ahead of tourism behemoths UK, Mexico and Italy.

That said, moderate obstacles to inbound tourism do exist. First, state-owned tour operators are less innovative and are insulated from competitive market pressures and as a result are less effective at attracting foreign tourists. The CNTA, China's tourism representative in the United States has not yet adopted western marketing practices and as such has had less success marketing China to Americans than other countries.

¹¹ <http://www.cnto.org/chinastats.asp>

¹² Ibid.

¹³ Foreign arrival data is based on nationality not origin. It is a good proxy

¹⁴ <http://www.cnto.org/chinastats.asp>

Another arcane Chinese government policy, the Approved Destination Status (ADS) regime, indirectly discourages inbound tourism into China. The ADS (discussed in more detail below) regime allows only approved countries to market themselves to potential Chinese tourists. As a result, Chinese tourists do not visit certain regions as much as they might. This impedes inbound tourism into China. Tourism is a two way flow; increased outbound tourism from China will increase reciprocal travel into China from those foreign countries. Conversely, exclusionary policies that limit Chinese travel abroad limits inbound tourist arrivals as well.

Lesser issues are tourist infrastructure, visa requirements and language differences. Infrastructure for foreign tourists has effectively been developed in the last decade. Considering the time lag in tourist preferences, it is not surprising that inbound tourism is only ramping up quickly in recent years. Tourist infrastructure will be relatively ubiquitous, particularly in the major urban and tourist areas, before the launch of the 2008 Olympics, so this factor should not be an impediment for long.

Foreign tourists do require a visa to enter China, but since most countries require some form of visa from most passport holders, this should not make China less desirable than other destinations. Similarly, the language barrier in China makes travel more difficult, but no more so than in other countries that speak a unique language. It is true that non-native language skills in China are still underdeveloped; few people speak English, French, German or Spanish, the languages most commonly spoken by Western tourists. Asian languages may be more commonly spoken in China, but only marginally so. The number of potential inbound tourists that speak Mandarin or other Chinese dialects is equally limited. But while language may be an issue, it is only marginally more significant in China than in any other Asian country, including Thailand which attracts millions of tourists every year. In short,

infrastructure, visas and language should not be major determinants of inbound tourism in the future.

Not surprisingly, most foreign visitors that did visit China arrived by air (57%), especially those from Europe and Americas. A significant number came across the border by Motor (16%) presumably in buses, or by Sea (12%). What is quite surprising is the number recorded by Government statistics as having arrived on Foot (12%)! Many of these must be border crossings for trade purposes; people carry goods across the border and might go back and forth several times per day. Nearly all the visitors from Macau come in this way.

Once they arrive, foreign tourists do not stay at their port of entry. According to surveys, more than half of the inbound visitors travel to other places after entering the country. About 15 percent traveled within the provinces or regions of their entries; 30 percent went to Beijing or Shanghai; and 5 percent went to the places where tourism development is advanced, such as Guangdong, Sichuan, Yunnan and Shannxi¹⁵. “Tourists entering at Beijing firstly went to the Middle region, then to the Southeast region, while tourists entering at Shanghai preferred to go to the Northeast region first, then stay in its nearby provinces. Tourists entering at Guangdong tended to stay in the same region, before traveling on to Beijing and the Northeast region; Shanghai and its nearby areas were the least visited places for them.”¹⁶. This is important data for non-coastal and interior tourist destinations that want to coax foreign arrivals into visiting off-the-beaten-path attractions. It should inform allocation of advertising spend, location of regional tour offices and sales efforts.

The distinction between SAR tourists and foreign ones is important when considering length of stay for these visitors. International foreign tourists stay an average of three nights per visit. SAR tourists overwhelmingly do day trips: average length of stay for tourists from Hong Kong is 0.3 nights and from Macau <0.1 nights. Surprisingly, the statistics show that

¹⁵ <http://web.ebscohost.com.ezp1.harvard.edu/ehost/pdf?vid=44&hid=21&sid=3483fb5a-856e-4a46-985b-f1ecd126cae1%40sessionmgr7>

¹⁶ Ibid.

Taiwanese visitors stay 2.8 nights per trip, almost as many nights as International tourists stay.¹⁷ The Taiwan statistic may suggest that Taiwanese come to the mainland to visit family, while Hong Kong traffic is predominantly business.

Foreign international tourists come to China for business (45%) and sightseeing (45%). The business category presumably represents most of the day trips described above. The business category also “Workers/Crews”, which represents labor brought in from outside.¹⁸ The Visiting Friends and Relatives (VFR) category is very small (2%) which suggests that Chinese nationals living abroad who return to visit family are being counted in sightseeing.

These data suggest that inbound leisure travel is an undeveloped market. Global averages show that leisure trips are twice as numerous as business trips worldwide. Inbound tourism to China is heavily business travel. Given China’s development model, these trends are not surprising. But going forward, this paper expects the distribution between leisure and business to approach global averages, meaning that inbound leisure travel will grow significantly in the medium term.

Foreigners in China spend when they travel. The average spend was \$1440 per trip per person for foreign visitors in 2005.¹⁹ The biggest cost item was transportation within China (32% of budget), presumably intercity air transport. This confirms the conclusion above that foreign tourists move around quite a bit within China once they arrive. Shopping is the next biggest item, accounting for 22% of spend, and more than accommodation and food combined. Foreigners flock to buy low-cost products from textiles to electronics and imitation luxury goods. Crackdowns on intellectual property violations and the rise of higher-quality Chinese products are changing the mix, but demand for Chinese manufactured goods will

¹⁷ CNTA – overnights.jpg; excel file

¹⁸ <http://www.cnto.org/chinastats.asp>

¹⁹ <http://www.cnto.org/chinastats.asp>

continue to expand. The remaining spend breaks down into Accommodation (13%), Entertainment (10%), Food & Beverage (9%) and Other (14%).²⁰

Growth prospects for foreign tourism, like all growth prospects for China these days, are significant. The WTO predicts that China will be the #1 tourist destination by 2020.

²⁰ <http://www.cnto.org/chinastats.asp>

Profile – Outbound Tourists

Outbound tourism is beyond the scope of this paper, but a brief description follows to complete the picture of China's traveling public.

The official statistics show that 34 million trips were taken from the mainland in 2005. The World Tourism Organization predicts that number will grow to 50 million in 2010 and 100 million in 2020. But most of those trips were to Hong Kong, Taiwan and Macau; XX million were non-SAR trips in 2005, and it is expected that outbound trips will be 30 million by 2020²¹.

When Chinese did travel abroad in recent years, they chose nearby countries. The top five destinations from 1999-2002 were Japan, Russia, South Korea, Thailand and the United States.²²

Foreign countries are getting mixed signals about the potential economic windfall from these tourists. Anecdotal evidence suggests that on the one hand they travel frugally. They stay in the most inexpensive hotels, as much as 50 miles outside the city, and eat only inexpensive Chinese food. On the other hand, what they save on lodging and food, they spend on shopping. As described above, retailers are predicting that Chinese tourists will be like the brand-conscious free-spending Japanese tourists that have been a boon to retailers in Europe and North America.

Cultural differences still abound between Chinese tourists and their foreign hosts. To help Chinese tourists to help adapt to cultural differences abroad, 'the Central Office for Civilization Promotion and the National Tourism Administration published the most typical "uncivilized behaviors" of Chinese tourists and called for a nationwide correction

²¹ Outward Bound., Economist, 00130613, 6/24/2006, Vol. 379, Issue 8483

²²http://adrf.trf.or.th/ADRF6update/Full_Papers/Tourism_Product_Development/Zhang_Wen/Zhang_Wen_pape_r.pdf

campaign..²³ Examples of the recommendations are not to spit in public, not to speak in loud voices and not to remove socks and shoes in public.

A range of factors including incomes and government policies have kept outbound tourism to small numbers. But as incomes rise and government policies become more liberal, outbound Chinese tourists will likely be the biggest group of foreign travelers. Chinese tourists already represent the largest traveler group in Asian countries, and tourist destinations in Europe and America are planning to capitalize on the arrival of these tourists there in the next decade.

²³ http://www.chinadaily.com.cn/opinion/2006-10/11/content_705561.htm

Profile – Business Travelers

The biggest driver of business travel in China is the rise of indigenous Chinese companies and intra-China economic activity. Chinese companies are increasingly spending on business travel within China, which they see as an investment to acquire new clients and to maintain existing business relationships. American Express Travel Services surveyed Chinese corporations and found that 28% of the surveyed organizations reported an increase in their T&E expenditure in 2005, and 87% of these expenses occurred in mainland China and Hong Kong²⁴.

The domestic Chinese business traveler is for the most part a no-frills traveler. They work for small and medium sized Chinese companies that are under increasing pressure to keep costs low. They will travel by air if they cannot travel by train or road. They seek out 2-star hotels, or whatever room can be procured for less than \$30 USD, and demand comfort, cleanliness and breakfast. But they are not picky about hotel lobby, meeting rooms, dining rooms or other frills. They are not brand loyal when it comes to hotels and they try to stay within 5km of clients or suppliers to minimize intra-city transportation costs. The number of such business travelers is expected explode in the coming years as Chinese companies move up the value chain, become more competitive, and as the domestic consumer market grows in step with the burgeoning middle class.

Inbound foreign travelers are a different breed. Most work for large multinational corporations. They are not very price sensitive and are loyal to high-end 4- or 5-star international hotel brands. They are repeat travelers, meaning they come to China multiple times per year. As a group they are significant in size; business travelers represent half of all inbound foreign tourists. Once in China, these tourists spend spare time shopping for electronics and textiles.

²⁴ <http://home3.americanexpress.com/corp/pc/2006/china-barom.asp>

Foreign inbound business tourism can be expected to grow as well as the growing domestic consumer market attracts foreign products and as Chinese suppliers gain market share abroad.

Drivers of Tourism Growth

Rise of the Middle Class

A most significant socio-economic result of the rapid rise of China as an economic power is the emergence of its middle class population. These households will represent the bulk of consumption that will fuel the growth of the Chinese economy- and foreign economies- in the coming decades. But today they are still a relatively small constituency.

This section will provide a brief overview of the characteristics of this emerging consumer group and how it is expected to change over time. How many households does it represent? How fast will it grow? Who are the people in these households? How much do they earn? What do they spend on? Do they borrow? Do they save? Most importantly for this paper, will they travel?

First it is instructive to define what middle class represents. The McKinsey Global Institute defines it as households living in the largest 130 cities in China, earning between \$2,500 and \$12,500 per year. To put this in context, \$12,500 in China buys a lifestyle equivalent to \$40,000 income in the US.²⁵ More specific definitions such as home ownership, net worth and employment characteristics could be used to further filter and define “middle class”. These characteristics are explored here to describe the current middle class group and the scale of potential growth ahead. But for the purposes of analysis, the broad definition of middle class, households living in the largest 130 cities in China, earning between \$2,500 and \$12,500 per year, will be used here.

Defined in these terms, the Chinese urban middle class represented 42 million²⁶ households in 2005. Relative to the approximately 200 million households living in rural

²⁵ “The value of China’s emerging middle class” McKinsey Global Institute, Special report 2006.

²⁶ Ibid.

areas, the middle class is still a small segment. It represents less than 10% of the total Chinese population. What is most astounding about this group is the *pace* at which it is expected to grow. The 42 million urban middle class households today will grow to 200 million households by 2015, and to 300 million households by 2025.²⁷ These projections imply that 300 million people, who are urban poor living in households earning less \$2000 per year today, will see their income double (in constant 2000 \$US) by 2015. Income levels will continue to rise into 2025, when two-thirds of the 300 million urban middle class households are expected to earn between \$5000 and \$12,500.

These increases in middle class household earnings will increase discretionary spending as a percent of total income. The increases in discretionary spending will come as (1) the number of middle class households increases, (2) the average after-tax disposable income per household increases and as (3) the percent of disposable income available for discretionary spending increases.

Disposable after-tax income of the urban middle class was \$240 billion in 2005 and it is expected to increase four times to \$1 trillion by 2015 and eightfold to \$2 trillion by 2025 (all in constant 2000 dollars).²⁸ Non-discretionary expenditures represent half of disposable income today. It is predicted that non-essential goods and services will represent 55 or 60% of the bigger base within twenty years.

The rising tide and changing mix between discretionary and non-discretionary expenditures will change *what* these households consume. The *share* of wallet spent on essential items such as food, apparel, household products and personal products is already declining as more households earn more than enough to pay for the basic necessities. This new disposable income will be channeled primarily into housing, transportation,

²⁷ Ibid.

²⁸ Ibid.

communication, and health care, which together represent less than 5% of current spend, and are expected to explode to 30% of total spend in 2025.

Housing is increasingly important as more people become home owners. According to government statistics, 73% of Chinese families now have a residence.²⁹ It is unclear how many of these households own their own residence, but it is increasing quickly. As a result sales in household and building products are expected to increase steadily over time.

Transportation spend is still quite low as there are relatively few cars in China. There are only 7 or 8 cars for every 1,000 people, compared with a global average of 120 and more than 600 in America.³⁰ But this is expected to change dramatically in the coming years. To illustrate: in 2004, there were 10 million cars in China, 5-million of which were sold in that year alone.³¹

The introduction of the family car will have a major impact on the way people travel. It will make them more mobile and will open a range of tourism options that were not previously available. Similarly the range of tourist destinations will become more decentralized as people become more mobile and can visit disparate locations without the help of tour operators. Transportation spend is a critical determinant of the growth of the domestic travel industry.

Middle class household expenditure on communications is already significant and is expected to grow. According to government estimates, the country will have close to 450 million mobile-phone users by the end of 2006 and more than 600 million, or 1 for every 2.5 people, by 2009.³² By comparison, India expects to have only 1 mobile phone for every four people in 2010, when the subscriber base is expected to reach to 300 million.³³

²⁹ <http://www.buyusa.gov/china/en/housing.html>

³⁰ http://www.economist.com/business/displaystory.cfm?story_id=4032842

³¹ Ibid.

³² http://www.atimes.com/atimes/South_Asia/HJ28Df02.html

³³ Ibid.

Internet access in China is still somewhat limited. In 2005 it had 111 million users and 34.1 million households with fast connections, which means that more than 90% of the population still does not have home access to the Internet.³⁴ As noted above, few Chinese use the Internet to research travel options or to make travel arrangements. Since home Internet penetration is low, this trend can be expected to sustain, impressive online travel agency growth notwithstanding.

Share of income spent on Recreation, which includes tourism, will grow at more than 9% CAGR from 2005-25, 50% faster than income growth itself, which is projected to grow at just over 6% per year over the same period.³⁵

One driver of future tourism growth is the rise of consumer credit. The Chinese traditionally save most of what they don't spend. National household savings are 45% of annual GDP, nearly twice the global average. But that, too, is changing- sort of. On the one hand, consumer credit growth has been extraordinary: 20% annual growth in consumer and housing loans³⁶ led the government to increase interest rates and directly advised banks to limit lending. On the other hand it is still quite small. In 2003, there were only 1 million credit card holders in China³⁷. Consumer loans currently account for 8 percent of total loans issued by all domestic financial institutions in China, compared to over 25 percent in the US.³⁸ One explanation is that the industry is unregulated and subject to fraud. Banks lend only to the most creditworthy customers. Another is a lack of expertise. S&P estimates that 31 to

³⁴ E-Marketer survey - <http://www.breitbart.com/news/2006/05/18/060518163500.mk2075cs.html>

³⁵ "The value of China's emerging middle class" McKinsey Global Institute, Special report 2006.

³⁶ Zhang, Yanchun and Sun, Guofeng, "China's Consumer Credit Sector Expansion and Monetary Transmission Mechanism: What Should China's Central Bank Do?", *JOURNAL OF CHINESE POLITICAL SCIENCE* vol. 11, no. 1, Spring 2006

³⁷ Kathleen E. McLaughlin, "China's busy consumers flock to easier credit", *Christian Science Monitor*, January 13, 2005.

³⁸ Zhang, Yanchun and Sun, Guofeng, "China's Consumer Credit Sector Expansion and Monetary Transmission Mechanism: What Should China's Central Bank Do?", *JOURNAL OF CHINESE POLITICAL SCIENCE* vol. 11, no. 1, Spring 2006

35 percent of China's bank assets in 2004 were impaired³⁹. The banks should be looking for smart risks to repair their portfolios. But mortgage default rates, for example, are still below 1%.

The entrance of foreign banks should bring expertise and hefty growth targets to the Chinese market. Under the WTO agreement, foreign banks are to be given access to the domestic market in 2007. But recent signals suggest that the Chinese government may not slacken the rules as expected. Charlene Barshefsky, the US trade representative who negotiated the WTO deal, recently described Chinese delays as “troubling”.⁴⁰ However it plays out, consumption of non-essential goods and services will grow as consumer credit becomes more readily available.

The rising middle class will increase the number of consumers, how much they spend and it will shift resources from essential expenditures to discretionary spending. Tourism will be a major beneficiary of these changes as hard-working people take advantage of better salaries and cheap credit to explore their county and visit with friends and relatives across China.

Expansion of Trade and Economic Activity

Business and trade are major drivers of tourism growth in China. Foreign businesspeople and workers/crews accounted for 45% of foreign arrivals in 2005. But domestic business, like domestic tourism, is the 800-pound gorilla driver of tourism growth.

Trade and FDI are good indicators of inbound *foreign* business tourism growth. The short-term predictions are favorable. Trade is expected to grow to \$1.77 trillion in 2006, up

³⁹ Kathleen E. McLaughlin, “China's busy consumers flock to easier credit”, Christian Science Monitor, January 13, 2005.

⁴⁰ Areddy, James. “In China, Citigroup encounters Hurdles to Retail Banking Plans”, Wall Street Journal, page 1, November 10, 2006.

approximately 25% over 2005. Growth for 2007 is expected to be 15% bringing total to \$2 trillion.⁴¹

Looking further ahead, liberalized trade practices should fuel sustained trade growth and more foreign business visitors. Tariffs are being reduced to comply with WTO commitments. The average tariff rate was 9.9% in 2006, progressively down from 15.3% in 2001.⁴² Administrative barriers to trade have been eliminated. Requirements on trade and foreign-exchange balance, local content, and export performance will be relaxed or eliminated. Granted currency controls and foreign investment restrictions are still in place, but over time the Chinese Government is expected to adhere to its commitments under the WTO.

FDI was \$72.4 billion in 2005; it is expected to remain flat in 2006.⁴³ An interesting side note is that while FDI has been flowing into China in vast quantities, outbound investment only began a few years ago. The total historical outbound FDI as of the end of Q1 2006 was approximately \$50 billion. A full 25% of that \$50 billion was invested in 2005 and the first quarter of 2006. Outbound FDI is going to grow exponentially in the next decade, and which should mean increased outbound Chinese tourism, which is beyond the scope of this paper.

Domestic economic growth is the real driver of business travel growth within China. The general economic outlook predicts growth at a sustained clip through 2025. Average GDP per capita growth will be 6.5%⁴⁴. In the next few years growth is expected to be higher at 10.5%, 9.6% and 9.3% in 2006, 2007 and 2008 respectively.⁴⁵ To the extent that Chinese businesses grow and expand supplier, customer, and human resource networks in different regions, business tourism will grow in step.

⁴¹ "China report sees \$150B trade surplus", CNNMoney.com, November 11 2006.

⁴² Hong Kong Trade Development Council

⁴³ China Ministry of Commerce

⁴⁴ "The value of China's emerging middle class" McKinsey Global Institute, Special report 2006.

⁴⁵ "China Country Report", Economist Intelligence Unit, November 2006.

Government Policy

The Chinese Government has been committed to developing China as a tourist destination for foreigners since the mid-1990s. Tourists bring valuable foreign exchange and fuel the local economies. But it is only in recent years that the government recognized tourism as a major contributor to economic growth. In terms of inbound and domestic tourism promotion, the government has made significant investment in infrastructure and policy adjustments (outlined in detail in subsequent sections) to stimulate and increase demand.

But on outbound tourism the government has been more sluggish and draconian. Before 2000, the government made it expressly difficult for Chinese nationals to travel abroad. That has changed in recent years and it has become somewhat easier.

The passport application process is a good example of the way in which the government once discouraged outbound travel, and the positive strides made in recent years. Before 2000, Chinese citizens were required to provide “an overseas *invitation* and permission from overseas relatives or friends”⁴⁶ when applying for a passport. A governmental “verification” was required. Passports that were awarded were valid for one trip that had to be taken within a one year period. In 2000, the rules were changed such that the invitation was no longer required, and proof of purchase from a tourism agency was enough “verification” to get a passport. These new passports are valid for five years and can be used repeatedly.

The new rules provide an expected approval timeline and they make passports reasonably affordable to acquire. Previously, an approved passport could get lost indefinitely in the government bureaucracy before it was issued. Under the new rules, the government pledges to issue within 15 days of approval. Finally, cost is not being used to discourage

⁴⁶ http://english.people.com.cn/english/200005/23/eng20000523_41409.html

applications. A passport for private affairs costs an affordable 300 RMB⁴⁷. The rules have been relaxed to allow, even encourage, travel abroad and technically everybody is eligible (except individuals who have been convicted of crimes, charged in courts).

Outbound tourism is further limited by the Approved Destination Status (ADS) system, which limits which countries Chinese nationals can visit and which countries can market their tourist destinations in China. The Chinese Government has negotiated bilateral agreements with 100 countries to grant them ADS preferred status. “Germany was the first EU country to be granted ADS independently in the year 2000. In February 2004 the Chinese National Tourism Administration signed a ruling with the European Union that granted ADS to Austria, Belgium, Finland, France, Iceland, Italy, Luxemburg, the Netherlands, Norway, Portugal, Spain and Sweden.”⁴⁸ Chinese nationals can apply for visas to ADS countries using their personal passports. It is considerably more difficult to get access to a non-ADS country.

As of mid-October 2006 a deal to grant the US ADS status had not yet been fully negotiated. Allegedly, the US is not on the approved list because of post-9/11 visa restrictions that have limited and slowed the visa process. Ironically, Nevada and Hawaii have been granted licenses to market travel to their states.⁴⁹

Two years ago “progress” appeared to have been made in December 2004, when China and the US finally signed a MOU to grant ADS status to the US. But the rules made it prohibitively expensive for Chinese nationals to travel to the US. Chinese were required to pay travel agencies a \$12,000 USD deposit, refundable only upon their return to China. These deposits are four times larger than the average cost of the trips themselves. This structure seemed to align the interests of US and Chinese policy makers, who both want to avoid massive illegal immigration from China into the US.

⁴⁷ <http://gr.china-embassy.org/eng/lqwhz/t146143.htm>

⁴⁸ Visit Britain - <http://64.233.161.104/search?q=cache:VpG2zi1-u0EJ:www.tourismtrade.org.uk/NewsletterArticles/VBTourismNews/default.asp+Approved+Destination+Status+China&hl=en&gl=us&ct=clnk&cd=1&client=firefox-a>

⁴⁹ China's latest export: Tourists -- and lots of them, USA Today, 07347456, SEP 07, 2006

Policy changes are underway, but ultimately freedom is not absolute in China and the long arm of the Chinese government lurks in the background. People are not yet free to come and go as they please. Movement between cities is still limited by the household registration system. And the right to foreign travel can be restricted for anyone who "might endanger national security overseas"⁵⁰. The move toward political freedom is a slow process in China, but it will come, and growth in the tourism industries- outbound, inbound and domestic- will follow.

Public Infrastructure

The government biggest and most visible policy shift is in the development of transportation (and lodging and entertainment, discussed later) infrastructure. According to the Civil Aviation Administration of China (CAAC), \$17.4 billion has been earmarked for air infrastructure from 2006 to 2010, more than the total spent from 1990 to 2005. The deployment of this capital will contribute to building 78 new airports, bringing the total to 220 by 2020. (It is worth noting that there are currently 14,807 airports/airfields in the US).⁵¹

The capital to build these facilities was raised mainly raised from central and local governments. But due to amendments to the Regulation on Foreign Investment in Airports, foreign investment is now permitted in *newly* constructed facilities.⁵² As a result, airport groups, banks and foreign investors are participating in these infrastructure projects. The Western regions of China, notably Yunnan province has provided a series of preferential treatments, including tax breaks and flexible funding sources, to encourage private participation in airport projects.⁵³

⁵⁰ <http://www.usvisanews.com/articles/memo2136.shtml>

⁵¹ Fu Jing, "Spending on airports to soar in 5 years", *China daily*, 2006-05-09.

⁵² <http://japanese.china.org.cn/english/2005/Apr/124986.htm>

⁵³ Fu Jing, "Spending on airports to soar in 5 years", *China daily*, 2006-05-09.

The airport capacity is being built in anticipation of increases in tourism. But the construction of these new airports is itself increasing tourism by opening up new locations that could not be reached by air before and by allowing for increased carrier competition out off more cities.

Air capacity is still low because the airport capacity is still quite small. “During the latter part of 2000, there were approximately 700 large-to-middle size cities in China, in which less than one-fourth had an airport. A survey of 40 countries showed that, on the average, there are 2.08 airports per 10,000 km² in these countries, as compared to China’s 0.127 airports.”⁵⁴ Bringing airports to these cities will open up a world of travel options to people living in and around those cities, and it makes mass market travel to those destinations feasible for the first time.

As a result of the increased airport capacity, a ton of new air carriers are emerging to fill the new landing slots. In 2002, Fifty-seven air companies from 43 countries operated air services in 13 Chinese cities.⁵⁵ There are hundreds of new carriers now trying to start-up. Private start-ups account for most of the growth. United Eagle Airlines, Air Spring, and Okay Airways are among the fastest growing new entrants of this type. Under the old rules, private airlines were forbidden. Private airlines are now allowed to start up providing they have 3 or more planes.⁵⁶ Foreign investment in airlines is now legal as well. Foreigners are permitted to own up to 25% of private airlines.⁵⁷

As the number of airlines increase in any given city, prices for air travel will decline as well. It is well documented internationally that the greater the number of carriers serving a given origin-destination pair, the lower the ticket price. The Chinese market should behave in a similar fashion. And as prices decline demand should increase, especially for short-haul domestic travel.

⁵⁴ Efendioglu, Alev. “Changes and Challenges in the Airline Industry in China”, 2001.

⁵⁵ *ibid.*

⁵⁶ http://www.chinadaily.com.cn/english/doc/2005-01/24/content_411642.htm

⁵⁷ *ibid*

A fascinating innovation designed to rationalize ticket pricing and introduce competition was the “China Civil Aviation Ji’nan Ticket Center”. It is a government created “supermarket” for airlines and customers to meet to buy and sell airline tickets⁵⁸ Of course, widespread usage of the Internet or ticket reservation systems like Sabre would render this system obsolete. But in the meantime, this supermarket-type arrangement serves as a marketplace for buyers and sellers, adds efficiency to the market and introduces competition that brings down prices.

The road network has been massively expanded, which, along with the introduction of more cars, will probably be the single biggest driver of budget travel growth.. By the end of 2004, China had 34,000km (21,000 miles) of highway, more than double the 2000 figure. Seventeen years ago it had none. The Government plans to double the highway distance again to 70,000km by 2020.⁵⁹ Every additional mile of road reduces the barriers to budget travel. Road trips are the largest source of travel in all developed markets. As the Chinese acquire more personal cars, the domestic Chinese tourism market will likely behave the same way. People will be able to transport themselves to wherever and whenever they want, within a certain distance.

The quality of the roads has been commended by international observers. "The highways linking cities in Inner Mongolia are better than the road between Sydney and Melbourne," marvels Bruce McKenzie, who oversees China operations for the U.K.-based InterContinental group⁶⁰. This high-quality road network will form an important vessel for the transport of goods, but will also be the backbone of the domestic travel industry. These infrastructure projects are paving the way for enormous tourism growth, whether by personal automobile or by bus.

⁵⁸ Efendioglu, Alev. “Changes and Challenges in the Airline Industry in China”, 2001.

⁵⁹ <http://www.time.com/time/asia/magazine/article/0,13673,503060807-1207866,00.html>

⁶⁰ <http://www.time.com/time/asia/magazine/article/0,13673,503060807-1207866,00.html>

Efforts have been made to integrate tourism infrastructure projects into broader government plans. Shandong Province, for example, implemented innovative programs to integrate tourism infrastructure projects into regional government development plans.⁶¹ Government procurement and construction plans there have been made to include tourism infrastructure projects, whether they are being developed publicly, in public-private partnerships, or pure private.

On a local level, the government established 12 national vacation tourism areas, most of which were located in Southeast China with its warm climate, nearby densely-populated cities and proximity to high technology development areas.

The government has begun to look at creating welcome centers, similar to those found in US states, to promote tourist destinations. At the end of 2005, those types of centers had not been created and very limited resources targeting domestic tourists were in place. Studies in the United States show that the presence of a welcome center to provide tourism information and to book tour packages increased the number of nights stayed and total dollars spent in a given region. Efforts to deploy networks of these centers in China should be initiated to support the development of domestic tourism.

Private Industry

The potential for extraordinary profits has attracted the attention of state-owned enterprises, private entrepreneurs and foreign investors. A storm of competition is brewing to get positioned to reap maximal profits before the tourism sector really heats up.

Hotels and convention centers are the major infrastructure projects. Prior to 1978, there were no world-class accommodations in China. The government then invested billions

⁶¹ Bihu Wu, Hong Zhu, Xiaohuan Xu. "Trends in China's domestic tourism development at the turn of the century", *International Journal of Contemporary Hospitality Management*. Bradford: 2000. Vol.12, Iss. 5;

of dollars to develop hotels. By the year 2000, state owned companies owned 63% of all hotels and rooms. Government owned hotels tended not to make the necessary capital investments to maintain the property and to keep designs up to date with current tastes. When foreign chains did manage properties, foreign managers were required to operate under the supervision of a *shadow manager*, a party official who oversaw operations. The government protected SOE hotels by taxing the importation of operating and technical equipment. All of these factors made it difficult for foreign chains, or even start-up domestic chains, to build a presence in China.

That is now beginning to change. Foreign brands deploying aggressive expansion plans. Accor, for example, plans to build 100 new hotels in China in the next 4 years⁶². Marriott currently has thirty-two hotels operating in China, and another thirteen under construction. Furthermore, he expects there to be over one hundred Marriott hotels open in China within the next seven or eight years.⁶³ Intercontinental runs 54 hotels in China, mostly Holiday Inn; plans to increase to 150 by 2008.⁶⁴

Joint ventures were common at first and now foreign companies are going in alone. The WTO relaxed the requirements about having local partners and the government has been quite helpful. But *guanxi* and the need to attract local labor and get reliable water and power still make a local partner quite valuable.

Domestic brands and independents have struggled somewhat. The domestic brands that began locally and have tried to expand regionally or nationally found political territoriality kept them out. Ironically, it has been easier for foreign brands to enter and go national than it has been for local brands to grow organically. The wheels of commerce need to be freed from the entanglements of politics. That said, domestic hotel management

⁶² Interview with Director of Asian Development, Accor Hotels

⁶³ <http://www.gale.com/BusinessRC/ops475.pdf>

⁶⁴ <http://www.time.com/time/asia/magazine/article/0,13673,503060807-1207866,00.html>

companies have been popping up. There were 39 companies managing 100 hotels in 1999⁶⁵; that number has surely increased several times in the last seven years.

Independents faced the standard business challenge of competing with large global competitors, but still prefer to develop and manage the hotels independently. Franchising is uncommon in China, mostly because franchisees do not get enough protection under China's legal system. Some independents first affiliated with a global brand, learned the business processes and IT systems, and then did not renew at contract end.⁶⁶

There are currently 10,000 travel agencies operating in China- 90% handle domestic and outbound tourism, the remainder focus on international inbound tourism. Internet penetration is still lower than in most developed countries and so brick and mortar travel agencies maintain a dominant presence in the travel sector. According to an American Express Travel Services survey, about one-third of organizations in China use a travel agency⁶⁷ for their business travel requirements.

The large number of agencies implies a healthy competitive industry, but that is not the case. The travel agency sector is highly concentrated, with market power centralized among few large firms. According to a paper published in the *International Journal of Contemporary Hospitality Management*, the top 100 agencies targeting domestic customers earn 99% of industry profit. The top 100 international focused agencies earn 70% of agency profit.⁶⁸ These results seem extreme, but the anecdotal evidence they suggest remains. The benefits of economies of scale in terms of buying power, financing, advertising and brand investment, have made it very difficult for small agents to survive. The smaller agencies allege that the big ones have engaged in predatory pricing, which has accelerated the demise of these small firms.

⁶⁵ <http://cqx.sagepub.com/cgi/reprint/43/3/61.pdf>

⁶⁶ Ibid.

⁶⁷ <http://home3.americanexpress.com/corp/pc/2006/china-barom.asp>

⁶⁸ Hanqin Qiu Zhang. "Accession to the World Trade Organization: challenges for China's travel service industry", *International Journal of Contemporary Hospitality Management*, Volume 16 · Number 6 · 2004.

How did this happen? One factor was the introduction of foreign competition. China's ascension to the WTO changed the rules to allow foreign investors to become major shareholders in joint venture travel agencies. In January 2006, wholly foreign-owned travel agencies were to be allowed and all restrictions on their ability to set up branches in China were to be lifted. As a result, competition became fierce and firms expanded locally then regionally, marginalizing sole proprietor agencies in the process.

The construction of entertainment parks is booming. Large-scale entertainment parks are almost all in the form of theme parks, such as Splendid China, Window of the World, and Chinese Folk Culture Village in Shenzhen, Guangdong province.⁶⁹

Cooperative Tourism Zones

On a regional basis, the Chinese government committed to participating in cooperative tourism zones. The Greater Mekong Sub-region (GMS) is a successful experiment of this nature. The GMS includes the Chinese Yunnan Province, Vietnam, Thailand, Myanmar, Laos and Cambodia. The goal of the GMS project is to use tourism as means to reduce poverty, empower women, and develop the region in a sustainable manner. The GMS organization is divided into functional areas focused on marketing, human resource development, heritage and social impact management, pro-poor tourism development, private sector participation, the facilitation of the movement of tourists to and within the sub-region, and the development of tourism-related infrastructure.⁷⁰ The Asian Development Bank has provided loans for the GMS Tourism Development Project. The UN Economic and Social Commission for Asia and

⁶⁹ Bihu Wu, Hong Zhu, Xiaohuan Xu. "Trends in China's domestic tourism development at the turn of the century", *International Journal of Contemporary Hospitality Management*. Bradford: 2000. Vol.12, Iss. 5; pg. 296.

⁷⁰ <http://www.adb.org/Documents/Books/GMS-Tourism-Study/tourism-study.pdf>

the Pacific (ESCAP) has supported the project as well.⁷¹ From 1980 to 2000, the tourism industry in Yunnan has kept growing at an annual rate of about 30 per cent in the past 20 years (CNTA, 1998).”⁷²

Another regional tourism arrangement is The Tumen River region. It includes China, North Korea, Japan, Mongolia, Russia, South Korea. The United Nations Development Program attaches great importance to the development in this region. MORE?

Mega-Events and Conferences

A number of international events and conferences have focused the world’s attention on China as an origin and destination for foreign travelers. The Kunming Expo (1999); the 2003 World Tourism Organization General Assembly in Beijing (2003); the World Heritage Conference in Suzhou (2004); the World Leisure Exposition in Hangzhou (2006); the Olympics in Beijing (2008) and the World Expo in Shanghai (2010) are only a few of the major gatherings slated to be held in China in the next five years. The government has actively promoted China as a destination for these events and they would not be held there if not for overwhelming government support.

The big question is what happens after 2010 once the Olympics and the World Expo are done? The building glut will be over, the spike in tourism will subside, the media attention will dissipate somewhat. Can China sustain the tourism?

To do: What is the role of Government-owned Tourism Agencies?

⁷¹http://adrf.trf.or.th/ADRF6update/Full_Papers/Tourism_Product_Development/Zhang_Wen/Zhang_Wen_paper.pdf

⁷² Bihu Wu, Hong Zhu, Xiaohuan Xu. “Trends in China’s domestic tourism development at the turn of the century”, International Journal of Contemporary Hospitality Management. Bradford: 2000. Vol.12, Iss. 5.

Increased Leisure Time

Increases in disposable income along with general modernization have increased the amount of time and money spent on leisure. The government has facilitated this process with policies that protect the rights of workers and encourage consumption of goods and services.

The trend toward increases in leisure time for the masses began with the government mandated 5-day work week. Prior to the dictate, people could be asked to work every day and had little recourse. In most regional and rural areas, workers still have limited recourse on this kind of thing. But the government move guides signals an important shift that may take some time to stick, but moves things in the right direction. The longer term impact is a cultural shift that puts a state sanctioned value on leisure time and work-life balance. Studies have shown, as will be discussed later, that cultural trips are the preferred form of leisure for Chinese travelers. Weekends off has planted the seed for short-haul domestic trips.

The biggest travel periods in China today are the three Golden Weeks, periods during which everybody takes 5 contiguous days off, of which three are paid vacation and two are regular weekends. The three Golden Weeks take place on Chinese New Year (January or February), May Day (May 1)-- also known as Workers' Day or Labor Day -- and National Day on October 1.

The government instituted these holidays to counter complaints that workers do not get enough time off and to stimulate consumption. Consumption was certainly up this past New Year golden week; China's retail sales of consumer goods added up to 190 billion yuan (US\$23 billion), up 15.5% year on year for that week.⁷³

⁷³ <http://www.chinanews.cn/news/2005/2006-02-06/18368.html>

In terms of tourism, the golden weeks truly are golden. The government predicted that 110 million trips would be made during the 2006 May Day holiday.⁷⁴ This would represent approximately 10% of all annual domestic tourism.

Some critics believe that rising incomes, not golden weeks, is the major driver of domestic tourism growth. Further they believe that the golden weeks should be replaced with flexible holiday time, which would be less disruptive to transportation systems and the broader economy, and less destructive to natural and historical attractions. They argue that spreading the tourism sales across the whole year would reduce the risk for tourist and retail businesses, for which unexpected disruptions would be catastrophic.

The holiday weeks do concentrate tourism consumption into clumpy waves. Ideally, demand would be spread equally across the year to minimize fixed capacity requirements in transportation and lodging infrastructure. From the consumer's perspective, this would probably lead to lower prices. The massive demand during these weeks leads to scarcity during those periods that force up prices. Furthermore, since tourism industry operators rely so heavily on those weeks and since the system implies significant business risk, prices remain high. That said, coordinated vacation weeks probably present externalities that increase tourism activity. Chinese tourists travel in groups, usually with family. If all people can take vacation at the same time, it is easier to coordinate. Further, the herd mentality may increase this effect; if everybody is traveling, others want to as well.

Wu Ning, a researcher at the Chinese Academy of Social Sciences, argues in favor of the holiday weeks for reasons related to workers' rights. Migrant laborers are disadvantaged relative to employers, who may not allow the vacation to be taken. As proof that employers cannot be relied upon to provide time off under a flexible system, he points to the example of the Beijing Municipal Government, which planned to give senior employees additional time

⁷⁴ http://www.usatoday.com/news/world/2006-05-01-china-mayday_x.htm

off. That plan, despite much hoopla, was simply not been implemented. If the government itself can't make flex-vacation work, can the private sector be expected to play along? ⁷⁵

Travel Insurance

Travel insurance is relatively well subscribed in China already. According to a director for AIG Assist's operation in China, 20% of outbound tourists in China buy individual travel insurance. Another survey conducted by Horizon-China before the tsunami in Beijing, Shanghai and Guangzhou, showed that as many as 40 percent of tourists bought travel insurance and 1 percent of tourists bought casualty insurance before they traveled. Anecdotal evidence suggests significant increase since the tsunami.

These numbers reflect modest penetration of travel insurance among current Chinese travelers. This level of penetration is somewhat surprising given the nascent state of the travel industry. One explanation might be the well developed general insurance industry in China, which has a long history and deep cultural roots. Another possible explanation is that Chinese overwhelmingly travel through tour operators, which may require that travel insurance be purchased, or at the very least push it for additional sales.

The low cost of travel insurance supports the former explanation of a mature and sophisticated insurance industry. In 2004, CPIC launched a family travel insurance product with premium of CNY 80. China Life, a rival of CPIC rolled out a product for 15-day domestic travel, with a CNY 10 premium that covers up to CNY 150,000 expenses for accidental injuries and medical treatments. For overseas travel, tourists can get coverage of CNY 300,000 for a CNY 30 premium.

High penetration notwithstanding, the market is ripe for massive growth. Thomas Herde, senior vice-president and head of the casualty specialty practice in the Asia-Pacific for the company Guy Carpenter, predicted that travel insurance (among others) will be a valuable

⁷⁵ <http://www.bjreview.com.cn/En-2005/05-09-e/09-zm.htm>

niche area in Asia. Other foreign players are capitalizing on WTO liberalizations to enter this and other financial services markets.

Conclusion

The drivers of domestic tourism demand all point in the same direction: growth will be extraordinary in the next 20 years. And the domestic travel sector in China is at such an embryonic stage that there are opportunities in nearly every sector. Airlines, airports, travel agencies, hotels, tourist destinations, financial services, entertainment parks, welcome centers, online portals, bus tours, tour operators are ripe for the taking by firms that can establish a brand and are focused on a niche segment.

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