

## CHAPTER 1

# The Pirate Ship

Two weeks before boarding my first flight to Asia, a friend of my mother's wished me well, letting me know she was jealous.

"You're so *lucky*," she told me. "Wish *I* was going."

She had never been to the Far East but was enamored by its ideas and traditions, especially medicine.

"Just think about it," she said. "They've been practicing medicine for thousands of years. They know *all kinds* of things we don't."

It was an unintended send-off as I found her words echoing back to me two weeks later in Taipei. I had been invited to join a group of office workers on a day trip their company had planned, and on the return—at the drop-off point—I managed to get my hand smashed in the door of their van.

"*Duibuqi!*" cried the woman who injured me.

I was frozen in pain. A colleague offered that she had something. "Chinese medicine," she said enthusiastically, before bolting.

A glass jar was presented, upon which were some handwritten Chinese characters. The lid was removed, revealing a dark, viscous liniment. And as it was applied to my hand, I held out hope.

Three women stood around me now, concentrating fully on my paw and taking turns offering commentary.

"That's better," one assured.

“Much better,” another confirmed.

While everyone stood around waiting for something to happen, my hand continued to throb and a strange thought entered my head: *Was this Chinese traditional medicine? Was this how these people thought the human body worked? Broken bones healed in a jiffy with a magic salve?*

I was in my twenties then and somewhat embarrassed to have such rude thoughts. But the scene struck me as comical, and I had to suppress the urge to laugh. Thanking everyone for an otherwise lovely afternoon, I lied and told them I was feeling better. I then made my way to an area hospital, where I received a set of X-rays for the hand, which luckily had not suffered any fractures.

It was a strange beginning to a career in Asia, and perhaps an unproductive one. Westerners in it for the long haul were supposed to arrive mesmerized—enchanted at least—and that condition was meant to carry them through the several years it took to pick up the language. The bloom would come off the rose eventually, but it was meant to do so only after a fair amount of time had passed.

The effect of having my bubble burst almost upon arrival put me in an odd disposition: Chinoiserie and other Orientalia now struck me as daffy. I had little interest in studying anything Chinese in the traditional sense, and along with that ennui went any intention of taking my time in this part of the world seriously.

Thankfully I was young—this was twenty-five years ago—and I didn't need much of an excuse to stick around. A reliable old motorcycle, a rooftop apartment in the mountains outside of the city, an assortment of colorful characters for friends, and the odd job would suffice. I spent no time on language training and managed to pick up a fair amount of Mandarin in spite of myself. Wrapping up three years in Taiwan, I returned to the United States and entered a graduate school program that began by sending me to Beijing for the summer.

And that was how I wound up in my first proper Chinese language course with a woman named Miss Zhang.

In our first one-on-one session, Miss Zhang tossed me what she must have thought was a softball question: “Why are you still in China?” She was taking the American government's dubious view (it was Beijing's as well) that the years I lived in Taiwan should be clocked as time spent in the People's Republic of China, and she asked because few nonnatives ever returned after a stint.

Although foreigners were arriving in significant numbers, when they finally went home, they rarely boomeranged back.

*Why had I returned?*

In making my way to graduate school—it was a business program with an international component—I had to explain in an application why I had wanted to study such things as discounted cash flow and conjoint analysis. On this other motivation, I was drawing somewhat of a blank.

On the surface, Miss Zhang appeared a serious woman. She considered me for the briefest moment and then broke the silence between us by saying, “You know what you should tell people when they ask you that question?” Then she giggled. “You should tell them, ‘*Wo shangle zeichuan.*’ I’m on the pirate ship.”

It was a twist on an old idiom, one that suggested it is easier to jump on a tiger’s back than to dismount. I got the reference but wondered: *Was the ship meant to be China? Who were the pirates?* In the back of my mind, a light bulb went off, one that would take me years to identify. Only later would I conclude that Miss Zhang had picked up on something—that I was lost—and what she ultimately offered me was not a conversation starter but a hint of where I ought to be looking for inspiration.

Not long after graduating from the University of Pennsylvania, I moved to Guangzhou, a sprawling metropolis located two hours north of Hong Kong, and from there I began a career representing American companies that had manufacturing interests in the region. The work put me in contact with Chinese factory bosses who were indeed pirate-like in their approach to commerce. And I appreciated that they shared a similar brand of humor to Miss Zhang’s.

In the middle of the boom in export manufacturing, I found myself riding a train in Guangdong, seated facing two questionable-looking characters who were dressed head-to-toe in black. My reputation as a fixer was established by this time, and they easily appeared to be the sort who traded merchandise for a living.

Almost as soon as we pulled out of the station, the man seated by the window began eyeballing me, so I thought I would break the ice.

“*Nimen cong nali laide?*” I asked him.

“You wouldn’t know the place,” he said.

“I’ve been around. Try me.”

“It’s a small city,” he demurred.

“*Ni shuo ba*,” I insisted. “Where are you from?”

“Chaozhou,” he said, finally. “We are from Chaozhou.”

I had worked in Chaozhou, with a factory there that made majolica-style pottery. It was an out-of-the-way place, and though I had never experienced trouble there myself, I was familiar with its nasty reputation. Putting on an air of familiarity, I told him that I knew his fair city well—because I had once been swindled there.

“*Wo zai nimen Chaozhou bei pianle*,” I said, deadpan.

He caught the joke and laughed. That a foreigner would be cheated in his roughneck city was a given. That the *laowai*—outsider—should take such abuse as the normal course of events made it hilarious.

His partner, who wore a cap, was considerably less amused.

“Cheated in Chaozhou?” he said, sounding incredulous. “That is impossible. The people of my city would never cheat a fine foreigner such as yourself. Whatever the circumstances of your dealings, surely there must have been some misunderstanding.”

His partner, the fellow by the window, was no longer smiling. I couldn’t quite catch the relationship between the two but knew at least which one could be trusted. China was a rough-and-tumble world all right, and there were those who were frank about the place and those who put on airs and graces. You appreciated the ones who gave it to you straight, because you knew that you could work with them. The other sort was nothing but trouble. Imagine standing under an awning in the middle of a downpour, commenting on the weather, only to have some stranger next to you respond: “Rain? What rain?”

China brought many meaningful lessons, but only in great retrospect. It takes time for the subconscious to process the unfamiliar. Patterns form only slowly, and then you have to wait as certain realizations bubble to the surface and become points of awareness. Along the way to enlightenment, it is also necessary to let go of preconceived cultural notions, which often impede understanding.

A few years ago, wandering around Hong Kong, I had the idea to buy a new pair of shoes. This was in Tsim Sha Tsui, in the days before they ripped down the Hyatt Regency Hotel on Nathan Road, replacing it with the popular commercial center iSquare. There used to be a small shop just behind the hotel right off Peking Road, and in the storefront window I spotted a sign saying that it was an official

reseller of a popular American walking shoe. It sounded like the perfect replacement, and after trying on a pair and immediately paying for them, I asked the shopkeeper to throw away my old shoes, explaining that I would just walk out with the new ones.

I almost immediately regretted the move. Within an hour, my feet were feeling pinched, and by the time I got back to my apartment in Guangzhou I was in agony. This confused me, because the shoe brand had such a strong reputation, and I wondered if the shoes were not somehow counterfeit. Just over the border from Hong Kong was Guangdong province, where the vast majority of the world's shoes were being produced. It made bootlegging easy, but this was an internationally known brand that I had purchased and the vendor had been officially licensed. It seemed unlikely that the shop would sell a bootlegged product, yet I had the feeling I had purchased shoes that were illegitimate.

An acquaintance in Guangzhou who was in the shoe game lived not far from me, and as I had not seen him in a while, I offered to drop by his office and say hello.

Taking up one of the shoes, he removed the insole and showed me evidence of a bad glue job. He then pointed out poor stitching and some odd stamp marks. It was not the work of a big-brand company.

"These are fake, for sure," he said.

"But the shop is an official reseller," I said. "How can they get away with selling knockoffs?"

The next few words out of his mouth would shift my perspective on the Chinese economy in a dramatic way.

"They probably sell both."

"Both?" I asked, not quite wanting to understand.

"Well, to keep their license, they sell some real shoes. Then, on the side, they sell a few fakes."

The scales fell from my eyes. Not only did I understand what he meant by such a hybrid business model, but I immediately also recognized that I had been seeing it for years—and that I had even run into a version of it during my first attempt at product sourcing.

After graduating from business school, I took what I called my *Four H's Trip*—a train journey that took me through Hunan, Hubei, Henan, and Hebei provinces—a bisection of the country from south to north. My final destination was Beijing, and a friend in the States who

knew I would be there asked if I would help him purchase a volume of costume jewelry in the wholesale market there.

I didn't know much about trinkets, but a contact in Beijing offered to make a formal introduction to a woman named Bei Bei, who operated a store within the Hongqiao Pearl Market. "Do not stop at any of those other shops," I was warned, because Bei Bei was the only plain dealer in the multistoried bazaar.

Seated at a table in Bei Bei's showroom, I went over samples with an assistant, taking photos and making a note of the prices, which seemed more than fair. The work went fast, and after two hours, I excused myself to take a break. On the way to the front door, I passed by an older European man who was also evaluating merchandise.

"How much for that one?" I asked, pointing to a piece he had been inspecting that was identical to an item I had been shown. I had no actual interest in comparing prices and was just making small talk, but the man peered up at me over a pair of bifocals and, smiling, he mentioned the figure he was about to pay. It was three times what I was quoted and, save for some unseen difference in quality, the variance in pricing seemed . . . unusual.

When I got back to the shop, I said nothing to the gentleman and walked straight to the room Bei Bei occupied in the back.

She had a small window that looked out onto the showroom. "What's going on out there?" I asked, gesturing with a thumb toward the old man.

"You needn't worry about him," she said, confirming my suspicion that a fleecing was in progress.

This made no sense to me, at least not at the time. How could I be treated fairly while another customer was being taken advantage of *in the very same shop*? Many of us have a preconceived notion that there are only two kinds of service providers: the good and the bad. You have the reputable mechanic and the dishonest one, the fair attorney and the predatory one.

Chinese business operators instinctively understand how a hybrid model achieves the highest level of economic returns. Businesses that offer a fair deal to everyone leave too much money on the table, but those that cheat indiscriminately risk entirely losing their reputation. The key is to provide a fair deal to those customers who provide a key benefit, such as large volume or a link to a reputation

network, while squeezing mercilessly those who do not bring such advantages. Chinese business owners split their customer base in much the way a farmer separates his milking cows from those bound for the slaughterhouse.

Mainland Chinese are sometimes described as *morally agnostic*, which is a way of saying that they choose to do “whatever” in a given business situation. But this is not what usually takes place. Chinese business operators who seek a hybrid business model look to lift profitability to a theoretical maximum. As though on a search for the Holy Grail, they pursue every possible strategy that has a hope of increasing profits. Business operators will use methods that appear haphazard, nonsensical, or even unscrupulous in their constant search for that *economically optimal point*.

Once you recognize this sort of thing is taking place, all kinds of previously unfathomable business models used in China suddenly make better sense. I once booked a room in a fashionable-looking hotel, but stepping inside I was surprised to find something from the Mao era: carpeting pockmarked with cigarette burns, wallpaper peeling at the corners, and, between two rock-hard twin beds, an antiquated-looking console with knobs and switches that no longer worked.

A manager eventually explained that there were two types of rooms on offer and that the refurbished rooms were located only on the seventh floor and above. I had seen an advertisement for the nicer type of room but had not taken care to book the one shown. This was not a bait-and-switch strategy but rather an odd hybrid with a four-star hotel situated above one of the same name that rated only two stars. In the United States, we would call this a branding nightmare, but Chinese are not bothered by the scheme. Quite the opposite—they welcome the flexibility. Taking a cheaper room, they might allow their friends to think incorrectly that they were staying at a luxury property.

Chinese economic behavior fascinates me in a way that traditional culture never could. Before they ripped down the Xiangyang Market in Shanghai, I enjoyed going there on occasion to bargain for merchandise that was obviously counterfeit. North Face knockoffs were especially popular, and walking past a vendor, you might be told that a jacket was being offered for 300 yuan. If you picked up the item and put it back on the rack, the price would immediately drop, and you

soon learned there was a natural floor at 150 yuan—or one-half of the original asking price.

It was supposed to be an open secret among tourists, but after visiting the market for years, an old China hand revealed to me that most merchandise could actually be had for only one-third of the originally quoted price. “One-half is for the tourists,” he explained.

How utterly efficient, I thought, that these vendors would have worked out such an informal system of price discrimination that placed all buyers into one of three buckets: the foolish naïf, the ambitious tourist, and the savvy local. It was certainly a good deal more efficient than the Arab souk, where sellers start by asking for an astronomically high price and buyers open with an equally ridiculous bid, with the two working out the difference slowly over several cups of tea and perhaps a game of backgammon.

The oddest thing about the market benchmark is that it has been in use for ages. In *Understand the Chinese*, published in 1934, William Martin wrote about these market vendors: “He asks for twenty dollars; you offer a third of it, as a rule.”

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A few years ago, interested in finding a new freight forwarder, I acted on a tip from a trader I knew in Guangzhou. “Call these guys,” he said, handing me a business card. “They are the cheapest.”

Ringling the company the following morning, I spoke with the receptionist, who asked me first where the goods would be shipping to. When I told her the United States, she gave me a different number to phone. At the other number, I was given a quote that was laughably high and threw the business card in the trash. I didn’t even think about the exchange until I ran into the acquaintance who made the original link.

He asked me how it had gone, so I told him.

“Your freight forwarder is crap,” I said.

“What are you talking about? They’re the best.”

Relaying my experience in detail, I explained that I had rung the company and was told to call their other office.

“That’s strange,” he said. “The freight forwarder is owned by my friend. He doesn’t have any second office.”



The receptionist, it turned out, fancied herself an entrepreneur, and while collecting a steady paycheck from her employer, she sent occasional leads to an outside company in exchange for a commission. This was another sort of hybrid model common to China, a combination of working faithfully for one company while quietly leveraging that position in order to earn a margin for oneself in an outside venture.

Chinese philosophy speaks of the *doctrine of the mean*, a principle that emphasizes midpoint solutions. When two people are arguing a case, for example, neither is judged as wholly right or wrong; truth is meant to lie somewhere in between. In a similar way, there is a tendency to recognize that absolute loyalty to a company (or a person) is not ideal, because utter fidelity is rarely a utility-maximizing proposition.

An American private equity company that I have worked with bought a sporting goods manufacturer based in China. The seller of the business, an enterprising Shanghainese, received forty million dollars in cash and, as part of the deal, he remained CEO on an annual salary of one million dollars. On top of that, he had an opportunity to earn bonuses and he retained a twenty-five percent equity stake in the business. But despite every incentive to play it straight, he quietly set up a separate, competing trading company and started redirecting new orders there. This was naturally in contravention of a noncompete agreement in place, so his business partners sued him.

The Americans involved presumed that it was the goal of the enterprising CEO to trash his original company entirely—to put it under while wholly supporting the new competing entity he had created. But that was not his plan at all, because such a move would not have been economically optimal. The separate business was nothing more than a backup, an auxiliary channel for reducing personal risk while increasing personal income by some small additional amount. Chinese operators enjoy hybrid models because they fit in with their mindset, which views incrementalism as a core strategy. The goal is always to establish a new foundation, and then from this starting position nibble one's way toward greater levels of advantage.