MARKUS B. HOFER
BERNHARD EBEL
Editors

Business Success in China

Springer

Business Success in China

Markus B. Hofer · Bernhard Ebel
(Editors)

Business Success in China

With 56 Figures and 6 Tables

Springer

Dr. Markus B. Hofer
Dr. Bernhard Ebel
Simon - Kucher & Partners
Haydnstraße 36
53115 Bonn
Germany
markus.hofer@simon-kucher.com
bernhard.ebel@simon-kucher.com

Library of Congress Control Number: 2006934982

ISBN-10 3-540-34614-7 Springer Berlin Heidelberg New York
ISBN-13 978-3-540-34614-2 Springer Berlin Heidelberg New York

Springer is part of Springer Science+Business Media

springer.com

Production: LE-TEX Jelonek, Schmidt & Vöckler GbR, Leipzig
Cover-design: Erich Kirchner, Heidelberg

SPIN 11765257 43/3100YL - 5 4 3 2 1 0 Printed on acid-free paper

Preface

Success depends upon previous preparation,
and without such preparation there is sure to be failure.
The Philosopher Confucius. 551-479 BC

As true for any business decision, the step to enter new markets is always a special one. And as Confucius says it needs special preparation. Targeting China seems a given for many managers at the moment. But often they do not consider problems and risks in sufficient extent. The chances and the potentials in this market seem to be unlimited for them justifying rush and insufficient preparation.

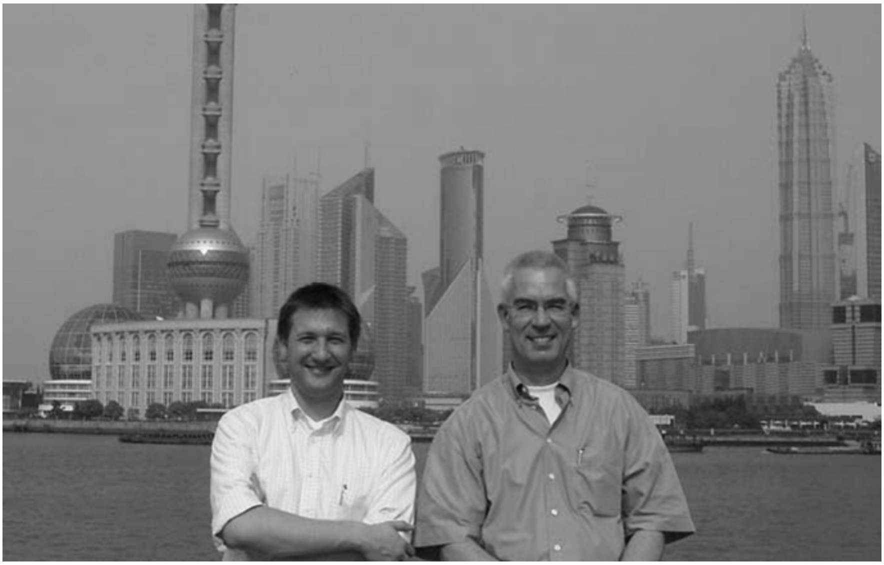
China is a fascinating country of unbelievable size and many differences. The speed of change is breathtaking. Moreover, it became obvious that China is more than a low-cost-production country or a sales market with huge potential. It is both. And despite the regular five-year-plans it plays the claviature of modern economics quite well considering its growth and the future plan to be a major player in the world market.

We want to express our gratitude to the authors of the many outstanding articles collected in this book: Helen Beveridge (COMPASS Asia Training & Consulting, Ludwigsburg), Prof. Dr. Shen Bin (Chinesisch-Deutsches Hochschulkolleg (CDHK), Tongji University, Shanghai), Chin-Ning Chu (Asian Marketing Consultants, Antioch, CA), Heinz Dollberg (Allianz AG, Munich), Prof. Dr. Hubert Fromlet (Swedbank, Stockholm; Blekinge Institute of Technology and Baltic Business School, Kalmar), Dr. James Gong (Wujin High-Tech Industrial Zone), Stefan Herr (Simon - Kucher & Partners, Bonn), Ralf Hanschen (VOLKSWAGEN AG, Wolfsburg), Dr. Kang Gang Hu (GE-AS Co. Ltd., Shanghai), Sylvia Knoss (COMPASS Asia Training & Consulting, Ludwigsburg), Dr. Stefan Lippert (Simon - Kucher & Partners, Tokio), Daniel Mohr (Plumento Corp., Shanghai), Fan Oswald-Chen (Simon - Kucher & Partners, Bonn), Dr. Markus Rall (MAN Roland Greater China, Hong Kong), Jana Schmutzler de Uribe (Simon - Kucher & Partners, Bonn), Dr. Matthias Schramm (THINK!DESK China Research & Consulting, Munich), Xuyong Shi (Wujin High-Tech Industrial Zone), Frank Sieren (Wirtschaftswoche, Beijing), Prof. Dr. Jonathan Story (INSEAD, Fontainebleau), Prof. Dr. Markus Taube (THINK!DESK China Research & Consulting, Munich, and University of Duisburg-Essen), Prof. Dr. Savas Tuemis (Tongji University, Shanghai), Dr. Sven-Michael Werner (TaylorWessing, Munich), Prof. Dr. Peter Williamson

(INSEAD, Singapore), Brigitte Wolff (Abacus Corporation Ltd., Shanghai), Johannes Wyrwoll (VOLKSWAGEN AG, Wolfsburg), Ying Yang (Simon - Kucher & Partners, Bonn) and Prof. Dr. Ming Zeng (Cheung Kong Graduate School of Business, Bejing). Thank you very much for your support, cooperation and patience! It was a pleasure to work with you.

We would also like to thank our team at Simon - Kucher & Partners very much. Special thanks go to Jana Schmutzler de Uribe who played a major role in developing and detailing the concept of the book. Jana, your ideas and support was highly appreciated. Thank you very much and all the best for your challenges overseas.

We want to support these China managers with this publication, who want to meet the challenges of entering China and who want to be prepared. The expected return should not be taken as granted. But the potential can be realized. Good luck!



Bonn, August 2006 Markus B. Hofer
Simon - Kucher & Partners Bernhard Ebel

Contents

Part One

Opportunities and Challenges in China

The Rise of the Dragon

Bernhard Ebel, Markus B. Hofer, and Jana Schmutzler de Uribe

Simon - Kucher & Partners, Bonn

1 A Giant in a Rising Region

China is back again after many decades of playing only a minor role in the world economy. Today's hopes and expectations of many companies seem to concentrate on this country in the Asian power region. But along with positive attitudes also come fears, disappointments and failures. In any case, however, China is clearly a new evolving economic world power. China is re-gaining strength and seeking its position in the world which has changed so much since the times when China was ruling for centuries. Since entering the WTO, China's economic progress and power have become obvious not only to experts, but also to many people around the globe, as the press and news coverage has reached new highs. There are positive sides like success stories of western companies, and negative sides like China's demand for energy and raw materials. The dragon's thirst is presented as being one driver for higher consumer prices such as gasoline in Europe and the US. The giant China needs to be "fed".

Table 1: Basic Economic Figures (2005).

	China	USA	EU 25	Germany	Japan
Population (million)	1,31	298	457	82	127
GDP (PPP) (trillion $)	8.2	12.4	12.2	2.5	3.9
GDP real growth rate	9.3%	3.5%	1.7%	0.9%	2.4%
GDP (PPP) per capita ($)	6,300	42,000	28,100	29,800	30,700
Exports (billion $)	752	927	1,318*	1,016	551
Imports (billion $)	632	1,727	1,402*	801	451
Inflation rate (cons. prices)	1.9%	3.2%	2.2%	2%	-0.2%
Investment (% of GDP)	43.6%	16.8%	19.6%	17.1%	24.4%

Source: CIA World Factbook (* 2004).

China is a giant in many ways and dimensions. Its population just passed 1.3 billion people, accounting for almost one quarter of the world. The area totals about 9.6 million square km, being slightly smaller than the US, but 2.5 times the size of the European Union (EU 25). But even bigger is the difference in the growth rate of the Gross Domestic Product (GDP): While Europe is low at 1.7%, and the USA reached 3.5%, China's GDP exceeded 9% in the last three years from 2003 until 2005, corresponding to a total of 8.2 trillion US $. A comparison of the last years proves that the dynamics of China's power economy are always close to over-heating.

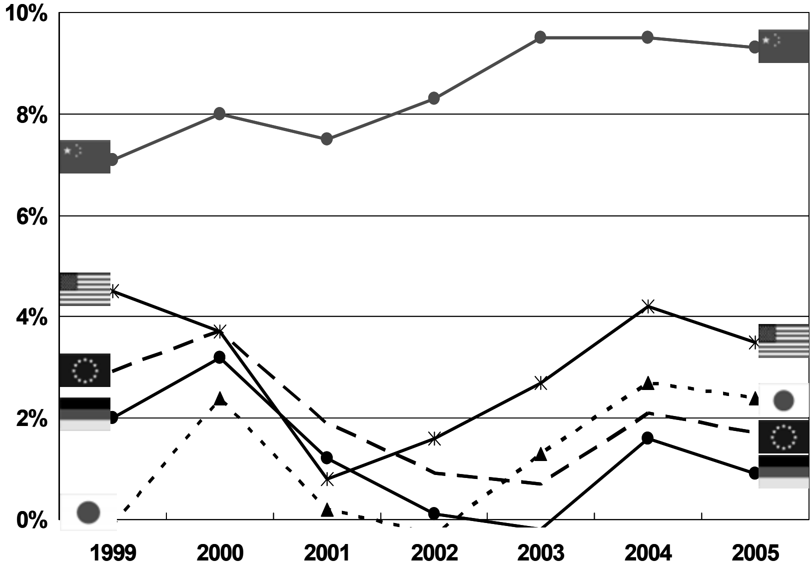


Fig. 1. GDP Growth Rates 1999- 2005 (Source: World Bank national accounts data, OECD National Accounts data files; CIA World Factbook).

Almost 50% of the total labour force works for only 15% of the GDP. The sectors industry and construction, worth 53% of the GDP, employ about 22% of the labour force. The main industries are iron and steel, coal, machine building, armaments, textiles and apparel, petroleum, cement, chemical fertilizers, footwear, toys, food processing, automobiles, consumer electronics, and telecommunications. In the third sector 'services' are 32% of the GDP and 29% of labour force. Export commodities are machinery and equipment, textiles and clothing, footwear, toys and sporting goods, and mineral fuels. Import commodities are machinery and equipment, mineral fuels, plastics, iron and steel, and chemicals.[1]

[1] CIA – The World Factbook.

Table 2: German Exports per Capita Target Country (2004).

Target Country	German Export in bn Euro	Population	German Export per capita target country in Euro
Austria	39.43	8,174,762	4,824
Belgium	41.16	10,348,376	3,978
Switzerland	27.95	7,450,867	3,752
The Netherlands	45.49	16,318,199	2,788
Sweden	15.86	8,986,400	1,765
Czech Republic	17.81	10,246,178	1,738
France	75.30	60,424,213	1,246
Hungary	12.50	10,032,275	1,246
UK	61.06	60,270,708	1,013
Spain	36.81	40,280,780	914
Italy	52.44	58,057,477	903
Poland	18.82	38,626,249	487
USA	64.80	293,027,571	221
Japan	12.69	127,333,002	100
China	21.00	1,298,847,624	16

Sources: Statistisches Bundesamt, Wiesbaden; CIA – The World Factbook; Calculations by Simon - Kucher & Partners.

With 21 bn Euros the exports from Germany to China were almost twice as high as the exports to Japan. Considering the enormous size of the country and, therefore, the respective German export per Chinese capita (16 €) being still on a very low level, this presents hopes and chances for more business with this powerful economy.

The economic power is based on the tremendous ambitions of the Chinese government to become a major player in the world economy. This is also proven by numerous projects and activities, be it the Olympic Games 2008 in Beijing, water power plants, building of economic zones, the restructuring of the cities, etc. Another sign of China's gigantism is the area of construction. Six out of the world's ten tallest buildings are located in Hong Kong and mainland China. The United States, the world's current superpower, is way behind. Eleven out of 21 skyscrapers among the 200 tallest buildings in the world were built in China between 2004 and 2005. Table 3 gives an overview.

Table 3: Tallest Buildings Opened in 2004 and 2005.

Year	Rank	Building	City	Height	Floors
2005	**17.**	**Shimao International Plaz..**	**Shanghai**	**333 m**	**60**
	18.	**Wuhan International Secur..**	**Wuhan**	**331 m**	**68**
	42.	**Chongqing World Trade Ctr.**	**Chongqing**	**283 m**	**60**
	62.	Triumph-Palace	Moskau	264 m	54
	88.	**Bank of Shanghai HQ**	**Shanghai**	**252 m**	**46**
	92.	Chelsea Tower	Dubai	250 m	49
	104.	Bloomberg Tower	New York City	246 m	54
	150.	**Suzhou Xindi Center**	**Suzhou**	**232 m**	**54**
	157.	**New Century Plaza Tower A**	**Nanjing**	**230 m**	**48**
	182.	Seven World Trade Center	New York City	226 m	52
	186.	**Grand Gateway Shanghai I**	**Shanghai**	**225 m**	**52**
	187.	**Grand Gateway Shanghai II**	**Shanghai**	**225 m**	**52**
2004	1.	Taipei 101	Taipei	509 m	101
	55.	**Dapeng International Plaz..**	**Guangzhou**	**269 m**	**56**
	64.	Tower Palace Three, Tower.	Seoul	264 m	69
	84.	**Langham Place Office Tower**	**Hong Kong**	**255 m**	**59**
	130.	30 Hudson Street	Jersey City	238 m	42
	156.	World Tower	Sydney	230 m	73
	163.	Time Warner Center North …	New York City	229 m	55
	164.	Time Warner Center South …	New York City	229 m	55
	166.	**Shanglong Building**	**Shenzhen**	**228 m**	**50**

Source: Emporis 3/2005, „Die offiziell 200 höchsten Wolkenkratzer der Welt”.

2 The Chinese Business Approach

While for many decades the Chinese economy was sluggish, inefficient and Soviet-style centrally planned, in the late 1970s it was moved to a higher market orientation. The hybrid system – tight political control and a market-oriented economy – created a surrounding of steady growth. But the historic roots remained effective especially in a genuine business approach (CIA World Factbook).

The Chinese business approach is characterized by basic values and the way of thinking: it is completely different from the Western world. In contrast, the western culture can be described as individualistic, egalitarian, information-oriented, reductionist, sequential, "seeking the truth", a culture of argument. The Chinese orientation is collectivist, hierarchical, relationship-oriented, holistic, circular, "seeking the way", a haggling culture.[2] These differences in culture and business approaches remain some of the biggest problems for Western companies. There is hardly an other situation where these differences are more obvious than during the negotiation processes (fig. 2).

	Western	Chinese
nontask sounding	• quick meetings • informal • make cold calls	• long courting process • formal • draw on intermediaries
information exchange	• full authority • direct • proposals first	• limited authority • indirect • explanations first
means of persuasion	• aggressive • impatient	• questioning • enduring
terms of agreement	• forging a "good deal"	• forging a long-term relationship

Fig. 2. Negotiation Processes (Source: Business Review, October 2003, p. 85.).

This Chinese mentality – Guanxi – incorporates facets widely unknown, not understood, and often underestimated in their relevance and impact. Guanxi is essential to succeed in China. Personal relationships provide security in legally insecure environments.

What does it mean?

Guanxi refers to the existence of a relationship between people or organizations, the contact and connection between people or particular people with whom one has strong ties.

Why did it evolve?

China's deficient legal system that has existed for a thousand years made it necessary to create an institution that secured relationships.

[2] Harvard Business Review, October 2003, p. 85.

關係

guanxi (relationships)

How does it work?

Guanxi is based on personal relationships, on common ground such as birthplace or university. The exchange of goods or services and the acceptance of abstract liability obligations are the core integrating powers. It is common to expand the network intentionally by giving and receiving “gifts”.

Why is it a problem?

It contradicts Western business ethics. The invested social capital may make up 20% of the income/ profit. The necessity to establish legal security and to lower transaction costs diminishes with the establishment of laws in China. The borderline between gift and corruption blurs more and more.

3 Barriers for Business Success

China cannot be considered as one market. There are vast regional differences - including the economical situation. Figure 3 shows the differences in the gross domestic product per capita in 2003.

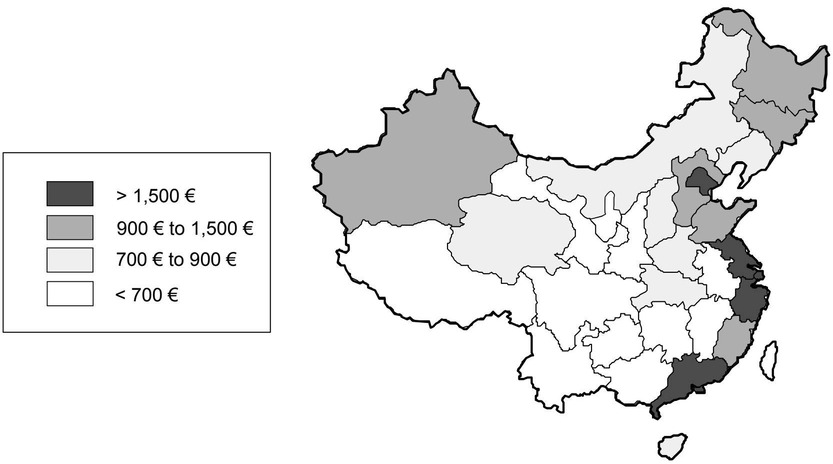


Fig. 3. GDP per Capita 2003 (Source: Der Spiegel, No. 22, 2005).

It becomes clear that the coastal regions profited most from the past economic development. But not all of the administrative divisions in China, which are divided into 23 provinces, five autonomous regions, four municipalities, and the two special administrative regions Hong Kong and Macau, participated in the growth in wealth and prosperity.

These differences are even strengthened by the seemingly uncontrolled behaviour of regional governments. The positive competition for investors turned into a bloody fight, causing dangerous eruptions and unbalanced developments, and resulting in a potentially uncontrollable overheating of the economy. In 2001, this situation was exacerbated by the accession of the WTO, which had a major impact on companies and businesses. Despite China's entry and the mainly positive impact, the institutional market entry barriers remain. Although the general business climate has improved for foreign companies as well, non-institutional barriers also prevail. The most pressing problems in China are shown in figure 4.

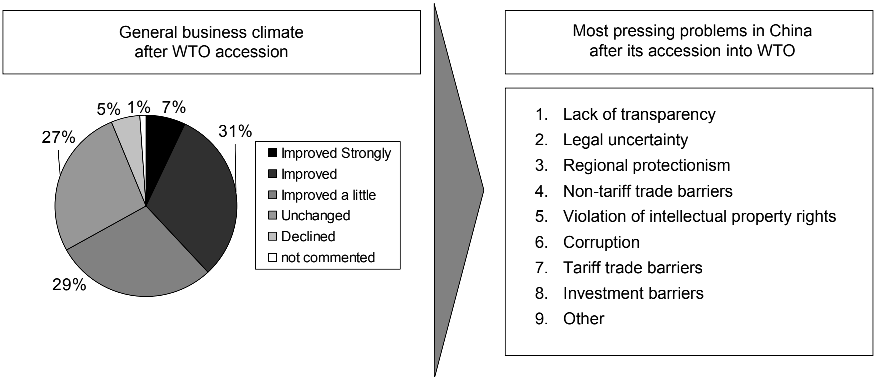


Fig. 4. Non-institutional Trade Barriers Prevail (Source: AHK-China 2003, Survey among German enterprises and representative offices in China).

4 Challenges and Opportunities in China

To master the challenges and opportunities of today and tomorrow remains the key objective for companies to succeed in China. From our perspective the main tasks are to:

- Adapt your products and services to local demand.
- Build strong brands to overcome price and copyright problems.
- Position your company and your products in the relevant segments.

– Create strong relationships and partnerships where necessary.
– Determine the right strategy with a realistic business plan.

The outlook for growth seems to be realistic, even if the growth rate slows down. In various industries, local competitors have grown very powerful within the Chinese markets. They have even started to conquer the world. China will remain or become a very attractive region for production facilities, R&D departments, and a market for strong brands and good products. The time is over, however, when Chinese customers accepted second-class products. China is becoming the market of the future – a real one.

The Chinese Consumer Puzzle - Placing Branded FMCG in the Chinese Market

Matthias Schramm and Markus Taube

THINK!DESK China Research & Consulting and University of Duisburg-Essen

1 Who Is the Chinese Consumer?

After coming home from a grueling ten-hour workday at the marketing agency, Li Chunhua checks the Hai'er refrigerator in the new three-room apartment she and her husband bought last year. The fridge is nearly empty, except for a nearly depleted bottle of Chinese-brand milk she bought for her daughter (because of the cool advertisement with the young girl dressed as a taikonaut) and a can of the expensive Japanese beer her husband likes to drink after dinner. She has to go and do some shopping. Li Chunhua puts on her no-name coat and the fake, but still fancy 'Nike' shoes she bought on the street market close by and goes out. On the way to the bus stop she recalls the discussion with her husband last night. He wants to buy a car. They could apply for a credit – although friends have told her that is still a hassle. Hm, anyway a car would be nice - they would be able to go more often to the new hypermarket on the outskirts of the city. Her husband said he would like to buy a German-brand middle-class car – but what is in a name? Or a brand for that matter? These cars are now produced in China as well ... And these new Chinese brands, they have a better design - 'Western style with Chinese characteristics', she chuckles, and they are cheaper, probably better value for money. She decides to buy one of these car magazines to learn more about them. Ah, here comes the bus ...

China – a market of 1.3 billion consumers. Each of them eager to spend his money on brand-name toothpaste, candy bars, refrigerators, TV sets, mobile phones, sports shoes, and cars. That is the myth. Rapidly rising incomes in an economy that has been featuring close to double-digit growth for the last ten years simply must have set the scene for strong and dynamic consumer demand. That is the mantra repeated over and over again. But what is reality?

Li Chunhua, whom we met in the opening paragraph, certainly is one of those Chinese consumers who exert a spell on the global consumer goods industry. But she certainly does not represent the average Chinese consumer. Instead, she stands for the new affluent urban upper middle class, which has distinctly different behavior compared to the remaining one billion plus Chinese consumers. Li Chunhua and all of her compatriots, however, are united by their experience of a rapidly changing consumer landscape. In quick succession completely new concepts have been introduced and are now shaping their consumer behavior:

- the sellers' market, formerly characterized by long cues and little product variety, has been substituted by a buyers' market featuring an abundance of goods and variety,
- marketing campaigns (by companies interlocked in fierce competition) have become as omnipresent as political propaganda in former days,
- brand names have been introduced as a completely new concept in product differentiation,
- the retail sector has been revolutionized and given way to completely new shopping concepts like hypermarkets and e-platforms, and
- consumer credit has become available, paving the way for consumers to satisfy all their dreams that are inspired by the media.

As a consequence of this onslaught of new concepts and patterns, not only is consumer behavior in China not homogeneous, but it is anything but stable as well. Buying patterns, product and brand preferences, etc. are still in a state of flux and prone to change quickly. All these market facets and developments make it extremely difficult to enter – and prevail in – the Chinese consumer market.[1]

The first issue to be tackled, however, is to define the relevant market. What are the real dimensions of the Chinese consumer market? Looking at the statistical data it becomes obvious that China's private consumer is no exception to the dynamic developments of the Chinese economy. In 2004 retail sales increased by 12.53% to 4,484 bn yuan RMB (ca. 460 bn euro) and in 2005 they grew by another 12.6% to 5,049 bn yuan RMB (ca. 490 bn euro).[2] In 2006 similar growth rates are expected. These figures already make China one of the largest ten retail markets worldwide today, and

1 Kotler, et al., 2003.

2 All data exclude restaurant trade, catering and the like (National Bureau of Statistics 2005). In comparison, total retail sales in Germany 2005 amounted to 361 bn euro featuring a year-to-year growth rate of -1.0% (HDE 2005).

given its exceptional growth rates, China might rise to number five in the next few years.

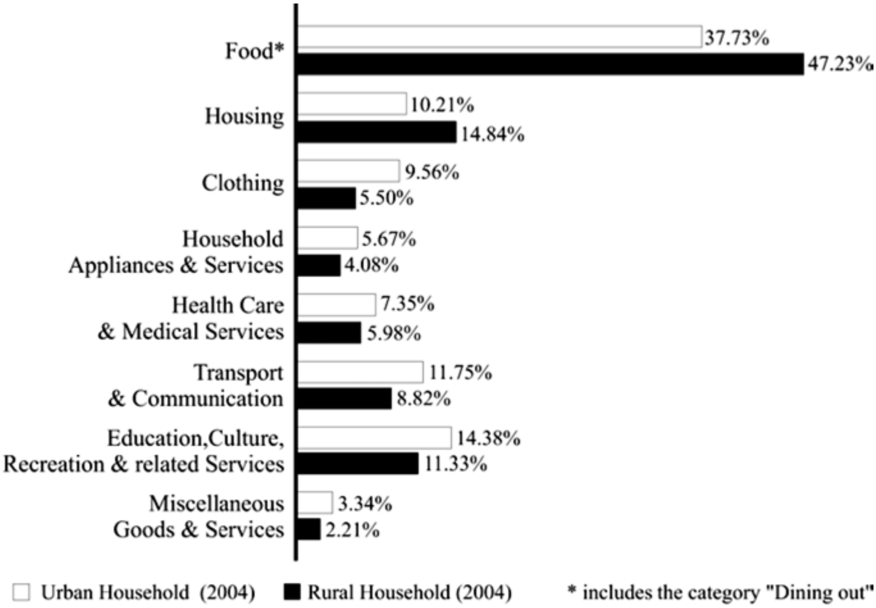


Fig. 1. Structural Composition of China's Retail Sales (Source: National Bureau of Statistics, THINK!DESK China Research & Consulting).

The Chinese retail market, however, is markedly different from markets of similar size in the United States, Japan, and Europe. First of all the Chinese market for consumer goods is still dominated by primary consumer needs. Expenses for food and food articles are extremely high while other categories are fairly under-represented (see chart 1). Secondly, purchasing power and consumer behavior differs dramatically between the Coastal Belt region and the Western hinterland as well as inside these regions between urban and rural areas. While there exists a small group of people that earn incomes on par with European standards, the majority of households still lives on incomes below the threshold level of US$1,000, which is used to demarcate the borderline between subsistence living and consumerism. All in all it seems warranted to classify no more than 80-100 million people in China as potential customers for the branded products of foreign producers. But given this definition of the relevant target group, it is still no easy undertaking to address the group as a whole, since they are anything but homogeneous: Although the target group amounts to only roughly the size of the German population, it is spread over a huge landmass. Furthermore, it includes people of very distinct local cultures and socialization patterns, people with very different tastes and shopping habits.

Based on a representative survey in Beijing, Wuhan, and Chengdu[3] the authors have tried to find some answers to the most pressing questions that face the consumer goods industry in China. In Chapter 2 we will look at whether Chinese consumers have already developed distinct brand preferences. And what standing do foreign brands have in the Chinese market - are they regarded as of superior value or do Chinese consumers prefer to buy domestic products? Chapter 3 addresses the question of where and how the Chinese consumer can be met and approached with branded products. In Chapter 4 we will conclude with some thoughts on how to prevail in the Chinese consumer market.

- Between the lingering myths and glittering facts it is still a hard task to determine the real dimension of the Chinese market for FMCG: the urban population of 1^{st}- and 2^{nd}- tier cities is a good approximation but 3^{rd}- and 4^{th}-tier cities are next in line and will be the battleground in the future.
- The Chinese market for consumer goods is still dominated by primary consumer-needs: Expenses for food and food articles are extremely high.
- Consumer behavior in China is anything but stable. Buying patterns, as well as product and brand preferences are still in a state of flux and prone to change quickly.

2 Brand Perceptions and Preferences

Do Chinese consumers have a positive attitude towards brands? Li Chunhua would surely be confused about such a question: Her daughter likes the famous Chinese milk brand *mengniu*, her husband celebrates his Japanese beer, and Li Chunhua herself loves her Nike shoes – even if they are fake ones. But Mrs. Li's case aside, this simple question is not as easy to answer as it may seem:[4] Brands and especially their sudden omnipresence

---

3 The survey is based on data collected in 2005 during more than 1200 face-to-face interviews with consumers in the cities of Beijing, Wuhan, and Chengdu. The project was carried out in cooperation with the China Economic Monitoring Center of the National Bureau of Statistics of China. All data referred to in the following and not marked otherwise are based on this survey conducted by *THINK!DESK China Research & Consulting*.

4 Hui, et al., 2001.

in daily life are a fairly new phenomenon for China's consumers. While European and US consumers have been accustomed to brands and branded products for more than a century, in China the first (international) brands did not appear until the early 1980s. Asked about their attitude towards their new glimmering and shining world full of brands, nearly two-thirds of all consumers stated that they are confused because there are so many different brands. Moreover, half of all consumers agreed that differences among brands and non-branded products are hard to discern.

At first glance this situation would seem to be a catastrophe for all brand managers, but it turns out that things are not that bad. Chinese consumers are generally positive towards brands – but they are focused on a rather small evoked set, i.e. only few brands per product range are kept in mind that are not simply known but regarded as acceptable with respect to image, price, etc and in line with one's own lifestyle.[5] Only a minority of all consumers asked said that they prefer to buy non-branded products. And even more importantly, they are willing to support their favorite brands even if they are more expensive than other products: 75% are willing to pay a premium for their favorite brand. Only a small fraction of all Chinese consumers is unwilling to pay more for brands (chart 2).

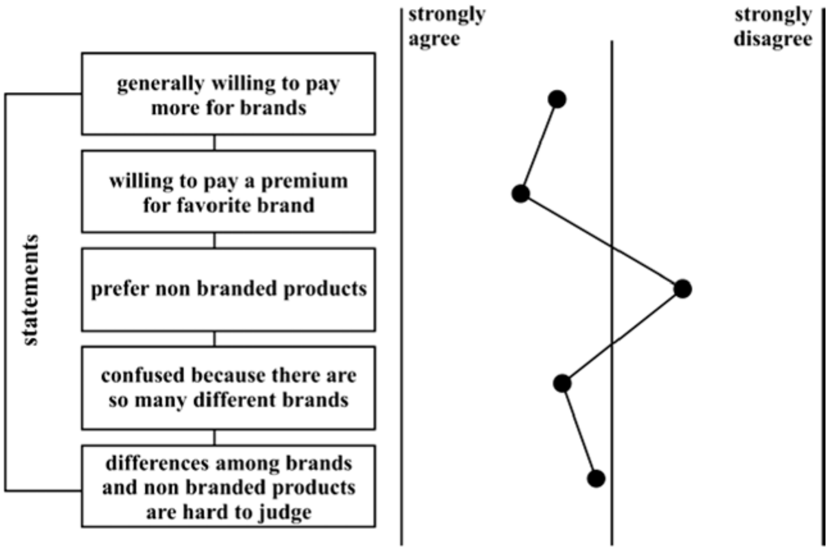


Fig. 2. General Attitude towards Branded Products (Source: Representative Survey in Beijing, Chengdu and Wuhan, THINK!DESK China Research & Consulting).

5 THINK!DESK, 2005.

This must read like good news to the international branded FMCG industry. They have had a head start on their Chinese competitors and lead in terms of brand management, brand image, design, and quality. But nothing stays as is for eternity. Chinese companies are learning fast, and then there is the Chinese consumer. While in the early years foreign brands had been perceived as a class of their own, far ahead of domestic brands, today foreign and Chinese brands are more or less understood as direct contenders. Parameters like the purpose and overall setting of consumption have a strong influence on the choice between foreign and Chinese brands.

When comparing perceptions of foreign and Chinese brands, distinct differences can be seen, but certainly not a simple "good – bad" dichotomy. Both foreign and Chinese brands are viewed as having specific strengths and weaknesses (chart 3). Foreign brands are perceived to be characterized by high quality, state-of-the-art technical features, and high prestige, with the prestige effect dominating all other characteristics. In all areas of conspicuous consumption foreign brands are used to display social status. Only 24% of all Chinese consumers disagree with the statement that foreign brands are of high prestige. At the same time, however, nearly three-quarters of all consumers think that foreign brands are too expensive. In comparison Chinese brands are associated with good quality and an excellent cost/performance ratio. And what is more, Chinese products are seen as more trustworthy than foreign brands – nearly 65% state that they trust Chinese brands more than foreign ones.

	foreign brands	**Chinese brands**
attributes	high prestige	very trustworthy
	excellent quality	sound quality
	cutting edge	"Chinese"
	very expensive	good value for money

Fig. 3. Perceived Characteristics of Foreign and Chinese Brands (Source: Representative Survey in Beijing, Chengdu and Wuhan, THINK!DESK China Research & Consulting).

Taking a closer look at the hidden preferences guiding Chinese consumer behavior, it becomes obvious that next to parameters such as "prestige" and "performance", other factors are growing in influence that are not directly connected with the respective product and brand (chart 4). Growing nationalism in combination with a lingering anti-American sentiment is probably the most important of these "external" factors determining purchase decisions.[6] More than half of all consumers surveyed say that they feel an obligation to buy local Chinese brands wherever and whenever possible in order to support the national economy and local employment, as well as make a contribution to China's ascent in the global arena. This special kind of nationalism – known in other countries only in a much weaker form and summarized as "buying local effect" – creates a type of "background noise" against which claims and images of individual brands are weakened.

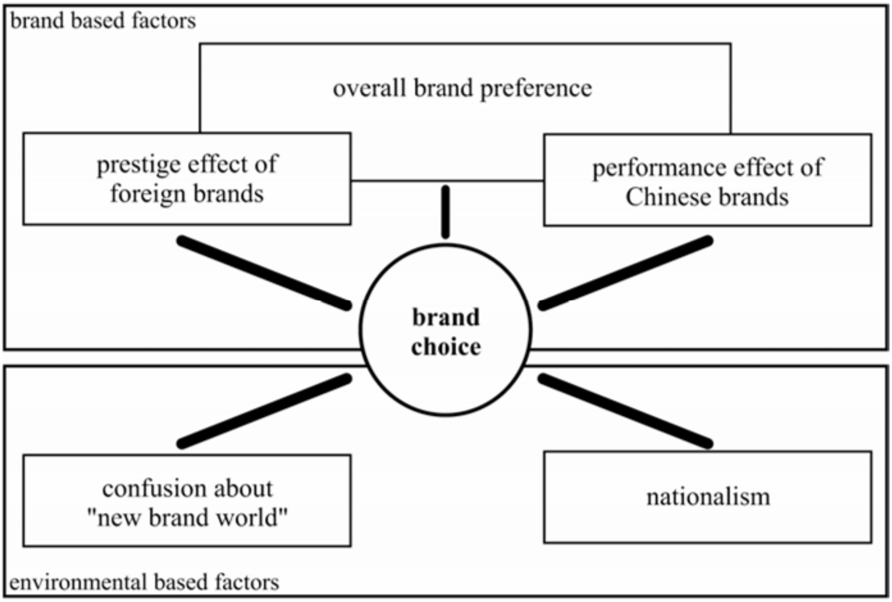


Fig. 4. Model of Brand Choice (Source: Representative Survey in Beijing, Wuhan, and Chengdu, THINK!DESK China Research & Consulting).

The brand managers of the *mengniu* milk, which Li Chunhua buys for her daughter, have made use of this background noise and positioned their brand as patriotic, with their advertisements celebrating China's achievements in space exploration. Foreign competitors, however, are in a dilemma: Although nationalistic messages obviously help to sell products, they cannot credibly start advertisement campaigns praising the achievements of the People's Liberation Army, for instance. They can, however, lose tremendously in terms of popularity if they strike the wrong note. The

6 Schramm, et al., 2005.

case of Nike, which allowed a NBA basketball player to defeat a Chinese dragon (China's foremost national symbol) in an advertisement, gives a perfect example of the dangers of playing against the nationalistic sentiment. Nike had to stop the campaign and apologized publicly – their image, however, remains seriously spoiled. Yet, the problems that foreign brand managers face do not stop here: When trying to communicate that the respective foreign brand product is manufactured in China – and is in line with the idea of "buying local" – the prestige effect dissolves and the consumers' willingness to pay premium prices may diminish dramatically.

Box: Country of Origin

Chinese brands are no longer underdogs but have long acquired the necessary knowledge to compete with its international competitors. Furthermore most often they get closer to 'their' customers, understanding their needs and wishes and are able to adopt this knowledge fast. In addition their rise is backed by growing nationalism which manifests itself in a tendency towards "buying local". Against this background the prestige effect of foreign brands seems to be the last refuge in which foreign brands are save and unchallenged by their rising local rivals. But in order to cut costs to remain flexible in the cut-throat competition of Chinese FMCG markets, nearly all "foreign" branded products are produced in China. At first glance this seems to be an advantage as "buying local" or "buying Chinese" to support the local industry and strengthen local employment remains one main trend. What sounds like a good opportunity to create a strong mixed position turns out to be one of the greatest threads – two examples demonstrate the resulting challenges also for German companies:

1) A leading German producer for high quality white goods – all made in China – is challenged by his largest Chinese Competitor Hai'er. One strategic marketing option might be to develop a label "Made in China" to indicate the close tie between the German brand and its Chinese Consumers. This option was tested – using conjoint-analyses – during a consumer survey in Beijing and Wuhan carried out by THINK!DESK China Research & Consulting. Using only the prestige effect of their brand the German company was able to reach a (calculated) market share of 61.5% despite of the strong Chinese competitor. While using the new strategy and adding a label marking the product as "Made in China" the market share drops to only 53% (Chart 5).

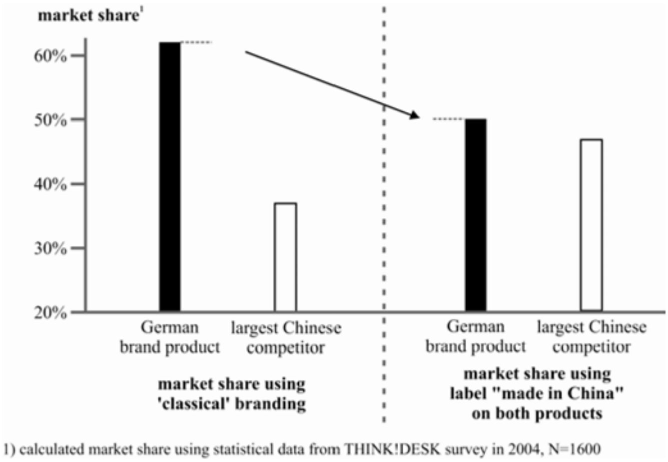


Fig. 5. Market Share of German Brand vs. Largest Chinese Competitor (Source: Representative Survey in Beijing and Wuhan, THINK!DESK China Research & Consulting).

Overall this case shows that it is crucial to clearly determine the branding and positioning strategy, because an opaque brand image will lose in any case. Localizing a brand is a difficult task that should be implemented carefully in order not to dilute the brand image.

2) Selling cars on the Chinese market is a tough business. Although growing fast, the Chinese market is burdened with overcapacities and cut-throat competition between all major international players and some domestic ones. The German VW AG was one of the giants in this market, selling cars in China for nearly 20 years. Within five years the giant stumbles and only recently has lost its leading position. What happened? During the 80's and 90's VW – and his JV-partner – had in fact nothing less than a monopoly using it to sell nearly obsolete models no longer sold on international markets. In the course of China's economic uprise, its opening up and the recent WTO joining international and local competitors joined the market. Today the market is no longer a sellers' market but a buyers' market dominated by technical innovation, design, and image. Today VW is associated with a dusty producer for cadres and seen as a Chinese more than a foreign company. Although as technically innovative as its international competitors VW image is that of a local company – with all it negative side-effects (Chart 6). Buying a car in China still is a privilege reserved for a few well-off consumers – and they want to show their special status. The image of the respective brand is a crucial factor in their purchasing decision where the prestige effect dominates all other factors.

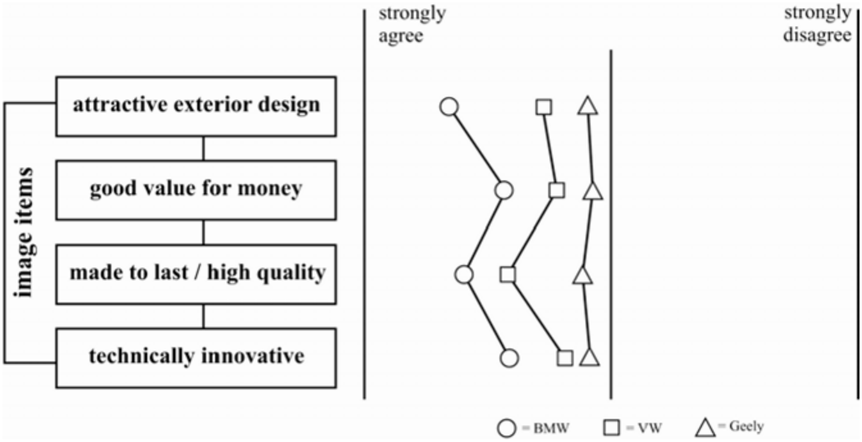


Fig. 6. Images of Selected Automobile Brands (Source: Representative Survey in Beijing, Wuhan, and Chengdu, THINK!DESK China Research & Consulting).

In general, a brand image must be chosen carefully with respect to the target group, as well as all Chinese and international competitors. In addition, sustaining that image is even more important in order to avoid confusing the consumer with a misty and blurred brand image.

- The omnipresence of brands in daily life is a fairly new phenomenon for China's consumers – the majority is confused about this shining new world.
- Chinese consumers are generally positive towards brands, and nearly three-quarters are willing to support their favorite brands.
- Chinese consumers differentiate between Chinese and foreign brands: Foreign brands are perceived to be high prestige while Chinese brands are trustworthy.
- "External" factors strongly influence purchase decision, the rising nationalism above all.

3 Branded FMCG – The Retail Sector as Gatekeeper

All in all, we can conclude that most Chinese consumers have a positive attitude towards brands – not necessarily foreign ones of course. At the same time branded products demand sophisticated retail formats in order to convey specific images and intangible product attributes. The battle for the Chinese consumer will therefore be decided by the ability to attract Chinese customers to shopping environments where branded products can be presented in an adequate fashion. Based on this consideration, super- and hypermarkets might be understood as the gatekeepers for the branded FMCG industry. But where does the Chinese consumer do his shopping?

Following Mrs. Li on her daily shopping tour, we will probably be surprised as to where she will take us. Her first stop leads us to the still omnipresent traditional street markets somewhere along a back road. Despite the fact that new laws and regulations have been adopted to close some of these markets (due to the SARS epidemic, avian flu and other threats) and shift demand to (new) retail formats, traditional street markets still play a major role in the shopping behavior of Chinese consumers.[7] Even in large metropolitan areas most Chinese consumers visit street markets daily, with the overwhelming majority visiting more than once a week (chart 7). It is mostly fresh produce that are bought on these markets. Branded products, however, are seldom found.

retail format	frequency of visits (%)				
	daily	more than once a week	once a week	1-3 times a month	never
traditional street market	60	20	8	7	5
Chinese hypermarket	4	31	30	29	6
foreign hypermarket	1	16	17	45	21

Fig. 7. Frequency of Visits to Various Retail Formats (Source: Representative Survey in Beijing, Wuhan, Chengdu, THINK!DESK China Research & Consulting).

But as also shown in chart 7, Chinese consumers are increasingly drawn to supermarkets as well. Nearly two-thirds of consumers in Beijing, Wuhan, and Chengdu visit a Chinese hypermarket at least once a week, while one-third visit a foreign supermarket. There is no doubt that buying behavior is changing and will continue to change quickly in the near future.[8] Chain stores do their best to present fresh products to their customers, and they offer value added services – such as ready-to-cook meals, cut fruit and vegetables, and even freshly made ready-to-eat delicacies to create an al-

[7] THINK!DESK, 2005.
[8] Hu, et al., 2004.

ternative to traditional street markets and attract modern, well-off customers. What is missing, however, is a comprehensive regional coverage – even in urban areas. Super- and hypermarkets are most often located far outside the residential areas, following strategic patterns designed for Europe and the USA. In China, however, this strategy does not fully meet the needs of a society in which the majority still does not possess a car and is dependent on public transport – or its feet.

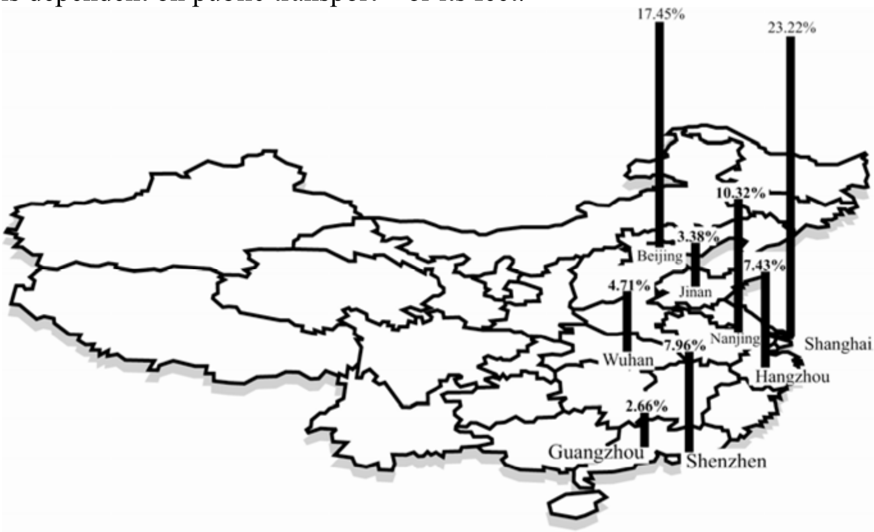


Fig. 8. Retail Sales by Chain Stores in Various Cities in % of National Total (Source: China Chain Store & Franchise Association, THINK!DESK China Research & Consulting).

Nevertheless, the modern retail sector paves the way for branded products in China. The branded FMCG industry therefore does have access to a substantial part of consumers in metropolitan areas and has the opportunity to address its (potential) clientele in the desired fashion. This opportunity, however, is subjected to harsh regional barriers. Unsurprisingly, the distribution of new retail formats like super- and hypermarkets follows the expansion of purchasing power. As a result these new types of distribution outlets are not yet widespread, but rather concentrated in a small number of metropolitan areas and can address only a small part of the population. Taking chain stores as a proxy for those sophisticated retail formats that are in a position to adequately present branded FMCG to the customer, it can be shown that only 12.5% of Chinese retail sales (560 bn yuan RMB, roughly 58 bn euro – data for 2004) are generated in these distribution outlets. Looking at their regional distribution, the accessible market, as seen from the perspective of the international branded FMCG industry, takes the form of a group of isolated island scattered in a vast ocean. But here too, extremes abound: 50% of the sales volume is generated in three cities only, eight cities make up for three fourths of total sales, 35 for 90% of all sales by chain stores (chart 8).

Mrs. Li, however, is proud to live in one of China's metropolises and loves her 'urban living'. Having finished her shopping on the street market, she moves on – she still wants to buy some toiletry articles and beer for her husband. After a 30-minute bus trip she enters the large *Hualian* hypermarket, a Chinese chain store company. Although an equally large French hypermarket, *Carrefour,* lies within walking distance, Mrs. Li, like many other Chinese consumers, prefers the Chinese store. Many foreign stores, even though they have adjusted their product range to Chinese buying habits, seem unable to strike the right note in order to attract Chinese customers. Chinese stores still have a better image concerning their product range, the overall freshness of products and their pricing.

	Chain Stores	Revenue (bn. Yuan/RMB)	Revenue growth 2003/04 in %
1	Shanghai Bailian	60.1	22.5
2	GOME Electrical Appliance	21.2	34.3
3	Dalian Dashang Group	20.5	27.0
4	Suning Appliance	19.7	79.6
5	Carrefour (China)	14.5	20.9
7	China Resources Suguo Supermarket	12.3	44.9
15	China Resources Vanguard Supermarket	10.5	6.7
20	Wal-Mart China	6.8	30.5
23	Metro Group	5.6	13.2

Fig. 9. Revenue of Selected Chain Store Companies in China 2004 (Source: China Chain Store & Franchise Association, THINK!DESK China Research & Consulting).

Thus, the branded FMCG industry has to rely above all on Chinese partners in order to address their clientele. Although a substantial number of foreign retail companies has already entered the Chinese market – currently more than 100 – the latter is still dominated by domestic companies. The leading international companies in China, *Carrefour*, *Wal-Mart*, and the German *Metro-Group* together account for only ca. 27 bn yuan RMB (2.8 bn euro) total revenue (in China), not even half of the total revenue of

China's retail giant *Shanghai Bailian* (chart 9). The total market share of foreign retail companies in 2004 adds up to no more than 2.6%.

Overall consumption habits and buying behavior of Chinese consumers are changing fast. Even though some traditional elements – like street markets – remain, the 'supermarket revolution' is unstoppable. Traditional markets will not vanish – they represent an important 'safe haven' for a substantial number of consumers with medium to low and lowest income.[9] But with super- and hypermarkets taking hold in more and more urban areas, their importance for the overall buying behavior is decreasing. Altogether this is good news for the FMCG industry which relies on these new shopping formats in order to address their clientele. The first generation of Chinese super- and hypermarkets, however, might be understood as a blessing as well as a curse to the branded FMCG industry. On the one hand, they mark the path to follow. While large Chinese and foreign chain store companies slowly advance into China's Central and Western hinterland, they pave the way for FMCG brands at the same time. On the other hand, the highly fragmented market turns out to be a strong gatekeeper with a lot of hands to shake on the way to the Chinese consumer. In order to distribute products on a broad regional basis, a multitude of retail partners has to be involved. A 'one-stop' solution to distribute branded products on a national scale still does not exist.

- The "supermarket revolution" is on its way and it is gathering speed – with the rise of chain stores, distributing brands gets easier as western style super- and hypermarkets begin to dominate the retail sector.
- Chinese consumers differentiate between Chinese and foreign super- and hypermarkets. They like Chinese stores because of their product range, freshness, and pricing. Therefore, Chinese stores must be regarded as an important distribution channel in addition to international players like Wal-Mart or Carrefour.
- Super- and hypermarkets mark the path to follow: While slowly advancing into China's 3rd and 4th tier cities they pave the way for FMCG brands.

[9] Lo, et al. 2001.

4 Management Implications

Who is the Chinese consumer? We have seen that there is no clear-cut answer. The Chinese consumer market is highly fragmented. Substantial variations in household incomes result in a situation where only comparatively small parts of the population are in a position to demonstrate significant consumer behavior. At the time being the number of Chinese who are in a position to wield significant purchasing power may be in the range of 80-100 million only. Since this group mostly inhabits China's metropolitan areas of the Coastal Belt, these are the urban areas that constitute today's 'relevant market' for the international branded FMCG industry. With China's economic ascendancy showing no signs of weakness, however, these islands of consumer markets will grow and be accompanied by more and more cities moving beyond the threshold line of modern consumerism. For the foreseeable future, however, China's consumer market will remain an urban issue – at least for international players.

How to address the Chinese consumer? Chinese consumers do have a positive attitude towards the notion of brands. However, there is no general preference for foreign brands. Many Chinese brands, most of them created only a few years ago, enjoy the trust of the Chinese consumers and hold their own against their foreign competitors.[10] While foreign brands excel in terms of prestige and quality ratings, Chinese brands are valued for their price/performance ratio, and their superior ability to address the specific "Chinese" desires of the customers. In addition environment-based factors have a strong influence. Strong nationalistic sentiment has created a background noise that provides domestic players with a 'natural' advantage and critically challenges foreign brand managers. What are the options to promoting foreign brands vis-à-vis their Chinese competitors and raising them to the evoked set of the Chinese consumer?

Given the heterogeneity of the Chinese market, it seems advisable to differentiate marketing and brand-placement activities between different types of local markets and their respective clienteles. Categorizing the cities in various tiers indicating local purchasing power, openness to the global markets, etc. might be useful.[11] In this understanding, metropolises like Shanghai, Beijing, and Guangzhou would have to be classified as first tier cities, while cities like Wuhan, Chengdu, etc. would classify as tier two cities. Both categories may be understood as the 'battlefield' on which the branded FMCG industry presently fights for the Chinese consumer. The target group here has a generally positive attitude towards brands and

[10] Gao, et al., 2003.

[11] A.T. Kearney, 2003.

is willing to pay premium prices. However, consumers are still in a "variety seeking" stage and exhibit little brand loyalty, brand preferences are shifting and remain fragile. In order to attain a strong brand position in this environment, foreign companies need to focus strictly on their own core target group and address it directly. In depth knowledge of one's customers (their expectations, wishes, etc.) is crucial – intensified market research may be the key. Otherwise the danger of getting lost in an overall "marketing noise" becomes excessive. In order to differentiate their own brand name from new Chinese brands and uphold a premium positioning, any vertical or horizontal brand stretching initiatives should be refrained from.[12] A strict focus and steadiness in respect of brand image is of utmost importance in order to create a steady position in a fast changing environment with new brands coming and going. Their own brand portfolio might be enriched by the acquisition of well positioned Chinese brands – especially in order to provide customers with medium-end alternatives. In the longer term, well introduced brands may gain by localization efforts, which position the brand closer to the Chinese context and may help to counter the discriminatory background noise of China's omnipresent nationalism. However, this is a dangerous game as at the same time the credit of "foreignness" is lost with all its attributes of prestige, quality, etc.

Third and fourth tier cities constitute the 'battlefield' of the future, but are hardly accessible at the time being. A lack of purchasing power as well as adequate retailing outlets prohibit comprehensive market entry strategies. However, it is possible to start making consumers acquainted with a brand name and attain an initial basic brand recognition. Following this broad concept, marketing strategies should focus less on a specific target group and more on a broader group of potential customers. This is the time for comparatively simple branding and positioning strategies. Starting with the issues of quality and price, design and image should be treated as only secondary arguments for a purchasing decision. Adjustments in package sizes and quantities sold might be necessary in order to facilitate price-based sales campaigns, while at the same time preventing a cannibalization of strategies employed in higher tier urban markets. Point of Sales activities may be employed as a primary instrument to address customers.

Where to address the Chinese consumer? The expansion of the international branded FMCG industry in China is restricted by the availability of retail formats that allow for adequate product positioning and facilitate the desired communication with the customer. China's retail distribution system is in the process of a dramatic reorganization towards larger formats and increasingly standardized chain store facilities. These modern formats,

[12] Chen, Penhirin, 2004.

however, are still greatly restricted in their regional coverage. The branded FMCG industry in China still has to deal with a multitude of retail partners, each of them with very limited regional reach and its own particular sales concept. Bringing branded products to the Chinese consumer is still a troublesome, cost-intensive process with huge potential for improvements. A sit-and-wait strategy, where a brand producer simply waits for 'his' retail formats to reach further and further into the market, may eventually result in broad regional brand coverage. However, such an approach is highly dissatisfying and drives the brand producer to take on a passive role, making him dependent on third party activities for his own market expansion. Shop-in-shop concepts, where brand producers design their own sales environments and place them in larger distribution outlets independent of any chain store affiliation have proven to be a successful means to steer regional expansion processes proactively.

There remains little doubt that China will become one key market of the years to come. But it also holds true that success will not come easy: Chinese consumers are hardly understood or known at present, their preferences are changing fast and brand loyalty is hard to acquire, Chinese brands have matured to become serious competitors to foreign brands, and distribution and supply chain management are still difficult. But despite all the threads, the opportunities prevail – efficient, continuous brand management based on solid knowledge of one's own consumers will help to conquer the world's largest FMCG market.

References

A.T. Kearney (2003). Winning the China FMCG Market – Growth Strategies for an Evolving Opportunity. A.T. Kearney Business Issue Paper. http://www.atkearney.de/content/veroeffentlichungen/whitepaper_practice.php/practice/retail/id/48978 (2006-01-31).

Chen Y., & Penhirin, J. (2004). Marketing to China's Consumers. The McKinsey Quarterly. 2004 Special Edition ‚China today', 63-73.

Gao, P., & Woetzel, R., & Wu, Y. (2003): Can Chinese brands make it abroad? The McKinsey Quarterly. 2003 Special Edition ‚Global Directions', 54-65.

Hauptverband des Deutschen Einzelhandels (HDE) (2005). Einzelhandelsumsatz im engeren Sinne, http://www.hde.de/servlet/PB/menu/1017774/index.html (2006.01.31).

Hu, D., & Reardon, T., & Rozelle, S., & Timmer, P., & Wang, H. (2004). The Emerge of Supermarkets with Chinese Characteristics: Challenges and Opportunities for China`s Agricultural Development. Development Policy Review. 22(5), 557-586.

Hui, A.Y., & Siu, N.Y., & Wang, C.C., & Chang, L.M. (2001). An Investigation of Decision-Making Styles of Consumers in China. The Journal of Consumer Affairs. 35(2), 26-345.
Kotler, P., & Ang, S.H., & Leong, S.M., & Tan, C.T. (2003). Marketing Management: An Asian Perspective, 3rd. ed. Singapore: Prentice Hall.
Lo, W., & Lau, H., & Lin, G. (2001). Problems and prospects of supermarket development in China. Journal of Retail and Distribution Management. 29(2), 66-75.
National Bureau of Statistics (2005): China Statistical Yearbook 2004, Beijing.
Schramm, M., & Staack, T., & Taube, M. (2005). Markenpräferenzen chinesischer Konsumenten: Eine empirische Untersuchung. ZFB – Zeitschrift für Betriebswirtschaft, forthcoming.
THINK!DESK China Research & Consulting (2005): Black Box China – Markenpräferenzen und Kaufverhalten chinesischer Konsumenten. München.

After the Hype: Investment in China?

Stefan Lippert

Simon - Kucher & Partners, Tokio

1 From Delight to Disenchantment

The hype over China has passed, despite the fact that the Chinese economic miracle continues. GDP growth of around eight percent is expected again in 2005, and, for the time being, in spite of high raw materials and energy prices, the market is not expected to cool down for a long time. But the international business community has been forced to accept the fact that GDP and profit growth are not the same thing. This is because, while an increased GDP offers more to distribute, business earnings are defined by revenue and costs; the difficult underlying circumstances are an added factor.

As of yet, there are no reliable figures on the profitability of foreign companies that have invested in China. Evidence suggests that the vast majority of the approximately one and a half thousand German companies in China has not yet reached the breakeven point and will not do so any time soon. „Sometimes it almost seems as if every relatively large firm believes that it must be represented in China. But very few of those that have expanded to China since the country's opening can claim presentable results"[1]. The same seems to apply for American companies in China: according to a study conducted by the University of New Haven, almost all of them have incurred losses. The meager total return of around 8 billion US dollars in 2003 in no way represents the total size of the market; in addition, almost one third of this amount can be attributed to five large-scale enterprises – three automobile manufacturers, Yum Brands (KFC) and McDonald's[2]. With regard to Japanese corporations, it has become noticeable that, after a strong engagement in China in 2002/03, companies are now starting to invest more strongly in Japan again – including production.

---

1 Ekkehard Rathgeber, CEO of a Chinese corporation, in: Kaufmann/Panhans/Poovan/Sobotka (Hg.): China Champions, Wiesbaden 2005, p. 195.

2 University of New Haven, CT, USA, Research Paper (4.3.2005).

Even if the transparency of the profit situation is limited and many corporations have no interest in accruing profits on site, it can be concluded that the boom in China hasn't brought most investors what they expected and that, even with continued strong growth of the Chinese economy, the real dry spell of consolidation, that is to say, the „endgame", is still to come.

But why is it that the true seriousness of the situation has not been sufficiently recognized as of yet, in particular with regard to German companies? It seems as if the Germans especially – perhaps fascinated by the contrast to poor macroeconomic performance at home – demonstrate an adversity to risk that far exceeds healthy entrepreneurial optimism: „Some companies seem to have completely lost their sense of the virtues of economics. The profits that they can expect to receive in the mid-term justify neither the investments nor the risks that companies are engaging in at the moment. Many of them completely overestimate the market potential and their ability to achieve the necessary market share. There is no guarantee that they will be able to compete against local Chinese businesses. In many industries, there is already a lack of profitable investment opportunities. (…) Many managers in the company headquarters have succumbed to a veritable investment frenzy with respect to China. They now fear that they might miss this seemingly unparalleled opportunity and therefore put enormous pressure on the local management and, at the same time, ignore the risks. Presently, many only see the opportunity side of the China coin and are blind to all of the risks involved."[3]

Such positions are well-known in the area of behavioral finance: The majority of all people handle wins and losses differently. Losses are often found to be more severe than wins; according to current studies, the factor is between two and two and a half. This also explains why investors often ignore the old rule of letting profits run and limiting losses as quickly as possible. Since losses hurt so badly, many throw caution to the wind and raise their bets in order to prove to others that they aren't losers. This behavior cannot be observed in winners; in general, they usually tend to play it safe early on in the game. This may also explain why China investors, who pinch pennies at home, use long-term considerations as an excuse to burn money in China and, apparently, receive no pressure from the shareholder side to do otherwise. Another consequence of this behavior is the fact that capital tied up in China cannot be used profitably in other markets.

[3] See Footnote. 1, p. 194f.

2 Why Is So Little Money Being Made in China?

Ranking first are the *revenues*, *which have turned out to be much lower than expected*. In light of strong competition and fast-growing capacities, strong GDP growth does not automatically lead to rising revenue. They can counteract each other, as the VW example shows. Though its market share in the late 90s was a good 50%, it is only half of that today - and falling. Korean and Japanese competitors have pushed forward and are expanding their capacities while VW has made a sharp turn towards consolidation. But what is driving the poor revenue performance?

– *Product policy*: Many German companies are positioned in the premium price and product segment which, with regard to pricing and costs, promises attractive profits but, with regard to volume, is structurally limited in China. Furthermore, there are few opportunities for downward growth because the risk of brand dilution is too great. This predicament of being – „stuck at the top" – affects B2C and B2B markets. Peak technological performance is expected of German vendors, but often not supported by the respective willingness to pay. For B2B business in particular it is important to note: competitors that offer 80% of the performance at 50% of the price make the deals in China. The 20% additional performance in German products is not backed by customers' willingness to pay and is, in this respect, over-engineering. But the path to the next lowest segment is generally blocked due to positioning and pricing issues. This is further aggravated by the unwillingness of many German companies to adapt their products to different countries or even regions. In certain cases, there may be good technical and/or commercial reasons for this but, in the end, German companies that fall behind Japanese or American competitors in their flexibility are only hurting themselves.
– *Pricing policy*: Even today, price decisions and price enforcement are often designed according to rigid cost-plus rules or simply based on competitor pricing. But, particularly in such difficult and competitive markets as China, it is especially important to develop an accurate understanding of the customer: Exactly how much is a customer willing to pay for what and how can this willingness to pay be exploited effectively? In doing so, it is not only essential to take price level adjustments in to consideration, but also to weigh the benefits of structural improvements: price differentiation (e.g. non-linear pricing) and bundling, in some cases with regional or segment-oriented adjustments. Intelligent pricing is the strongest earnings driver and offers three advantages to

volume increases and cost reductions: speed, low capital expenditure and direct financial impact.

- *Communication policy*: Communication must also be targeted toward the value to customer. A single-sided focus on product performance generally does not lead either to ideal revenue or optimum profit. And the peculiarities of Chinese perception must also be considered: Technical performance and perfection in detail are appreciated but they should be embedded in a larger, integrated context. A sales brochure that merely lists a series of technical performance factors has little chance of success in China: It is considered to be a manifestation of western rationalism, which is missing the warmth and sensitivity for the things that truly count in life. So, for example, while an advertising campaign which employs philosophical poems to praise a new industrial zone would be offensive in the West, it would be considered completely appropriate in China.
- *Distribution policy:* In sales and logistics, it is also important to maintain a balance between East and West. On site there is often a lack of trained personnel; management and sales methods are as inadequate as product and process understanding. This sort of personnel will not be capable of professionally achieving segmentation according to customers, regions and products and aligning the distribution policy accordingly. Further, ompetent employment of business practices on site plays a decisive role, to which the continuous integration of all stakeholders - including the political and administrative authorities - belongs. It seems obvious that a Chinese organization is much more capable of this than a western corporation driven by the spirit of financial controlling.
- *Concubine economy*: Western OEMs that have invested in an assumed First Mover Advantage in China have often been played against each other by the state - in a manner similar to the concubines at the emperor's court in ancient China[4]. The Chinese government, which, for example binds western automobile manufacturers to Chinese partners, is banking on technology transfer. The stronger the belief in the First Mover Advantage, the more likely western companies are to agree to these terms. A good example of this are the concessions of the Japanese Shinkansen high speed train consortium which competed against the German ICE train for a major 12 billion US dollars bid and won. In some cases, major Chinese automobile manufacturers will cooperate with two different Western corporations that are in direct competition with one another (e.g. Shanghai Automotive with GM and VW). The „divide et impera" principle puts pressure on the profitability of western

[4] Cf. Frank Sieren, Der China Code, Berlin 2005, p. 250ff.

companies, which are practically defenseless against this game as long as they do not limit themselves exclusively to sales-only business in China.

- *Suppliers*: Many western suppliers went to China with their OEM customers without exactly knowing what to expect there. In the vast majority of cases, these companies remained dependant on the OEM's demand. Business expansion through supply to additional OEM customers only proved possible in a small number of cases. This obviously limits revenues and profits. Ignorance of the Chinese market conditions often played a key role on the part of the suppliers. These companies invested large sums of money based solely on their trust in their OEM customers and in their own company's talent for improvisation, which, from today's standpoint, will only pay off in the very long term at best.

Ranking second are the *costs* of investment in China, which are often underestimated. The supposed low-wage country China has consistently proven to be a location with the actual cost structure of an iceberg. Which specific cost drivers can be accounted for?

- *Top management attention*: Commitment in China must be at the top of the management agenda. This applies to the corporate headquarters as well as to the Chinese office. Whether the top position on site is filled by a Chinese manager or an expatriate is a widely discussed, yet subordinate question. The most critical factor is that, along the entire supply chain – from strategy determination to operative control of purchasing, production and sales – top people are on site that are in constant, close contact with and receive the necessary support from the main office. Many China investments, especially those from mid-market companies have failed due to a lack of human and capital resources.
- *Quality problems*: High rejection quotas for locally purchased products which sometimes reach levels of 50% and more reduce or completely eliminate the unit cost advantage. In addition to costs for visible products and processes, a level of complexity evolves which must be kept in check. Based on experience, this „invisible factory" leads to additional costs of 20 to 30%, which, however, cannot be clearly allocated and are therefore difficult to battle. Conventional „Quality Management", which works after the fact and from the top down, doesn't do the job. Quality develops from the start and in a bottom-up fashion: with the pre-supplier and the delivery, in the individual process steps within one's own organization, in the delivery to the customer, in complaint management. It is difficult to describe this process-oriented way of thinking to Chinese employees but it is crucial in the mid and long-term, because China is

no longer suited as a purely low-cost location where the simplest products are manufactured solely based on cost factors.

- *Missing standards*: One way of dealing with the „invisible factory" is implementing and strictly enforcing standards. The success of Japanese factories in China is inextricably linked to the standardization of products and processes. Standards must be diligently communicated and exemplified by management. Clear, visualized work instructions and self-imposed pressure through team work are important building blocks on this path. Quality which is high enough not only to reliably and profitably supply the local market but also demanding third-party markets requires quality consciousness at all levels in the company. It is here that western companies can learn much from the Japanese manufacturers in China (e.g. Honda).
- *Educational measures for local employees*: Costs are driven by high turnover among employees and the prevalent attitude that selling one's own labor here and now at the highest possible price (and not investing in the acquisition of specialized skills and, as such, bearing certain opportunity costs) is acceptable. It is not easy to find either blue collar or white collar functional specialists with industry experience. Alternatively, it is certainly possible to train such specialists but after one or two years this often results in providing a neighboring competitor with a well-trained (and informed) workforce. Unlike Japan, the company one works for is not considered a type of family with life-long membership, but rather as a station in transit; this also reflects the upheaval in Chinese society, the break up of hitherto existing social structures in the country and the push into the cities. The only long-term relationships are those within one's own family; every thing else transient.
- *Increased labor/property costs in boom areas*: The most highly frequented locations in the metropolitan areas of Shanghai, Beijing and Guangdong are in terms of costs by far not as attractive today as they were ten years ago. There are alternatives in the Northeast (Dalian/Shenyang/Changchun regions) and in the Chongqing area. The problem in these areas is that qualified foreign personnel can hardly be won; even high-paid leadership positions at renowned international corporations remain unfilled for months at a time because no suitable candidates can be found. This problem is often underestimated by executives that fly to China for two or three days, make a short trip to the factory, meet with local authorities and then fly home.
- *Recruiting/retention costs*: Chinese managers and employees display a high tendency to switch employers even if wage differences are minimal. Only when wages are paid at rates far above the norm – as a gen-

eral rule, German companies tend to calculate an extra 100% – can there be a certain amount of stability but, naturally, at much higher costs than originally calculated. The use of pay scales popular in the West for Chinese labor in different regions is therefore rather limited. An investment calculation should not only include significant wage increases in the coming years but also costs for wage premiums or – alternatively – continued recruiting and the respective training expenditure.

The third reason for poor earnings in foreign companies in China is the *difficult underlying circumstances*. Three core problems can be identified:

- *Lack of legal certainty*: China is a dictatorship, not a liberal, constitutional state of western mould. The high level of pragmatism and obligingness that the state and party are showing international investors should not belie the fact that there is no legal certainty in terms of „rule of law" but, at best, a „rule by law". It remains completely unclear how the communists will react if the economic upswing should end or if the internal tension should increase dramatically. With the exception of the Tiananmen Square Massacre, the past 25 years of China's history have been a fair-weather period. An entrepreneur class and a budding middle class have formed; the power still remains with the KPC functionaries. If this position of power were to be threatened, adventures in foreign affairs could not be ruled out; the well-organized anti-Japanese protest campaigns in the spring of 2005 showed how such a power play might unfold. The primate of politics is unchallenged and, at the moment, there is no evidence to indicate that the population's orientation on economic prosperity is leading to a drastic change in political conditions.
- *Technology theft/product piracy*: Even though increasing numbers of Chinese companies have a genuine self-interest in the protection of intellectual property, a strong change process on a broad scale cannot be predicted in the coming years. In the previous decades, political officials have done everything in their power to facilitate the flow of information from the West to China in both the scientific and commercial fields. Western universities and companies have supported these requests. No company was ever coerced into investing in China and adhering to the local rules of the game. In view of some, in part, grotesque cases – a German textile machine manufacturer, for example, reports on Chinese competitors offering an exact copy of their product at a neighboring exhibition booth – western investors have begun to rethink things; for example, an investor can place an emphasis on an investment environment with minimized risk, as offered by well-organized industrial areas (for instance, Wujin). Japanese companies have begun strictly separating their strategic core competencies or relocating them back to Japan. On

the mental side, it must be noted that the reproduction of foreign products is seriously considered as a type of reverence in China. As such, even well-educated Chinese can be heard saying, for example, that Yamaha should be proud of the fact that an estimated 80% of the brand's powered two-wheelers in China are clones. That merely proves how highly respected the company is. Here, the underlying opinion is that it is the natural role of the middle Kingdom to set trends even if only in the area of reverse-engineering.

– *Cultural differences*: In close relationship to the previously mentioned issue there exist deep cultural differences which can only be partially covered by mutual business interests and interpersonal „chemistry". In addition to the differences in day-to-day business practices, the framework of cultural orientation plays an important, often overlooked role. The basic frame of reference for the Chinese is the family, more so than the country or the company. However, national pride currently plays a strong and increasingly important role. Achievements in space exploration and sports are accepted with enthusiasm. Among the well-educated, the notion that the world is returning to normalcy after the confusion of the past centuries is frequently observed: China, the middle Kingdom, the country around which others are centered (and, one must add, pay tribute to). These issues resonate subcutaneously when western companies invest in China; the notion of merely doing business and blinding out the cultural circumstances is naïve. Every investor should be completely clear on the fact that the cultural background will not change anytime in the near future and that, with increasing nationalism – the dominating orientation of the young elite studying abroad seems to point in this direction – the risk of total loss also increases. This is especially true when, due to a lack of size or significance, direct political support is not available.

3 Conclusion: Investment in China?

In light of the danger of a distorted perception of opportunities and risks, a commitment in China should be soberly addressed, regardless of whether or not a company has already invested. Realistic assumptions vis-à-vis the market and the available resources should be employed in developing a solid business plan. "Strategic relevance" should be quantified on the basis of the difference in the reflux of funds for an alternative investment.

Companies that are already engaged in China can choose from the following alternatives: If the investment is already profitable or, if the breakeven point is expected in the near future, then the company should remain in China and – if the market and resource situations permit – evaluate a stronger commitment. This is the simple case. The situation gets complicated when the breakeven point is significantly further out of reach than it would be with alternative investments. In this case, there are three alternatives:

- Alternative 1: Business continues to be conducted in the present manner. Marketing policy can be as much a deciding factor in this ("we simply need representation in China") as a well-founded prospect of a long-term Return on Investment.
- Alternative 2: Business is restructured. For example, only the parts of the supply chain that guarantee attractive returns are left in China, in some cases in cooperation with other companies (e.g. focus on sales, outsourcing of production, establishment of a local procurement platform with another company).
- Alternative 3: Business is sold. China is served as an export market, for instance while cooperating with local distributors or licensees.

In years to come, investment and divestment activity will take place on many levels in China: Not only foreigners but the Chinese themselves will also take over business units or even entire companies that are for sale, whereby it is still unclear which shares will be accounted for by corporate buyers and financial investors. International financial investors are already waiting in the wings but it is also evident that the difficulties – legal and regulatory restraints, lack of transparency, management deficits, financing problems, uncertainty on exit channels – are still significant in China. The sustained inflow of capital, the increasing lack of attractive investment opportunities in North America and Europe, the rise in secondary and tertiary buyouts in western markets on one side, the consolidation and privatization of Chinese state-owned enterprises on the other side, could lead to China becoming the investment Mecca of the Asian continent.

All in all, China provides highly attractive opportunities for corporate and financial investors as well. But the key success factor is caution. Caution means deciding only upon solid information and the willingness to accept delays. Entrepreneurial chuzpe is unlikely to win in China.

The China Boom - What's Left for Us?

Frank Sieren

Wirtschaftswoche, Beijing

1 The Yellow Peril?

Radical changes have at least one unfortunate characteristic: they are not immediately recognized as such. The effects of China's boom are an example of how important it is to follow changes closely, even when they are taking place on the other side of the world, and to adjust to them swiftly, in an appropriate fashion. One is reminded of a family picnic being disturbed by the sound of distant thunder. Everyone wants to polish off the pâté-rolls before making a beeline for the Range Rover and then the heavens open.

China is certainly the good news world economy needs. This huge country has been booming for the last 25 years and has its internal problems under control. Its leaders deal calmly with new challenges posed by world economy, at the same time contributing to greater stability in Asia. All this against a background of more than a billion people, corruption, dictatorship and Manchester capitalism which by western standards would be considered a highly explosive cocktail. And yet none of this threatens to undermine China. On the contrary, it is getting stronger every day. Global structures are undergoing fundamental change.

China is a past master at skillfully exploiting the dynamics of capitalism for its own purposes. It seems reasonable to assume that this distant country's rapid ascent and aspiration to regain its role as the Middle Kingdom will have a more lasting effect on the personal destinies of young people in the west than just about any other factor. In a far more committed way than seemed to be the case initially, China has used globalization to weave a fine web of dependencies around us. It is setting world standards that even the leading industrial nations such as the U.S., Japan and Germany ignore at their peril.

Nearly everything we buy, from dustbins and shirts to CD players, notebooks and container ships is imported from China. China is not just the biggest producer of shoes and clothing, but also of mountain bikes, micro-wave ovens and mobile phones. It is even the world leader for high-tech products like notebooks. At the same time, China is not just the „factory of the world", it also represents the most promising market in the world for the sale of products. That is why, for a number of years, China has been attracting more foreign investment than any other country: over 60 billion US$ just in 2004.

2 China is Well Attuned to Globalization

The global upheaval, the epicenter of which is in China, is being driven by a motor propelling the world in a new direction: globalization. Migration, trade, wars, communication technology and travel have all played their part in putting people in touch with each other over the centuries. Nowadays global interdependencies are so complex as to no longer be visible to the naked eye. China and nearly all other countries in the world are being forced to co-operate ever more closely. Of course, economic globalization is several steps ahead of its political and social versions. This development is being influenced essentially by three factors which apply with almost uncanny accuracy: firstly, money flows to where the returns are highest and is withdrawn when these fall. Secondly, companies, nations and regions pursue world market shares to assure future profits and improve their standing in the world. And thirdly, thanks to new media and fast transportation, companies are less tied to particular places or countries.

China appears to be well attuned to these challenges – because China has a tried and tested business plan: it sells market shares in return for technology and know-how transfer. That is the bottom line whenever western managers negotiate with Chinese entrepreneurs. As a rule, it is the Chinese who benefit more from these alignments, because they can play off international companies against each other, while they have the trump card of being the market with the biggest growth potential. While China's leaders do have a good negotiating position, they are far too shrewd to overplay this card. China has learned from numerous crises in the U.S.A., Japan, South America and its Asian neighbors how to deal with the risks of globalization. Learning also from their own history, China's leaders have also developed a healthy mistrust of other countries. Just as the Emperors of the Han dynasty built the Great Wall over 2,000 years ago to protect the country against the Mongols, the leaders of the 1990's erected a modern-day protective wall against global financial flows: the Chinese currency, the „Renminbi", is not tradeable, but firmly linked to the US dollar. Stock markets, the financial system and the real estate market are to a great extent protected from foreign investors. The wolves of globalization have long picked up the scent, but China remains inaccessible for them.

3 China is Fortunate to Have No Competition

China can afford to limit the extent to which it opens its markets to the world economy, because as a market of the future it has something akin to a monopoly. The faster the pace of globalization, the clearer it becomes that China is unbeatable as a market of the future, given its heady combination of potential, stability, infrastructure, price levels, and production capacity. There is no other big country which can match its stability. This unique position enables China's government to stipulate the conditions under which foreign companies are allowed to enter the country. Chinese economic planners have devised a system which could be described as a „concubine economy". Competing foreign companies are obliged to form joint venture companies with a Chinese parent company. They must then seek the favor of that parent company, much like the concubines of former times, *vis-à-vis* the Emperor. In many globally important industries like the automobile, steel or chemical industries this is the prevalent system. Similarly Chinese politicians create conflicts of loyalty among the governments of powerful nations. The only certain winners in this game are the Chinese.

Although China is much more stable than generally assumed, it must confront problems at home more difficult than all the challenges currently facing the countries of the European Union, for example. China's greatest potential is also its greatest curse – its huge population. The creation of a social system that can provide 1.3 billion people with at least minimum standards of nutrition, medical care and education is currently way beyond the country's capacity. The ongoing struggle to distribute inadequate resources is carried out with great severity and human rights are a frequent casualty. It is the rural population which suffers most, i.e. some 2/3 of the total population. People die of AIDS, because they are treated with contaminated blood in state hospitals. Hardly a month goes by without miners being killed due to inadequately secured mineshafts. Even in urban areas there is little chance of people being treated according to the rule of law if they are suspected of a transgression. Political dissidents are pursued with unrelenting vigor. The Chinese government makes the point – with some validity – that it took more than just a few decades to implement so-called western standards of civilization – and that in much smaller countries. There can be no doubt that the people of China have the power to fight for and secure more freedom, should they choose to do so. The country is too big and already too closely connected with the outside world for the government to be able to impose its will on a rebellious population. It is, however, unlikely that human rights abuses and social problems will lead to an economic collapse. We should, therefore, get used to a few paradoxical combinations (at least by western standards) for the foreseeable future – macroeconomic stability and social chaos, economic boom and corruption, dictatorship and freedom. It does look as though these extremes actually have far less influence on each other than we would have thought possible.

Our hopes of deriving enough benefit from the Chinese boom to maintain our own standard of living will not be fulfilled. The Chinese boom is taking place in China and nowhere else. The Chinese are still buying our machines, but are beginning to produce their own, sometimes under license, more often as pirate copies. Chinese market regulators support domestic companies to the best of their abilities – often in breach of WTO stipulations. Under these circumstances it is only a matter of time before Chinese engineers adopt our technologies and develop them further. Between 1998 and 2002 China advanced in the world ranking order of high-tech locations from 31 to 21 – equal with France and in hot pursuit of Germany (no. 15). China's pool of talent is, of course, immense. Every year some 250,000 IT specialists complete their studies in China and proceed to work for a quarter of their western equivalents' salaries. Even China's age structure works in its favor: the population under the age of 18 is greater than the combined total populations of U.S.A. and U.K. A mere 10 % of the population is over 60 years of age.

4 Opportunities for the West

A shift of economic and political muscle to Asia makes it clear that Europe and America are not in the kind of cyclical economic crisis that can be overcome just by perseverance and positive thinking. The global risk society poses new challenges for which there are no easy solutions. Under no circumstances should we sit back and watch these developments which, in turn, create their own opportunities. As Sherlock Holmes said to Dr. Watson before sending him on his first case: „Don't develop theories before you know the facts". That certainly applies when making a sober evaluation of what is happening in China. If anyone thinks that China's boom is nothing more than belated modernization or the logical way down a long-established road to development, they are limiting their options considerably. China functions according to its own set of rules – a „China code". If we want to know how the world will be in future, we have to try and crack this code. To do this we have to look at things from a Chinese perspective.

China's self-image differs from our image of her in two fundamental ways. While we are waiting for the big crisis to happen in China, the Chinese are convinced that their big crises are behind them. And while we perceive China as emerging from its status as an underdeveloped country, the Chinese are convinced they are in the process of reclaiming their former mantle of greatness.

China's decline is indeed a thing of the past. It is some 150 years since a collapse which seemed at the time like the end of a civilization, but was in retrospect no more than a blip in the long history of China. It lasted a good 120 years and ended with the death of Mao Tse-tung in 1976. The Chinese have not forgotten how far they plummeted from their former pinnacle of success and how brutally hard the landing was. That China was once the Middle Kingdom gives its people self-confidence. And the more closely China becomes integrated in the world, the more people remember that China always went its own way.

5 The Demands of Globalization

In simple terms the three different regions of the world pursue different strategies to promote their influence globally. The Americans use force of arms, the Europeans have values and the Asians – especially the Chinese – do it with merchandise. Until well into the 18th century force of arms, i.e. the law of the jungle was the most efficient way to become more powerful. The wars in Korea and Vietnam, the Cold War and more recently, the second Iraq war, have demonstrated to the U.S. the increasing difficulty of achieving and maintaining dominance by force of arms. The Chinese, on the other hand, seem to have developed their own effective method of increasing their influence in the world - as swift and penetrating as it is inconspicuous. The invasion of Chinese products is barely noticeable, but represents an influence far more subtle, long-lasting and powerful in effect than any military incursion.

6 The Concubine Economy

The effects of China's rise on western economies have been considerable. Up to now we have been able to learn from China. But now we have to change. With the „concubine economy" the Chinese created an economic precedent - a mixture of market and planned economy that not only integrated China into the world, but, above all, integrated the world into China. It operates in all the main industries of which the automobile industry was the first to be involved. Because all the industry's global players were determined to enter the Chinese market, they agreed to conditions of production they would never have accepted in any other country. They had to form joint venture companies with Chinese manufacturers, which also co-operate with international competitors and can therefore play off the different partners against each other. The Chinese always win. Chinese capitalism has developed one of the most effective ways of strengthening its own position – using foreign money and know-how. The Chinese are masters of practical implementation: „Sound principles are one thing" said Kenneth Arrow, the 83 year-old Nobel Prize winner for economics, in 2004 „Practice is something else. In that respect China has the best economic policy, although it violates sound economic principles".

7 The Globalization Trap

China's influence on the world economy and its dependence on it continue to rise. As a WTO member China is so powerful it can choose when and to whom it opens its markets. Neither the U.S.A. nor, by any stretch of the imagination, the General Secretary of the WTO can do anything about this new balance of power. China's strategy of gaining power through business rather than through values or force of arms is now paying off. Although China has begun to aggressively purchase mineral resources, both in neighboring countries and in Australia and South America, it is welcomed with open arms everywhere, as it does not attach moral conditions or requirements to business dealings with the countries concerned. China has set off a kind of global chain reaction. The nation's economic rise puts the power of the U.S.A. into perspective, because their economy is becoming increasingly dependent on Asia. Competition is forcing a growing number of U.S. companies to buy and produce cheaply – especially in China. This means job losses and less tax revenue in the U.S.A. The U.S. budget is under pressure. To finance their deficit the U.S.A. have to borrow increasing amounts of money abroad. These state bonds are bought primarily by Asian countries, especially Japan and China. They earn large amounts of money from the sale of their products in the U.S.A. At the same time the U.S.A. are under pressure from terrorism, Europe's new self-confidence and the strong Euro. The more Washington feels the U.S.A.'s power eroding, the more aggressively it reacts and the greater its concern about the future welfare of its population. That in turn depends primarily on the ability of the U.S.A. to secure sufficient and lasting supplies of natural resources. In that respect China and the U.S.A. are standing eyeball to eyeball. At the same time China's economic power is setting the agenda for global politics. One of the reasons for the last Iraq war was that China and Russia had begun to buy Iraqi oil fields. The U.S.A. were able to prevent that with a war. However, they were not able to prevent China securing a large portion of Iran's mineral resources.

The self-confidence of the Chinese government, under Prime Minister, Wen Jiabao, has been fuelled by their global successes. It has even dropped the policy founded by Deng of „growth at all costs". Under the slogan „the people first" they now see it as their primary task to distribute the country's income more justly. One consequence is that they will do their level best to assure that China creates jobs in China, not in the West. If China was a victim of globalization thirty years ago, it now represents a „globalization trap" for the West.

8 What's Left for Us?

The global shift of economic power is also to be seen in a renewed cultural self-confidence. Just as the Kingdom of the Middle felt able to determine the values of the world in the 19th century, until the West disputed that right, so China now disputes the universal validity of western values. All that needs to be said to that is: different countries, different customs. However, it is difficult for us to accept this: the frequently held notion of the development of China as „belated modernization" suggests a development measured by common standards. But this is not the case. The alternative will only emerge gradually. Then, the multi-polar world order will be reality. But multi-polarity also means a relative shift in our position. The western elites (and to a certain extent also Japanese and Korean elites) display the usual behavior of established groups *vis-à-vis* outsiders. Their self-image is derived from the most progressive of their own members, and the image of outsiders based on the most backward underdogs imaginable. Stigmatized to this degree, they do not appear capable of posing a threat. Western culture would be well advised to adapt to a fundamentally new position. If China's ascent continues as it has, then for the first time in modern history the West will see itself competing with an „haute culture" equipped with the economic muscle to be taken seriously worldwide. Nowadays, for the first time in history, the Chinese are even making a name for themselves as global heroes. Chinese sportsmen, writers, musicians and actors now have the opportunity to become world stars and lengthen the list of world-famous Chinese personalities, limited until now to Confucius, Mao Tse-tung and Bruce Lee. China's expansion of power is taking place at just the right time.

9 China Creating a More Just World – At Our Expense

One look at China should make any left-leaning politician worth his salt rejoice at such a gigantic redistribution of wealth. Never before has so much money been channeled from the First to the Third world as with the investments in China. The industrial nations have so far transferred 530 billion US dollars to China. Furthermore the country profits from every exported product „Made in China". In 2003 exports amounted to some 440 billion US dollars; a growth of some 40% over the previous year. The boom is not evenly distributed, but even the income of the poorest of China's citizens has increased fourfold in the last twenty years according to the World Bank. For the first time ever, one country can succeed in reversing the long-term trend of global income development: in 1820, the per capita income of the poorest compared with the richest country in the world was 1 to 3. In 1992 the ratio was 1 to 72. One of the few prognoses that Nobel Prize winners for economics agree on, is that China's meteoric rise will lead to a more just distribution of the world's wealth over the next 50 years. „The per capita income in countries like China will grow more quickly than in the more advanced countries", predicts George Akerlof. His colleague, Milton Friedman, agrees: „The main reason for today's imbalance is the difference between developed and underdeveloped countries. This difference will decrease in size in the course of globalization." Lawrence Klein concurs: „Growth is so promising in China and India that poverty has already been reduced to a considerable extent." Even Joseph Stiglitz, the leading critic of global institutions, is sure that „the Chinese will have higher incomes. Even when it is no longer growing at the same rate as in the last 25 years, the imbalance between China, the EU and the U.S.A. will decrease substantially."

Paradoxically, what critics of globalization demand at their demonstrations is in the process of happening throughout China. It must be a sobering realization for them that redistribution of global wealth would take place without their advocacy. It is not the political pressure of critics that has changed the world, but, of all things, the very global economic system they denounce. It might even be said that to some extent globalization is devouring its critics.

The good news is that there is a chance of a better world. The bad news is that the way the world is going, every day the Chinese become richer means we grow poorer. Years ago we would have used the racist expression „yellow peril". But it is not the Chinese who threaten us. They are just acting shrewdly according to the capitalist rules of the game we put in place. That is both the big surprise and the huge dilemma of the early 21st century: capitalism is putting China's leadership in a position to distribute the world's wealth more fairly – at our expense.

Tao, Strategy and Li

Chin-Ning Chu

Asian Marketing Consultants, Antioch, CA

> The proficient warrior, in ancient times,
> first secured his own invincibility,
> then waited for his enemy to provide the opportunity for victory.
> To secure oneself against defeat depends on your own efforts,
> while the opportunity for victory is presented by the enemy.
> —Sun Tzu (4.1)

As the good Chinese proverb goes, „The Marketplace is a battlefield," and Sun Tzu, the ancient Chinese strategist, emphasized that the first and foremost importance in war is self-preservation; followed by victory over your opponents. For 5000 years, the most important golden rule of Chinese commerce has been a single, powerful word: Li. Even as the Chinese practice the high ideals of the Tao of business, they always keep their eyes on the realism of the Li of self-preservation.

> Secure your Li (gains) first,
> then add the world's Li to it.
> —Chinese proverb

The secret of winning in China's market lies at balancing the paradox of two opposing forces: Tao (Ethics) and Li. Everything is a numerical game; sooner or later your numbers will tally; your house of cards will crumble or pay off. Yet, one thing is certain; the ultimate self-preservation strategy in China is being ethical in your business dealings.

Good Intention is not Enough to Govern

> Good intentions alone
> are not enough to govern.
> —Meng Tzu

Meng Tzu was the greatest student of Confucianism, born 200 years after Confucius. In the world of paradox, ethics alone does not always get you to your destination; sometimes you need to be like a dragon possessing a fox's wit. A proficient Chinese marketer is one who is morally and spiritually ethical; one who is an aficionado of the Chinese, the people and culture, and one topped with a proficiency of strategic intelligence.

Make Your Move According to Li-Profitability

> The reason your enemy will come your way of his own accord
> is because he is motivated by Li (potential gains).
> —Sun Tzu (6.3)

Once Tao is established as a given, but the motor that drives Chinese commerce is Li. Without Li, there would be no human evolution, no new inventions, no business, and no war. Because humans are programmed as animals with a strong sense of survival, we seek gain from every situation. While Li functions as the motor propelling one to action, Tao is the brakes that prevents one from recklessly derailing.

The ancient Chinese sages and wise ones told us:

> When your self-gain is in line
> with the gain of the greater world,
> then, as you rise, the world will benefit.
> When your gain benefits your family,
> your family will support you.
> When your gain benefits the village,
> the whole village succors you.
> When your gain benefits a nation,
> the citizens get behind you.
> When your gain benefits everyone under Heaven,
> the whole world will endorse you.

For this reason, so many corporations that truly have their Chinese consumer's interests in mind put forth a great effort through marketing programs to convince their consumers that „I will build my gain based on your gains.“ When your gain and my gain are two sides of the same coin, we have the impetus to synchronize our actions.

In every lecture I deliver, it is guaranteed that someone in the audience will ask me, „Do the Chinese believe in ‘win-win’ or only ‘win-lose’?“ The answer is, „Yes, the Chinese believe in win-win among their allies, and win-lose with their enemies.” In a business situation, your alliance is a symbiotic relationship with your customers and benefactors, and your enemy is your competitor. Yet, beware the golden rule of war: there is no eternal enemy; your competitor today may very well be your customer tomorrow.

The originator of the Chinese Bing Fa, Tai Gung Wong, 3,500 years ago, stressed the same point when he said:

> When benefits are mutual,
> then co-operation will follow.
> Mutual co-operation results in benefits,
> thus leading to affection.
> —Jian Tai Gung’s Art of War

Humans, as survival-driven beings, follow the unconscious: unwritten laws that mandate the principles of utility and mutual benefit. By adopting the principle of Li, we can get things to go our way.

Let the Chinese Use You

While you are looking to benefit from China’s market, see how you can be useful to them. If everyone is looking for how to gain, who is going to be the giver? If there are no givers, only takers: then what?

Take inventory of what you and your company have to contribute. You can not give illegal bribes, even though some may welcome it. But personal friendship in terms of kindness, support, wisdom, guidance, and professional know-how are valuable to the information hungry Chinese who has his eye on the corporate ladder. With limited resources, you should select a target that is in line with your personal and professional objectives, such as lending your expertise to organizations or individuals that share the same aspirations. By helping them, you shine; and thus, ensure your own gain.

Ripple Effect of Li

In Sun Tzu's book, all the strategies are interwoven to create an ever-expanding ripple effect. In the midst of these ripples is the circle of „know thyself and others," encompassed by the wider circles of Tao, Tien, Di, Jiang, Fa, and finally, the last circle, Li – gain – the desired outcome. This is the underlying dynamic that drives Sun Tzu's „Art of War" to action.

These circles are not necessarily in the order I have illustrated, because they are interconnected; I could have drawn another picture that shows you „know thyself and others" as the outermost circle, where all other elements are layered within and the innermost circle is Li. These circles appear randomly, so do not get stuck in any order that materializes in your venture with China.

China's marketers are governed by Tao while they maneuver strategies to achieve profit; good fishermen do not look for an instant catch, they set the line long and deep, and then they wait. Whether your aim is for instant profitability or long-term gain, ruminate on the possibilities encircling Li – while never losing sight of Tao.

This article is excerpted from Chin-Ning Chu's book: Wisdom of the Kings: Ultimate Guide to Strategic Thinking according to Sun Tzu's Art of War.

Part Two

Strategies for Market Entry and Business Success

Conquering the Dragon – Entry Strategies for the Chinese Market

Jana Schmutzler de Uribe, Bernhard Ebel, and Markus B. Hofer

Simon - Kucher & Partners, Bonn

1 Does the Earth Tremble?

"China is a sleeping giant. One shall let it stay asleep, as if it awakens the earth will tremble." Napoleon

About 300 years ago, Napoleon predicted a scenario that seems to apply to present times. The death of Mao Zedong heralded a new era not only in Chinese politics but even more in the Chinese economy. In the early course of the economic reform process, China gave up its policy of "self-reliance" and started accepting assistance from abroad. A wary, yet steady unfolding to the outside world that entailed increasing foreign economic connections was one of the most crucial driving forces for the change in the economic order.

In the early stage of the reform process, China emerged as one of the largest recipients of Official Development Aid (OAD); for the succeeding years it has been receiving one of the biggest shares of foreign direct investments (FDI). The development of the foreign capital inflow reveals how the pendulum has swung from one extreme to the other. Early skepticism paired with an underestimation of the Chinese economy has given way to great euphoria.

No wonder: China has grown at an annual average rate of about 10 percent. And even the recent attempt of the Chinese government to force its economy to land softly did not substantially slow down its rapid growth. At the same time, this growth spurt coincided with a sustained economic stagnation, even recession, of most of the Triadmarkets. A seemingly huge market of 1.3 billion potential customers promise a great future compared to the stagnating and saturated Triadmarkets. Low factor-costs offer a solution for the international companies in their search for cutting costs. However, one should remain realistic when talking about China.

Looking at the Chinese market means looking at the coastal region, encompassing the province of Shandong in the north to Guangdong in the south, including the major cities Beijing, Shanghai and Nanjing along the Eastern coastal line. Most of China's Gross Domestic Product (GDP) is generated in these provinces, most FDI are finding their way into that region, and most exports have its source in China's East. And it is here, especially in the major cities, where the middle class of China, approximately 100 million people with the necessary purchasing power, is found.

China's labor costs are low, but there is only one direction the income can take coming from such a low level: upwards. The consequences of this development can already be anticipated in the booming coastal cities. For example, rural incomes in the Pearl River Delta, China's manufacturing heartland, rose 10.6% in the first half of 2004[1]. A shortage of skilled laborers has already been observed for some time. However, even a shortage of unskilled labor is becoming more and more visible. And although China can still benefit from a large and cheap rural unskilled workforce, this pool is drying out. Furthermore, China's baby boomer generation will enter retirement age in about 10 years, putting an end to China's demographic advantage of rich labor sources.

What can be said about the sleeping giant? It has awoken and the world is feeling its presence. However, China should not be forced with fear but with curiosity and openness.

2 Should You Conquer the Giant?

"Know your enemy, know yourself and you can fight a hundred battles with no danger of defeat." Sun Tzu, The Art of War

Looking at the newspaper, there seems to be no doubt: any company which wants to compete on the global market place has to be somewhat active in the Chinese market. Such an answer might be true for the global players: but is it necessarily true for any company? The potential is impressive – but so are the risks.

---

[1] http://www.asianlabour.org/archives/002490.php.

The early success stories of foreign companies – often a result of skimming off the wealthiest Chinese in the big cities along the east coast combined with the advantages of being the early entrant – may create a false picture of the sustainability of economic success for foreign companies in China. Take, for example, the automotive industry: Volkswagen has been doing business in China since 1985. It was the first Original Equipment Manufacturer (OEM) to enter the market – this has paid off. According to Goldman Sachs' estimates, Volkswagen earned 70 to 80% of its earnings per share in China. However, with production capabilities rapidly building up in the last two to three years, supply is about to surpass demand. Competition is now not only stemming from the growing number of global OEMs. Chinese automotive manufacturers, long considered to be one of the big losers of China's entry into the WTO due to their lacking quality and economies of scale, are catching up. As a result, today's automotive market is shaped by fierce price competition with rapidly diminishing profit margins.

Among the thousands of foreign-invested companies in China, it would probably be difficult to come up with a truly novel market entry strategy. And even if it were possible to do so, it is also possible that an identical strategy could succeed in one instance and fail in another. Thus, any strategy must be tailored-made to one's company – an approach not taught in any book. However, a guideline regarding what should be done and which pitfalls can be avoided can be given.

There are three questions that any company considering expansion into China should honestly think about: Does China fit into the company's overall strategy or are we blindly following a current trend? Why do we want to enter the Chinese market? What are my competitive advantages and how can they be useful in China? The current spirit might entice a company to rapidly answer these questions: the competition is increasing in China and it seems that whoever waits a little longer will not be able to get a slice of the cake. However, as Confucius has already said: "Desire to have things done quickly prevents their being done thoroughly." Take the current example of OBI, which opened up its first Chinese do-it-yourself-store in 2000 and is now retreating from the Chinese market, selling its holding to its competitor. The supervisory board of the company states on its webpage that it wants to focus its expansion plans on Europe. Having thought about them five years ago might have saved OBI resources that they spent in China and could have been used elsewhere in a better way.

The reasons for entering China will be different for every company: one company that is focusing on Europe might think about sourcing in China to lower its costs and compete with lower prices in Europe, whereas the global leader might want to market in China to exploit the opportunities of so many potential consumers. For a company producing computers the reason again will most likely differ from a power supplier – even if their strategic alignment were similar.

In order to successfully compete in a specific market, a company should carry out a thorough analysis of the market regarding its own competencies, the competitors, and the customers (strategic triangle). Just how difficult it is to get the relevant information one is revealed by a German company. Even though they had done their homework by conducting a market research survey, which revealed that there are three major competitors currently operating in the Chinese market, the company could not meet sales expectations. A second market research showed that small local manufacturers, who at first sight had not been considered to be serious competitors, were in close contact with the local authorities issuing the technical accreditation. This strategic advantage helped them succeed despite having several disadvantages when compared to the "three major" competitors. Thus, when investigating the competitive environment one should identify both domestic and foreign competition, their level of technology and price. This might already give some indications of what Chinese customers might prefer. Chinese customers are different from their European and/or American counterparts. Consequently, their potential reaction to the foreign product should be tested in advance in case of potential adjustments which need to be made.

It is not only important to know the elements of the strategic triangle like the back of one's hand, but one should also have a good sense of how these three elements relate to each other. It is, for example, not sufficient anymore to have a good product in absolute terms to satisfy its customers. One must be better than its competitor. The video system 2000 of Philips/Grundig, for instance, was considered to be technically superior to the VHS system of Matsushita, but Matsushita succeeded in installing the VHS system as the worldwide standard by penetrating the global market. This means strategic competitive advantages must be generated and defended.

What constitutes a strategic competitive advantage? It must – as the graphic below shows – concern an attribute that is important to the customer. This advantage needs to be perceived by the customer to be a real advantage. And it must be sustainable to some extent with competitors not being able to copy it within an instant. One must be aware that the strategic competitive advantages might differ substantially from one country to another. Both, the importance of an attribute as well as the perception of its superiority are entangled in the culture of the country – and that the Chinese culture is substantially different from the European, the American and even the Japanese is widely known. The question of whether a specific competitive advantage is sustainable and cannot easily be copied has quite a different denotation in China, the land of the copycats. As a result, it is even more important to investigate this point.

In addition to the three elements of the strategic triangle, it is inevitable that time should be spent for investigating laws and regulations by which a company might be affected. China's entry into the WTO has initiated a flow of new regulations and laws. Many of these laws affect foreign-invested companies. For instance, one that was launched in April 2004 extended the full distribution rights to foreign-invested companies. This law now allows foreign-invested companies to distribute not only locally manufactured goods but also imported goods. The first resources when investigating laws and regulations are:

www.fdi.gov.cn
www.ccpitinvest.org
www.ccit.org
www.tcdtrade.com
www.macrochina.org

3 How Can You Conquer the Giant?

"Corporate leaders are beginning to learn what the leaders of nations have always known: in a complex, uncertain world filled with dangerous opponents, it is best not to go alone." K. Ohmae

There are three fundamental ways of entering the Chinese market: export, forming a co-operation with a Chinese company, or setting up a company on its own. All three forms offer advantages and disadvantages. Choosing one of them will depend on the company's overall strategy and how well it fits one form. Depending on the development stage of a specific market in China, the market entry strategy might differ as well. When at its infancy, a sole production base which serves mainly the Chinese market is the preferred option, because a more mature whole business set-up might become necessary with customers being more demanding and competition being more fierce. Whereas sometimes it can also be an option to serve the Chinese market only through imports.

Choosing the right legal form for a FDI is mainly dependent on

- experience and contacts a foreign company has in the Chinese market
- the decision about whether one wants to join in a Chinese partnership

– the financial and personal engagement
– Chinese regulations and laws depending on the product and the industry.

The following paragraphs give a short overview of the different legal forms.

3.1 Exporting

Perhaps the fastest way to enter the Chinese market is to export goods and sell them directly to one or more authorized trade group. Especially for those companies with few resources, it offers advantages. One does not need to invest heavily into evaluating and getting to know the Chinese market, as a distributor is well accustomed with it. The risk of loss is relatively low. Yet, especially in the long-run there are also some disadvantages that need to be considered. Exporting to China through a distributor means that one never has direct contact to its customers. Especially in a market so distinct from others, this can pose a significant disadvantage, as local insights are necessary to adapt products to the Chinese customer. Choosing the right distributor for one's products is a challenge, particularly because the manufacturer depends almost 100% on its distributor. Thus, the level of control is very low. All business activities of all companies and individuals engaged in import or export trade are supervised by the MOFCOM. After the revised PRC Foreign Trade Law, which came into effect in July 2004, an approval by MOFCOM is no longer required. However, any company wanting to export to China needs to register with this ministry. There are still many products for which import restrictions and quotas apply. For goods that are subject to such a quota, a license needs to be obtained. Another disadvantage which should be taken into consideration is the import tariff applied to every product. Even though China has lowered import tariffs upon the accession to the WTO, they still are high enough to form a strategic disadvantage. An exception to the mentioned regulations is the Free Trade Zones in China. Special policies involving exceptions to the common custom regulations apply, for instance no requirement for licenses or quotas (except for passive quotas).

3.2 Representative Office

Establishing a representative office was very common in the early era of FDI inflow into China. It is a relatively inexpensive way of establishing a presence in China and presenting one's company and product. Acting as a liaison between the Chinese market and the home office, it offers the advantage of getting into closer contact with the Chinese market and thus gaining more insights than exporting through a distributor might offer. However, Chinese law restricts the scope of activity undertaken by such offices to “indirect business activity“. This means that such an office may not engage in trade directly, receive fees for services, or sign contracts. Put into more general terms: any activity that a representative office might engage in cannot result in earnings or profit. The resulting disadvantages, apart from not being able to use the low production costs of China, are obvious: the representative office cannot act independently of the home office. Market opportunities, where a quick reaction is necessary, are more difficult to exploit. Any foreign company wishing to establish a representative office must achieve approval and complete formal registration. Going through these procedures can take time.

3.3 Joint Venture

For many years a joint venture was the only means for foreign companies to build a factory in China. And even though other legal means are now permitted in most cases, joint ventures still are one of the preferred legal forms for setting up a company in China. If a company decides to set up a factory by cooperating with a Chinese partner, the Chinese law differentiates between two main forms of a joint venture – the Equity Joint Venture (EJV) and the Contractual Joint Venture (CJV).

In an equity joint venture the profit and risk sharing is divided according to the investment shares. For the cooperative joint venture – which at times is called a contractual joint venture as well – it is divided according to the contract. As the cooperative joint venture is formed according to a contract, there is no minimum investment for the foreign partner. Hence, the cooperative joint venture allows for more flexibility in terms of organizational structure, management and assets. The contributions that each partner brings into the CJV do not need to be of financial kind. The CJV can be formed as a non-legal person entity and consequently there is no need to establish a new cooperation in China. Both parties involved may act as separate legal entities and bear liabilities independently. On the other hand, the EJV is usually structured as a limited liability company. The foreign partner has to contribute a minimum of 25% of the registered capital.

The advantage a joint venture offers, apart from the fact that the investment to be made is smaller than that of establishing a company in China on its own, is that the Chinese partner is well accustomed to the Chinese market, its consumers as well as its regulations and laws. Furthermore, a Chinese partner may already be familiar with the local authorities, which can open up doors in China. The foreign partner can benefit from this knowledge. Compared to setting up a representative office, sales and production activities can be carried out through a joint venture.

One of the biggest disadvantages – if not the biggest disadvantage – is that the foreign company is to some extent dependent on its Chinese partner and is giving up absolute control over the production in China. Protecting one's intellectual property is almost impossible with the Chinese partner not only having access to the production facilities but also with Chinese employees working at the production site. In many cases, the aim of forming a joint venture differs greatly between the foreign and the Chinese party. It is, therefore, extremely important to spend time choosing the right partner, negotiating well, and have a solid contract. However, as with any information in China, it is hard to obtain the necessary information needed about the Chinese partner.

Establishing a joint venture requires going through an approval procedure. In order to set up a joint venture, a project approval has to be obtained. A letter of intent as well as a feasibility study precede this project approval. Even though the letter of intent is not legally binding, it outlines the mutual understanding of the two partners.

3.4 Wholly Foreign Owned Enterprise

As already mentioned, apart from joint ventures the option still exists to found a company without cooperating with a Chinese partner. The Wholly Foreign Owned Enterprise (WOFOE) is the option chosen most often. In the recent past, this legal form has increased significantly, especially compared to joint ventures.

The most important advantage it offers when compared with a joint venture is the independence from a Chinese partner which also means independence from a partner's burdensome past – such as too much personnel, old production facilities or overestimation of fixed assets – and more flexibility in any decision-making process. There are no two partners with very different aims, goals and thinking patterns that have to come to a consensus. Long-lasting negotiations with a potential joint venture partner do not have to be carried out. A Wholly Foreign Owned Enterprise, in contrast to a joint venture, gives much more protection to the intellectual property, especially one that is process-based. However, it does not fully protect from infringements, as almost any product can – and most likely will – be copied by one of the seemingly indefinite number of copy-cats. Setting up a WOFOE requires – just as setting up a joint venture – an official approval by the Chinese government.

Compared to setting up a joint venture, the big disadvantage of setting up a WOFOE is that one cannot rely on a Chinese partner. Thus, insights into the Chinese market have to be obtained through extensive market research – a time and resource consuming activity. Sales and distribution channels also have to be established in this vast country.

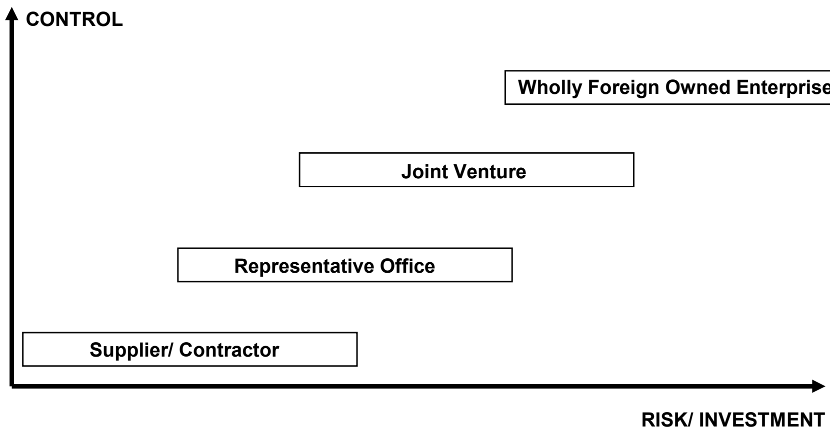


Fig. 1. Increasing Control and Investment – Entry Strategies for China.

4 Where Should You Conquer the Giant?

"Nothing can be more treacherous than to judge China according to European standards." Lord Macartney, 1794

The mere size of China poses an enormous challenge to foreign companies when entering the Chinese market. The geographic proximity to the customer – which matters for some companies more than for others – is difficult to obtain when a country covers about 9.6 million square meters. Thus, there are several approaches for coping with this challenge, especially when building a factory.

The gateway strategy, where a company starts to enter China in one region and then slowly expands to others, offers the advantage that it needs lower resources: at the beginning, one can test the market and the losses as failure is decreased. Its disadvantage, however, is that it loses the pioneer advantage anywhere else but in the region where it first enters the market. This disadvantage is not given once a company enters all the important regions simultaneously. This strategy requires a high amount of resources right at the beginning, the losses of failure are bigger, and no concentration is possible. Another strategy is to set up a production site in a central region and distribute products across China. Through this functional concentration a high market penetration is possible, but it is difficult to set up distribution canals, and the losses of failure are again higher.

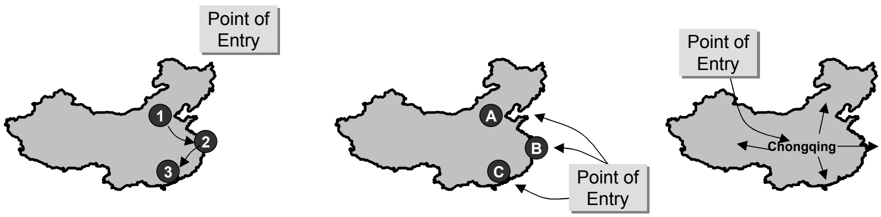


Fig. 2. Point of Market Entry.

No matter which strategy a company chooses, the location must be picked. And even though most global players prefer the capital Beijing or the booming mega-cities Shanghai or Guangzhou, regions along the periphery of the these cities can be especially attractive for small and medium-sized enterprises (SME).

Since China set up four Special Economic Zones in the mid-1980s, different "zones" alluring foreign investors with attractive conditions have sprung up like mushrooms all over China. The variety of names for these zones seems to be never-ending. ETDZ (Economic and Technological Development Zone), FTZ (Free Trade Zone), HIDZ (High-tech Industrial Development Zone), EPZ (Export Processing Zone) are just a few examples. In the face of more than 1,000 different zones on a national, regional and local level, it seems almost impossible to find the "right" one.

The following criteria might help when trying to decide which location(s) should be chosen:

- Geographical location
- Infrastructure
- Present local and domestic companies
- Cost and tax advantages
- Social and living environment
- Availability of work force
- Support of local government

The geographical location of an industrial zone needs to be evaluated for how well it is situated with regard to all of China and with regard to the bigger cities nearby. Factors like economic development, production factors as well as accessibility and size of the market volume are factors that need to be considered. At present time, two top economic regions exist in China: the Pearl River Delta in the south and the Yangtse Delta in the triangle Nanjing, Hangzhou and Shanghai. The economic development and market size are top – definitely one of the reasons why a high amount of FDI flows into these two regions.

A good transport connection to all the import economic regions of China as well as to overseas is of existential importance. Even though the Chinese government has invested heavily in expanding the highway networks, there are still regions which lack them. The proximity to the sea, which is offered along the big rivers and along the coastal line as well as an airport close by, offers alternative transportation means to street and railway. An adequate supply of energy and water, a well-functioning communication network and waste disposal need to be secured. The huge demand for electricity in China has created a shortage which at times results in blackouts.

The proximity to suppliers facilitates a smoother production flow and just-in-time delivery, which has gained importance. Research and production co-operations are made easier. For those companies working on a B2B level it is important if and how many potential customers are located in the region. Yet it is not enough to evaluate the mere number of suppliers and potential competitors. Qualitative factors such as product quality, innovation potential, willingness-to-cooperate and competitive strength are some criteria that need to be further investigated.

One of the main reasons to choose one of the industrial zones is the attractive tax conditions they offer. But the flexibility of local authorities makes an evaluation of cost and tax advantages difficult. Tax reductions might differ depending on negotiation skills; prices for land usage in the industrial zones are not always identical with official prices. Even though a comparison is therefore difficult to make it is worth while. Cost advantages of more than 50% between the periphery and the big cities are not uncommon and can be a decisive factor when deciding for a location.

The living environment and the recreational possibilities are important for future employees. While an attractive environment has been helpful in the last years to attract expatriates, it is becoming more and more important for attracting Chinese employees as well. Since a war for talents – especially experienced high-skilled workers and executives – has already broken out in the top economic regions and even a shortage of unskilled workers can already be felt, an attractive environment can not only help allure new employees but also help to keep Chinese employees in their company.

The top universities of China are mainly located in Shanghai and Beijing. Considering the excellent foreign companies located in these two cities, it is very difficult to attract well-educated talents from these universities. Yet this does not mean that a company considering a location outside of the hubs won't be able to find good employees. The opto-electronic valley in Wuhan shows that universities that are not considered to be top overall but top in one field can provide the research needed for a specific industry. A high concentration of companies in one industry can also be a good indicator for a strong technical level. However, a relatively high educational level alone is not a guarantee for good employees. Cultural differences and differences in the educational system make it necessary to prepare Chinese personnel for the expectations and demands of a foreign company.

The automotive cluster in Shanghai demonstrates just how influential the support of the local government can be. Local content regulations forced Shanghai Volkswagen to source from Chinese suppliers. Local suppliers received credits at lower interest rates. At the same time the local government raised prices for the VW Santana. The resulting cluster is today one of the strongest in the automotive industry. The support of the local government can pose a very strong strategic advantage and should therefore be evaluated thoroughly.

5 Conclusions

When evaluating the chances and the risks of engaging in business in China one should not follow the mainstream. Evaluate the market thoroughly, do not underestimate the risks and do not overestimate the opportunities. Remember, China is different as the following story tells:

When in 333 A.D. Alexander the Great started a campaign towards the East, someone in Gorion, the cusp of Asia, showed him an ancient knot. According to the legend, the mythical king of the Phrygians tied it. Whoever was able to dismantle it shall be victorious and become sovereign of all of Asia. Alexander the Great battered it with his sword (see: Bauer, W., „China und die Hoffnung auf Glück", München, 1989, S. 574).

China tells a similar story, which is written in the book "Spring and Autumn of Lu Pu" and goes it as follows. A man of Lu gave King Yuan of Sung a knot as a present. The King sent out a message to all parts of his kingdom that all clever people should come and try to dismantle the knot.

But no one was able to do so. A scholar of Erh Shuo asked to be allowed to try it as well. But he was only able to dismantle one half of the knot, the other one he could not. So he said to the king: It is not that one can dismantle this knot, it is only who cannot do so. But this knot cannot be dismantled at all. So the man from Lu [to whom the knot belonged] was asked. And he answered: Yes, it is true that one cannot dismantle the knot. I made it myself and thus know that it is like that. But one who has not made the knot and still knows that it cannot be dismantled is even cleverer than I am. The scholar of Erh Shuo dismantled the knot by not dismantling it. (Lü-shih ch'un – ch'iu, 17,2:202, as cited in: Bauer, W. "China und die Hoffnung auf Glück", München, 1989, p. 575)

Solving the insolvable can hardly be better pictured in its extremes than in those two stories. Alexander's sword did not solve the problem but destroyed it in an irrevocable way. The scholar of Erh Shuo on the other hand knew about the problem but he was afraid to take action (according to Bauer, W. "China und die Hoffnung auf Glück", München, 1989, p. 575). This example illustrates just how different the Chinese are from Europeans – a fact that one should not forget.

Competing in the Dragon's Den: Strategies for a Changed China

Local companies are now threatening multinationals' plans to conquer the China market. It's time for a new kind of response.

Peter Williamson and Ming Zeng

INSEAD, Singapore and Cheung Kong Graduate School of Business, Bejing

1 Introduction

The night before China's WTO entry, Motorola held its global board meeting in Beijing for the second time and announced an ambitious "$10 billion plan" for growth over the next five years. Ericsson, meanwhile, decided to more than double its investment in China to $5.1 billion over the same period. General Motors' plans call for Chinese operations, generating over $3 billion of revenue by 2008. By that same year, Bayer intends to have the second phase of its $3.1 billion, state-of-the-art production facility up and running, to meet forecast growth in its China sales. These represent just a handful of the thousands of multinationals, who have ambitious growth in revenues from China etched into their strategic plans. As China's accession to the WTO gradually opens up new markets and with continued market growth above 9% per annum, even those that have long resisted China's temptations are jumping in.

Experienced multinationals are aware of the many challenges they must overcome to build a successful business in China, summed up by the old adage, that in China: "everything is possible, but nothing is easy". Learning from the experience of pioneering companies, savvy investors know they have to contend with a minefield of competing local interests, overloaded infrastructure, difficulties in retaining skilled people, tortuous supply chains, unfamiliar local HR practices and communication barriers.[1] But few predicted what is fast becoming the most formidable obstacle to multinationals realizing their ambitions in the China market: the emergence of tough competition from local Chinese players.

A decade ago, the possibility that Chinese companies would pose a serious competitive challenge to multinationals looked improbable. It wasn't surprising, therefore, that, in 1995, just a few years after China's personal computer market opened up to foreigners, *The Economist* magazine predicted that by 2000, multinationals would have captured an 80% market share from their hapless Chinese competitors. Things started off well. Multinationals like IBM, HP and Compaq quickly won over 50% of the market.

But in sharp contrast to those optimistic predictions, the opposite has occurred. Just one year after *The Economist*'s confident pronouncement, the local company *Legend* (today *Lenovo*) became the number one PC supplier in China. By 2000, *Legend* owned 29% of the desktop PC market in China, with two other local players, Founder (9%), and Great Wall (5%), as number two and three. Respectively, Legend maintains its lead today, with a market share of around 30%. The combined market share of multinationals had dropped to only 20%. Instead of multinationals coming to dominate the China market, the local champions had eaten their lunch.

2 The Challenge of Local Competition

Our detailed research into the battles between multinationals and local Chinese companies over the past five years reveals that, while market dominance by local champions is far from universal, it is becoming ever more frequent. Take the case of beer. From the late 1980s, over 25 foreign brewers from the US to Denmark, the Philippines to Australia piled into the market. They were armed with global brands like Budweiser, Fosters, Carlsberg and San Miguel that were supposed to win over Chinese consumers at premium prices. In the last few years, after losing tens of millions of dollars every year, more than a few beer multinationals are closing capacity or, like Fosters, quitting the market altogether. And who is confidently buying up this capacity to fuel expansion across China? Two companies majority-owned by Chinese interests: Tsing Tao (in which An-

1 P.K. Jagersma and D.M. van Gorp, „Still Searching for the Pot of Gold: Doing Business in Today's China," Journal of Business Strategy 24, no. 5 (2003): 27-35.

heuser Busch recently increased its stake to 9%) and Snowflake (a joint venture in which South African Breweries is the 49% minority partner).

The same pattern is repeated in many more industries. In 1999, local manufacturers only accounted for less than 5% of mobile phones sold in China. Despite the intense focus on China by the industry's global giants (Nokia alone has seven subsidiaries and a substantial R&D centre there), by November 2003, Chinese companies had won more than 60% of the market, with two exponents, Bird and TCL, ranking number one and two in the industry – overtaking Motorola and Nokia[2].

Even more worrying, the challenge from Chinese competitors often seems to appear from nowhere and in record time. BYD Battery Inc., for example, only started manufacturing rechargeable batteries in 1997. In the space of 5 years, they have won a 15% share of the world market, second only to Sanyo. Nice Chemical, a small township company located in a remote area in China, became the largest detergent producer in China within two years of entering the market once dominated by global giants P&G, Unilever, and Henkel. Nice's total production volume is now four times larger than the total of all of the multinationals that produce detergent in China combined. Worse still, to fill their capacity, some plants owned by Henkel and P&G in China are supplying bulk detergent to Nice, a product that the company then markets under its powerful local brand. Meanwhile, local beverage producer Wahaha introduced its own cola brand "Future Cola" against Coke and Pepsi only in 1998. Future Cola captured an 18% of China's cola market last year, fast closing in on Pespi – the number two player. Today Wahaha is the largest beverage company in China, surpassing Coca Cola – despite Coke's consistent investment in building a network of local operations since 1979.

The message is clear: as China now opens its doors wider in the wake of the WTO, there are new opportunities, but – just as in more developed parts of the world – multinationals must now factor robust competition from local players into their strategies. David Taylor, general manager of P&G's shampoo business in China, sums it up this way: "These days new local brands are always coming at you. And we take them very seriously, whereas five years ago all eyes were on the other multinationals." This means multinationals have to make more of their potential strengths while trying to neutralize their weaknesses versus the local competition. Yesterday, local competitors were practically an irrelevance. In the next round, Chinese local champions, just as much as familiar global rivals, will be the ones to beat.

---

2 Official statistics by MII, although Motorola disagreed with the ranking.

3 Rethinking Competition in China

To understand the way competition between multinationals and local champions is evolving and to pinpoint the keys to success, we traced the evolution of competition in China in 10 industries over the last 10 years.[3] We conducted over one hundred interviews with dozens of leading companies, both multinationals and locals, operating in China, backed up by thousands of pages of secondary data, tracking measures like market share over time.

The picture of competition that emerged from our research can best be described, not in terms of traditional market positioning, but as a battle of competencies between multinationals and local players.

3.1 Multinationals' Advantages in China: Rhetoric and Reality

Multinationals generally start off with two sets of clear competence advantages: first, they have better industry-specific technology and know-how (including products, processes and systems); and second, they have a higher level of managerial competence in functions like marketing and brand building, financial management, and IT.

But multinationals also face four fundamental handicaps in the race to build competitive advantage in China. First, poor supporting infrastructure often prevents them from exploiting the potential of their advantages: given Chinese conditions, they simply can not use their technologies, know-how and functional skills to anything like full effect. Many multinational companies are equipped with sophisticated marketing and brand-building skills, for example, that are way ahead of most of their local counterparts—many of whom are still struggling to master elementary distinctions such as the difference between marketing and sales. But in order to deploy their marketing and branding expertise, multinationals need specialized inputs like detailed market research. These specialized inputs are often unavailable or poorly supplied in China, where good market research companies are scarce. So the multinationals either have to make do with inadequate inputs or perform these functions in-house (even when they lack the requisite skills). As a result, their ability to exploit their potential advantage in marketing and brand building is severely compromised.

---

[3] The industries were: home appliances, televisions, personal computers, telecom equipment, mobile phones, elevators, batteries, beer, drinking water, and detergents. We also collected less systematic information on such industries as animal foods, cameras, office equipment, retailing and fast food.

Likewise, many multinationals rely on strong distribution channels that can not only deliver their products reliably, but also educate customers on the more subtle advantages of their offering. But efficient logistics and distribution are new concepts in China, and there are almost no national distributors. Put a multinational's great offering through a Chinese distribution system and many of its advantages may be compromised by late delivery or damage. Characteristics that make the multinational's product superior may never be properly communicated to potential customers, because local distributors lack the knowledge or incentive to present them properly, or they may compromised by poor installation and operator training. Multinationals' potential advantages in supply chain management, meanwhile, are often rendered ineffective by the lack of competent local suppliers. Toshiba, for example, spent more than five years to develop a local supplier for one high technology component it needed for laptop PC production. Until it succeeded, its total supply chain performance was constrained by this weakest link.

Multinationals' second handicap is the lack of flexibility and higher costs that come with the need to ensure their China operations can integrate with their global organizations. This includes the extra costs of international coordination and the fact that implementation of international, corporate standards may put them at a competitive disadvantage to local rivals who are content to match Chinese norms.

Slower decision-making that can result from having to involve corporate headquarters and sister subsidiaries, meanwhile, can be a fatal handicap in a fast-moving market like China, where local competitors can „turn on a dime". At one Japanese firm in China we interviewed, it usually takes almost two years to approve a project. They are powerless to speed up the process back at headquarters, even though the managers on the ground in China knew that by the time a project is approved, it is probably no longer relevant to the market and competitive needs. Not surprisingly, of more than twenty projects launched by the company in China, only a few are making money.

Third, the fact that China's potentially huge market is still locally fragmented and plagued by provincial trade barriers and protection of local enterprises, means that multinationals' ability to reap economies of scale and spread the high fixed costs of implementing sophisticated systems and installing advanced equipment. In the beer market, for example, several multinational players initially spent money on national or regional advertising campaigns hoping to reap scale economies in brand building, only to find that it was impractical to supply significant volumes of product outside the province in which it was brewed. Otis Elevator, meanwhile, found it needed to maintain production facilities in multiple regions of China in order to respond to the buying preferences of city and local authorities that controlled the bulk of large building projects. Government regulations specific to foreign investors have aggravated the problem. Until recently, multinationals wishing to build their coverage across China had little option but to enter joint ventures with different partners in possibly tens of provinces. The resulting fragmentation of their operations involving local partners with different agendas makes seamless integration virtually impossible. These difficulties in exploiting scale economies reduce the gap between multinationals operating in China and Chinese enterprises which typically start from a strong base in a geographically limited, provincial or local market.

A fourth important factor that mutes multinationals' ability to build competitive advantage is the early stage of development for many markets in China. Despite the impression given by sophisticated consumers in central Shanghai or Beijing, over one billion of China's consumers can still only afford products that serve their basic needs so that superior quality, functionality, or service potentially offered by multinationals cannot be translated into premium prices or higher market share. The same is true for business and industrial buyers who are struggling to finance ever-increasing demands for new investment. The experience of a multinational that markets power transformers illustrates the point vividly. The company has two major product lines: one for installation in underground sites, the other for installation on platforms outdoors. In the underground segment the multinational thrived because the high costs of repairs meant buyers were willing to pay for superior reliability. But in the outdoor segment, where the vast majority of buyers were content with a cheaper, but less reliable product that could be easily repaired, its market share was less than 5%.

In sum, while multinationals have potential to build significant advantage in China, their ability to do in practice is severely compromised by lack of supporting infrastructure, the costs and inflexibility associated with international coordination, market fragmentation, and the fact that the bulk of potential customers currently demand products and services that meet their basic needs at affordable prices, rather than a sophisticated, premium offering. As a result, the actual gap between locals and multinationals in the areas where foreigners have the technology and functional competence to excel is much narrower than we might expect.

Of course this wouldn't matter much, if the Chinese competitors lacked advantages of their own. After all, Chinese companies also face the handicaps like lack of ready market research, inefficient distribution, and inadequate supply chains, and their level of industry expertise and functional competence is generally lower than multinational competitors in the first place. The problem is that Chinese companies do have unique competencies that need to be set against the multinationals' muffled strengths.

3.2 Reassessing the Chinese Competition

The advantages Chinese competitors enjoy fall into three basic categories. First, they have a better understanding of what will work in the local environment, be it the right advertising campaign, or the right way to incentivise their staff. Nice, the detergent producer we mentioned above, is expert in understanding the psyche of Chinese consumers. In one of its widely acclaimed advertisements, Nice shows a young girl helping her mother, who has been laid off from her job (or „Xia Gang" – literally „leave your position"—in the parlance of Chinese taboo) to wash the family laundry. The advertisement succeeds, because it connects with the emotional thread of „Dongsi" in Chinese society, something that has no direct counterpart in Western cultures. Roughly translated, „Dongsi" refers to a transition that happens, when a child starts to understand his or her role and responsibilities to the family and society – a critical part of growing up. Promoting this transition is one of the most important and satisfying achievements of a parent. Another advertisement simply urges consumers to „buy the right one, not the expensive one" – attacking the guilt complex consumers may feel as a result of their limited purchasing power in a status-conscious society.

Chinese competitors' understanding of local lifestyles is often subtle. In the appliance market, for example, while multinationals like Whirlpool launched large, impressive-looking machines based on foreign models, the leading Chinese competitor, Haier, pushed a machine dubbed „*Little Prince*" capable of handling small loads with very low consumption of electricity. Haier's insights: the fact that most Chinese parents prefer cotton diapers over disposable paper ones for their „little princes" – a label that itself taps into emotions associated with the „one child"-policy in China. As an added bonus, the machine was useful to the entire family during hot Chinese summers where clothes are washed daily. Little Prince became an instant hit, sold more than millions of units.

Another result of Chinese companies' detailed understanding of the local market is their ability to compensate for the limitations of existing Chinese distribution systems in a cost-effective way and access China's vast, but largely untapped, rural market. This affords companies like Legend, TCL and Wahaha a critical advantage compared with many multinationals that are poorly represented outside major cities. Starting in 1998 the computer maker Legend, for example, opened their 1000th store in October

2003, giving them a dedicated distribution network branded „Legend one+one" that now covers more than 300 cities.

Not surprisingly, local knowledge also helps companies manage the complex web of relationships that are necessary for operating in China. Such relationships – with state and local governments, buyers, suppliers, and those that control access to infrastructure – are seldom transparent. Even ensuring continuity of power supply, for example, is not always as simple as paying utility bills on time; it takes the right relationship to make sure that, when power is rationed, your plant is among the priority users. Multinationals that now have 15 or 20 years of Chinese operational experience under their belts, are very competent networkers, but those that have entered more recently generally lag behind their Chinese competitors in the subtle arts of managing relationships.[4]

A second key advantage often enjoyed by Chinese competitors compared with multinationals is that they are more flexible and leaner, with lower costs. This may seem paradoxical, given that these firms have frequently emerged out of the straightjacket of a planned economy. But after 20 years of reform in China, state-owned enterprises now account for only about one third of China's GDP, mostly concentrated in industries that are still heavily regulated – such as telecommunications and financial services. Many of the most powerful Chinese competitors are actually run by highly entrepreneurial people who have either built their businesses from the seed of a flexible „township enterprise", transformed a SOE into a joint stock company with strong managerial autonomy, or launched one of the new breed of private business emerging in China. Still led by their founding entrepreneurs, these companies continue to benefit from their early flexibility and cost-consciousness, despite rapid growth into giants.

A third advantage enjoyed by Chinese companies in many industries is that in today's open global markets, they can buy-in a significant proportion of the technologies and expertise they need, to catch up with the multinational competitors. In white goods, for example, where the technology is well understood and has been very stable, it is easy to buy a production line that incorporates technology capable of matching what multinationals can bring. Cola market challenger Wahaha, for example, was able to build the most modern production lines in the world using imported machinery – purchased in volume at a very competitive cost. With the world's highest concentration of manufacturers of components used in personal computers, located in DongGuan – a small city in the GuangDong province – Chinese

[4] D. Ahlstrorn and G.D. Bruton, „Learning from Successful Local Private Firms in China: Establishing Legitimacy," Academy of Management Executive 15, no. 4 (2001): 72.

PC makers have a supply of world-class technology on their doorsteps. Meanwhile, the latest tools and technologies developed in Silicon Valley now arrive in China within months.

3.3 A Battle of Competencies

Our reassessment of the real strengths and weaknesses of multinationals in China compared with their local competitors points to a coming race, where each group seeks to better exploit its inherent strengths while filling sharply different gaps in its competence base. Multinationals must find ways to overcome the limitations of China's inadequate hard and soft infrastructure, its fragmented market, the cost and flexibility handicaps associated with the need to integrate their China operations into a global network, and the need for very subtle adaptation of the offering to meet the needs of China's mass market, so that the potential advantages of their superior technology and functional skills can be realized in practice as well as on paper. Chinese players, meanwhile, need to acquire and develop an improved technology and build stronger functional skills so they can create the world-class products, services, brands and systems necessary to complement their subtle understanding of local consumer behaviour and distribution, their entrepreneurial flexibility and low cost base. In short, multinationals and local companies in China are both in a race to build new competencies that can help complement and exploit their existing capabilities before the other group establishes an unassailable lead. And interestingly each group tends to be strong in the very competencies the other lacks.

The starting positions in this race vary by industry. In industries like personal computers, white goods, and television sets, where technology is relatively stable and easily acquired and internalized; the market is regionally fragmented and local economies are critical to costs; distribution is fragmented and unprofessional; and local adaptation is critical. The Chinese champions (like Haier or Legend) have already developed or acquired most of the competencies they need to succeed. The multinationals in these industries are therefore faced with the struggle to catch up.

By contrast, multinationals start from a strong position in industries like medical equipment where the technology is complex and rapidly changing, where the technology and industry expertise is difficult to acquire (because it resides deep inside a few global firms), local knowledge is less important, it is possible to exploit economies of scale, and where functional management competence is critical.

Regardless of industry, however, multinationals have mostly time against them. The reason is simple: the competencies that they need to master, like a subtle understanding of Chinese consumers, or how to patch up the deficiencies in local distribution and supply chains, can not easily be bought. Instead, they have to painstakingly be learned „by doing". Conversely, what their Chinese competitors need, to fill the holes in their portfolio of competencies – improved technology and systems – can be more easily acquired on the open market. The wildcards in this contest are function management skills: just how fast can Chinese companies build or acquire access to world-class competence in areas like marketing, service excellence, product design, effective R&D and financial management?

4 Winning in the Dragon's Den

Facing strong local competitors and time as an enemy, what should multinationals do to cope with the new realities of the Chinese market and win the next round of competition? In this final section we discuss the prerequisites – things the multinationals need to get right before they even qualify for the race, along with five core strategies that can improve the chances of success.

4.1 Pre-requisites for the Next Round

Positioning your company to win China's next round of competition begins by setting realistic expectations. We expect China to maintain the seven to nine per cent growth rates it has achieved over the past decade for the foreseeable future. But all too often, the forecasts companies put into their strategic plans for China are unduly influenced by the need to meet corporate growth targets in the face of stagnant demand in the West and a mindset that casts the Chinese market in the role of the last, unconquered frontier. Growth plans need to be realistic about fierce competition emerging from local companies, as well as from other multinationals, for a share of China's growth.

To be competitive, many multinationals in China also have work to do to get their existing house in order. A mix of government regulation and opportunism has often resulted in China-operations comprised of an unwieldy collage of joint ventures, representative offices, partnerships and wholly-owned subsidiaries – sometimes numbering forty or fifty individual units. Such structures make it impossible to achieve economies of scale and to start building national brands or unified and consistent distribution and service. Multinationals can now form foreign-owned joint stock companies that fall under China's new Company Law rather than the tangle of regulations generated by China's Ministry of Foreign Trade and Economic Cooperation.[5]

Path-breakers like Kodak, Alcatel and Unilever have already completed this kind of restructuring. In March 2003, Nokia announced that it will fold its four manufacturing joint ventures (each with different partners) into a single company, in which Nokia will hold 60% equity share. Michelin is consolidating all of its joint ventures in China into a single production network, while moving marketing and sales to a centralized function located in Beijing. Many Japanese firms are making similar moves. Nissan, for example, is folding Dong Feng Automobile Co., the third largest auto producer in China, into its global network.

4.2 Five Core Strategies

Having laid solid foundations, some combination of five core strategies is necessary to win the battle of competencies that will characterize the next round of competition for Chinese markets.

1. Expand your market coverage

Seeking to exploit their superior technology and brands, most multinationals entered China through the high end of the market. This was true for everything from beer (where American and European entrants positioned their brands at between three and five time the price of the low-end Chinese brews) through to electronics and equipment (where companies like Toshiba and Hitachi sought to compete by continuously introducing new, leading-edge products at premium prices). But such a strategy is unlikely to succeed in the coming battle of competencies for two reasons. First, unless multinationals break out of high-end niche markets which generally exist only in major cities, they have little hope of building the competencies they need to succeed long-term – such as the ability to overcome the limitations of China's inadequate hard and soft infrastructure or the subtle, sometimes peculiar adaptation of their offering needed to build volume. Second, unless multinationals expand into the mass market they will be

[5] Under the new law, for example, a joint venture is treated as a local joint-stock company with limited liability. A key difference is that under the old regulations, the local minority shareholder of a joint venture had wide-ranging powers of veto. Now it will be treated as a typical minority shareholder represented in the board.

dangerously exposed, as local Chinese firms use their expanding competence base to **move up aggressively up** market, financed by their massive volume base in the low-end.

Many multinational firms are now starting to move into lower price, mainstream market segments and into markets beyond China's more developed coastal strip to win back share lost to their Chinese competitors. A year ago, Hitachi, for example, decisively extended its market reach when it launched a new mini washing machine directly targeted at Chinese mass of mid-market consumers. Kodak, meanwhile, has a major campaign of „Marching West" – extending its coverage into the western provinces of China.

Clearly, a strategy of extending market-reach requires a slew of complementary initiatives from the need to craft a keenly priced product offering and re-jig marketing through to expanding distribution into secondary cities and even the rural hinterland. In order to win back its lost market share to local rivals, for example, P&G has cut the prices of some of its leading products by more than 40%, introduced low-priced small package for rural consumers, and signed up new distributors to cover even the most remote areas. The result: its market share is increasing again after declining for three years in a row.

2. Focus on dramatically lowering your costs

With the integrity of their international reputations to protect, there are valid reasons why multinationals usually have higher costs than locals in a number of areas. But as the battle of competencies heats up in the future, it won't be possible to sustain the magnitude of cost differentials with locals that often existed in the past. First, because the technology and quality gap with locals will narrow. Second, as the next stage of growth requires multinationals to capture customers outside their traditional niche markets, price premiums will be constrained by customers' ability to pay (never forget that despite China's economic miracle, annual income per capita only passed the $1000 mark for the first time last year).

The evolution of the market for television sets in China provides a telling example of these effects at work. Five years ago, Japanese brands of TV could charge a premium about 20% over local products. Today the viable price premium is only 5%. The magnitude of cost reduction required to respond to this kind of shift in pricing won't come from incrementalism. Multinationals will need to look at wholesale re-engineering of their business processes in China. And there is no time to lose, because as they build their own competencies, the Chinese aren't standing still. BYD Batteries, for example, have succeeded in developing their own proprietary process for manufacturing rechargeable batteries. The result: BYD has close to a 40% price advantage in the end product market.

3. Streamline your distribution channels

Recall that leading Chinese firms have begun to equip themselves with a powerful competitive weapon in the form of dedicated sales channels and networks of distributors coverage that extend well beyond China's major cities. This gives them a direct control over retail outlets and associated „push" marketing and sales techniques. Legend, for example, has built a network of over 4,000 distributors in addition to the 1000 branded „one + one" stores we mentioned above and have accumulated a great deal of experience in how distribution can best be managed. Hitherto, multinationals have been handicapped in this area by regulations that effectively prohibit their direct involvement in distribution and retailing activities. Canon, for example, despite having its latest production facility in China, has had to run its sales activities through its HK office for many years.

Today, however, the removal of these restrictions as part of China's deal to join the WTO is opening up important new opportunities for multinationals to streamline their channels. One option is to emulate the Chinese practice of building dedicated distribution networks that can be used to smooth the supply chain, get closer to customers, and gain better control of the flow of marketing and communication through to the point of sale.

Alternatively, multinationals can now take advantage of the fact that China's excessively fragmented retailing sector is consolidating fast – driven by the aggressive expansion of retailers like France's Carrefour, America's Wal-Mart and Britain's Tesco, along with emerging local chains such as „N-Mart". By working closely with the rapidly emerging retail chains, multinationals can expand their market coverage, improve distribution efficiency, and make sure superior product quality and performance is communicated effectively to end customers. This will enable them to side-step the problem we described above, whereby poorly performing distributors effectively destroy much of the differentiation a multinational potentially has to offer.

4. Localize your R&D

One area where multinationals are generally streets ahead of their local competitors in the battle of competencies is in technology development and the management of R&D. In the past, however, most multinationals have viewed their China operations as importers of the results of their R&D elsewhere. But in the coming battle of competencies where multinationals need to play to their strengths, there are good reasons for localizing more R&D in China.

Locating your R&D closer to the target Chinese customers should improve both your chances of meeting local customer needs and increasing speed to market – two of the areas where multinationals need to eliminate the advantage currently enjoyed by local competitors. In addition, given China's vast supply of cheap and talented scientists and engineers, localizing R&D can substantially reduce its costs. Lastly, transferring R&D to China will do a lot to help sweeten relations with government at every level and can provide a powerful bargaining chip for soliciting official support for other parts of your China business.

Of course the IPR issues associated with local R&D need to be carefully managed. But leading multinationals in China are recognizing the potential of China as an important R&D base. Others need to follow. Over the last few years, more than 100 global R&D centers have been established by leading multinationals such as HP, Microsoft and Motorola.

5. Proactively drive industry consolidation

Many Chinese industries are now highly fragmented by world standards. This fragmentation has resulted from a combination of the break-up of former state-owned enterprises, entry by over 320,000 foreign companies, the creation of new companies by private entrepreneurs, and the strategies of aggressive diversification adopted by many Chinese firms.

While fragmentation persists, economies of scale will be undermined, excess capacity and cut-throat price competition will remain endemic, and even fundamentally sound companies will struggle to make adequate returns. Until recently, it has been difficult for companies to do much about this problem given China's under-developed market for corporate control, held back by regulatory restrictions on takeovers. It's not surprising, therefore, that, while 80% of foreign direct investment takes place by acquisitions in the rest of the world, the figure for China is only 5%.

Opportunities to drive industry consolidation, however, are now starting to open up. A pioneer in this area was Eastman Kodak. In 1998, Kodak negotiated a deal with the Chinese government to take over three large, state-owned enterprises in the photographic industry (Shantou Era Photo Material Industry Corp., Xiamen Fuda Photographic Materials Co., and Wuxi Aermei Film & Chemical Corp.) and integrate them into a holding company with Kodak's existing operations. The aim was to assemble the future leading player in the Chinese market. In return, the Beijing government also agreed to close down two other domestic film plants[6].

Kodak continued to drive consolidation in the industry, a strategy that led it to acquire five of the seven largest state-owned photographic film companies.[7] Of course Kodak had no illusions about the fact that Fuji of Japan and the largest Chinese-owned player, Lucky Film Corporation, were likely to remain as important competitors. Its objective wasn't to drive these other serious players out of the market. Instead it had two other goals: (1) to drive the formerly fragmented market towards a tripartite game where the bases of competition would shift towards quality, brand strength and convenience; and (2) to use its first mover advantage to improve its chances of becoming the dominant player. By 2003 it appeared to be largely succeeding in both objectives, with competition in the industry now focusing on building brands and distribution, and with Kodak enjoying a market share of the roll-film market that is estimated to exceed 60% at attractive margins. In October 2003, Kodak achieved another major breakthrough and won government approval to own 20% of the last Chinese photographic film maker, Lucky Film Corporation.

Other multinationals are now following Kodak's lead. The French-based food and beverage company Danone, for example, has acquired major shareholdings in the leading companies in the drinking water market in China, driving consolidation and becoming the leading supplier. Certainly, proactively driving consolidation is a bold strategy, but given the huge potential payoffs, if the profitability of an industry can be transformed as a result, it should be on the agenda of an increasing number of multinationals in China.

Some combination of these five strategies: expanding market coverage, focusing on dramatically lowering costs, streamlining distribution, localizing R&D, and proactively driving industry consolidation need to be part of a multinational's response to the emergence of powerful Chinese competitors and the battle of competencies that has begun.

To implement such strategies successfully, multinationals' China organizations will have to become more flexible and faster learners. This will require a dialogue between corporate headquarters and local management in China about the realities of the „battle of competencies" between foreign and local firms, and the necessary local autonomy and „elbow room" to respond to nimble Chinese competitors. To achieve this, in many

6 INSEAD-CEIBS, 2000, Kodak in China (A), (B) & (C), Case No. 02/2000-4881.

7 J. Kynge, 2001, „Fuji Considers Chinese deal to Rival Kodak", Financial Times, 27th February.

companies, such as P&G, Microsoft and Motorola, their China operations now report directly to the global CEOs. The seniority of China heads has also risen dramatically. For example, the president of Samsung China is one of the three key decision makers back in the headquarters.

It also means that multinationals will have to squarely face the fact that the competitive edge potentially available from superior technologies, products and systems will be severely blunted unless they build much stronger local competencies. In many cases this means a new willingness and determination to master the complexities of distribution, sales and service in China's secondary cities and rural heartland, and to learn how to more sensitively adapt everything from products and processes to marketing messages to the peculiarities of the Chinese market – competencies in which their local competitors are currently streets ahead.

5 China and Beyond: Preparing for Tomorrow's Global Battle

Of course, multinationals have another strategic alternative to slugging it out with their rising Chinese competitors: to ally with them instead. Given the fact that the competence bases of multinationals and Chinese firms tend to be the mirror images of each other, alliances have obvious attractions. But these would be very different from the kinds of joint ventures that have characterized the China scene to date. Rather than the Chinese partner simply providing dubious Guanxi or government access, new-style alliances would be fully-fledged partnerships between a multinational and a Chinese company with competencies of its own to bring.

Such alliances have already started to emerge. In August 2002, for example, Philips formed a new partnership with a major competitor, TCL – one of China's biggest TV makers – that combines the complementary competencies of each company. Under the agreement, TCL has begun distributing Philips televisions in five Chinese provinces, while Philips says it will help TCL expand its product line to include things like high-end flat-screen televisions. Commenting on the move, Johan van Splunter, head of Philips' Asian operations, said simply: „Cooperation for us is now an absolute must."

In November 2003, Thomson also announced an alliance with TCL. In this case, the deal combines both parties' businesses in consumer electronics ranging from television sets through to DVD players. TCL holds 60% of the new company, which will market products under the Thomson and RCA brands in Europe, TCL in Asia, and both companies' brands in the

USA. Meanwhile, telecommunications equipment supplier Huawei recently announced a joint venture with 3Comm that will combine Hauwei’s full product line, low manufacturing, and R&D costs with 3Comm’s technology, brand name and channels. The aim: to mount a serious challenge to Cisco’s dominance.

In addition to the fact that they bring together complementary competence sets, one of the other interesting aspects of these new-style alliances between Western multinationals and Chinese companies is their global scope. By defining an international remit for these partnerships, a multinational can effectively recruit a strong Chinese company to fight on their side in the broader battle with their global rivals.

In developing your China strategy today, as Toshiba’s now retired chairman, Taizo Nishimuro, aptly put it, „thinking about winning in China alone is not thinking big enough”. Given the strategic importance of the China market, the China battle will have global consequences. And meeting the challenges of competing in the dragon’s den is not a bad preparation for winning the global war.

Business Strategy in China's Transformation

Jonathan Story

INSEAD, Fontainebleau

How much should we commit to China? Many business people ask. The answer depends much on how we look at the broader dynamics at work in China's transformation. In terms of traditional Chinese historiography, which posits history as cyclical: is the communist dynasty heading for a new golden age, or about to succumb to corruption and decay? The thesis here is that, if we start by a definition of corporate strategy as shaped in part by the top team's view of what constitutes right policy, (Prahalad, Doz 1987) our top team has to consider the details of corporate activities in China in terms of China's possible futures. Let us look briefly at four different interpretations of where China may be heading, to remind us that the future remains open, as a prelude to asking: how is the *party-state* evolving? Then, what *business conditions* do we meet in China? Finally, how do all the above impinge on the *managerial* issues of doing business in China? Foreign investors in China are simultaneously ambassadors, participants in local market institutions and managers of their enterprise.

1 The Party-state's Transformation is Open-ended

The first requirement of our top team is to become familiar with the recent history of China, starting arguably with the open door policy in 1978 – the year located at the base of the vertical line presented in Figure 1 below. On the outer vertical of the figure are listed some of the larger questions which our top managerial team should be asking themselves: what is happening worldwide in terms of the on-going redistribution of capabilities between the major powers and markets? How is this affecting the global structure? How is China incorporated into the global, interdependent economy? Not least, how is the transition proceeding in China?

When China's paramount leader, Deng Xiaoping, embarked on a policy of reforms in 1978, he substituted development for class war, and launched China on its transformation from an autarkic and poverty stricken country, to its present condition where national income has quadrupled and at least

300 million people have been lifted from poverty. Yet opinions about where China may be heading range from a real and present danger of sudden regime death (Chang, 2001); to China as an introverted, and at best regional power (Segal, 1999); through to China as a belligerent and assertive rising great power (Christensen, Betts, 2001); or to the regime as having no option in the longer run but to „common marketise" China into becoming like the rest of the world (Fukuyama, 1989). My argument is that communist China is not dying but morphing into something else; the regime gives priority to domestic affairs in order to emerge in the longer term as a pillar of global society (Story, 2003). The factor of time is thus crucial to an understanding of China, and of how to operate there.

The vertical line on Figure 1 stylizes China's transformation in four stages towards some point in the future, when consolidation of a noticeably different political and business system occurs. This approach does not allow us to conclude that China is on a smooth path of evolution, but it does help us to isolate the major challenges which lie ahead. First comes the pre-transition phase, accompanied by a growing list of problems which the incumbent power is unable to resolve. The key political detonator for change from command economy towards a more market-driven system was the initial consolidation of Deng's position in 1978, leading to various market-oriented measures, growing inflationary pressures, and demands for accelerated democratization, culminating in the brutal crack-down on the students demonstrating in Tiananmen Square in June 1989 (Qian, 1999). After three anxious years, China's leadership resumed market-opening – a trend confirmed in its response to the East Asian financial crash in 1997-98, and the subsequent successful bid to enter the WTO in 2002. WTO membership means incorporating global norms into Chinese legislation and practice.

Politically, the regime has not yet changed its governing norms. So far, former President Jiang Zemin has talked in traditional Marxist-Maoist-Leninist terms of the party as representing „three forces" essential to China's future: advanced productive forces; advanced cultural forces; and the fundamental interests of the largest number of citizens. The definition distances the party from its roots in class warfare, but continues to assert its claim to the leadership of China. In other words, the party is on the cusp of the definitional phase, when leaders start to distance themselves from previous policy paradigms. Were further steps in political rhetoric and practice to be taken, China would be embarked on regime change, where *one* destination would be a consolidated Chinese democracy, located up the vertical path labeled „normalcy". Regime change and all the uncertainties associated with it lie ahead in China.

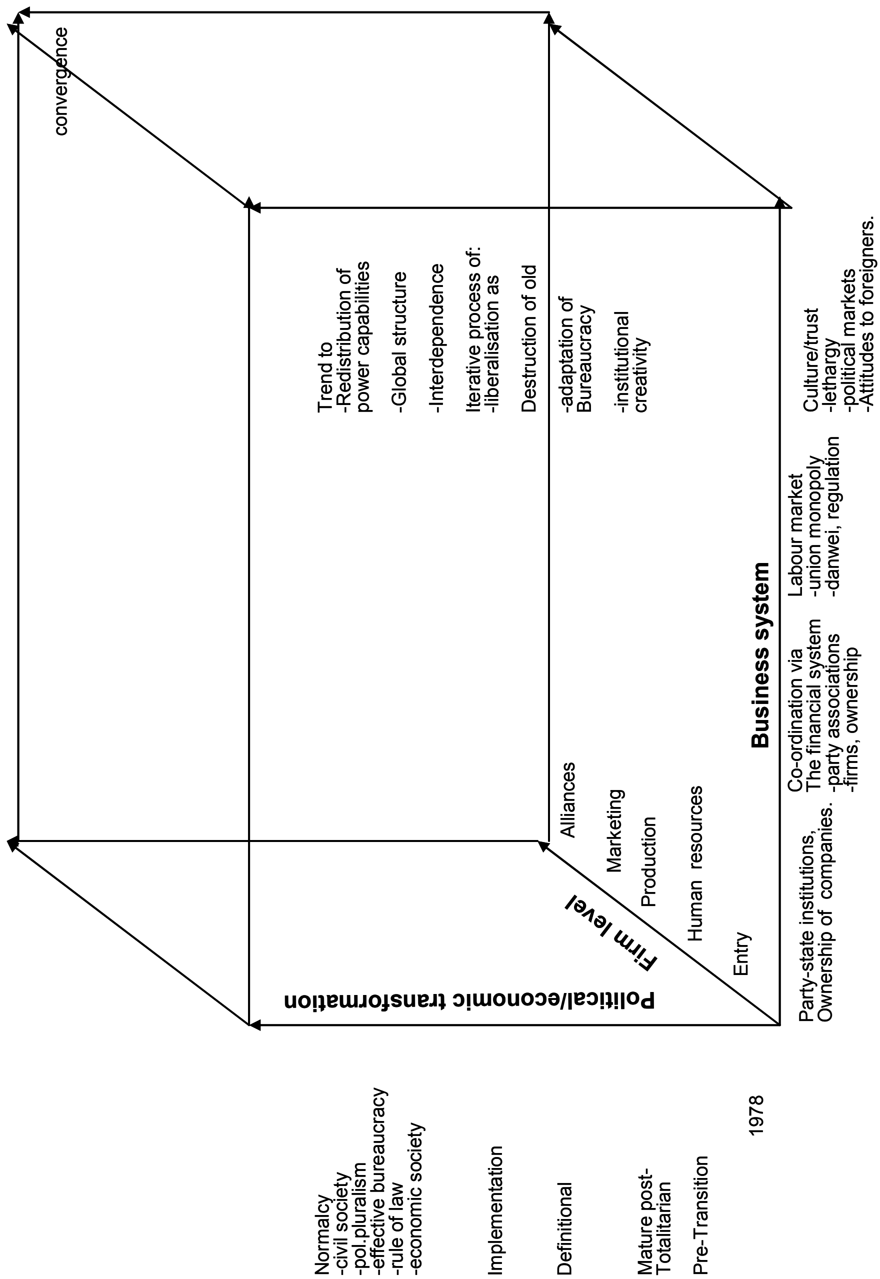


Fig. 1. FDI and the Transformation of China's Business System.

A consolidated market democracy holds five key features (Linz, Stepan, 1996): a vibrant civil society, where organized groups are able to express their values and objectives autonomous of states; a political society, where citizens may elect their political representatives on a regular basis; the rule of law, where due process prevails over rule by law; an efficient bureaucracy, where civil servants are accountable to courts and legislature; and an economic society, by contrast to a market system or a command economy. This listing indicates what tasks lie ahead, and how much remains to be done. China's party state has to continue to move towards laying the institutional foundations of a constitutional order, if a market economy is to be consolidated.

2 China's Business Conditions

Business conditions are crucially structured by party state institutions, four key components of which are presented on the horizontal axis in Figure 1 (Whitely, 1999).

1. The prime force in China for reform is the tremendous competitive pressures running through the markets. Given the absence of clear property rights, and the party's central role in allocating business risk, China does not present a level playing field for companies. There are at least four major types of corporate establishment in China: the large state enterprises in relatively protected markets; the state enterprises and collective enterprises in the competitive sectors, such as consumer electronics, foods, or textiles and where price competition is fierce and barriers to market entry low; the smaller enterprises, often attached to local governments, many of which are or have been in dire financial straits (Table 1); and the booming private sector, whose crucial role the Politburo acknowledged in October 2003 by adopting further reforms to protect private property and the rights of entrepreneurs. By then, private enterprises were estimated to produce one third of China's output, employed more than 100 million people, provided the main source of new employment, were more efficient in the use of resources, and were present in all sectors.

Tab. 1. SOES and SOE Assets, 1997 and 2001.

	SOEs				Assets in RMB millions		
	Central	Local	Total	Total in deficit	Central	Local	Total
1997	26,000	236,000	262,000	65,9%	4,862,440	7,635,000	12,497,520
2001	17,000	157,000	174,000	51,2%	7,321,100	9,349,860	16,670,960

Source: Chinese Financial Yearbook, 2002.

2. The party-state dominates the financial system, through which business risk is allocated. True enough, China has moved away from the mono-bank system of 1978-79, as the number of intermediation channels between savers and borrowers has multiplied, along with the growth in the number of financial market agents. But the party-state still rules supreme over the financial system, including banks, insurance and securities markets. This creates major conflicts of interest. The banks continue to channel loans to loss-making enterprises at the expense of the needs of private businesses. On the securities markets in Shanghai and Shenzen, the China Securities and Regulatory Commission (CSRC) has power to prevent insider trading. But 90% of the 1200 enterprises listed on the two markets are state enterprises (Liu, Sun, 2003). Listing is decided by a highly politicized quota process, where new issues have been kept firmly in the communist party family. There is thus a glaring contradiction between the government's efforts to crack-down on fraud in the financial markets, and its use of the media to talk China's 60 million or so frequent share buyers into buying state enterprise stock.

3. The third key element of China's business system is the party-state's gradual abandonment of its key constituency, the urban working class, just as its control over the countryside has slackened since the dissolution of the rural communes in the early 1980s. The link between ownership and market has involved the re-assertion of managerial authority over operations (Feng, 1999). Maoist worker committees have been relegated to a subordinate position. More discretion for managers means separating government functions from enterprise operations, and the elaboration of corporate law to provide a framework for companies becoming either limited liability or joint stock companies. In essence, the party-state has decided against socialist corporate-based insurance, but at the same time has continued to provide bank loans to inefficient enterprises to maintain „social cohesion". With 15 million new entrants to the job market per annum through to 2020, plus restructuring in state, township and village enterprises, unleashing private enterprise on China is the only way forward to create the jobs needed to avoid an explosion of unemployment and violence in countryside and cities. Unleashing private enterprise conflicts with providing the party-state constituencies with privileged finance.

4. The fourth element to condition China's corporate reforms is the level of trust in workforce and society towards public officials. The evidence suggests that the general public in mainland China has rather low expectations about government. The public may complain, but people do not withdraw their support (Shi, 2001). There is thus a stock of lethargy on which the regime can draw as it proceeds on its way. But it cannot afford to take this passive support for granted. Private business and farmers have used the

nascent legal system to protect themselves against local officials. Government promotion of communications facilitates the organization of the discontented, who are too disparate to challenge the incumbent regime for the moment. What opinion polls do show is the widespread disapproval of corruption, accompanied by the penetration of the party-state by organized crime converge (Ding, 2001). The communist honey-pot is too tasty for the sake of its guardians.

The paradox is that, while the party-state insists on its leadership prerogatives in China, the Chinese economy is more than ever in the hands of consumers and savers. Companies controlled by the CCP have to adapt or die. So far, the CCP has preferred to adapt. If it is to cleave to this policy, as it has so far, the subsequent steps are clear enough: resources must be better allocated than hitherto, regulators particularly in the financial markets have to be more effective, corporate management has to be further taken off the drug of bank subsidy or rigged equity valuations, the party has to step much further back from corporate patronage, private enterprises have to be placed on a footing of equality with their competitors, and private property rights have to be inserted at the heart of China's political system. What the CCP has going for it is the stock of public lethargy on which it can continue to draw. Let's trace what this all means for foreign investors in China.

3 Managerial Implications of China's Transformation

Last on Figure 1 come the implications for corporations of China's transformation, both of its political and of its business system. What this spells for foreign businesses seeking entry to, or already operating in China, we can examine by following the firm level at the base of our cube, in terms of market entry, human resource management, production, marketing in China, and corporate alliances.

3.1 Market Entry

There has been an untidy collective learning process by corporations and government departments about how to benefit by promotion of inward direct investment. In the early 1980s, multinationals treated China much like other developing countries as places to sell old products or as locations for the manufacture and distribution of old technologies. Because they knew little about the country, they often proceeded tentatively. The party-state behaved no differently. Public ownership was to be protected, but sufficient incentives provided for a successful absorption by local firms of western technologies and know-how. The inter-action of evolving public policy, as depicted above, and a collective corporate learning process about how to operate in China may be illustrated as in Figure 2. The inter-actions yielded a widening range of policy instruments, from joint venture to wholly-owned foreign enterprises and holding company status, extended unevenly across a widening range of sectors. The horizontal axis traces the widening of options available to foreign investors as public policy changed, while the vertical axis traces the prospective significance of the China market to the corporation's top management team. On the right hand horizontal planes are the basic questions which the top management team would have to be considering. „What is the risk of doing business in China?" they would be asking. We don't know much about the country, so perhaps we should find out first. Definitely, we don't know ahead of time what the costs of operating there will be. All we can do is to make a ques-timate of the expected benefits. Those are going to hinge very much on how we enter the country. So what approach should we adopt?

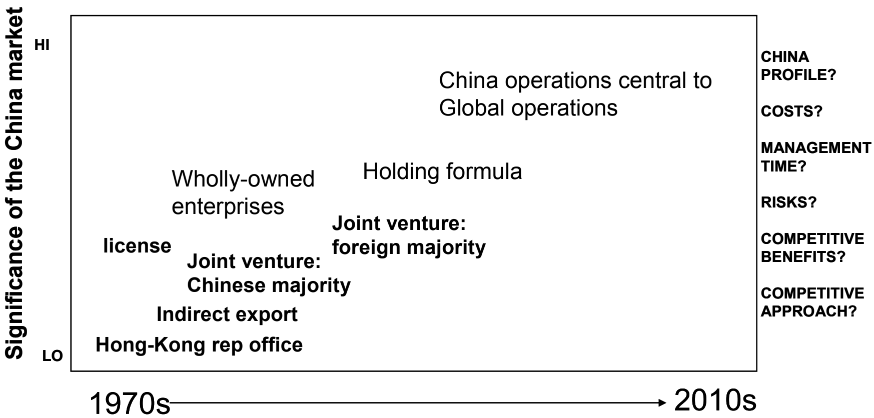


Fig. 2. Evolution of Entry Mode to China Markets.

The takeaway for businesses entering China is that the options available now are much more diverse than they used to be, though business condi-tions encountered in the old industrial centers of the north or inland where party-state enterprises provide the backbone of local economies are com-parable to conditions encountered in the 1980s. Even so, a few rules of thumb still hold for the future: be clear about your own objectives and those of your Chinese partners; don't tailor your strategy to government demands; control is best exercised by a majority stake, but failing that, considerable influence can be exerted by exploiting the leverage derived from the provision of know-how, technology etc; being in there for the long-term does not mean running a loss-making operation indefinitely; develop good antennae to help you learn about China's changing environment; remember the government in China is not a monolith, and relations have to be cultivated at all levels of the state. Not least, remember that the best partner, as the Chinese saying goes, is one who shares the same dreams but not the same bed.

3.2 Human Resources

China is not a cheap labor country. Foreign firms operating Joint Ventures generally pay between 20 and 50% more than local firms, while non-wage costs vary widely across regions. Many other features of the labor market conspire to drive up total labor costs. Western firms have to select employees with an ability to anticipate problems, and who have local market knowledge. This is not the same as having people with English language skills. Then, once hired, companies have to invest in training and to recognize thereby that they make their employees attractive to other companies. In addition, workplace relationships are on the radar screens of western social auditors, as Nike and Reebok discovered when conditions among their sub-contractors in China, Indonesia and Vietnam became headline news in the US. Many corporations have instituted their own voluntary standards program designed to record their own performance, and satisfy shareholders.

The human resources function is one of the most important for foreign investors to get right. As Claus Tønnesen, plant manager of the Wuqing operations of Danfoss, the Danish heating equipment manufacturer, explained: „Probably the single most important aspect of Danfoss' success in China has been human resources and our ability to manage the local Chinese culture… If you can't make the people issues work, forget it." A key challenge is to find and retain the right people, who can adapt to the corporate culture. „I've learnt that I too easily hire the wrong people without realizing it," says Tønnesen. Close examination of dossiers, recommendations, and interviews by Chinese employees helped avoid cheating and misrepresentation. This required delegating much of the responsibility for selection to the Chinese staff, who had to feel at home in the Danfoss culture, if they were to make the right choice for the firm. There were many elements in achieving this cultural change. One was a flat organization: a President, Vice-President, ten managers, six supervisors, and some 250 staff. The number of expatriates was kept low, and there were no trade unions – a liberty which the party-state is seeking to correct in order to strengthen its representation within foreign-invested operations in China. Danfoss, of course, conformed to Chinese regulations, while introducing Danish human resources practices in its operations there. Blue collar loyalty to the firm, as Tønnesen pointed out, is very high.

3.3 Management of Production

Once a viable operation has been set up, how to run the day-today business takes over. In essence, this entails managing the technology transfer process, where the Chinese partners want the best fast but the foreign investor prefers a gradual build-up of local capabilities. Over time, foreign investors have acquired a body of practical experience about the many aspects related to raising productivity. One set of lessons may be taken from the process of setting up a local supply chain, where the investor's prime concern is to ensure quality and to protect the brand name. It took Shanghai Volkswagen about a decade to move from importing standard kits to about 100% local content – establishing standards, bringing in home country suppliers, choosing appropriate locations and keeping a close eye on transport problems. Another cluster of lessons relates to protecting intellectual property rights (IPR), in a country which is one of the world's champion infringers. Not least, there is the perennial problem of anticipating demand. Statistics are inadequate, as foreign companies tend not to be forthcoming about their operations in China, while local competitors notoriously keep multiple accounts.

One of the prime reasons given by foreign investors for going to China is low unit labor costs, allied to the prospects of achieving western levels of labor productivity as operations develop. But as investors have discovered, the absence of solid logistics and supply chain management can waste the cost savings from cheap labor and materials. Setting up operations in China requires heavy investment upfront, through sequential steps to ensure quality. As Kjeld Staerk, until 2004 global head of the Commercial Refrigeration & Air-Conditioning (A/C) Controls division (RC Commercial), at Danfoss emphasized: „You have to climb the ladder in the right order. Focus first on quality and delivery; once these were secure, focus on cost and engineering issues; and, only later, deal with knowledge and R&D transfer." It took Danfoss' management about eight years to capture the cost savings, which then drew the attention of other corporate product divisions to the benefits of setting up international purchasing offices (IPOs) in China to source materials for their factories throughout the world.

3.4 Marketing

China is not yet one integrated market. Local authorities are protective of their own producers. So the temptation of foreign businesses is often to congregate in the large cities where per capita incomes are reasonably high. Even here, it is worth remembering that per capita incomes are far below western norms, and out in the countryside, where 900 million people live, they are sometimes at the level of the lowest in Africa. Getting products to this vast population is no easy task to achieve. Take the case of distribution networks, which the state began to marketize in the early 1990s. The sector was opened up to joint ventures, and rules about advertising were eased. Carrefour, the French retail giant, seized the opportunity to build up China's second biggest retail chain in the short space of five years. By 2000, Carrefour could boast 28 outlets in 15 cities and nearly a $1 billion turnover – all the while ignoring Beijing's required say-so to open retail joint ventures. A key to its success is to provide a simple, large store space, offering a large variety of products and low prices. The stores move goods fast, cut tough deals with suppliers, carry minimal stocks and cater to local tastes.

Avon, the US direct-selling corporation, had a rather different experience. Like Carrefour managers, Avon found lobbying in Beijing unrewarding, and headed for the provinces. Guangdong authorities were receptive, and the company began to roll-out its plans for door-to-door sales. Others soon followed Avon's example, so that by 1997 there were about 2,300 direct-selling firms in China, employing up to 20 million people and generating a sales volume of $2 billion. But the State Council in April 1998 issued a blanket ban. All door-to-door sales operations were ordered to convert to standard retail distribution or go out of business. One reason for the crackdown was to flush out the get-rich-quick artists. But the main reason to stop door-to-door sales operations was political: officials did not like the rituals used to arouse enthusiasm at marketing meetings. They were too much like religious revivalist movements. Avon had to concede, and swiftly altered its business model to turn its supply stores into retail outlets. The motto is that foreign investors must know when Beijing is in earnest, and when it is less so. Beijing is definitely in earnest about stamping out opposition movements before they can organize.

3.5 Corporate Integration in China and into the Global Business System

A common problem for multinationals in China is integration of the business units which have been negotiated across the length and breadth of the country at different moments in the past. In the 1990s, foreign investors followed the example set by Johnson & Johnson, the US pharmaceutical corporation, which decided to launch its oral care, baby and female hygiene products under the wholly-owned foreign enterprise formula (Vanhonacker, 1997). The formula allowed for greater control over operations, quicker expansion, less time spent on arduous negotiations with public officials and managers, and more protection over patents. Motorola, along with Nokia and Ericsson, a major force in China's huge mobile phone market, went even further, and created a hybrid wholly-owned and joint venture operation: Motorola ran the integrated circuits and cell-phone operation itself, but entered joint ventures for marketing and sales. It thereby gave local partners a stake in the business and managed to develop country-wide. The risk for a wholly-owned operation in China is to be a self-sufficient island, cut off from Guanxi and therefore at risk of not winning contracts and placing orders.

Another way to consolidate is through the holding company formula, opened up by government measures to allow companies to register as joint-stock companies. Foreign companies have been able to convert joint ventures and wholly-owned operations into holding companies on the say-so of MOFTEC, and after demonstrating three years of profitable activities. Corporations such as Coca-Cola, Henkel, Siemens or Unilever took advantage of the opportunity. In fact, it served both western corporations and Beijing's top brass: the multi-nationals could overcome local particularisms in which their joint ventures were embedded by giving them a minority stake in the success of a country-wide, and more efficiently-run group. It served Beijing's top brass by accelerating the diffusion of technologies and management know-how around the country.

And helping the multinationals to achieve greater integration in China also helped Beijing achieve more of its industrial policy objectives. This was the theme of the State Development Planning Commission's report supporting the „Kodak model" (Vanhonacker, 2000). Kodak's management anticipated that China would be the world's largest film market by 2005-10. How to move fast, get products to market, and keep brand and quality were some of the major problems to overcome. The government's problem was how to avoid pouring more money into „national champions" which failed to fly, while developing a national capability in the industry. Eventually, government and Kodak negotiated a holding company formula, which gave Kodak more centralized control over its joint venture partners, and opened the prospect of making China the photo-film manufacturing hob for the world market in a decade. China is learning to hitch multinational corporate strategies to its own industrial purposes.

There are many other sectors where similar deals have been struck. Take the example of Cisco, which provides the hardware that powers the Internet. Cisco is helping to integrate the platforms of the Civil Aviation Administration of China, and in 1999 supplied the switches to the third phase of China's National Financial Network (CNFN), linking eight of China's financial institutions. The corporation's practice is to form strategic relationships with the leading US technology firms as a way into winning business in China's extensive para-public sector. Another is BASF, the German petrochemical giant. Petrochemicals is par excellence government regulated. Once BASF had established a joint venture with Sinopec, it began lobbying for an integrated petrochemicals site. The joint venture took five years to negotiate, allowing BASF to begin construction in 2001 on 8 downstream units and a central naphtha cracker. Production is planned to start in 2005. BASF also has a $1 billion stake in a Shanghai operation to produce the raw materials for polyurethanes. In other words, BASF is on the way to creating a comprehensive basic-industry empire in China, with the government as partner.

Franchising is one other formula that is helping companies to expand their market reach. Franchise owners grant rights to franchisees to use their trademarks. In China, the appeal of this formula is to small family businesses. It was used by Beijing's Quanjude, a well-known roast duck restaurant, to establish over 60 restaurants across China, and Legend has used franchising to build up its sales network. KFC, the US fast food chain, used a special franchising formula to develop nearly 450 outlets, first on the east coast and then in the poorer, inland provinces where families liked to go for weekend quality lunches at affordable prices. Affordable prices were helped by centralization of KFC's supply system. In the mobile phone business, Ericsson managed to build up a franchising network among provincial telecom authorities. This enabled the Swedish giant to fasten its hold on China's richest regions, including Guangdong. The motto is that countrywide reach is achieved best by giving the locals a major stake in success.

4 Conclusion

This chapter starts from the premise that China's open-ended process of transformation lies away from its inherited communist party-state structures, and provides a framework to help conceptualize the party-state's evolution. Prevailing business conditions derive from this transformation, which lies at the heart of management's dilemmas in doing business in China. Looking forward, we are in the very early stages of China's incorporation into the global business system. China's entry is as good as irreversible. That means extensive and continued further changes in the way that China's markets evolve, and a long learning process ahead for companies operating there. What matters in China, for management, as well as for the regime, is muddling by on a day-to-day basis, with a broad vision of where we want to go. The regime is undecided, which is one further reason why in China regime change lies ahead.

Literature

Chan,R.Y.K. (1999) „At the Crossroads of Distribution Reform: China's Recent Ban on Direct Selling", Business Horizons, September-October, 41-45.

Chang, G.C (2001) „The Coming Collapse of China", New York, Random House.

Christensen, T. J. & Betts, R.K. (2001) „China: Getting the Question Right", The National Interest, 62, 17-29.

Ding, X.L. (2001) "The quasi criminalisation of a business sector in China", Crime, Law and Social Change 35, 177-201.

Feng, L. (1999) „State, Market, and Enterprise: The Transformation of Chinese State Industry", unpublished Ph.D. dissertation, Columbia University.

Fukuyama, F. (1989) „The End of History", The National Interest, 1989, 3-18.

Linz, J. & Stepan, A. (1996) „Problems of Democratic Transition and Consolidation: Southern Europe, South America and Post-Communist Europe", Baltimore, The Johns Hopkins University Press.

Liu, G. & Sun, P. „Working Paper in Chatham House Asian Programme", 2003.

Prahalad, C. K. & Doz, Y.L. (1987) „The Multi-National Mission: Balancing Local Demands and Global Vision", New York, The Free Press.

Qian, Y. (2000) „The Process of China's Market Transition (1978-98): The Evolutionary, Historical and Comparative Perspectives", Journal of Institutional and Theoretical Economics, 156(1), 151-171.

Segal, G. (1999) „Does China Matter?", Foreign Affairs, 78 (5), 24-36.

Shi, T. (2001) „Cultural Values and Political Trust", Comparative Politics, 33(4), 401-419.

Story, J. (2003), „China: the race to market", London, Pearson's.

Vanhonacker, W. (1997) „Entering China: an Unconventional Approach", Harvard Business Review, March-April.
Vanhonacker, W. (2000) „A Better way to Crack China", Harvard Business Review, March-April, reprint.
Whitley, R. (1999) „Divergent Capitalisms : The Social Structuring and Change of Business Systems", Oxford University Press.

A Guide to Business Success in China for Foreign Enterprises

Kang Gang Hu

GE-AS Co. Ltd., Shanghai

1 Introduction

China‘s fame as one of the four ancient civilized cultures is well known, and people are also familiar with China’s achievements after 1978 when the country opened to the outside world. Many foreigners believe themselves to be sinologists, or „China Experts", after they have made several trips to China. This assumption is a big mistake. In fact, even native Chinese cannot claim to be totally familiar with this country, particularly in these rapidly changing times. A Chinese proverb states „only study can make people aware of their ignorance", and this proverb is important both to individuals interested in China and to enterprises that want to succeed in China.

1.1 China's Age-old Tradition

The first difficulty for foreigners is, of course, language. Firstly, the Chinese characters are pictographs and Chinese also differs from Western languages in that it is a monosyllable language. Secondly, foreigners will find it hard to communicate with Chinese, because most Chinese receive a more limited education than westerners and have little proficiency in foreign languages. Even after foreigners have stayed for a long time in this country and have mastered Chinese sufficiently to be able to communicate without a translator, however, they are still likely to meet obstacles when talking with Chinese people. This cultural obstacle stems from a lack of unvoiced understanding of the different culture and is by no means a phenomenon unique to China. Everyone can experience it when meeting foreigners in one's hometown, but this lack of unvoiced understanding will become more obvious, if the history and culture of the country are long and rich.

China is a country with a 5,000-year old civilization. The Han Nationality has ruled this country for more than 2,000 years. Therefore China's profound cultural influence can never be underestimated. Since the Han Dynasty, Chinese culture began to evolve with Confucianism at its core. This culture was not spread or extended through schools, but took root in the people's minds by social ethics through the people's self-regulation. This cultural influence can be found everywhere, and a failure to understand it will create obstacles. This is why foreigners will still find difficulties in communicating with Chinese even after they have mastered the language. Understanding a foreign culture and forming an unvoiced understanding of this culture will take more time and be harder than just learning the local language, and for some it will even be an insurmountable task.

Conclusion 1: Mastering a language is only the beginning: understanding a culture constitutes the basis for communication.

1.2 Ongoing Renovation

China's rich culture and long history are destined to have a major influence on the future. In the Yuan and Qing Dynasties, several foreign races ruled China, but they were finally assimilated by the Han culture. However, China's culture and traditions have not remained unchanged for thousands of years, for China has long regarded itself as the world center. Even when China called itself a heavenly empire and insulted other countries as uncivilized barbarians, it never stopped exchanges with other countries. After a series of miserable diplomatic failures in modern times, the Chinese had to admit that foreign warships and cannons as well as their technology were far better than ours. There was a fierce dispute and debate between the Westernization Advocators, who supported learning from foreign experience, and the Conservatives, who criticized the former for betraying our ancestor's admonishments and described them as traitors, but in the end, reform is the only way! The reforms, beginning from the end of the last century, are now in a new round of renovations. China is changing!

However, China's traditional culture demands that any changes harmonize with Chinese Characteristics. Experiences that have proven successful in foreign countries are not automatically applicable to China as every successful practice needs a complete support system. Numerous stories from the past have proved that a mechanical graft or the isolated importing of foreign practices will only cause chaos. China's two thousand year old centralization of authority raises the possibility that some individuals (at least for a short period) can control the fate of the nation on their own, making it more difficult to foresee China's future. Therefore, it is easily understood why the World Bank gave China the highest rating in terms of its stability.

Conclusion 2: The changes in China's politics, economy and society are more difficult to foresee than for other countries.

1.3 A Rapid and Sustained Economic Development

The wit and wisdom of the Chinese people have been widely recognized. But another question, that of collective cooperation, often attracts attention (People say that one Chinese is a dragon, but ten Chinese will be ten snakes). The crux of cooperation in fact lies in the fair allocation of resources. If this problem is properly solved, the wit of the Chinese people will burst out like a volcano. This can also be fully demonstrated by China's economic growth rate of 9 percent each year, since the policy of opening up to the west begun 20 years ago.[1] Even with some statistical errors, this figure is still unparalleled.

China's rapid economic growth can be attributed to its stable political situation, its people's pursuit for economic benefit, and an effective reference to the experience of other countries. The government has shifted its focus onto economic construction and given top concern to it whenever treating international affairs or domestic politics (As Deng Xiaoping claimed: „Development is the absolute principle."). This practice is in line with the historical tendencies and the people's willingness as the Chinese people now have unprecedented economic desires, and as a result economic activities are now soaring, so that people can create and accumulate huge social wealth in a short time. It's true that the consequent fair social allocation is waiting to be handled, but the rapid and sustained growth of the national economy is at the same time guaranteed. Considering the fact that China started much later than other developed countries and even at a lower level, we are confident that China can overtake these countries in a short time as long as we manage to draw upon their experiences.

Conclusion 3: China is a potentially huge market always moving forward. It is justifiably regarded as the center or even the sole hotspot of world economic development at present and in the near future.

[1] National Bureau of Statistics of China, www.stats.gov.cn.

1.4 Grasping the Opportunity

In recent years, China has become the world champion at introducing and using foreign capital. In other words: many overseas companies have strived to invest in this market, for they recognize its development potential. However, a future market is not equivalent to a current market, as the future market is at best a potential one. Whether a potential market can be converted into a real one depends on the ability of enterprises to grasp opportunities. In the same environment, enterprises in the same industry differ from each other in terms of their performances, so someone who considers China a heaven full of instant gains will only be disappointed by their wishful thinking.
Conclusion 4: Opportunity should be grasped, and the precondition to grasping the opportunity is to fully understand and aim toward the objective.

2 China's Macro-Economy

2.1 The Government and the Policy

Despite some different political policies from time to time, for two thousand years China has maintained a high level of centralization of authority. This has determined the all-in-one administration concept in Chinese society, as well as the supporting values in the culture, such as „The Emperor rules the ministers, and the father rules his sons and daughters", and „All people beneath the sky are servants of the Emperor". The centralization of authority has also guaranteed the smooth implementation of the political opinions of parties. From these views, it has been fully proved that in China politics is the concentrated embodiment of the economy. Therefore, in this country, the leading position of the government and its influence on society and the economy is unparalleled. The government often more considers political factors than economic ones when making its policy, so that it will rarely be influenced by enterprises (not even by large state-owned enterprises). This situation has continued for many years and seems destined to continue, so those western firms who are already used to the taxpayer-government relationship must readjust their mind-set and social position when in China.

Conclusion 5: Companies should adapt themselves to the Chinese-type centralization of authority which is determined by politics and appears to be substantially unchanged in the short run.

2.2 Economic Restructuring

The reform and opening policy is required firstly by politics and secondly by the economy. Due to the unchallengeable position of the ruling party in China, a large scale trial experiment with the national economy is made possible. In this view, it is not feasible to predict the possible processes of political system reform. Once such a demand appears in politics with a bearing on the economy, the reform will automatically take place.

The economic restructuring over the past 20 years was noteworthy not only for the rapid economic growth, but for the acceptance of the private economy. It is outside the scope of this paper to distinguish between politics and the ideology that the Chinese Communist Party does not deviate from Marxism. However, the private economy was recognized as a subsidiary of the dominant public ownership, and then upgraded as an important component in the socialist market economy. Moreover, the privatization of the Chinese economy has proved to be swift and fruitful. For instance, the proportion of the non-public economy in China's national economy rose from 0.9 percent in 1978 to 64 percent in 2002 (This is the figure in a broad sense, including foreign companies and Hong Kong and Taiwan companies. The figure in narrow sense, excluding those companies, is 48.5 percent)[2]. The rise of the private economy in China not only helps accumulate social wealth at a faster pace, but also propels the planned economy to shift into a market one.

Conclusion 6: China is now shifting from a planned economy to a market one, and the trend will be the marketing of the economy in an all-round way.

2.3 Some Typical Problems

The reforms meet China's political and economic needs. However, as the central government conducted this „large scale experiment" without any

[2] Wu Jinglian: „Pleasant Stage of Private Economy", Wenhui Newspaper December 9th 2003; Huang Mengfu: „Analysis to Chinese Private Economy 2003", January 30th 2003, www.acfic.org.cn; Dong Zhikai: „Changes of Ownership Structure of the P.R. China in the last 50 Years", www.cei.gov.cn; and National Bureau of Statistics of China, www.stats.gov.cn.

previous experience to draw upon, it is acceptable and understandable that there will be some problems, mistakes and even backward steps during the implementation of this experiment. Some enterprises are likely to hinder their current businesses, while others will implement their long-term strategies and investment decisions. Understanding these problems earlier will be helpful to those who want to enter the Chinese market. Here are some common examples for your reference.

Intangible Policies

The experimental nature of policy and the central government's control of it make changing policies an easy matter. However, appearing to improve the efficiency of execution actually reduces its duration and stability. Besides, departments at all levels may have various understandings of policy and pay varying attention to it. This attitude will probably baffle enterprises. Before they enter China, some firms hope that consulting agencies will be able to provide complete legal documents and reports on policy decision-making environment. But they don't know that besides those documents yet published or ready to be published, there are numerous other types of documents, such as internal or complementary documents, temporary regulations, administrative orders, phone notifications, etc. Even the grass-roots departments in charge usually fail to make all of the documents clear in a timely manner, let alone the consulting agencies. In China, it has been a common practice to execute contradictory orders at the same time. If enterprises fail to understand or gear their practices to this setting and just complain, they will find it hard to do many things.
Conclusion 7: Companies should become familiar with current local policies. They cannot merely rely on documents or experience.

Lack of Basic Resources

Any companies that do not have full knowledge of local resources before they enter the Chinese market will come across many obstacles in their future operations. Most serious is the lack of two basic elements of production: human resources and finance.

It is believed that human resources are one of China's advantages. But that belief only considers the quantity. As far as quality is concerned, because education has not been generally available, and vocational education is still at a lower level, mid-level or senior talent is really in short supply in HR markets. In addition, there is a more serious problem for foreign companies: few professionals are able to communicate face-to-face with foreign experts or head offices in fluent English. Many specialists have failed to be appreciated by their foreign leaders and their talent has gone unrecognized. This situation has further reduced the lack of qualified talent. If foreign enterprises cannot understand this problem and make due preparations such as offering language training to experts ready to be sent to China so as to help them better converse with Chinese employees, this problem will become increasingly more serious. Companies wishing to compete in China have no other choice but to solve these problems on their own because both the quality and the quantity of social vocational education fall short of the requirement.

Even if one called China's current economic structure a market economy, one thing should be clear: China has no real financial market at all. In other words, currency, an intermediary of commodity exchange, cannot flow freely in China to where the best performance can be gained. So it is incorrect to call China's economy a market one. Whether in key projects on state-level or in a company's daily business, capital circulation problems are often experienced, and banks as well cannot really perform functions which are common in their western counterparts. A lack of financial resources can directly restrict a company's business and development scale, especially on high-end merchandise. Foreign firms should fully prepare for this possible bottleneck before accessing the Chinese market.

Conclusion 8: Fully prepare for the lack of resources and take effective initiatives.

Uneven Market

The rising market of China was born out of the monopoly of state-owned enterprises. Along with the politics-oriented centralization of authority, the phenomenon of state administrative control can be seen nearly everywhere. The key for companies is to understand the trends of state policy and to design their development strategy according to it. Otherwise, they will find obstacles in their way with nothing accomplished. Before investing, companies are supposed to know the market demand and the relationship between demand and supply, as well as the government policies toward relevant trade. Because of these policy restrictions, some industries and fields are unavailable to foreign companies. Even though these fields have great market potential, companies will still find no access to the market, so they must keep out of it. The restriction or encouragement of the state also changes from time to time. In fact, the government changes the contents of its guidance to foreign investment nearly every year. For instance, when China's huge basic investments are in urgent need of foreign capital, investment in financial items will be accepted readily. And in order to improve the added value of industrial production, China has always been encouraging and providing preferential policies for investment in high-level and new technology. The changes in the national economic structure have generated a huge surplus of labor force in rural areas, so the state prefers labor-intensive companies that can help the government solve social problems. Another example: China removed its trade barriers after joining the WTO causing the problem of balancing the foreign exchange rate. Hence, the government favors export-oriented companies. But for other industries, especially those pillar industries such as automobile, real estate, and communication, the government does not intend to involve foreign capital, so the restrictions or even prohibitions are very strict. Because they are restrained by WTO regulations, the government cannot prohibit foreign investment through laws, but the central authority can still use administrative orders or internal rules for control. Under such a circumstance, except for some mega SOEs who have a good relationship with the top authorities, as well as some special items with political and diplomatic concerns, common small or medium enterprises are incapable of breaking these prohibitions. For that reason, when making certain of its market objective in China, foreign firms should fully know what kinds of market are accessible.

Conclusion 9: Before entering the Chinese market, foreign firms should analyze this country's industrial policies and choose a good approach for investment and production.

3 China's Market Characteristics

After talking about the macro-environment, we are going to analyze the major objective of entering China: its market. We plan to study the common and different points of domestic and overseas markets as well as the characteristics of the Chinese market, hoping that preparations for entering the market can be carefully made.

3.1 The Regional Difference

China boasts a land mass as large as the whole of Europe. If the concept of The Greater China (a term commonly used by Euro or American firms in recent years) is applied, then an even larger land area will be included. As a result, language, culture, customs, market behavior and client mentality in different regions vary, just the same as in European countries. Actually, the regional disparity in China is even greater than that in some European countries. For instance, the Beijingese are unable to understand the dialects of Shanghai or Canton, and clients from the North or the South may have great gaps in negotiation price.

China's regional disparity results not only from these concerns. In reality, different areas have developed unevenly, so that there will be major contrasts in economic power, technology, infrastructure and education. In addition, enterprises will differ from each other in cost control, resource usage and potential, thus making them choose different market orientation and clients. Therefore, it is advisable to divide the whole Chinese market into subsections that comprise several provinces, and this approach has been taken by many western firms in China and has proved to be successful.

Conclusion 10: Sometimes, regional disparity in China is even greater than in European countries.

3.2 Distortion of Information

As everyone knows, key information and statistics are vital to a market survey. However, errors or distortion are always found in the statistics released in China, especially those concerning specific trades or product markets. Thus it will be hard to use these figures as references. Many reasons contribute to the errors or distortions. Some are attributed to the lag between data collection and publication, so that data has expired. Some are due to the non-uniform statistical methods or sources, so data becomes inapplicable. And some figures are even falsely presented in order to mislead.

According to this situation, some companies would rather survey the market by themselves. Of course, some rather prefer to use official or semi-official data along with their own information to verify each other, and combine the results of market research so as to reveal the correction. Attention: data cannot be obtained in a short time, so companies should pay careful attention to data collection at the very beginning lest they waste their time.

Conclusion 11: Statistics are not totally believable in China, and companies are recommended to collect figures on their own.

3.3 The Instability of the Legal Environment

We have mentioned that authorities at various levels have their own understanding of policy and may execute it in different ways. Besides that, considering local development, local governments may take some different measures when executing or interpreting policies and laws - we call it the

Edge Ball. Man generates these differences so that specific executors will affect the result, also time and spot will be influential. Here are some cases:

Case 1: One public servant holds this view: anything that is not outlawed in the documents should be allowed. However, another public servant argues: anything that is not recorded in the documents should be prohibited. Obviously, the two people generate different results from the same documents.

Case 2: The government authority has ordered that one provision shall be enforced from a certain date. Many companies complain that it is impossible to be done within such a short period. Careful examination reveals that this provision was not a newly-established one but one that had already been issued years ago without being enforced.

Case 3: A local government provides favorable treatment to a foreign company along with a written memo and contracts, aiming to attract foreign investment. Years later, the company receives a notification, saying that the promise made by the local government violates policy and should be cancelled, and all the documents concerned shall at the same time be abolished.

Many other examples can demonstrate similar situations. Government departments, not considering the overall situation, often practice laws and regulations in contradiction with each other. After discovering the contradiction, they still refuse to coordinate with each other, leaving companies no way out.

Conclusion 12: The understanding and enforcement of law should depend on and consider the different conditions and circumstances caused by all factors.

3.4 Price and Payment Method

China is currently lacking a mature financial market (see 2.3.2) so that most enterprises (especially those privately-run ones) will have difficulties in raising funds, therefore there is a high demand for price and payment method in the market. When examining their cost-performance ratios, enterprises always show concern more about the price and payment method of products than other functions (such as technology, quality, delivery term, and service). That is why fake or counterfeit cargo can prevail in the Chinese market only by its lower prices and preferential payment method. A new comer must fully prepare for this condition both mentally and in reality. Only by doing so, can he face the challenges of low-end products.

In accepting the payment method, he should beware the features of China's legal environment. In fact, default and chain debts have become deep-rooted illnesses in China. Moreover, the lack of good solutions in law has deteriorated this phenomenon (in some cases, a winner in the court still gets no arrears). Some companies even use other's arrears to them as a justification for refusing to pay their debts. Thus, any strict clauses in contracts will then become invalid. Furthermore, companies offering installments will become worried that they have to pay huge energy costs, human resources costs and money costs to get their debts settled. This demonstrates why the central government ordered state-owned insurance companies to drop out of the business of „guaranteeing the execution of contract", and this is also the reason that miscellaneous favorable payment methods can attract so many clients in the market.

Conclusion 13: Price and payment method are useful weapons for low-end products. Full preparation and effective measures should be made, and close attention should also be paid to guard against the risks from the unsound Chinese legal system.

3.5 Market Disorder

Once emancipated, the Chinese planned economy, which has been used to instructions from the central government, will appear in disorder. Though they have gained exceptional freedom in decision making, their capacity of analysis and judgment still remains stuck at a primary level. Once a trade or a product shows good momentum of development and profitability, imitators will swarm into the similar markets in no time without analyzing market capacity and the supply-demand relationships (especially during the period when the intellectual property rights are not under good protection in China), thus an oversupply will immediately appear. Afterward, competitors will launch a cut-throat price war, and finally they will reap no profits in the market. The latest two sessions of the Chinese government both warned of the risks of duplicated construction, which also shows the dangers inherent in this problem.

The overall strategy of the macro economy is this: The country controls only the 40 to 50 key industries which have a vital influence on the national economy (administrated by the newly established Large Industrial Committee), while the rest are thoroughly freed up by private enterprises. In this case, when state control drops out of these fields, for reasons aforesaid, the market is likely to be thrown into chaos. So enterprises need clear thinking and must be fully prepared for the market under these conditions.

Conclusion 14: Keep the identity from your company and products to your rivals!

3.6 Official Standard: Trade between Money and Power, and „Guanxi" (Connection Skills)

Thousands of years of centralized authority as well as the Chinese cultural reverence for bureaucrats (see 2.1) has resulted in authority having a powerful influence over the economic and social activities in China, as well as a prominent position in market trading. Although trade through an abuse of influence is illegal in many circumstances, most people and enterprises in China have accepted it and strive to make full use of this situation. Of course, this type of trade practice should be categorized as „corruption", but in the existing deeply-rooted system, the illegal trade of „power for money" is hard to separate from responsible trade practices. In this regard, we can often hear people say „Giving preference under the same condition".

Western people and companies have already recognized and studied the word „Guanxi" (connection) and its wide-spread power in China. They have many examples to demonstrate that foreigners (long nose) will find it difficult and perhaps even impossible to establish such connections with Chinese officials. Besides language obstacles, other cultural discrepancies have hindered the formation of this tacit relationship between foreigners and Chinese officials (see 1.1). To foreign enterprises, it is a privilege or duty for their Chinese employees to establish and use this special interpersonal relationship. In addition, the private feature of these affairs is apt to make foreign partners lose control or distrust the whole procedure due to the lack of transparency, thus leading to a breakdown in cooperation. In fact, dealing with the situation properly is important, difficult, and requires a high degree sensitivity and seize.

Conclusion 15: The problem of „Guanxi" (connection) is everywhere and exerts a powerful influence. This reality needs to be properly recognized and responded to.

4 The Influence of Chinese Culture in Enterprises

In addition to its own culture, companies create sub-cultures within each branch or office that are a result of the culture of the local community. As a result, differences often will emerge even if every local branch tries to incorporate the uniform culture of the parent company. How to effectively implement the company culture under the specific local culture has become a fundamental task for each firm. In China, a country with a long history of civilization, the solution to this problem has become a fundamental task for transnational corporations. We will elaborate on this issue.

4.1 The Clash of Cultures

As we have said, the influence of Chinese culture is extensive (see 1.1). In terms of the basic ethic category, this influence has no direct relation to the educational level of the Chinese people. Actually, most of its impact is formed with no relation to systematic education, but through day to day influences from family and social circumstances. So, in addition to the language, understanding of the culture is an obstacle for foreigners in China. The cultural connotations are far richer than language itself (if language is confined to daily oral language only because of utilitarian objectives), so it is difficult to master.

The differences between Chinese and foreign cultures creates very distinct feelings or judgments as they deal with the same thing. This creates communication difficulties and leads to a „lack of understanding". If the situation is based on a lack of tacit understanding, then the efficiency will be lessened; if the dispute fails to be solved, in the long run, bigger problems may occur, and cooperation may break down completely. Hence, in the dispute resolution attention should be paid by each side to the cultural differences. Doing so will gradually and effectively remove the disadvantages the foreign companies face.

Conclusion 16: Both the Chinese and the foreign company should pay attention to cultural differences. Each one cannot regard his own understanding as the sole correct view and force the other to accept it.

4.2 Differences within the Chinese Culture

If anyone whose native language is Chinese is deemed as a Chinese (no matter his nationality) and if the small distinctions in dialects and regional customs are not considered, you still find differences between Chinese in accordance with their own cultural background. Chinese people from Hong Kong or Taiwan can talk with people from the mainland without difficulties. This is why western companies have liked doing business with Hong Kong based companies at the beginning of the reform and opening policies. Overseas Chinese (such as people from Southeast Asia or who born in America) perhaps have relative poorer language skills than people from Hong Kong or Taiwan, although they have no big problems in talking with mainland Chinese. As we have pointed out, it's not merely the language but the cultural gap that hinders cross-national communication. Chinese from Hong Kong, Taiwan or other countries grew up in a different cultural environment from the mainland, so if they only rely on their original language knowledge and cultural background without special training, they will also find it quite hard to hold a deep conversation with a mainland Chinese. Actually, in the eyes of the mainland Chinese, bosses or managers from Hong Kong and Taiwan are considered foreigners, not Chinese.

Consequently, people from the mainland are more suitable for public relations or cross-employee communications, and of these, local people are the best. Of course, considering that communication is a two way process, these people are still required to be proficient in the foreign language and familiar with the foreign culture. As well, They should have the experience of living and studying abroad or have received top quality language education in China, otherwise, they will not be successful.

Conclusion 17: Significant cultural differences exist among Chinese people based on the different background of their roots. Chinese who have received a western education are more suitable for the job in foreign enterprises.

4.3 Trust is the Foundation of Cooperation

No matter how competent the employees are, if they are given no confidence and no opportunity to give full play to their intelligence while undertaking their duties and making decisions they will be unable to cooperate successfully. Traditional ideology in the Chinese culture is playing a deep role both in society and in interpersonal relationships.

- Trust people, otherwise do not use them!
- The commander disobeys order from the emperor when at war.
- The emperor regards me as a talent, so I respond to him as well as I am able.

These thoughts are applicable to the whole of Chinese society, and are not only restricted to one of enterprises. Similar, if trust cannot be established outside a company (to the society with such like supplier, authority department or customers), then cooperation will be hard to sustain.

In western cultures, trust is limited and generally only emerges as a subsidiary method of control (i.e. German proverb: „Trust is good and control is better"), which is in conflict with Chinese tradition. In the Ming dynasty, this method prevailed: The emperor felt he must dispatch one of eunuchs as his reliable agents to oversee the general at war. The agent was favored by the emperor but had no ability to command the battle. In the end, the troops lost the war and even the emperor himself was captured. Appraising the history since some centuries has become a conclusion and made the Chinese people skeptical of this kind of management. If foreign enterprises are familiar with the background of Chinese thinking and its sensitivities,

then they should act as carefully as possible in dealing with the mutual-trust relationship. If such a policy must be pursued, effective measures should be taken to diminish the degree of „Control" as lessening control will improve efficiency and may reduce unnecessary conflict that could otherwise impact on cooperation.
Conclusion 18: Trust is a fundamental for a successful cooperation!!!!!

4.4 A Complicated Mentality

Just like the drastic conflict which occurred when the Qing Dynasty held the „Yangwu" (Westernization) Movement, the Chinese people are contradictory when doing business with foreigners. From the miserable experience of being bullied in modern times, to the breakdown of the propaganda („2/3 of the people are suffering in the world"), most Chinese people on the one hand are impressed by the advancements made in foreign countries and thus suffer an inferiority complex. On the other hand, the old thinking that the great China is the center of the world still plays its role and sustains people's arrogance. This mixture of self-humiliation and arrogance generates a complicated mentality for the Chinese in their external exchanges. As a half-colony in old times and a front door for opening up in contemporary times, the city of Shanghai is representative in this regard.

Half a century ago, Shanghai earned the name of „metropolis infested with foreign adventurers" and „the Oriental Pearl" where the rich colonial flavor enabled the Shanghainese to better understand western culture. At the same time, however, Shanghainese collided with foreigners because of the foreigners' contempt. A contentious sign at the gate of the Huangpu Park once read: „Chinese Chow and Dogs: Keep out", for example. After „self-reliance" education, the self-esteem of the Chinese people was greatly reinforced, and today there is even a degree of sensitivity on the matter of Chinese pride. If foreign entrepreneurs fail to recognize this new attitude, or became angry because of the attitude of one person, or show their superiority in front of the Chinese, then a good cooperative relationship will certainly become impossible.
Conclusion 19: You must respect others before others will respect you: A sensitive issue.

4.5 Impersonal Expression and Informal Organization

In China, many proverbs have taught people not to be different from those around them. Of course, after the reform and opening to the west, many new people have emerged who are seeking personal liberation and acting differently. These persons help to differentiate this period from the period of the Culture Revolution, when every person was dressed in a blue „Mao uniform”. However, tradition appears to be pervasive and not easily overthrown in a short time. As a result, when expressing their own opinions (especially different one), Chinese commonly tend to use the words such as „we hope”, „we all feel”, or „as everyone knows”, or they use neutral words „it is reported” or „it is thought”. In this way, a tendency of conformity is engendered, and individuality and independent opinions are submerged in the „the boundless ocean of the people's war”.

Another social principle is „leaving some space”, a principle which has been recognized universally. Most people favor thinking where both sides gain, so they are inclined to use ambiguous languages such as „maybe”, „possibly”, „perhaps” or „probably”. In China, the skill to fully understand what the other person really wants to say has been extremely complex and depends on much experience so that even many native Chinese are worried. For instance, „not bad” or „basically good” always contain a sense of doubt while evaluation. And „pretty much the same thing” or „passable” show a euphemistic criticism in many cases. While evaluation to own achievement people try - based on traditional understanding that „Modest is virtue” – to transfer the real meaning of „excellence” with wording such like „not enough jet” or „still need improving” etc. Thus many foreigners will feel that the Chinese people sometimes are excessively friendly and sometimes hard to be understood. Due to this ambiguity, reports can be unclear.

Understanding the traditional ways the Chinese express themselves can contribute to a correct evaluation of reports and an understanding of the writer's attitude, leading to „getting twice the result with half the effort.” In this way tasks can be smoothly practiced. Otherwise, some small groups maybe consider their personal benefits too much and create more difficulties overall.

Conclusion 20: Know and practice the traditional thinking and expressions of the Chinese people.

5 The Uncertainties

The above analysis and cases are all based on the past experience, and so they can only serve as references for future operations. Any attempts at speculation or thoughts of luck are dangerous because the Chinese situation is greatly influenced by governmental policies which are very changeable and unpredictable (see 2.1 and 2.3.1). All we can do is to be down-to-earth, keep track of the changes of macro and micro conditionals relevant to all companies, and make timely, rational responses, getting as ready for the various changes as possible.

There is little point in discussing the micro-environment since all companies are engaged in different trades and conditions. Therefore, I will only point out the following trends of changes to the macro-environment for your reference:

– Likely change in the political system and its influences on economy (changes in guidelines of the new government)
– Hitherto complicated and confusing developments in the money market (reform in the banking system, phasing out of the insurance industry in the finance sector, monetary policies and the ongoing macro adjustment and control)
– The direction of reforms in the taxation system and in revenue policy
– The trends of policies in foreign-invested companies and economic development regions (strict favorable policies, and tight controls on project approval)
– Anfractuous world economic situations and China's foreign trade based on political and foreign policies (promises and interior control after entry into WTO, tariff alteration and canceling after verification policy for foreign exchange)

The passing events are just like the flowing river,
Days and nights,
Never stop!

Confucius

Effective Pricing Strategies for Foreign and Chinese Companies

Stefan Herr, Fan Oswald-Chen, and Ying Yang

Simon - Kucher & Partners, Bonn

1 Introduction

For foreign companies with high quality products, China is seen as an easy-to-conquer market that offers huge potential along with breathtaking developments. In contrast, Chinese companies see foreign markets as a challenge best confronted with their typically most effective strategy: low costs. Yet the situation for both foreign and Chinese companies is far more complex and these traditional approaches hardly take the real dynamics into consideration.

Chinese firms frequently perform better than expected with mixed strategies, leaving the low-cost sector to compete with international rivals with high-quality production. On the other hand, foreign companies often face serious pricing challenges when trying to gain considerable market share growth and become profitable on the Chinese market.

To gain a deeper understanding of effective pricing strategies for both Chinese and foreign companies, we have analysed the situation from three perspectives: the pricing of Chinese companies in their domestic market (chapter 3); the pricing of Chinese companies in foreign markets (chapter 4) and the pricing of foreign companies in China (chapter 5). But before we start with the three cases, let us take a closer look at the basic concepts of pricing (chapter 2) which is a key instrument of success in the processes of strategy building.

2 Pricing Basics

2.1 Importance of Pricing

Pricing has traditionally played a tactical rather than a strategic role in the business world. But the role of pricing is changing. Growing emphasis on shareholder value, modern telecommunication technologies and more sophisticated methods of measuring the effects of value and price have put pricing at the forefront of strategic thinking.

Three value drivers make up the basic profit formula: price, volume and costs. In the 1990s, management mainly focused on costs, giving birth to concepts such as lean production and just-in-time production. Consequently, costs have significantly been reduced, as seen in the automotive industry. Today, the cost reduction potentials have been almost completely exhausted and profit problems can no longer be solved by cutting costs. As many companies set prices using cost-plus method, decreasing costs may lead to lower prices and hence, lower profits.

To increase profit by increasing the sales volume is a difficult task. In a saturated market, gaining greater market share is the only possibility for raising the sales volume. This would have negative effects on the competitors, forcing them to try to keep their market share. Even in innovative product markets, demand can be saturated rapidly, as seen in the markets of mobile phones, broadband internet access and digital cameras. Although emerging sales markets like China appear promising in terms of market volume, the investments and the number of competitors have to be considered as well. In other words, huge market potential does not necessarily guarantee a growing sales volume.

Price is the only value driver that has a stronger leverage effect than costs and volume. Compared to costs, price as a value driver has three basic advantages: lower investment costs, fast implementation and a direct impact on profit. The differences between the value drivers are revealed in the figure below.

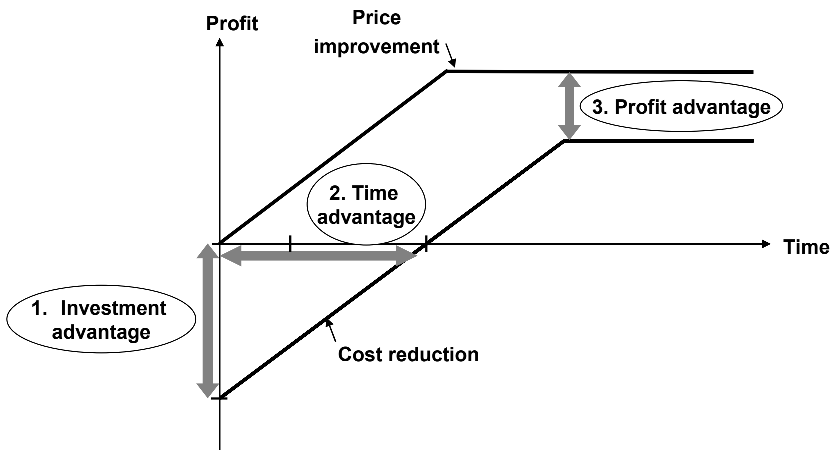


Fig. 1. Advantages of Value Driver Price.

The price lever can have an enormous effect on profits, as illustrated in figure 2. If the product prices of 12 German and Japanese companies were raised by 2% (assuming ceteris paribus), the possible profit increase potential is immense. The profits of Metro, Toshiba and ThyssenKrupp would double and the profits of other companies would significantly improve.

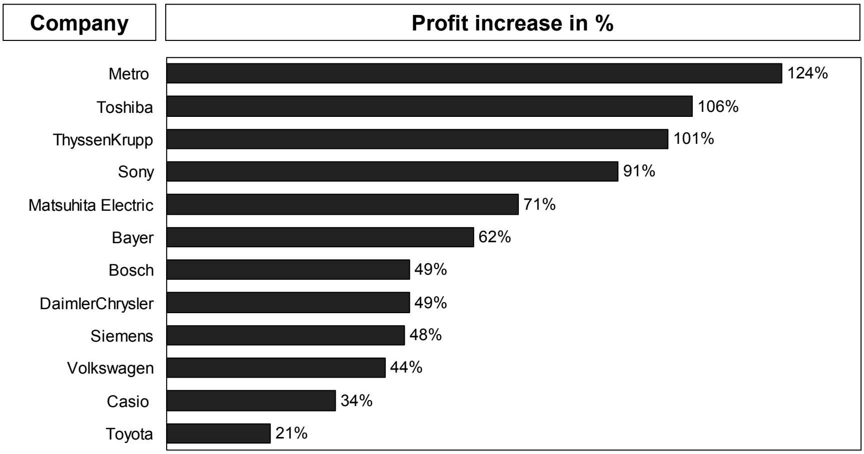


Fig. 2. Effect on Profit Through 2% Price Increase (Source: Calculation by SKP from Annual Reports 2004 and 2003/2004).

Given this strong leverage effect of price, it is astonishing how contradictory the perceptions of price are. According to a management survey of the decisive aspects in business, price has been rated as the factor with the most decision power. Yet, many managers seem poorly informed of their customers' willingness-to-pay and of the price they could charge their clients.

2.2 Pricing Methods

Pricing is a very sensitive instrument, because it directly affects profit. Once a manager has implemented a price change decision, it cannot be easily reversed.

In general, pricing as a value driver can be separated into two categories: price optimization and pricing process. Price optimization focuses on determining an optimal price for particular products, whereas a pricing process deals with improving the whole process chain from strategy to price implementation to price monitoring.

There are three different methods applied in the price determination:

- cost-plus pricing
- competition-oriented pricing and
- price optimization based on price-response function.

Cost-plus pricing is the easiest method to find the right price. It is based on cost data and supposed to cope with market uncertainty. The production costs have to be covered by the price; a fixed profit margin is usually added to the costs. In some cases, the decision-makers of pricing – often in the finance or accounting department of companies – tend to think in cost-plus terms. If competitors have similar cost structures and apply the same mark-up, cost-plus pricing could become an instrument for silent collusion. The further disadvantages of this pricing method are that a higher willingness-to-pay of the customer is not fully utilized and cost reductions are immediately obvious in the market. Moreover, the demand side must be considered when setting prices, because the customer's willingness-to-pay should not be determined by the costs of a product, but by its performance and value to the customer. In spite of its popularity and simplicity, cost-plus pricing is not a recommendable method since it ignores the central factor of the customer's perception of value.

Competition-oriented pricing is based on the competitors' prices. The price position of the product is calculated according to the competitors' product prices. With this method, the company's own price premiums and that of the competition must be taken into account, making pricing quite complex.

The third method calculates a profit-optimal price by analyzing the price-response function and profit function. Through this method, the customer's willingness-to-pay is considered and the company's profit is maximized. Depending on the specific case, methods such as expert judgement, customer surveys, price experiments and the analysis of historical market data help to identify the price-response functions.

2.3 Pricing Strategies

Depending on the individual market situation, different price strategies can be distinguished. Figure 3 gives an overview.

Customer-based price differentiation assigns different prices for different customer segments. For example, Sixt Car Rental Company offers separate rates for private customers and corporate customers. Regional price differentiation depends on the place where a product or service is purchased. For instance, the price of beverages in a common supermarket is usually cheaper than in a shop near tourist sights. Similarly, temporal price differentiation is based on the time when a product or service is bought. Telephone calling rates are a good example for this kind of price differentiation, as the price charged per minute depends on what time and day a call is made. Price differentiation during the product life cycle is based on the phase of a product's life cycle. A newly introduced product can be charged higher than a product in the saturation phase. A very extreme example is laptops; as soon as a faster and better-equipped laptop is introduced, the prices of the older ones fall rapidly. Moreover, the price decline of laptops starts already on the first day it is available in the market. With these four pricing strategies, the price is adjusted according to certain fixed criteria, e.g. location and time, and cannot be influenced by the customers.

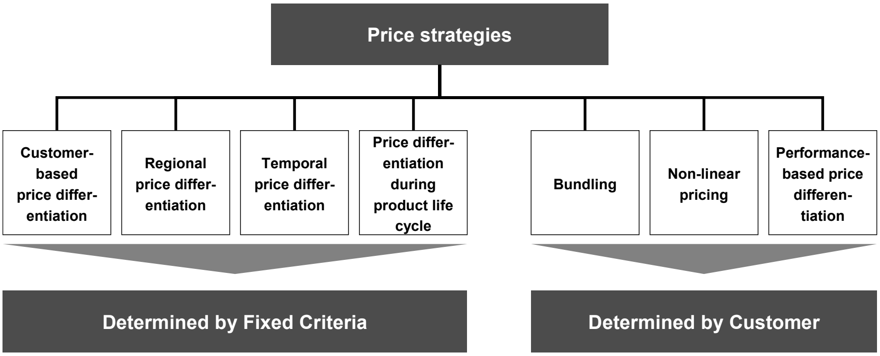


Fig. 3. Price Strategies.

There are also price strategies which require the customers to make a selection. Bundling – when several products or services are pooled together – gives the customer the opportunity to buy a „package“ for a cheaper price than the sum of individual purchases. For instance, the meals offered at McDonald's include a beverage, a burger and French fries, but if one buys these products separately, it is more expensive than the price of a meal. Another alternative is non-linear pricing which is oriented on the intensity of usage. Mobile phone tariffs, for example, which often consist of fixed and variable prices, are a matter of choice for customers. Frequent users can choose tariffs with a high fixed price and a low variable price. For those who rarely make phone calls, price options with low fixed prices and high per minute charges are offered. Customers can choose the optimal tariff according to their usage preferences. Performance-based price differentiation, the last strategy, adjusts the price according to the product or service quality that customers require. A typical example can be seen in air fares for economy and business class.

3 Pricing of Chinese Companies in China

Basic pricing issues of companies in their domestic markets are not country or industry specific, but are universal. In other words, pricing for Chinese companies in China is similar to pricing in Europe, USA or elsewhere. Generally speaking, Chinese customers are more price-sensitive than Western buyers. In light of this trait, there are two pricing issues that are frequently neglected by Chinese companies in their home market.

3.1 Price Quality as an Incentive

In China, high discounts are common in many industries. The sales force often gives discounts in 5% or 10% intervals. A typical distribution of the discounts is shown in the figure below.

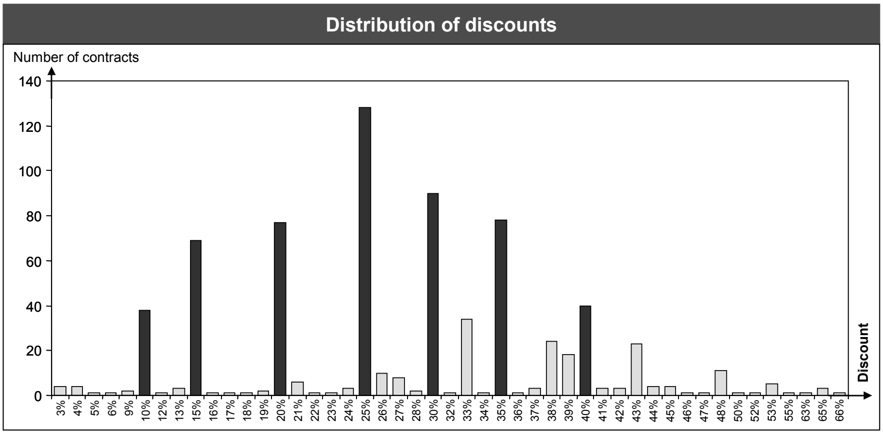


Fig. 4. Discounts in 5% and 10% Intervals.

This kind of discount giving is a fatal signal, as it may give the impression that a higher discount range is still possible. It makes more sense to give discounts in intervals of 1%, and in industries with low discount levels, even in intervals of 0.1%.

Another pattern among sales people in China is the tendency to give the maximum authorized discounts. This phenomenon is not only observed among the sales people of lower hierarchical level, but their superiors behave in the same way. This kind of pattern arises from the lack of incentives offered to those who negotiated a lower discount.

Since the salary of the sales force in China usually depends on order inflow and turnover, it is necessary to provide incentives for the sales force to reduce discounts and improve price quality. One possible solution is a bonus payment in addition to the salary. In several recent projects our clients were able to improve their price quality with this measure. Some sales people have even reduced the average discount by about 5 percentage points without sacrificing turnover.

3.2 Value-based Selling

To sell successfully, not only are optimal incentive and price systems needed, but it is even more important to have the right arguments for selling the products and services. The following questions must first be answered:

- Who are the relevant competitors?
- What are the customer's most important purchasing criteria?
- Regarding the purchasing criteria, how is my own relative position in comparison to the competitors?

The relevant competitors have to be identified by the sales force and the latter two questions could be answered using a customer survey.

In a recent project, our client's performance in five out of the top ten purchasing criteria was better than the main competitor and worse in four criteria. From this data, it may seem that the market share of both companies is nearly equal. In fact, the main competitor's market share was three times larger. How could this happen?

After a detailed analysis and discussions with sales, it became clear that the main competitor used very offensive sales documents. The strengths compared to the other companies were pointed out in these documents, so the customer was distracted from the company's weaknesses. Conversely, our client pointed out its weaknesses and was not able to emphasize its strengths. Moreover, the sales documents of the competitor were structured around value instead of focusing on the technical aspects. In addition, the competitor customized its customer presentations according to the functional level of the audience. When a presentation was given for a plant manager, aspects like non-stop production, short reaction time in case of breakdowns and optimization of the machines were the main content. For the top management, factors such as corporate goals, frame contracts and financial aspects are more relevant. Using a value-based selling strategy, the competitor was able to gain a phenomenal market share and achieve an excellent price level.

4 Pricing of Chinese Companies in Foreign Countries

At the International Motor Show (IAA) 2005 in Frankfurt, a Chinese sport utility vehicle named Landwind caused a sensation. More important than its fantastic introduction into the European market, its presence at the IAA completely changed the mindset of people about the Chinese automobile industry. The acquisition of IBM's PC business by Lenovo in 2004 and the impressive market penetration by Huawei Technologies, one of the leading telecommunication infrastructure equipment producers worldwide, are other prominent examples of the growing success of Chinese companies in foreign markets. What are the typical pricing tactics of Chinese companies in foreign countries and to which implications do those tactics lead?

Taking the motorcycle industry in Vietnam as an example, in the 1990s, Honda was by far the clear market leader, with a market share of about 80%. The situation changed dramatically as Chinese motorcycle companies entered into the Vietnamese market in 2000. The Chinese products were offered at a price even lower than one third of the competing Honda product called „Honda Dream“. With this incredible price advantage, the Chinese motorcycle companies were able to reach a sales volume more than six times larger than that of Honda. In the first year of sales activities in Vietnam, Chinese manufacturers took over the market leadership by selling through prices.

In reaction to the Chinese competitors, Honda reduced the price of „Honda Dream“ by nearly 40% in the following year. They also launched a new product with the name „Honda Wave“ one year later to compete against the Chinese products. This new product was positioned as a high quality product with a competitive price at a level comparable to the Chinese motorcycles. By applying these pricing and product measures, Honda was able to oust the Chinese newcomers from the market in 2003.

An aggressive price policy is a common weapon of Chinese companies to conquer foreign markets. Although it may help to achieve short-term market share growth, in many cases it turns out to be insufficient in achieving a sustainable market position, because the competitors – especially those from low-cost labor regions – can relatively easily catch up.

Examples like the Honda case show that Chinese companies cannot only rely on price advantages to establish themselves in foreign markets, but that they have to build up real strategic competitive advantages. Obviously, it is very difficult to earn long-term profit on low prices. The company-customer relation has to be seen as part of the strategic triangle that also involves the competitors in the market. To make money with a product and to achieve real value-to-customer, customers have to perceive considerable advantages over similar products of the competitors.

While in the past, Chinese companies commonly acted as subcontractors for foreign OEMs, they are now struggling to a greater extent to build their own global brands. There is no lack of evidence for the Chinese urge to expand. Haier, well recognized worldwide as China's leading maker of home appliances, seems to be the ultimate success story with factories and branch offices in over 100 countries. For years, Haier has enjoyed an unbelievable annual growth of sales of about 70%. To reach a place under the top three white good makers, Haier is not exclusively pursuing those low-cost strategies that have been the greatest advantages of Chinese manufacturers and does not mainly rely on niche strategies. In fact, Haier has announced its goal to increase responsiveness to customers by producing abroad, to improve its distribution and service networks outside of China, and to invest more in product design.

The consumer electronics maker TCL is another example of probably one of the most aggressive expansion strategies of Chinese companies. After having acquired the two brands Schneider and Dual in 2002, TCL joint an alliance with Thomson, TTC Corporation, which forms today the biggest manufacturer of TV sets worldwide. Furthermore, TCL Mobile paid off Alcatel after an initial joint venture. These ambitious acquisition strategies are to help the company to gain access to new markets and technological know-how and to develop sales channels. „Our aim is to become the Samsung from China“, said its Chairman, Li Dongsheng.

While Samsung started as an unknown domestic market-oriented and manufacturing-driven producer, it today enjoys a reputation as an innovative global company that offers the latest high-end products. The company, known in 1990 as the „cheap Korean“ for its air conditioners and TV sets, has become the world's second biggest chip producer behind Intel, number two in LCD displays after Sharp and number three in mobile phones worldwide. Its revenue has doubled in the last five years to 45 billion euros in 2004 and for the forthcoming five years, Samsung aims at the repetition of the miracle. Moreover, the company's profit margin growth continues to be double-digit, amounting to 8.5 billion euros last year. It is by far the most profitable company in the electronics industry. With its market value of 68 billion euros, Samsung is already Asia's most expensive electronics giant. Its success factors, including striving for technological leadership, time-to-market as well as offensive investments rather than a price-driven strategy, are regarded as a kind of paradigm motivating Chinese firms to focus on global growth. With Chinese companies showing discipline and the willingness and attitude to learn from Western competitors, it's only a matter of time until global players like Samsung will arise among them.

5 Pricing of Foreign Companies in China

As more and more foreign companies expand their business in China, a considerable number of them face the serious challenge of making a profit in this price-driven market. In this context, innovative pricing strategies for the Chinese market are increasingly becoming a key factor of success.

In general, foreign companies have often been able to achieve a price premium for their products in China over the domestic products of their Chinese counterparts. This is especially true for technology-centered industries such as electronics, machinery and engineering, but also for pharmaceutical, biotech and medical device producers who typically have large research and development expenditures. In these industries, the prices of foreign suppliers are often 10-15% or even higher than the prices of the Chinese competitive products. However, this price premium is normally by far not high enough to cover the cost disadvantages of producing outside of China compared to in China.

For a machine supplier of the electronics industry, China is the most promising sales market with an increasing sales forecast. To take advantage of this market potential and to reduce the costs compared to the Chinese competitive products, production in China seems to be the logical strategy for the company. But a blind pursuit of this strategy i.e. a strategy with no fine-tuning would diminish the company's profit potential to achieve premium prices which are supposed to be up to 30-40% higher than those of the Chinese competitive products. The reason is that Chinese buyers often consider foreign products to be more prestigious and are thus willing to pay a higher price. If the product of a German company was manufactured in China, it would lose its status a made-in-Germany product enjoys regarding premium value.

Is there any way for a foreign company to tackle the apparently impossible goal of low-cost production in China without giving up higher prices? The machine supplier of our case chose to outsource labor-intensive production processes to China and ship those semi-finished products back to the home country for the assembly of mainly high-tech components before selling the end products in China. Although the transportation costs thereby incurred are rather high, they are negligible compared to the price advantages. With this strategy, the company is able to target premium prices and simultaneously take advantage of lower production costs in China.

Another characteristic of the Chinese market is a high degree of price transparency. The CEO of an international machinery company once said that „prices are public in China“. Chinese customers do not hesitate to communicate among each other about the price information they receive. Furthermore, they are used to bargaining heavily in price negotiations and obtaining high discounts. Thus, a temporary special discount would be soon known to all customers and would then be considered as a normal discount that customers expect.

To deal with this risk, some foreign companies set the sales price at the level of the list price and give no discount in China. Even though this rather radical action normally leads to initial dissatisfaction among customers, it results in minimal price differentiation and price negotiations. More importantly, this one-price policy effectively helps to avoid a possible price war. It is remarkable that, to get this practice widely accepted in the market, companies take advantage of the unique behavior of Chinese customers to exchange price-related issues among each other.

Yet the one-price policy cannot be used as a universal remedy. In many cases a low level of price differentiation would give the EBIT potential of pricing measures away. Compared to Chinese customers, the performance requirements of European customers are higher and the customers are willing to pay higher prices for a better performing product (value buyers). In contrast, Chinese customers are much more price sensitive and attach less importance to having more product features than to higher price levels (box to box buyers). Therefore, it often seems fruitless in China to sell exclusively through product features. The differences in requirements and in price elasticity give manufacturers the possibility to differentiate prices and discounts.

A global company of the electronics industry identified additional sales potential in China for a lower price segment. In response, the company changed its one-product-line strategy into a two-product-line strategy to capture the additional volume of this segment. By offering a new high-end product to customers with a higher willingness-to-pay, the company achieved premium prices. At the same time, by offering an existing product with higher discounts to very price sensitive customers, the company gained access to new customer segments.

The success of this two-product-line strategy greatly depends on the implementation of effective „fencing“. This means that the products determined for different customer segments have to be distinguishable in terms of performance levels, service levels, price levels and customer care, as shown in the figure below. For the electronics company, the product with a lower price was a phase-out model which was no longer sold outside of China. By applying price segmentation with different discount levels, innovative pricing measures might boosts profit significantly.

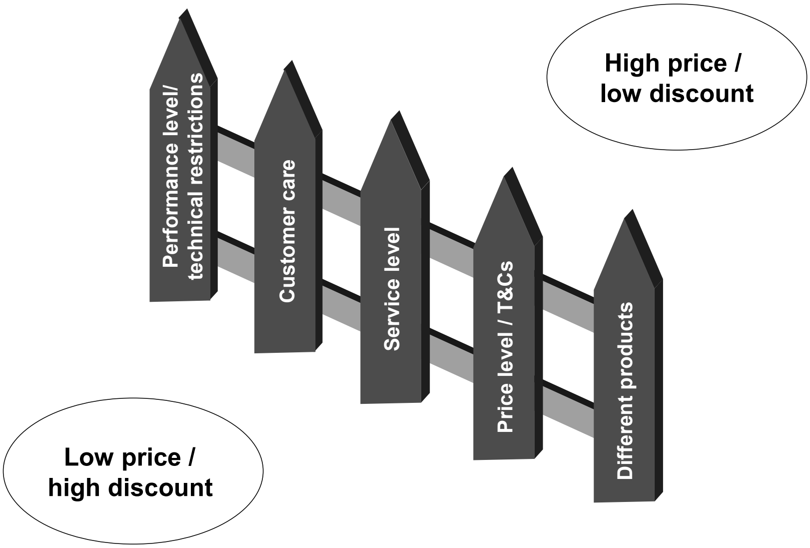


Fig. 5. Effective Fencing Strategies.

6 Conclusion

With more Chinese firms competing in international markets, marketing, pricing and branding competencies are crucial to establish a global positioning. Traditionally, Chinese companies have been cost-driven and pursued low-cost strategies. We have often observed, however, that such strategies frequently do not work in the long-run. By adapting to the lower price level, producers from South-East Asia have been able to counter the Chinese competitors. This has prompted Chinese firms to focus more attention on value-based approaches. Some have integrated these approaches successfully in their general pricing strategy. Yet, Chinese companies still have more to learn about pricing from their Western competitors. An incentive system for sales to improve price quality and value-based selling are two pricing issues that are still often disregarded in China.

On the flip side, foreign companies need to adapt their pricing strategies to the market characteristics and requirements valid for China when developing business in the country. A simple transfer of mechanisms and methods appropriate for the domestic market to China will not work. Innovative pricing strategies which combine both the company's objectives and the local rules of behavior and operation are essential to break into a new market. They will be the key for profitable business in China.

The Run to China – and the Need of Better Information and Analysis

Hubert Fromlet

Swedbank, Stockholm; Blekinge Institute of Technology and Baltic Business School, Kalmar

1 China's New Role As a Global Player

China has achieved a remarkable economic upswing since Deng Xiaoping started his economic reforms in the late 1970s. The figures tell it all. According to John's studies[1], poverty levels have been coming down since the economic liberalization process was started about a quarter of a century ago. This is an important achievement despite a generally assumed increased inequality of income, shown for instance by Demurger *et al.*[2]

A splendid introduction to China's economic development and sources of growth in recent decades is given by Dougherty.[3] He asserts that only 10% of GDP growth during 1978 to 1999 can be related to the growth of labor input, while 62% can be attributed to capital accumulation – figures that are confirmed by many other studies. That means, of course, that the remaining 28% is attributable to total factor productivity gains. At the same time, Dougherty also makes the remark that „neither capital nor labour can be allocated efficiently if markets are not well developed enough to allow them to be priced and allocated efficiently. And well-functioning markets require well-functioning institutions to support them …"

---

1 John, Rijo M. (November 2003) „Poverty Reduction in the 1990s: A Comparison of India and China". Working Paper, Indira Gandhi Institute of Development Research. Mumbai.

2 Demurger, Sylvie/Sachs, Jeffrey D./Wing Thye Woo/Shu Ming Bao/Gene Hsin Chang/Mellinger, Andrew D. (2002) „Geography, Economic Policy, and Regional Development in China". NBER Working Paper No 8897.

3 Dougherty, Sean M. (2004) „Strategic Issues for China's Economy". Economic & Financial Review (European Economics and Financial Centre, London). Autumn No 3.

China's future growth will likely be determined by its ability to mobilize not only labor and capital, but also to progressively improve its institutional framework. One can reach the conclusion that China still is not optimizing its factor input of labor and capital – certainly a still hidden potential for a sustained good growth rate.

Optimizing factor input is also a precondition for achieving long-term growth. According to Dougherty, China's income per capita still amounts to only 13% of the OECD average. With current growth conditions, however, real income per capita could be doubled every dozen years. China still has, consequently, a very long way to go in its catching-up process, even if very high rates of growth can be maintained.

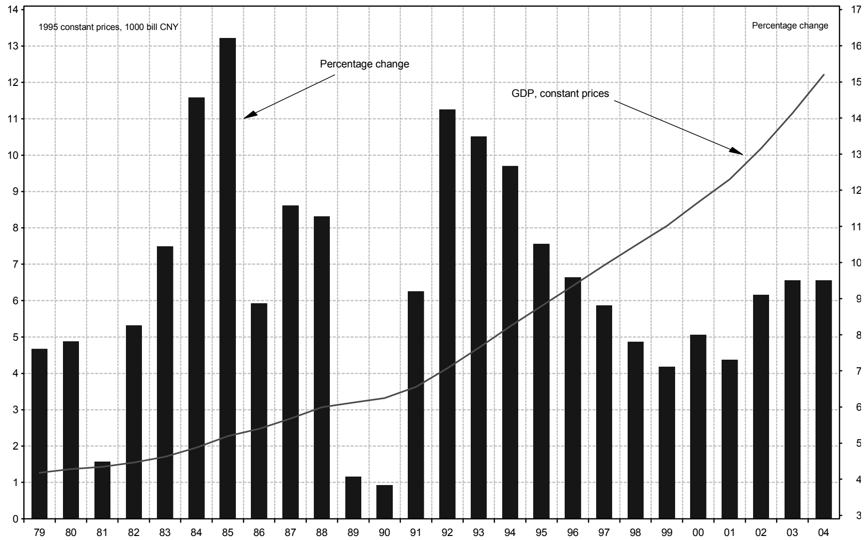


Fig. 1. Chinese GDP in 1000 Billion CNY and Annual Changes (Source: Ecowin).

Important countries like the U.S. and Japan have become increasingly dependent on low-price imports from China. But the opposite is also true. Exports to the U.S., Japan, and the EU nowadays amount to about half of the total Chinese exports. China's integration into the world economy is now most certainly a fact.

This is also underlined by the fast accumulations of foreign reserves. In 2002, the world noticed a Chinese figure somewhat above 200 billion USD, which was a lot at that time. Two years later, the corresponding figure exceeded 600 billion USD, giving China the number two position in the world after Japan. Further considerable increases can be expected in the future.

Should this be interpreted as a positive trend? The answer is not quite obvious. On one hand, one can fear growing inflationary pressure, because of insufficient monetary policy tools. On the other hand, academics like Eckaus[4] argue that China needs a lot of foreign reserves because of the leadership's ambition to make Shanghai an international financial center. Another reason may be increasing capital market volatility: an important consequence of a future change in exchange-rate policy and the forthcoming cautious deregulation of the current account, i.e. moves to more financial cross-border transactions.

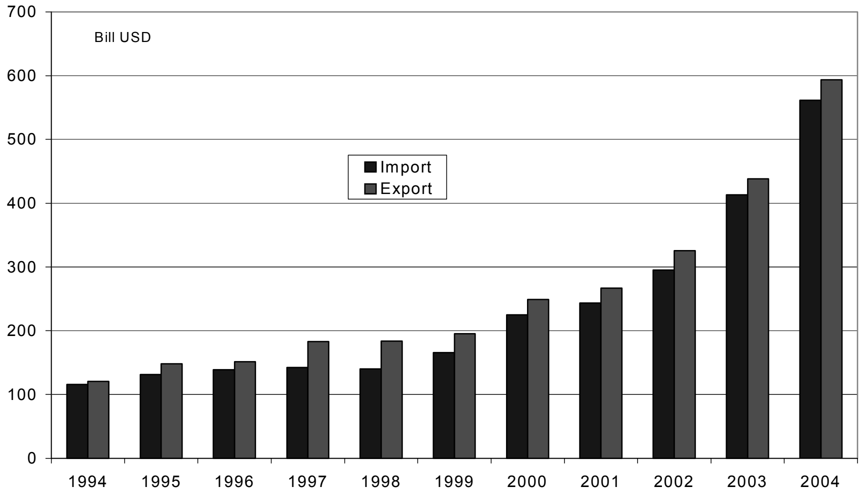


Fig. 2. Total Chinese Exports and Imports 1994-2004 (Source: WTO).

Only a couple of years ago, China became one of the top ten exporting nations. In 2002, China was already number five after the U.S., Germany, Japan and France. Two years later, China advanced further, to number three. The trend seems obvious. Even better positions will be achieved. At the same time, the increase of imports is noticeable as well. During the past decade, imports almost quadrupled. However, the big increases of exports in recent years also indicate vulnerability of China: if conditions for exports deteriorate significantly as a result of an endogenous or exogenous shock. Simultaneously, importers of Chinese goods and services have become increasingly dependent on stable conditions in China. Purchasing managers dislike delivery irregularity.

[4] Eckaus, Richard S. 2004. „Should China Appreciate the Yuan?" MIT, Department of Economics Working Paper No 04-16.

Another success story for China is its attractiveness to foreign investors. In 2004, foreign direct investment (FDI) amounted to more than 60 billion USD, which gave China an outstanding position as a destination for foreign investment. Annual numbers in the range of 40-50 billion USD have been usual in recent years. This can be compared to the total stock of FDI in 1990: roughly below 20 billion USD. In the past 15 years, this stock has become about 30 times bigger – and with many approved (Greenfield) licenses still in the pipeline. Many econometric models have contributed to the opinion – Zhang's[5] is one of them – that FDI promotes income growth, and that these positive effects so far have been strongest in the coastal areas. This can be confirmed by corporate practitioners who usually agree that this is their preferred location for investments. This is not only a recent development, but was also the case in the past: for logistical reasons.[6]

The ongoing Chinese export boom is a direct consequence of FDI. This is singled out by Eckaus[7] among others. In other words, without foreign companies investing heavily in China, the Chinese growth boom would have been less significant.

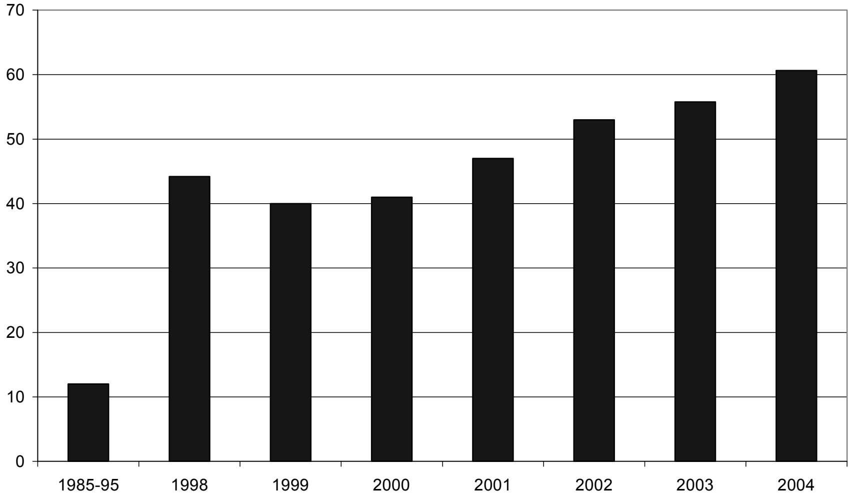


Fig. 3. Foreign Direct Investment to China, Billion USD (Source: UNCTAD).

---

5 Zhang, Kevin H. (2001) „How Does FDI Affect Economic Growth in China?", Economics of Transition, 9 (3).

6 Keller, Wolfgang/Hua Shiue, Carol. (2004) „Market Integration and Economic Development", NBER Working Paper No 10300.

7 Eckaus, Richard S. (2004) „China's Exports, Subsidies to State Owned Enterprises and the WTO", MIT Department of Economics Working Paper No 04-35.

Some other facts tell us even more. In recent years, China was a major lender, helping finance the U.S. current-account deficit. China absorbs one-third of the global oil demand and is now the second largest oil consumer in the world. China's share is one-sixth of global paper consumption. Chinese steel consumption is huge in a global perspective as well; when it comes to production, China's global share has increased to about one fifth. China boasts almost 5,000 cement factories.

But despite these big numbers, there are shortages in almost every imaginable sector. This makes Western investors ambitious – sometimes too ambitious and too myopic to consider the bottlenecks and shortages in China. Needs are not always the same as future demands – which is very important to remember. Finally, tackling shortages, and consequently factor input, will be very decisive for the long-term prospects of the Chinese economy. The outcome is not sure. What will the supply of energy, water, metals, human capital, financial markets, and also the state of institutions and the environment look like a decade from now? How will commodity prices develop if the current Chinese trendgrowth continues? These are big questions that so far cannot lead to credible answers and forecasts. More research is needed on these important topics.

2 Positive Developments in the Economy

This analysis is partly targeted at some of the major potential risks and analytical weaknesses in the Chinese economy. But it is essential to look at the positive aspects and trends as well. From a purely macroeconomic point of view, GDP growth is considerable – 9 ½ % in 2004 and 9 ¼ % on average annually during the past decade. In recent years, Chinese growth may have been even higher than officially noted because of underestimation of growth in the service sector.

There are, admittedly, major statistical uncertainties and significant inequalities in income distribution. On the other hand, which country in the world avoids major GDP revisions? That said, the statistical problems of China should not be underestimated, despite some progress recently. Many analysts do not give enough weight to the statistical shortcomings when analyzing the aggregates of GDP, its deflators, labor markets, government debt, non-performing loans, etc.

A very positive, but incalculable factor is that some hundred million people seem to have an education that gives them the chance to move upward. And many people are eager to improve their educational levels. This is certainly promising. A number of economists (for example, Mankiw, Murphy, Porter, Romer, etc.)[8] have convincingly demonstrated that human capital formation is decisive in determining the trend of economic growth. For instance, positive human capital formation makes a country, region or city more attractive to foreign investors.

However, it should not be forgotten that there is also research that rejects a significant relationship between the formation of human capital and growth, which Schweickert/Thiele[9] clearly singles out. The reason for these skeptical attitudes is the fact that the human capital comparisons between countries tend to neglect quality differences in education. Furthermore, it cannot be ruled out that given China's ongoing economic expansion, bottlenecks will emerge in education as well. Can the formation of human capital happen sufficiently fast in the long run? Sustained high GDP growth assumes a continuous long-term rise in educational levels. This is a topic not many economists discuss intensively – maybe because no one has an answer.

WTO membership since 2001 means that China must open its economy more to the international movement of goods, services and capital. This will happen gradually – but probably not without occasional disputes and distortions. Still, violations of patents are very frequent. In any case, WTO membership should gradually make China more of a market economy, even if there are further microeconomic distortions. WTO will most probably be positive for the Chinese economy in the longer run, though the road is bumpy at times. China will benefit more from opening trade barriers than most other economies, at least from the position of producers. In general terms, WTO membership favors Chinese long-term competitiveness, both domestically and in the international arena. Tariff levels are already below 10 % on average, which is lower than in India and many other emerging markets.

These positive effects should not be overestimated outside China. Clarke[10] warns convincingly that WTO membership has quite a limited impact on China's international legal practice. Clarke argues that WTO membership does not require a perfect legal framework *per se* and – which

---

8 As an example may serve: Romer, Paul. 1997. „Idéer skapar ny production. FöreningsSparbanken (Swedbank) Analys 1 (31). (Translated: „Ideas Create New Production").

9 Schweikert, Rainer/Thiele, Rainer. 2004. „From Washington to Post-Washington? Consensus Policies and Divergent Developments in Latin America and Asia". Kiel Discussion Papers No 408.

10 Clarke, Donald C. 2003. „China's Legal System and the WTO: Prospects for Compliance". Faculty.washington.edu/dclarke/pubs/.

may be important – that a potential non-fulfillment of WTO rules will not automatically lead to dispute-settlement procedures. Chinese interpretations of WTO rules could be stretched considerably. German companies, for example, have been complaining. Global companies should consider this.

Brooks/Ran Tao[11] are among the authors who discuss the effects of WTO membership on China's labor markets. They find high GDP growth is needed in order to avoid major negative effects on employment or, as they also put it: „The main challenge facing China's labor market in coming years is to absorb the surplus labor into quality jobs while adjusting WTO accession". This is a fact often forgotten when foreign politicians and corporate leaders complain about the Chinese export offensive: China struggles with high unemployment. In the very long run, even China will have a demographic problem because of many years of low population growth. In 2004, China already had 135 million people above 65 years of age.

Liberal trade optimists should theoretically have a positive view of China's increasingly active role in the world economy. Yang, Askari, Forrer, and Teegen[12] belong to the group of academics who enthusiastically support China's integration in the world economy. China is currently adding to world demand and GDP – and will continue to do so as long as political and economic distortions can be avoided. Analyzing imports of the old industrial world, one can easily realize the growing Chinese share of national imports. This has had a dampening effect, particularly on American and Japanese consumer prices in recent years. On the other hand: how will the huge Chinese demand for commodities affect global inflation in the longer perspective?

Looking at exports from the U.S., Japan and Germany to China, the picture looks quite similar. China is gaining in importance for Western and Japanese exporters. It should be added that trends of exports do not tell the whole Chinese internationalization story, since the Chinese market also absorbs goods (and services) that are produced by foreign companies in China.

A relatively new positive element is the amendment of the Chinese constitution guaranteeing the protection of private property rights. In theory, this change sounds promising. However, it remains to be seen what this

---

[11] Brooks, Ray/Ran Tao (2003) „China's Labor Market Performance and Challenges", IMF Working Paper No 210.

[12] Yang, Jiawen/Askari, Hossein/Forrer, John/Teegen, Hildy Jean (2004) „US Economic Sanction Against China. Who Gets Hurt?", The World Economy No 7. Pp. 1047-1081.

improvement of conditions for private ownership will mean in the longer run. It should not be forgotten that China now has something like 3 million private companies – who knows exactly? – with around 35-40 million employees. Apart from that, more and more Chinese are becoming apartment owners. This fact makes private property protection important not only to foreign companies, but also to an increasing number of Chinese people. It also puts pressure on the authorities to avoid bursting a real estate bubble.

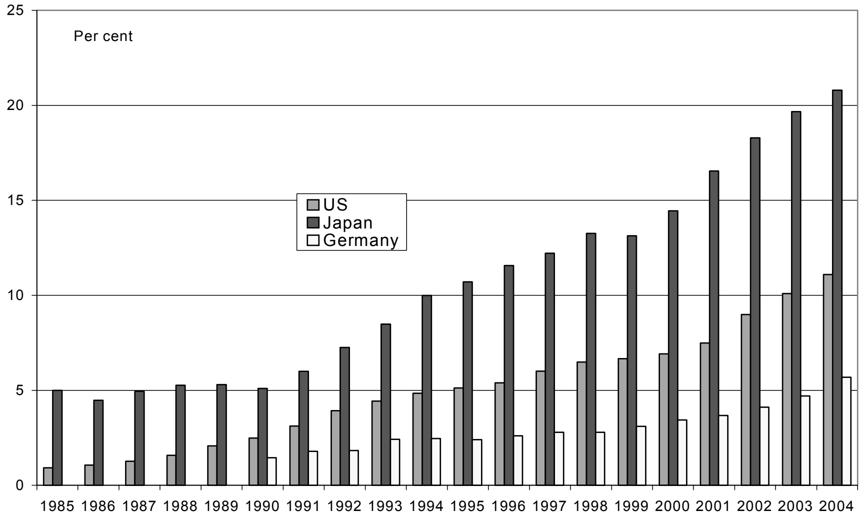


Fig. 4. Import Shares of Chinese Goods in the U.S., Japan and Germany (Source: Ecowin).

China's environmental problems are certainly not discussed sufficiently nor are they big topics in global political summits or in commercial negotiations. According to Dougherty,[3] there are regions in China where environmental degradation can be considered as big enough to impede future growth. There is a risk of a global malign neglect as far as China's responsibility for the future global environment is concerned.

Conclusion: China has the potential to make many positive long-run contributions to the world economy. However, looking at all the political, social, structural, and environmental economic challenges that China has to tackle in the future, it would be naïve to expect that periods of problems and disappointment will be avoided. It still seems uncertain to what extent China will be able to exploit its good long-term growth potential. Despite this uncertainty, China can already be seen as an economic power house. For this reason, China should recognize the importance of better statistical standards and more transparency.

3 The Structural Problems in the Economy – Benign or Malign Neglect of the Foreign Corporate Sector?

Despite important positive developments, China is also a country that already faces big problems. And many problems are yet to emerge[13]. It might be better to describe China as a continent rather than a country. Taking this approach makes it easier to understand the wide range of regional and structural disparities – and the difficulties of conducting an effective economic policy for the whole nation. 800 million people still live in the countryside, with much lower income than the urban population.

In my opinion, a great number of foreign executives underestimate both the number and the range of Chinese structural problems. This happens because most analysts extrapolate current high GDP growth, market potential and low costs. Swedbank's China Survey[14] of March 2005 reports that only 18% of the participating 60 European, American and Asian economists think that foreign companies are not underestimating all future risks in China and that around 80% consequently do so.

Many structural problems can be listed in this context. Some examples are:

- the dominating role of government economic planning
- the lack of understanding of a market economy
- the shortage of modern monetary policy tools
- inadequate capital markets
- the dysfunctional banking system
- many bankrupt or poorly performing state-owned companies
- major social and regional disparities
- an inadequate pension system
- big disparities in education
- enormous shortage of commodities
- a corrupt bureaucracy

This list can be made much longer and should be part of strategic corporate considerations and decisions. Sure, improvements will occur gradually in most areas mentioned above. But how big and how fast?

A sustained recovery of the dysfunctional banking system is, with no doubt, one of China's major forthcoming challenges. Whether nonperforming loans (NPL) are roughly 15% or 40% of total credit stocks –

[13] Schoettli, Urs. (2004) „Hürden auf Chinas Weg zur Grossmacht." Neue Zürcher Zeitung. January 10/11, p. 5.

[14] Swedbank's „China Survey" from March 2005 involving 60 European, American and Japanese economists.

probably the latter figure is closer to truth than the lower and official one – the existing enormous bank problems are not without consequences and will become very much a fiscal burden some time in the future, even if there has been a growing effort to reduce the massive capital shortage of the big state-owned banks. However, much more strengthening of capital reserves is needed. This, also because of the prospective opening of the Chinese banking market to foreigners by the end of 2006, as a result of WTO's liberalization rules.

According to Fernald/Babson[15], the bad shape of Chinese banking gives strong reasons for major concern. The two authors add that „it is dangerous for a country to have weak, poorly regulated banks making policy loans to inefficient, overleveraged state enterprises. This should be said, even if an imminent banking crisis is not expected. Fernald and Babson also remind us of the fact that „in a market system, pressures generally force rapid adjustment when institutions are, or are perceived to be, insolvent. These mechanisms do not operate fully in China. For example, banks can continue to operate regardless of balance-sheet weaknesses, because of the government's support."

Allen/Qian/Qian[16] stresses the interpretation that China is characterized by poor legal and financial systems. They add however, „that there are effective, informal financing channels and governance mechanisms to support the growth of various firms in the economy". On the other hand – one should add –, this grey credit sector could turn out to be an impediment to a more effective monetary policy which China urgently needs.

Apart from this, experts on China also talk about the risk of local or regional real estate bubbles, which for the already weak banks certainly would be impossible to manage by themselves.

Other economists, however, argue that a forthcoming cleaning of the Chinese banking system could have major positive effects on the Chinese economy. Barth/Koepp/Zhou[17] finds that „investors and policy makers … would be patently wrong to ignore the tremendous upsides that should accompany China's banking reforms." That said, it will be painful and expensive to get a healthy banking system. There is reason to believe that the

[15] Fernald, John G./Babson, Oliver D. (1999) „Why Has China Survived the Asian Crisis so Well? What Risks Remain?" Board of Governors of the Federal Reserve System. International Finance, Discussion Papers No 633.

[16] Allen, Franklin/Qian, Jun/Qian, Meijun. (June 2003), „China's Financial System". China Journal of Finance, Pp. 1-28.

[17] Barth, James R./Koepp, Rob/Zhou Zhongfei (February 2004), „Banking Reform in China: Catalyzing the Nation's Financial Future." http://papers.ssrn.com/ sol13/papers.cfm?abstract_id=548405.

costs for this restructuring are underestimated, also from a fiscal point of view. Major progress in achieving a healthy banking system would certainly give a fundamental push to the Chinese economy all the same – despite huge costs.

Today, government debt is – perhaps – 40 % of GDP, depending on the accounting methods and other factors used. This means that merely cleaning up the bad banks could lead Chinese public finance into very uncomfortable territory. Unfortunately, there is absolutely no transparency to help us figure out future fiscal development in China.

Foreign investors should be aware of both insufficient corporate governance as well as a lack of transparency. Too many listed companies remain state-owned or state-dominated. It should not be forgotten that China, despite its emerging market economy, still is dominated by the rules of a planned economy. This also means that rules of a market economy mostly are neither understood completely nor applied by decision makers.

The existence of regional disparities is confirmed by traveling around the country. Coastal regions and Beijing have performed much better concerning growth in the past two decades than, for instance, central and western China. Referring to Demurger *et al.*[2], these authors came to the conclusion that the strongly expansionary regions in China benefited particularly from important deregulation policies. Thus, Demurger et al. argue that the best strategy to reduce regional disparity would be by extending deregulation policies to the west and by improving infrastructure in the lagging provinces.

In my view, deregulation would not be sufficient, but could correct some distortions, if China really wants to achieve a division-of-labor-effect in its own country. If China can achieve major progress in this respect – which seems to be possible but is far from sure – growth potential could get a new dimension. A similar conclusion could be reached if the research result of Shang-Jin-Wei and Yi Wu[18] could be verified further, i.e., that Chinese cities which are open for trade and globalization demonstrate a greater decline of income inequality between urban – and neighboring – rural areas.

A similar conclusion was reached by Kui-Wai Li:[19] that productivity is higher in coastal provinces than in inland provinces. Apart from that, Kui-Wai Li deserves recognition for the research confirming that foreign direct

[18] Shang-Jin-Wei/Yi Wu. 2001. „Globalization and Inequality: Evidence from Within China". NEBR Working Paper No 8611.

[19] Kui-Wai Li. 2003. „China's Capital and Productivity Measurement Using Financial Resources." Yale University Economic Growth Center. Discussion Paper No 851.

investment – in China largely greenfield investment – is more useful than state-funded investment.

Foreign companies should also pay attention to the research of Huang[20]. Huang strongly emphasizes his research result that China's FDI surge not only can be attributed to good economic growth but also to „the failings of the domestic corporate sector" – including that China's product and capital market are extremely fragmented. Huang concludes that „this market fragmentation constrains domestic firms more than foreign firms". If this theory turns out to be practically relevant, foreign investors should be aware of the medium, and long-term risks, before China's product and capital markets get better organized and become competitive. This would mean, in general terms, that foreign companies usually should avoid a long period before investments pay off.

Research and general wisdom agree that corruption is an important impediment to growth. Despite poor transparency in many areas, the Chinese leadership regularly admits that corruption is one of the main problems of the Chinese economy and society. However, Chinese corruption is so deeply rooted that major improvements cannot be foreseen for a long time. According to Transparency International[21], China is ranked as number 71 out of 133 countries on its corruption scale for 2004. Finland is the least corrupt country in the world. Since corruption means unnecessary transaction costs and inefficient distribution of financial resources, the negative impact on growth is obvious, despite current good growth figures.

Zhang and Ke's paper[22] is also interesting. They have done work on cross-regional development: on the relationship between trust and growth. The paper argues strongly that „regional diversities of education, marketization, population density and transportation facilities have an impact on trust in public decision-makers and consequently in developments in the country". Zhang and Ke promote the approach „that sustainability of further economic development of China depends on how fast China can build trust-facilitating institutions". This is a very important conclusion.

---

20 Huang, Yasheng. 2004. „Economic Fragmentations and FDI in China". William Davidson Institute Working Paper No 37.

21 Transparency International, http://www.transparency.org/.

22 Zhang, Weiying/Ke, Rongzhe. June 2003. „Trust in China. A Cross-Regional Analysis." William Davidson Institute Working Paper No 586.

4 A Probable Chinese Strategy and Its Impact on Foreign Companies

Corporate governance is also part of a country's institutional framework. Bai/Liu/Lu/Son/Zhang[23] argues that investors pay a significant premium for well-governed firms in China. This leads us to the conclusion that good corporate governance these days must be regarded as an exception rather than a reflection of standards. There are no indications that any noticeable change has occurred in this context in recent years.

It is hard to say to what extent foreign corporate leaders underestimate these imbalances or risks, as these problems are rarely discussed openly by foreign investors. Sometimes, however, one gets the impression that some of these critical issues are more deeply discussed by the Chinese themselves than by foreign investors. This is particularly true for corruption.

There is no doubt that the relatively new Chinese leadership – president Hu Jintao and prime minister Wen Jiabao – has an ambitious global and regional economic short- and long-term strategy. They are internationalizing the country, pushed already by past president Jiang Zemin.

One can speculate about the long-term economic strategy of the Chinese leaders all the same. Chinese leaders need high rates of growth for three reasons. First, to reduce unemployment and regional economic disparities. Second, to achieve more equal income distribution. Third, to keep the communist party's dominant position intact. To achieve these goals, they will need to allow markets to function to an ever-increasing extent. Something else that Chinese leadership will be forced to do is to visibly improve educational levels. This implies huge volumes of both imported technology and knowledge.

Swedbank's „China panelists" conclude that broadening educational and technological opportunities in China can be seen both as a risk and a positive challenge for the Western world and Japan. It is a positive challenge because of the increasing pressure on companies and governments in traditional industrial countries to become more innovative. However, no one knows how this challenge will be handled in individual countries and companies. There will be losers as well. Pessimists see potential future risks in massive Chinese exports, with gradually increasing value-added, based on imported technology. Such goods would threaten many Western, Japanese and other Asian producers.

The Chinese are serious in applying their model for progress in exports. One should, for example, not forget that Chinese delegations to foreign

---

[23] Bai/Liu/Lu/Song/Zhang. 2003."Corporate Governance and Market Valuation in China". William Davidson Institute Working Paper No 564.

countries usually are well prepared with professional marketing and sales people. This ambitious attitude has certainly contributed to China's success on many markets all over the world.

Eichengreen, Rhee, and Tong's research[24] is very interesting in this context. They come to the conclusion, that China's exports crowd out exports of other Asian countries, particularly when it comes to consumer goods. They also note that other Asian countries get their sales opportunities from the capital-goods sector. This is certainly true in the current stage of China's development. The question is, however, whether this will be the case in the longer run as well. Anyway, China will create a much more competitive environment in Asia – with both winners and losers.

The same can, of course, be said about all traditional OECD countries, particularly in Europe. Heilbroner and Thurow[25] think that necessary adaptation to changes of this kind is achievable. They point to the example of Taiwan, which for some time has been concentrating on more sophisticated products, reflecting its expanding outsourcing activities in mainland China.

China will certainly get much more foreign resources for research and development. Sieren[26] expresses this trend as Chinese market shares for the import of know-how and technology. This is a perfect description of the Chinese business model, which attributes a strong negotiating power to China. Another example of Chinese economic power lies in the fact that two-thirds of Chinese exports to the U.S. can be related to U.S. firms in China. In my opinion, many Asian countries – not having China's size and market potential – are in urgent need of structural and institutional improvements in order to compete with China in the future.

China will become a major player in the next round of globalization, something one could call the globalization of innovations. It is hard to predict how China will handle this future responsibility – and to what extent foreign companies eventually will accept such increasing dependence on China. How will global companies handle their risk diversification? Corporate strategy concerning this topic will be most interesting in the forthcoming decade – and will also have a big impact on the development of

---

[24] Eichengreen, Barry/Rhee, Yeongseop/Tong, Hui (2004) „The Impact of China on the Exports of Other Asian Countries", NBER Working Paper No 10768.

[25] Heilbroner, Robert/Thurow, Lester (2004) „Wirtschaft – Das Sollte Man Wissen", original title: Economics Explained. Everything You Need to Know about How the Economy Works and Where It's Going, Campus.

[26] Sieren, Frank. 2005. Der China Code. Wie das boomende Reich der Mitte Deutschland verändert. Econ.

other Asian countries such as Malaysia, Indonesia, the Philippines and Thailand.

Looking at the development of Chinese exports there is no doubt that, in the next decade, China will try to become a much bigger global player than it is today. This is necessary to make it possible for China to earn the foreign exchange needed to pay for rising imports. Whether deeper market penetration can be achieved without a protectionist reaction from the U.S. and EU remains to be seen. If there are future massive market-share gains by Chinese producers, there could be strong reactions from Washington and Brussels.

A survey – recently made by Swedbank and Silf – gave some important hints from the real world of 100 Swedish purchasing managers. These exporters and importers of industrial products gave China the following positions – survey-results that should not be underestimated.

Tab. 1. Purchasing Managers' Preferences in Sweden (Source: Swedbank's and Silf's Puchasing Manager Panel, April 2005).

	No. 1	No. 2	No. 3	No. 4	No. 5	No. 6
Most important purchasing market of today	Sweden	Germany	Finland	**China**	UK	Poland
Own judgment on low tech/lower mid-tech products of today	**China**	Sweden	Poland	Germany	Estonia	Czech Rep.
Own judgment on countries that will become increasingly important as suppliers of goods	**China**	Poland	Estonia	Germany	Latvia	Czech Rep.
Own judgment on countries that will become increasingly important as suppliers of services	**China**	Poland	Estonia	Lithuania	India	Latvia

For some time, a relatively noticeable Chinese strategy has been to put economic reforms in the first place – and not political ones. The Chinese find this priority much more attractive than the Russian example, which puts politics first. Blanchard/Shleifer[27] makes the point, which is still valid five years later: „In China, local governments have actively contributed to the growth of new firms. In Russia, local governments have typically stood in the way …" China has a big long-term disadvantage versus India with respect to democracy: singled out also by Gary Becker[28] and others.

According to theory and empirical research, the institutional messages of Douglass North and consorts should be included in all economic analysis that is done on China. An important aspect must, of course, be given priority by the Chinese leaders: the fight against bottlenecks and shortages. One should not forget that high growth rates also imply the need for more resources every year. This relates to human capital, energy, commodities, financial services, and other input factors. In the worst case, structural shortages in these areas could jeopardize high long-term growth. In the best case, demand can go on surging.

Anyway, one important question will remain unanswered for quite some time: to what extent can foreign companies get satisfactory information, statistics and transparency in order to make their strategic decisions analytically well-based?

5 Foreign Companies and Psychology

Behavioral finance has become a popular research area in the past decade. Psychology is highly relevant for individual decisions and markets. This is what behavioral finance is all about.

Many academic researchers have come to the conclusion that behavioral finance can be applied in a historical perspective. For example, it helps explain bubbles ex post. It also helps interpret certain statistics. This has, of course, some advantages. One is that an increasing number of analysts are realizing that judgement on an economy should be based on factors aside from available statistics.

Consequently, behavioral finance still cannot serve as a numerical forecasting tool. But it can give signals as to future risks, particularly when herd behavior has been apparent for quite some time. Substantial increases

[27] Blanchard, Olivier/Shleifer, Andrei (2000) „Federalism with and without Political Centralization. China Versus Russia", Harvard Institute of Economics, Research Paper No 1889.

[28] Becker, Gary S. (2004) „What India Can Do To Catch Up With China", Business Week, February 16.

that have been going on for some time could mean overshooting, or could mean exuberance – with increasing risk of a forthcoming downturn.

What behavioral finance can do is send messages about risks of overconfidence, and sometimes even bubbles. Milton Friedman once said to me that the worst thing about bubbles is that we never know about their existence until they burst. This is certainly true. However, extremely strong moves in a specific market over a considerable period give hints about exaggerations and overconfidence – and consequently on disappointment and/or future negative market reactions.

Today, there is good reason to suggest that the current global corporate emphasis on China should also use some behavioral finance.[29] After having myself studied more than 100 corporate leaders' comments in Swedish and international newspapers on their motives for investment in China, three main arguments can be singled out:

- the size and potential of the Chinese market
- the need to outsource to low-cost countries which may help to protect jobs at home
- the rapidly growing presence of key global competitors in mainland China.

The Chairman of the Siemens Supervisory Board, Heinrich von Pierer, put it this way: „The risk of not being in China is far bigger than the risk of being there".[30] Obviously, many Western and Japanese leaders feel the same way about participating in the ongoing Chinese boom.

There are several reasons for that. First, market potential and cost-cutting are good reasons. To some extent, however, it also seems to be a matter of self-justification. Many executives certainly do not want to be criticized some time in the future for having taken a reluctant strategic position in China. Doing what many competitors do can quite easily be explained – following the herd usually feels safer. Or, one can apply the words of John Maynard Keynes that „worldly wisdom teaches us that it is better for reputation to fail conventionally than to succeed unconventionally."[31]

---

[29] Fromlet, Hubert: „The Run to China: Another Example of Herd Behavior?" 2004. Economic & Financial Review (European Economics and Financial Centre, London). Autumn No 3.

[30] Heinrich v. Pierer (2003) „Attraktivität Chinas nimmt weiter zu", interviewed by: Handelsblatt, December 1, p. 1.

[31] Keynes, John Meynard (1936) The General Theory of Employment, Interest and Money. Macmillan, London, p. 158.

Second, there is also reason to apply what behavioral economists call „overconfidence". Robert Shiller[32] describes this „as people think more than they really do" and that „there are a lot of know-it-alls out there" – people of who are followers of the herd and believe that they understand everything completely. My experience tells me that this phenomenon is at least partly true of many foreigners doing business in China these days.

Third, headquarters usually do not have many executives who understand Chinese political and macroeconomic trends and challenges very well. Usually, a lot of informational input comes from their own people working in China – people who, by nature, tend to be optimistic rather than cautious. When executives from headquarters show up in China, it is unlikely that they won't be impressed by the enormous and visible progress that can be observed in Shanghai, Beijing and other major cities. The construction activities are impressive – regardless of whether they are necessary or not. However, this does not give a complete picture of the Chinese situation.

Fourth, there may be a forgotten, but important, psychological factor that may be contributing to the ongoing China euphoria. Media report big headlines about China's growth and Western investments there, often without any questioning. We have seen such exaggerated – or short-sighted – reporting in the past during the internet boom. Robert Shiller writes about that in an aggressive, but correct way „that most people are not interested in long-term economic growth forecasts for the aggregate economy. Economic theory would suggest that they should be interested, if they are behaving rationally. But in fact the topic is too abstract ..." This psychological wave should not be underestimated either.

Fifth, a final – but quite important – driving force for the run to China is the shortage of rapidly growing major economies in the world. To put it differently: there are more and more mature economies. Many OECD countries suffer from low or mediocre growth at the best. Big catch-up economies with underexploited potential have become rare. There are, perhaps, only three: India, Russia, and, of course, China. This constellation of many mature – and only a few big – markets with obviously good growth potential puts a lot of psychological pressure on executives to be active on these few big emerging markets.

According to the economists from the U.S., Japan and EMU countries who joined Swedbank's „China Survey" in March 2005, 88 % believe in (some) herd mentality when it comes to foreign investment in China. This number should give some reason for second thoughts.

[32] Shiller, Robert. (2000) „Irrational Exuberance", Princeton University Press.

6 Summary

Morrison presents a good summary of globalization. She writes: „Globalization has brought about dramatic changes in the way that people live and work, opening up new opportunities but also creating new risks and uncertainties [...]."[33]

These lines certainly can be applied to China as well. China is a country with lots of opportunities and risks. Without doubt, China will become a much more important global player in the world economy in the medium and long run – hopefully without increasing chauvinism.

However, the way for China to get there will be quite bumpy, with inevitable distortions because of the great number of structural deficits. This should be kept in mind by the euphoric Western and Japanese corporate leaders. There will be foreign winners in China – but also many losers. A big potential market does not guarantee commercial success. The Economist put it this way: „Doing business is far from easy – and often not very lucrative".[34]

Psychological pressure on Western and Japanese companies is considerable. Being reluctant in China can provoke uncomfortable criticism at home, at least in the years ahead. It should not be forgotten either that suppliers to major foreign corporations can be forced by their biggest customers to join them in producing in China, without knowing the long-term outcome of such a move. Foreign executives in China may be tempted to send the brightest pictures of the Chinese outlook to their head offices.

China is not an easy market – and certainly not producing good profits „automatically" because of its size. Of course, there are opportunities for good business in China as well, particularly for purchasing. Seeing many global competitors making major efforts in China does not, however, guarantee long-term success. In China, from domestic and foreign companies as well, competition will become much tougher in the future.

All experts in Swedbank's „China panel" from March 2005 expect a major slowdown in Chinese growth at some time in the future. But more than half of them argue that the time for that considerable slowdown is not predictable. Two thirds of these economists also believe that foreign companies underestimate the future risks in China.

Conclusion: Business economists and corporate decision-makers should keep a close eye on all suspected herd mentality trends when it comes to investments in China – not only today but also in the years ahead. Just be-

---

33 Morrison, Janet. 2002. The International Business Environment, Palgrave.

34 „Doing Business in China. Fools Rush in." 2004. The Economist. August 7. p. 50.

ing a follower of fashion is not good enough – despite the huge Chinese market potential! However, this does not rule out further success of foreign companies in China – despite an increasingly competitive and toughening business climate. Good analytical work and transparency, however, makes success easier.

References

Statistics from SCB (Sweden), WTO, UNCTAD, EcoWin, Swedbank's and Silf's Purchasing Panel (April 2005).

Market Research as a Module in Market Strategies in China

Brigitte Wolff

Abacus Corporation Ltd., Shanghai

1 Introduction

It is widely known that around 1000 years ago China was further developed than the West. It was not in fact Gutenberg who invented the letterpress but it was the Chinese in the ninth century AC who were the true inventors. Almost one hundred years before Columbus, the Ming Emperor, Zhu Di, had sent his eunuch admiral Zheng He (1371-1435) to cross the world's oceans with a fleet, bigger and mightier than all existing fleets in Europe together[1]. China was like a kind of USA, but of the Middle Ages.

The Chinese saw themselves as independent: they did not need to trade with other countries because they did not consider foreign goods as a necessity for the Chinese population. So after Zheng He's death it was even forbidden to build a ship. The country closed its borders for a couple of hundred years.

If they had done some market research at that time then they would have exported more of their advanced products and knowledge than just silk and bone china to Europe and maybe by now we would all speak Chinese instead of English[2].

During my first business trip to China in October 1993, I was not aware that market research was practically unknown at that time.

The project was about the packaging of liquid food and had the objective of evaluating the market demand for high quality packaging for milk and juice.

Not only was the use of internet for research very unusual and internet access was scarcely available, but other sources were also difficult to come

---

1 Spiegel Special, 5/2004.

2 Hirn, Herausforderung China 2005.

by. For example, associations did not exist or were not knowledgeable enough about market data.

The first approach was disappointing: the General Managers and Chief Engineers that I met during my trip from Hong Kong to Beijing, via Guangzhou and Shanghai, were not very well-informed about their own markets. One interview partner even just „guessed" that his customers preferred beautiful – but expensive - packaging over the rather unattractive packages that existed at that time. He had not discovered this through consumer research.

The problems I faced at that time are still the same today: the project leader at home did not believe that the structures of market figures simply did not exist; some of my customers still believe this today.

At least they expect me to find intelligent ways to derive the market data from other areas and to use my 12 years of experience in this field.

Facing the economic potential of China and the increasingly tougher global competition, international companies are being challenged to a greater extent. They can not avoid making this key decision: invest in China or not.

The basis of each entrepreneurial decision is the implementation of a decision making document in terms of a feasibility study, in order to obtain a more realistic view of the relevant market for the specific product range that they are offering.

The statement: „We have to sell our products in China!", is only the beginning of this process. The important questions are: Who are our customers?", „How do we reach these customers with the news that we are here and inform them about the product?", „What is the realistic market potential?", „Who are our competitors, particularly the local ones?" and so forth.[3]

Information research is one of the requirements of a dynamic, competitive strategy for a successful company. It is the basis for developing a strategy. [4]

China in the Elevator from Middle Age to Modern Society

China, the Middle Kingdom, was not only the most advanced civilisation in terms of technology and administration, but also by far the biggest country in terms of population and economy over the longest calculated period of time. It was only in the 19th century when China drifted into severe

[3] Genzberger et al: China Business, San Rafael o.J.

[4] Grünebaum: Marktchance China, Frankfurt/ Main 1995.

poverty and was colonized by Western countries, Russia and Japan. It was the century of humiliation and every Chinese person still acknowledges this today.

Between 1949 and 1976, Mao destroyed the infrastructure of China to the extent, that after Mao's death Deng Xiao Ping had to turn the wheel energetically in order to develop the Chinese national economy and to offer a better standard of living for each individual.

Today China's economy is twice the size of both India's and Russia's put together[5]. The former German ambassador to China, Dr. Seitz, expects an economy as powerful as that of „multiple Japans" to arrive in the world market[6]. By taking the steel consumption of China during 2004 into account, there is certainly enough evidence for this.

Nobody can resist the urge to tap their foot into the market. Heinrich von Pierer, the retired Chairman of Siemens, said back in 1995, „It is a higher risk NOT to be in China, than to invest there!", and almost every year he is quoted similarly.

The automotive industry in China is certainly a well-researched field in terms of the entire economy. The figures concerning the automotive industry tell us that there will be an oversupply of local made vehicles in 2005, yet foreign car-makers still announce their million dollar investments.

The focus is linked to consumer behaviour. The car company offering the most suitable car to the majority of new drivers will gain the highest market share. As easy and simple as it sounds, what is equally interesting is the fact that in other industries it is still like a mysterious adventure to have such a reliable and realistic picture of the markets.

2 History of Market Research in China

Does consulting and in particular market research have a history in China?

There is one and there is none. In Chinese culture there have never been paid consulting services like we know of in the West. Chinese consider giving advice to be free. When you have to make important decisions, you usually ask your friends and relatives for advice, which comes at no charge. It was only in 1979, with the start of the open policy, when the prerequisites for a market economy and also for market research began to emerge in China. Therefore, market research is a relatively young industry with around 25 years of history[7].

---

5 FAZ, Dr. Christoph Hein; Indien die Supermacht, 2004.

6 Dr. Konrad Seitz, China – Eine Weltmacht kehrt zurück, 2000/2004.

7 Schaaf: bfai, Marktforschung in der VR China, Beijing 1996.

In the early 1980's, Chinese companies carried out their first market research projects.

For example, Taojiang County Plastics Products Factory sent 5 market research teams into neighbouring provinces to find out the reasons why their turnover had gradually shrunk between 1979 and 1981. They discovered that the supply of small plastic parts was negligible because the competitors made more profit with bigger parts. Then Taojiang decided to focus on the production of small parts and was able to achieve a profit growth of RMB 44,000 in the first two quarters of the following year[8].

Around that time, market research firms based in Hong Kong started their exploration of the Chinese market, using Hong Kong as a springboard to the mainland[9]. At the end of the nineties they had achieved growth rates of between 20% and 30% p.a. [10]. In the mid 1980's, the first consulting companies in mainland China emerged; all were state-owned. China's first professional marketing research service, Guangzhou Marketing Research (GMR) was founded in 1988.

The first private consultancy (South China Market Research Co.) started in 1990, in Guangzhou and in 1992, the first Joint Venture was signed by Hongkong Survey Research Group (SRG; today – after the acquisition of Nielsen SRG) and a local partner in Guangzhou. [11]

In the same year, the first wholly foreign owned (WFOE) consulting company started in Haikou, Hainan province (Snowball Business Consulting; today Abacus Corporation). The entrepreneur was a young German Banker who saw the big potential of consulting projects in China. His major projects at that time were market research projects.

The demand for market research of the Chinese markets has continued to grow rapidly up until the present time.

3 The Industry

At the end of 2003, the number of market research companies and organisations was quoted at 1500, not including the various state-owned and University Institutes on a national and local level.

---

8 Li et al: Sun Wu‘s Art of War and the Art of Business Management, Hongkong 1997.

9 Steele: Marketing Research in China – The Hong Kong Connection, in: Marketing and Research Today, August 1990.

10 Hüssen: Marktforschung in Hongkong und der VR China, Hongkong 1995.

11 Schaaf: Marktforschung in der VR China, Beijing 1996, S. 8.

These government-related consultants are not only hired by their fellow-countrymen but also by international companies and are now charging expensive fees for information that was formerly free.

Between 400 and 500 of the total of 1500 have grown to a certain size and 50 of them now operate on a large scale and are clustered in Beijing, Shanghai and Guangzhou.

ESOMAR (European Society of Market Research Organisations) lists 39 of them on their webpage.

The international and local Management Consulting firms which offer a market research service must also not be forgotten.

The number and the variety of state-owned and private market research firms or consultancies with various reputations and industry specialisation is a challenge for foreign companies seeking market data in order to find the right partner.

After the foundation of China's Market Information Research Association on April 8th, 2004 in Beijing, a more detailed overview is expected.

Barton Lee estimated that China's market research companies billed around $65 million in 1997. [12] In 2001, a figure of $230 million was reached and in 2004, it was around $500 million. The average growth rates from 1997 to 2004 were around 34%.

The whole consulting market in China, in 2004, accounted for $1.1 billion. To make a comparison with the figures for Germany's consulting association BDU, in 2004, it is estimated that the German consulting market was at €12.3 billion ($15 billion), showing a growth of 1%.

Wider Scope

Initially, marketing research studies focused on daily consumer products such as laundry detergent, shampoo, beer, tobacco, etc. The past few years have also brought about changes in this field. Today, high-tech products (i.e. medicin, mobile phones, automobiles, data networks.) are being evaluated by manufacturers prior to entering the marketplace. Now, even service industries such as banking, insurance and real estate will seek marketing research services.

The entrance of foreign products into the Chinese market forced domestic Chinese companies to begin to rely on marketing research data in order to guide their marketing efforts. International advertising agencies such as Ogilvy & Mather and Saatchi & Saatchi aided this process. They quickly

[12] Barton Lee, Tony Zhao, David Tatterson; Emerging trends in China's marketing research industry – 11/1998.

acquired domestic clients and taught them the value of research in guiding their advertising. Some of the large domestic companies now maintain their own marketing research departments. The next step for Chinese manufacturers is to begin using foreign marketing research firms in the countries to which they export.

Procter & Gamble (P&G) supported the start and the development of China's marketing research industry. P&G provided, and continues to provide, training and funding of research projects to such respected marketing research firms as Guangzhou Marketing Research Company and East Marketing Research Institute (EMR) in Guangzhou and All-China Marketing Research Company (ACMR) in Beijing. [13]

4 Reasons for a Detailed Market Research

In the mid 1990's, a leading western company in bottle neck foils made of aluminium for beer bottles, was quite successful in exporting these highly challenging products to China. There were only a handful of high-class competitors visible on the world market and the market position in the world seemed to be quite comfortable.

A market screening performed by one of the representatives showed a need to invest in a production plant, because at the same time the benchmark competitor started with a small factory close to Shanghai. Yet, the company still did not decide to do so.

Today, the world market is flooded with Chinese bottle neck foils and the international benchmark competitor has been upgrading his production over the years and delivers to foreign brand companies in and outside of China. The former market leader is not present in China at all.

Many of the reasons for a detailed market research are the same as in the west: market size, positioning, market potential, competitors.

In addition, a few decisive criteria are of great strategic relevance: each product has a position in the value-added chain. Take the beer again, no-label-look labels: here the direct customer is the brewery and the customer of the brewery is the retail shop whose customers are the consumers.

In the West, everybody can tell you the leading breweries by heart, but this is not so in China. We do not know either the structure of the industry, the technology level or the market leader without having visited China for the first time.

---

[13] Barton Lee, Tony Zhao, David Tatterson; Emerging trends in China's marketing research industry – 11/1998.

Furthermore, the retail shop can tell whether beer is a price sensitive product or a product driven by brands, as happens in Germany or the US. Even though in more mature markets brands have been developed with packaging that can be sophisticated because the higher price will undoubtedly be paid by faithful customers, in China, the price is decisive, consumers shift regularly between brands and brands will only be developed.

Tsingdao is a good example, but only recently it allowed itself to be relaunched with a more expensive and more attractive bottle decoration.

Back to the bottle neck foils: they had to be cheap. Therefore, it was not possible to import at a reasonable price after local and locally made international printers offered a sufficient quality for a good price.

In the West, a serious institute would go for a focus group in order to find out what kind of packaging people really want. In China, because of the rather immature consumer, it would be the last choice. Whatever the consumer says, if in the whole of China only 6 high speed labelling machines were operating, then the result of the focus group might not have been achieved due to the missing technology.

One of the challenges of the Chinese market is to judge in which phase of the life cycle, a product range or a whole industry is in. The further up the curve you are, the more important it becomes to carry out an intensive market research. For a market in its early stages, there are only two possibilities which are almost impossible to predict: either it does not get started at all or the company is able to make contributions which shape the market to a greater extent.

If you take Triumph, the bra company, as an example. The general manager came to China in the 1990's to explore the opportunities for his company. His interpreter at that time sadly commented on the findings: „There is no market for bras in China, the woman do not even need them!" The answer was: „So what? Then we 'make' them tits." Today every Chinese girl who wants to be fashionable wears a bra, some of them with cushion layers…and Triumph has a decent market share in it.

In 2003, Abacus Corporation was asked to investigate the market for Polyamides (PA). The product and certainly the customer stood at the very beginning of the value added chain (VAC), able to supply various industries with the chemical raw material. First we analysed which industries might have some interest in PA and which industry-specific value added chain stood behind them. Then we focused on the automotive, electronic and packaging industries, the most interesting customer segments in foreign markets. Then we interviewed the experts in each section of the VAC, such as Shanghai Volkswagen as the end-user of PA in the automotive industry.

The market itself was quite mature, as is the automotive industry in China. Only the necessary hi-tech qualities were still imported, but local suppliers were about to catch up. International suppliers were also on the starting-ramp to manufacturing superior qualities locally. Our customer was a follower with little chance of gaining market shares without rushing into China with sales, marketing and production activities. [14]

Maze of Big Numbers

One might calculate that 1.3 billion Chinese people is equal to 2.6 billion shoes or chopsticks. Today, investors are still bedazzled by the size of the country. In order to result in a realistic market size for the respective product, the investor should carefully analyse the value added chain, including target customers, their purchasing power, technological state-of-art, investment behaviour and when it comes to investment, the legal form of the future company as well as the location should also be considered. Being far from the Point of Sales (POS), the machinery company is required to analyse even more intensively than the consumer goods company does.

A few years ago, Roland Berger analysed that Western firms still considered China as backwards and as a country which needed to be supplied with western goods. So they introduced products to China which already existed and without market research. With disbelief they came to realise that better selling and more competitive products were much more successful. In order to compete with other companies, they were forced to adapt their products and this proved to be more costly than an accurate market research project would have cost.

„It is the Germans in particular who strongly believe that their products are the best - they forget to carefully watch the specific needs of the market", the survey quoted. Most of the products are very expensive and have too many features which the market does not require and therefore, is not willing to pay for. The belief that it is enough to sell products on the sole basis of them being „Made in Germany", has proven to be wrong[15].

In 2002, Mario Fazzi, General Manager of Körber China (KPL) [16] approached me with the unusual wish to find a Market Research Institute which was linked to a University. Körber is a $1.3 billion market leader for machine tools, machines for tobacco, paper and tissue.

---

[14] Abacus Corporation: own research.

[15] vgl. Wunde Punkte deutscher Firmen in China , 2000.

[16] Mario Fazzi: Körber Engineering (Shanghai); Design for Localisation, JV-Roundtable 1/ 2005.

Even if Abacus Corporation usually offered exactly what Körber needed, it was already the company policy in Germany to support academic bodies. My interest was awoken, as I had no idea if market research institutes attached to a university chair existed at all and to what extent they were prepared to carry out such a demanding project.

Even if I was helping my competitor to start a project, we were also investigating the situation in Shanghai. I was not astonished to discover that only the two most renowned universities of Fudan and Jiaotong provided market research to the industry.

After an impressive presentation and a detailed proposal, Fudan Business Consulting Co. finally got the project. The objective was: „Detailed market research and analysis of the tissue converting and packaging machinery, as well the hygienic paper machinery market, focused on KPL's competitors in mainland China"

China is the third largest tissue market in the world after North America and Western Europe. The forecast is even more interesting, bearing in mind that the consumption per capita in China of 2.4 kg is currently around one tenth of that of the US.

The project had two major outcomes:

1. The advantages of a university/governmental related market research institute lay in the field work: they are able to go deep into the provinces and due to their governmental links they can basically recruit everyone and every company as an interview partner.
2. The wish-list of potential customers of KPL was shorter than expected: less features, but locally competitive prices

KPL made a leap frog decision to build a lean version of their worldwide - bestselling machine, which was started in July 2003:

- Designed by an Italian designer
- According to the Chinese local needs
- Locally assembled at Koerber Engineering Shanghai (KES)
- European technology and quality at local prices

The localized Concept X proved to be successful:

The first introduction took place during Tissue World Exhibition China in December 2004, which was attended by 2,300 visitors during the 3-day exhibition.

KPL held an Open House at their Shanghai plant, where more than 250 customers watched the new machine. 32 machines were sold directly during these 2 days.

Concept X is mainly promoted for China and Asia. As worldwide customers have also showed an interest in Concept X for rounding up their machinery park for smaller runs, it is also available for worldwide sales.

The discovery that the Chinese market needs leaner equipment is not a new one but Koerber realised this as a consequence of their market research.

I can already hear the intensive discussions on a board level, about not bending the product philosophy of highly-developed and multi-feature machinery. But it is a survival strategy to go the extra mile for the product that the Chinese market really needs. This does not mean the company cannot sell their advanced technology in China, but maybe not now and only to a few customers. The market will develop and the product portfolio goes along with this development.

5 Types of Studies

The types of research used in Western countries are more or less available in China, e.g.:

a. Opinion Poll
b. Consumer Study
c. Monitoring
d. Investment Study
e. Competitor Analysis

In a communist country the *opinion poll* certainly has another definition, but for non-political issues it has a serious function.

Consumer studies are becoming more and more popular. As soon as an industry develops to the point where the consumer has a choice, consumer behaviour becomes more and more important.

One of the key aspects to take into account is that China is far from being a homogenous market where one size fits all. „China in this respect is far more like Europe," says Miriam Greaton, [17] Managing Director of Art de Vivre PR Agency. Just as Stockholm and Athens do not have the same consumer behaviour, the 31 Chinese provinces are also quite different in terms of dialect, cultural attitudes, climate, infrastructure and spending power.

Shanghai Volkswagen started 5 years ago with consumer market research but reports that it is still in its infancy. [18]

The international New Car Buyer Study (NCBS), which is a project supported by all car manufacturers that is already established in the USA

[17] Shanghai Business Review, August 2004.

[18] Abacus Corporation: Interview with Beatrix Frisch, Managerin Corporate Communications SVW, 2005.

and Europe, has just started in China. Some criteria, such as the average holding period of a car, have not yet been determined.

Since 1999, the „Car Park Study" – a profile and image survey has been carried out once a year. Starting at the beginning with only Beijing, Shanghai and Guangzhou, now Dalian, Chengdu, Xian, Qingdao and Wuhan are also covered.

Still some results raise question marks rather than giving answers: One of the most important requirements of the car customers, besides the price, is safety. If you ask what it means to them, then they can not even tell you. No wonder that with around 6 million cars, 100,000 people died on China's streets in 2004; this is equal to every eighth traffic victim in the world.

Another way to carry out market research is to monitor the market. The respective market in China might not have started yet, but with a deep insight into the market, a forecast which can help plan further investment activities is possible.

An indicator for this is to always watch the step that the benchmark competitor is taking as well as number 2 or 3.

For Abacus Corporation as a management consulting firm, qualitative and quantitative *investment studies* are among the core products and are mostly combined with a *competitor analysis*.

When we investigated the market for press fasteners for the well-known German market leader and brand company Prym, we were well aware that we were facing a severe challenge. [19]

We had to confess that the market of press fasteners in China is not statistically documented. The truth was that there was no information at all about this market which was available.

We decided to pursue 3 different ways to eventually obtain close-to-reality market data:

1. Industry segmentation:
   The estimated consumption of press fasteners per garment segment combined with price level segmentation low/high/imported
2. Industry index:
   0.25% of total garment production = press fastener market volume in Western countries
3. Competitor production figures

In fact, a fourth method was taken into account: we spoke to as many industry experts that we could identify. Unfortunately there weren't many.

The industry segmentation was the core part of our project - finding out the total volume of the market and the individual segments. Another result

[19] Abacus Corporation: own research.

was that the industry index in China was more than double that of the West.
The reasons were:
- Imported press fasteners are more expensive (duties, import tax)
- Production value of Chinese clothing is cheaper while press fasteners are relatively more expensive
- Clothes without press fasteners in Western countries do have them in China, e.g. knitting ware, blouses, women's/men's shirts
- Stronger focus on garments with high press fasteners usage

The analysis of the competitors was complex because we had to carry out almost 100% research, but on the other hand, we found that the phenomenon of a „press fastener" city, which is quite common in China, applied to almost all of them.

The customer first glanced in disbelief but once we were further through our presentation he accepted that the way in which we determined the market figures and evaluated them was feasible. Based on this, Abacus Corporation and Prym developed a restructuring strategy for China.

6 Methods of Research

The classical approach of desk and internet research, telephone and personal interviews - structured or with a guideline- or through a written survey - mail or email or CATI based - is more or less similar. Even if for a long time, telephone interviews have been considered as impossible, CATI equipment is still implemented and used in China.

There has been a significant increase in the use of focus groups as a qualitative method of data collection.

Access to Information[20]

An intern of Abacus Corporation described her experience of data collection in her thesis: „In China, obtaining reliable statistic data is almost impossible. We had several diverging sets of figures for the overall food industry, for example, and it was impossible to establish which set was more accurate. When we phoned the China Statistical Bureau, whose figures had been cited in an independent report by a German economist, they refused to either confirm or dismiss the data without further explanation.

[20] Katja Pesselhoy, Intern at Abacus Corporation 2002: Thesis.

By the same token, getting hold of accurate and relevant market research reports is very hard, since these are only accessible through insider channels and against steep fees, if at all. Whereas, in the West, a multitude of market indicators are widely available through industry associations' websites or government agencies, in China it even turned out to be impossible to compile a reliable list of the ten biggest Chinese food manufacturers and traders by sales volume - despite days spent on internet research and telephone calls.

As regards company data, although most companies do put some of their business figures on their websites, these are often measured differently, depending on corporate customs; or different figures are provided which cannot be compared.

Apart from the selective information about their business operations that companies make publicly accessible through their websites, there are also numerous journalistic articles about the progress of foreign companies in Asia which are published in magazines such as the Far Eastern Economic Review or on the (American) China Online Website.

But for us the problem was that companies filter information in line with promotional criteria, whereas independent publications focus on groundbreaking successes, failures or scandals.

In each case, information is sketchy and does not allow long-term observations of the day-to-day processes. Therefore, no coherent picture could be obtained. Furthermore, even this level of coverage only applies to well-known multinational companies (MNCs).

Small and medium enterprises (SMEs), which are not in the public eye, largely go unnoticed."

Reliability of Data as a Daily Challenge

The quality of information is still questionable: different sources quite often contain different figures, only to find out that they use different definitions. For example, in a recent survey about the Chinese printing ink market, two figures were found for the market size in two different charts, not to mention that in one of them, only 80% of the printing companies were taken with more than a CNY 50 million turnover.

It is often necessary to calculate the market new, to use support tools to estimate the real market size or to talk to industry insiders.

All of this is much more time consuming than in the West. After establishing Eurostat, European associations as umbrella organisations for country associations and the start of the Euro, statistics in Europe now seem to be widely available.

Unless in China:

The National Bureau of Statistics (NBS) issues the Statistical Yearbook of China on a yearly basis, yet still the figures are very often not last years but older ones. The other issue is that the data is of questionable origin. At least in the past there were rumours that the provincial bodies were manipulating the figures to their favour. The higher the figures, the closer the promotion.

Each province has its own Statistical Yearbook, which does not necessarily contain the same information as the All China Book. So officially we could report the figures for 2001 when we actually need the 2004 figures. During that period of time the changes were enormous, so we were unable to extrapolate or to just estimate.

In Europe, a growth rate of between 0 and 2% cannot be wrong, but in China we face growth rates from 8-60%.

Internet is becoming a more and more useful source of information:

- more and more Chinese companies have webpages
- more portals contain general industry information – both in Chinese and English
- more research is done and published for common use
- more government related webpages

Interviews are the major way in which to gain authentic information on the market in China. While the first contact and request for an interview appointment is usually via telephone, the quality of telephone interviews still has room for improvement. It is particularly difficult to obtain detailed information from the 'cold calls'.

The experience of personal interviews, however, is very positive: the interview partners in the industry are on the most part agreeing to meet and during the interview itself they are quite open, straight forward and informative.

One reason for this might be that they want to obtain information from us about a foreign supplier, foreign technology or the European and American market. These interviews are usually longer though.

It can happen that, long after the project, they still contact us with questions – this is when we have become part of his „guanxi"- network.

The factor „X" in China is exactly this „guanxi" network. It is well known that in Chinese culture the relationship is very important: if you belong to the family then you are in the inner circle, around which are the friends, then the professional acquaintances. It is certainly much easier to keep the business in the familiar relationship of family, friends and colleagues. Once you are „in”, there is always somebody who knows somebody who can give you the answer that you desperately need.

So we also keep our networks alive which constantly helps to improve our work.

7 Challenges of Market Research in China

7.1 Quick Changes

Another of the unique features of the Chinese market is the rate at which it is changing. Eugen Rothermel [21] wrote in his thesis in 1999, being still the same today: As the rapid growth in the economy filters through to the pockets of the Chinese consumer, he is being rapidly confronted with a growing range of buying decisions that are completely novel to Chinese society.

7.2 Correct Target Group

Various approaches to creating something similar to the Sinus Milieus [22] have been published. This definition is subject to a constant change, as the „lost generation”, who had no education due to the cultural revolution, grows older and will soon enter the retirement age.

– Single kids
– Young Boomers (<35)
– Best of middle agers (35/45)
– 45/55 (lost generation)
– Senior citizen (60+)

The spending income is in the hand of the younger generation (<45), rather than in the grey generation, as it is in the Western world. Therefore, it is extremely important to know the target groups.

„Survey: Chinese lovers busy: Forget the conventional thinking that says Chinese people are conservative when it comes to sex, they actually have more sexual partners during their life time than anyone else on Earth!” This was the front-page headline in the November 3, 2004 issue of the Shanghai Daily[23]. Everyone reading this headline, raised their eye-

[21] Eugen Rothermel: Thesis Fachhochschule Ludwigshafen: Market Research in China 1999.
[22] Sinus Sociovision: Informationen zu den Sinus-Milieus 2002.
[23] Shanghai Daily; November 3, 2004.

brows in disbelief. According to the Durex Global Sex Survey 2004, the average Chinese person surveyed has 19.3 sexual partners during his or her lifetime, well above the global average of 10.5. But how could this result have been found out?

The article continued: More than 100,000 Chinese, of which 87,304 were male, participated in the internet survey from May to July 2004. Most of them were between 25-34 years old.

Mr. Ma Xiaonian from the Chinese Sex Association commented on the result: „Internet surfers are young people and the bigger proportion of male participants certainly contributed to the large amount of sexual partners stated.

Not always is the result to a question so obvious and the target group so easy to identify. It was stated that this survey had the character of an advertisement and its objective of ending up in the press was fulfilled; it was only the result which was questioned by those other than the officials.

Another survey, the Sleep Index of Swiss based Isopublic, showed that only 7% of Chinese people use the bed for intimacy and affectionateness. One might ask about the plausibility of one or the other result.

7.3 Local Competitors

The competitors that a company meets in China are usually the well-known „enemies", of which the market research department files information around the world. Their websites contain valuable information about their activities in China.

Different and much more complicated to obtain is information on the local competitors. They are often small and hidden away in the countryside so it is more complicated to detect them. Exhibitions and fairs are a recommended way of becoming more aware of their existence and of obtaining more detailed information about them.

There is an old story which states that Linde in Xiamen would not have started with such a huge production of fork-lift trucks had they been aware of the fierce local competition involved.

7.4 Brand Building and Awareness

Chinese brands other than Haier are difficult to name.

The role of brands in the life of a Chinese consumer is fundamentally different to that of the West. [24] Chinese people are very price sensitive,

[24] Shanghai Business Review: Jumping on the Brand Wagon, August 2004.

therefore, there are only a few products they will pay a premium for unless there is a clearly perceived brand value, such as the perception of their position in their society, health or education; in the case of companies, a better quality image in the eyes of the customers.

When it comes to branding, Coca –Cola is the undisputed world leader. Entering the Asian market in 1920, the Company found it necessary to provide a Chinese name for the brand. In a name search competition in 1930, a Shanghainese scholar came up with „Ke Kou Ke Le". The Chinese characters meaning „delicious and happy" were an instant hit and it has since become one of the most popular brands names in Chinese.

In general, it is recommended that a Chinese name should be chosen for a company - one which sounds similar to the brand name and simultaneously has a positive metaphoric meaning, which matches the product features. Another example is BMW: the Chinese name Bao Ma means „treasure horse" or „precious horse".

8 Conclusions

As the Chinese market continues to grow and is subject to constant change, careful preparation for market entry is essential. Effective market entry strategies can only result from a deep insight into the relevant market that the company plans to tap in to.

This requires a well thought-through market research including competitor analysis. In the consumer product field, a focus on much more regional differences is a must. Companies have to adopt a China strategy which is not necessarily similar to the „international" one and which is based on the local market data.

Even if there are signs that China will grow into the international world community, Chinese culture and local peculiarities will remain to a certain extent.

The foreign company should choose a partner for its market research who knows the Western and the Chinese markets.

Legal Constraints on Business in China

Sven-Michael Werner

TaylorWessing, Munich

The past and current changes in China bring a great challenge to her legal system. What used to be a mixture of socialist law and traditional Chinese confucian legal principles is rapidly transforming into a western-looking civil law jurisdiction, at least in the field of business law and according to what the text books say. What now appears to emerge is a legal system with even more chaotic underlying principles and origins. The sources of law have become disturbingly unclear, but the path China is taking is obvious: departing from an authoritarian administrative system and heading for a rule-of-law based legal system.

Still, although the foreign investment regime has been the first area of law being subject to deep reforms, foreign business undertakings face many restrictions, some of them of legal nature. It is the purpose of this chapter to raise the awareness of such difficulties. This chapter will focus on two particular difficulties often encountered in practice: the nature of the legal system itself and the foreign investment regime.

Of course, China has a sophisticated legal regime in place to direct and regulate foreign investment and international commercial transactions, far from the common perception that there is no law in China. Not only does it restrict business, but also provides guidance how to structure China transactions in order to assure a legally sound development of the project. But another hurdle is the Chinese legal system itself, its sources of law, mode of operation and ambiguity of its rules.

1 The Chinese Legal System

1.1 Heritage of Chinese Law

The Chinese legal system since the 1990s is to some extent a mixture of the three sources of law developed in the preceding phases of Chinese legal history, i. e. the traditional confusion principles, the highly regulative socialist-style law after the 1949 Maoist revolution and finally the European-civil-law-style laws enacted since the early 1980s. Thanks to the highly instrumental approach towards law, China does not seem to be troubled too much by these parallel legal traditions, but the practitioner needs to deal with the often contradictory terms and principles. These difficulties mostly appear in areas of law facing transition. One very good example where these difficulties become visible would be bankruptcy law: In order to protect the confidence of all actors in each other's ability to pay their debts, the market economy system needs a mechanism whereby non-competitive enterprises would be taken out of the market and liquidated under the protection of creditors' rights. The socialist system of a planned economy with its state-owned enterprises, however, does not need such mechanism. The macro-economic and social functions of these state-owned enterprises require maintaining their existence. Now, after the Central Government has several times delayed any serious commitment towards privatizing these enterprises, it has finally started to apply market mechanisms to them. Accordingly, a modern bankruptcy law is urgently needed which also applies to state-owned enterprises. But it is not there yet. Now, how can a market economy function if actors appear on the stage who cannot go bankrupt even if they do not repay their due debts?

1.2 The Hierarchy of Norms

According to the PRC Security Law of 1995, land and buildings may be used to provide security to creditors so that these would be able to realize their security by selling the land and, in case the debtors have gone into bankruptcy, receiving payment out of the proceeds. Now, there exists a notice of March 1997 issued by the State Council that the proceeds from the sale of land use rights in any insolvency shall primarily be used to settle the workers' claims and provide for their social security even if such land use rights are encumbered by mortgages in favor of a third-party creditor. Mortgages and other security interest in land is regarded as good title in western market economy systems and hence protected by law. How can a market economy system work if an informal notice supercedes a formal law protecting lawful ownership?

This exemplifies another difficulty one may face dealing with Chinese law: the nature of two contradictory norms does not always tell which norm should take precedence in practice. Generally, the most recent norm shall also be most authoritative, or the norm which originates from the organ closest to the Polit Bureau of the Communist Party of China (CCP).

Besides legal norms there exist certain political norms issued by the CCP which may be even more authoritative than any law. Such political norms may not be published and are not self-executory. Legal norms would serve as instruments to execute political norms. Sometimes political norms are existent and valid without directly executing legal norms if they are very general in nature.

1.3 Law and Politics

It has often been said that despite the change the Maoist revolution brought about China in 1949, the communist system provides for a strong continuity with imperial China: both systems are authoritarian and law is subject to the superiority of politics. Neither in imperial China nor under Mao Zedong, law was allowed to play an independent and autonomous role – law was always just an instrument to govern the country and control the society, maybe not even the most important one. Education and indoctrination through mass campaigns make sure that the Chinese behave in the expected manner without the ultimate application of external force of the law. Law therefore reflects the political program of the ruling – or, in Imperial China, the confucian „li" – and does not have any autonomous validity. The snap-shot-character of law: it provides for an image of the political program at a specific point of time, like a snap-shot-photo. But politics moves on and so the photo becomes out-dated. You will need to look for a more recent expression of politics.

1.4 Operation of Law

Traditionally, in China law regulates the vertical relationship between the government and the people rather than the horizontal relation between individuals. This has tremendous effect on the way the judiciary works. A legal verdict issued by a Chinese court would not be seen as the decision between two individuals' contradictory interests on the basis of objective and valid norms, but rather as an authoritative order of the state how such dispute shall be resolved to the benefit of the community. This work of judges is administrative rather than legal. No reasoning needs to be given as the judgment is no result of the parties' action. Public interest is the only consideration it is based on.

Due to their marginal existence in traditional China legal proceedings have been unusual until recently. Law has basically been criminal law with the objective to discipline the people. This let to a common hostility towards anything that has to do with law. If someone is entangled with the law or any court proceedings he behaved in an improper manner or has been unable to resolve his affairs through friendly negotiations. The maintenance of harmony shall prevail over confrontation if conflict arises.

For the development of a legal system in nowadays China a functioning judiciary is inevitable. Courts are the place where the proper operation of law becomes visible. The role courts are playing in China has to be completely reinvented. Unfortunately, doubts about the independence of courts are more than feasible. Until 1982 the system of independent courts and judges has been rejected in China. The CCP-controlled legislation was viewed to be the highest authority of the state. Courts were not only institutionally dependent, but were also staffed with judges individually highly dependent on personal networks as communist cadres. One of the goals of the legal reforms after 1979 was the creation of an independent judiciary which was formally written into the new constitution as a matter of formality. One of the hurdles still today is the lack of qualified lawyers to staff these courts.

A particular problem is the execution of judgements. Any judgement or arbitral award, be it domestic or foreign, need to be enforced by local courts at the place of incorporation of the debtor. Therefore, „local protection" issues often arise as local judges are hesitant to act against people within their local network.

1.5 Judicial Review

Another aspect of the absence of the separation of power is the lack of effective judicial review of administrative actions. The legal determination of all administrative actions is an indispensable part of the rule of law. The law shall provide the administration with a defined framework for its actions. The compliance of all state organs with such legal requirements needs to be controlled by an independent judiciary.

In China this is a crucial issue which touches upon the question of the relationship between politics and law. The constitution of China contains some basic provisions for judicial review exercised by the courts. According to Art. 42 of the 1982 Constitution each citizen who's rights have been violated by state organs shall have the opportunity to defend his rights and challenge such administrative actions violating his rights. Art. 5 of the constitution provides for the principle of lawful administration. One of the main problems in China with administrative review is the lack of any separation of powers. The National People's Congress holds the indivisible power of the state and controls both, the government and the Supreme People's Court. Mutual checks and balances are therefore very unlikely to occur, if not impossible. In order to overcome these hurdles Art. 126 of the constitution honours the right of the judiciary to exercise judicial review over administrative acts.

After remedies became available against certain administrative acts as early as in the beginning of the 1980s the administrative litigation law was enacted in 1989 which contains detailed provisions on the competent courts, the right to appeal, proceedings and reasonings. An appellant can choose between an objection against the challenged administrative act and a formal law suit with the competent court. The objection is an alternate procedure rather than the prerequisite for the formal law suit and has been newly regulated in 1999.

According to the black-letter law China has already a system of judicial review of administrative acts, although restricted to certain areas of law. The main hurdles still lie in the judicial practice. The traditional focus of courts on criminal law and, to some extent, private law has still not been overcome and judges still lack the necessary self-confidence vis-a-vis the government and the CCP. Here also lie important ideological problems as the party's claim to possess the truth collides with any concept of judicial review.

For the time being the administration is still the most important institution for legal practitioners if it comes to the interpretation of law and receiving any definite decisions on how the law shall be applied on concrete cases. The courts are not authorized to interprete the law as the concept of „legislative interpretation" prevails in China. Principally, the Standing Committee of the National People's Congress shall be in charge of interpretation, but it rarely issues any formal interpretations. Instead, the Supreme People's Court has issued numerous interpretations in the past years the legal basis of which is dubious.

2 The Foreign Investment Regime

Take any foreign investment project in China – what are the common issues and restraints it will have to address in the course of its establishment and operation? Certainly, each case is different, different in regard to its industry, size, location, partner, form of investment, etc, but there are nonetheless certain questions all of them will have to consider in one way or the other. The following aims at these questions.

2.1 Investment Approval System

Any foreign investment in China needs various investment approvals. Technically, since the Contract Law has been promulgated in 1999, the concept of freedom of contract prevails. However, this general concept is limited by several exceptions, one of them would be foreign investment. First, since 2004 the parties to a foreign investment project need to prepare a project application report which was formerly known as the project proposal and the feasibility study and submit it to the National Development and Reform Commission (NDRC), either on the local or the national level, depending on the size of the project. This project application report shall contain fairly detailed information of the contemplated project, including size, form of investment, partners, location, planned business activities, market evaluation and production facilities. Until 2004 the necessary project proposal and feasibility study with similar contents needed to be approved by the planning authorities. The new laws on the project application report in 2004 require only the „verification" of this report which essentially means the approval by the authorities.

Furthermore, all substantial corporate documents of the planned project, such as a joint venture contract between the shareholders and the articles of association of the to-be-established company need further approval. The Ministry of Commerce (MOFCOM) would be the competent authority for this approval. While MOFCOM has traditionally reviewed also all commercial provisions of such documents, it has step by step shifted towards a mere legal review. In any event, MOFCOM approval requirements include the in-depth-review of the terms and conditions of any foreign investment project. Usually, in order to tie ancillary contracts to the joint venture contract and its validity, such ancillary contracts like know-how or trademark licence agreements, contribution-in-kind agreements, lease or land use right agreements are attached to the joint venture contract. This results in the review and approval of these ancillary contracts by MOFCOM, although these contracts technically do not require approval for their validity.

The length of such approval proceedings depend on several factors, such as the location of the project, the size and, as a result of that, the level of approval. Chinese partners usually tend to press for local approvals which in some cases result in the splitting-up of investment projects into two or three smaller projects. This practice bears the risk that the higher-level authorities would consider the project illegal as it would have required higher-level approval. Chinese partners in some cases, however, argue that their good relations to local-level authorities guarantee a smoother approval proceeding.

2.2 Foreign Investment Guidance

Contrary to what you may expect in the West, an investor cannot freely decide in which targets to invest his money. China's macro-economic adjustment policies would tell him what to do.

As for foreign investment projects there is no concept of freedom of contract, the possible areas of foreign investment in China are defined by law. The regularly updated Foreign Investment Guidance Catalogue, the most recent updated is effective since January 1, 2005, divides foreign investment projects into the categories „encouraged", „permitted", „restricted" and „prohibited". The catalogue usually refers to certain industries and branches. According to the categorization of a foreign investment project it will enjoy certain investment incentives or face restrictions for its structure. Encouraged projects are generally eligible for taxation benefits in special investment zones, whereas restricted projects are sometimes limited to joint ventures with a Chinese party which in some cases would be required to hold the majority in the company.

The rational behind such categorization is to avoid investment in overcrowded industries in which supply outgrows demand. Also restricted are projects which utilize outdated technology or damage the environment. For instance, the updated version of the catalogue as of January 2005 deleted the manufacturing of mobile phones and related equipment from the encouraged category so that these investment projects are from now on only permitted. This is supposed to be the result of heavy investments in these areas in the past and the resulting excessive production capacity. Prohibited are usually projects which touch sensible areas such as defence. Definitely encouraged are generally investments in high-technology industries or industries where a great demand exists within China.

Of great importance for foreign investment is the service sector. Due to China's accession to the WTO in 2001 this area of business has been subject to far-reaching changes, in particular since 2003. China's commitments to the WTO include the liberalization of the service sector and the opening-up for foreign investment. The Guidance Catalogue contains a detailed schedule for the opening-up of the service sector for both, wholesale and retail trade. Also franchise business and commission agency as well as after-sales-services are contained. These new rules result in a fundamental change to the distribution sector of China where it was the general rule that distribution of imported products shall be done by the Chinese. Since December 2004 even wholly foreign-owned enterprises are now allowed to do any kind of domestic trade and distribution. Before, this has only been true for self-manufactured goods. The trade and distribution sector can therefore be seen now as greatly liberalized in accordance with China's

WTO accession commitments, compared to what used to be the practice until 2004. But the 2004 changes can be seen as a streamlining of Chinese law along internationally practical guidelines.

2.3 Investment Vehicles

Finally, the foreign investor is not free to conduct his investment by any means of his choice. There is a conclusive list of investment vehicles available to foreign investors. These include

- Representative offices
- Equity and contractual joint ventures
- Wholly Foreign-Owned Enterprises (WFOE).

Since a couple of years now foreign investors can also acquire shares of existing Chinese companies including shares listed on the Shanghai and Shenzhen Stock Exchanges.

The choice of any of these investment forms depends on various factors and therefore there is no general answer which of these shall be chosen. A representative office is not allowed to generate own revenue and enter into contracts itself so that it can only engage in liaison business for its principal. While a cooperative joint venture has more flexible rules for its internal organization and does not necessarily constitute a legal person the equity joint venture is by far the most common and time-tested investment vehicle.

Joint ventures, in comparison with WFOEs have the advantage to share both investment and risk. Even more important, the Chinese partner may contribute all those assets which the foreign investor lacks in order to go alone, such as land and production facilities, domestic business know-how, distribution networks, supply connections, general market access. The success of the joint venture with a Chinese partner would almost always depend on the specific relation between both shareholders: what are their goals for their participation in the venture? Why do they do it with the other party rather than alone? These are crucial questions for the foreign investor to ask about his Chinese partner, and the answer is often related to his technology and know-how he will be expected to contribute to the joint venture. Therefore questions of intellectual property protection must be addressed, as well as of confidentiality and competition restraints – if the mutual interest in the joint venture is not well-balanced it might look tempting for the partner to walk away and start a similar business on the green field next door as soon as the know-how has been passed. Then the good connections of the Chinese partner which had looked so promising in the beginning will turn against the foreigner. Yet again, there are brilliant win-win situations for sino-foreign joint ventures and experience shows that these are usually the result of long-standing and well-developed business relations rather than the ad-hoc decision to go with one particular Chinese partner due to time pressure or other inadequate considerations why a joint venture shall be the vehicle to go for right now.

WFOEs are increasingly popular for two reasons: first, more and more industries especially in the service sector are being opened for these 100% subsidiaries, and second, it is the perception of foreign investors that China is not as inaccessible as before and can be done without a strong and experienced Chinese partner. Decision-making within WFOEs is much easier and so is the establishment as no joint venture contract has to be negotiated between the parties. There are no assets contributed by the Chinese side which would need mandatory valuation or even public auction procedures if the Chinese party is a state-owned enterprise. Exit strategies are easier to implement: no consideration is needed in regard to what happens to the foreign party's name, trademarks, know-how and, last but not least, invested equity.

The newest way into China is going to be the acquisition of an existing Chinese enterprise. This relatively new field of law is rather underdeveloped in China in comparision with Western countries and poses several difficulties. New merger and acquisition rules issued in April 2003 try to clarify the most important issues. The general legal framework for foreign investment applies to these M&A transactions in the same way, in particular the foreign investment guidance with its restrictions. If state-owned shares are acquired such transaction would trigger possibly troublesome questions of valuation and public auction proceedings. Practical problems contribute to the difficulties which cannot always be efficiently solved by conducting a legal due diligence as would be done in the West. Documentation would be found inadequate and incomplete and, most important, not reflecting the real conditions on the site. But due to the increasing practical importance of M&A transactions in China the existing rules are expected to be improved and supplemented sooner or later. For the time being the acquisition of a Chinese enterprise does not seem to be a real alternative for the average foreign investor in most cases.

3 Law in China – Restriction or Opportunity?

Surely law in China traditionally functions as a constraint to business undertakings, for both foreigners and Chinese, rather than as guidance for how to facilitate what one wants to do. Perhaps this is one of the reasons why the Chinese would prefer informal practices over formal and justiciable arrangements in their business activities. This will still very much be the perception of any foreign investor entering China as he will need to deal with several questions of approval and registration requirements set by the laws and regulations of China. But increasingly the law also provides for guidance how to structure transactions and provide for stability and predictability which is commonly regarded as a pre-requisite for any prosperous economic development. The latest move of the Central Government in regard to the reform of the investment framework shows that the parties to any business undertaking will increasingly be left to decide upon their mutual legal relation by themselves. This is not only a programmatic step forward for the Chinese government but also a necessity for an administration overwhelmed by day-to-day affairs.

Successful Business Relations with China – To-Dos and Taboos

Sylvia Knoss and Helen Beveridge

COMPASS Asia Training & Consulting, Ludwigsburg

In 1788 German aristocrat Adolph von Knigge published his book „How to Deal with People", which was to be the entry ticket to the German noble society for ordinary citizens. Even today an entry ticket is needed to participate in business in one of the world's biggest future markets. Without this it is hardly possible to enter. It is like a concert. The door man is the barrier. The concert can be over before it even started. There is nothing more than a few faint tones to be heard outside the concert hall.

1 Getting in Touch and Starting Business

Europeans tend to start targeted negotiations already during the first meeting with the Chinese. Many business people even travel to China with the intention of coming back with the signed and sealed contract. Great disappointment combined with a feeling of being „put off" arises after returning.

However, the Chinese rarely come to the point during a first meeting. It is much more important to do business with people who are known and can be trusted. This way of getting to know people and building trust takes a lot of time, especially for small talk. The following chart[1] shows clearly how long people of different nationalities usually take before they start talking business.

Taking time while building business relations with China is one of the key success factors combined with the ability to build a good relationship. Relationships are mostly cultivated during meals. That is why there should always be time for invitations. It is also impolite to show your Chinese business partner that you are under time pressure because you have to visit more business partners during your present trip to China. Having a flight ticket with a fixed return date is foolish in China.

---

[1] According to Lewis, in: Michael Schugk, „Interkulturelle Kommunikation. Kulturbedingte Unterschiede in Verkauf und Werbung", Verlag Vahlen, S. 223.

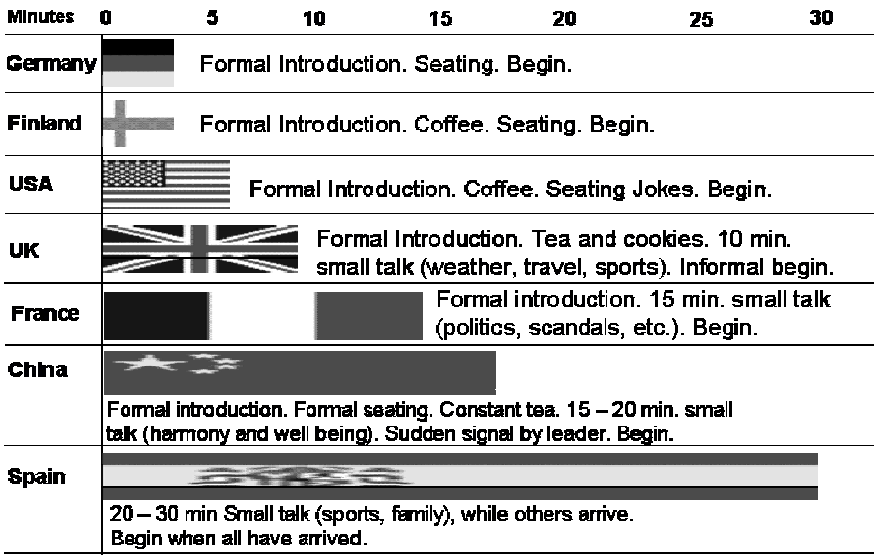


Fig. 1. Intercultural Communication: Opening a Meeting.

For example, Germans only need 3 - 5 minutes of small talk before talking about business, there is hardly time left for getting to know the other side. The Chinese, on the other hand, ask many questions during a first encounter, which seems to be much too personal for a European. Questions like: „Are you married?”, „Do you have children?”, „What is your religion?” are not purely curious. They actually serve the purpose of better getting to know and assess their counterparts. Europeans, however, are afraid to ask the same questions back and keep returning to the topic of business. The Chinese consider this as being impatient or even proceeding way too fast.

Hierarchies

In China a strong hierarchical system and way of thinking can still be found. Usually business partners communicate and negotiate always on the same hierarchical level. Hence, it is extremely important to have the right level (not title!) on your business card (see chapter 3). European business people again and again travel to a first meeting with hierarchical levels that are too low, i.e. on an expert level or with sales people. However, considering the strong preference for hierarchies mentioned before, an expert will face big difficulties getting an appointment with a decision maker at all. This kind of travel for contact search is rarely crowned with success.

2 Gifts

The Chinese give gifts always and everywhere. They say gifts keep friendship. However, there is a distinction between give-aways and delegation gifts of higher value.

Give-aways are appropriate for secretaries, drivers or delegation members of lower levels. Give-aways can be ballpoint pens, golf hats, golf balls, chocolate, boxes of chocolates or other typical products of the home country which should have a value of about up to 5 Euros. They serve mainly as appreciation for small services and favours or simply to maintain a good relationship.

Delegation gifts are mainly exchanged during official dinners. These are usually gifts of higher value. The value of both gifts should be roughly the same. One of the favourites are coffee/table books. The gifts are handed over by the two highest ranking people or the leaders of the delegations.

Gifts are always wrapped (except for very small give-aways like ballpoint pens etc.). White wrapping paper is to be avoided, since white is the colour of mourning in China. In Japan and Korea red wrapping paper should not be used. It is also uncommon to open gifts in front of others to avoid embarrassing anybody and giving the impression of greed. However, should your Chinese business partner insist that you open his gift, you should do so. Chinese business people are acquainted with these western habits and wish to be polite.

The following gifts are to be avoided: gifts related to the number „4", since its pronunciation resembles „death". Also knives („cutting a friendship/relationship") or clocks, especially alarm clocks („your time has run out") should not be given. Watches, however, are acceptable. Should you accidentally give knives or clocks, you might find your Chinese partner trying to „buy" these gifts for a small amount of money.

It always makes sense to give gifts at the preliminary stage, except for delegations where as mentioned, gifts are exchanged during an official dinner.

3 Business Cards

The issue of business cards is still widely underestimated by western business partners in their relations with the Chinese. A business card is like an entry ticket. Besides company name, name and title of the bearer, there is an absolute need to state his position. Without mentioning the position, a business card is pretty useless for a Chinese business person, because he will not be able to assess the hierarchical level of his counterpart. He does not know whether the person in front of him is his appropriate counterpart. A business card that does not state position will surely cause uncertainty in a Chinese person. Correspondingly, mentioning a position that is too low will hardly lead to a positive answer to a request for a meeting with a decision maker.

However, there is an enormous inflation of titles all over Asia. Every taxi-cab driver calls himself, in English, „President" of his one-man taxi company. Thus, the title on a business card has to be thoroughly double checked or even discussed with a Chinese person of trust before printing. But also Asian people know about the hierarchical structures in big western enterprises and that the meaning of „director" is different in small enterprises.

The business card should be printed one side in English, the other side in Chinese. European names are printed in Chinese according to their sound and sometimes cause a smile for Chinese readers. However, the position will then be correctly translated into Chinese. As a final test the card should be translated back into its original language.

If you have existing contacts with China, we recommend using them to have your cards printed locally. Business cards are ready in China within a few hours' time.

As already mentioned, a business card is like an entry ticket. A card is considered to be a little like the face of one's counterpart and always has to be dealt with respectfully. This means cards always have to be given and received with both hands. A card is transferred with the text toward the receiver so he or she can read it instantly. The card must never be carelessly put away: it has to be studied thoroughly in order to honour one's counterpart. Notes must not be written on it, nor may it ever be folded.

Cards must never be put in men's wallets, which might possibly be carried in one's back pocket. Just consider the card as your partner's face! All over Eastern Asia special card boxes made of metal or leather are used. These can be carried in one's chest pocket or inside pocket. Ladies should use their handbag or a briefcase.

4 Communication Style

From at the chart in chapter 1, it is evident that western business people engage only in short small talk before changing to business issues. However, Chinese communication behaviour is totally different. This can be seen well in email communication between western and Chinese business partners. While western people tend to come up with their request after short greetings, the Chinese usually first express thanks for good cooperation, then often mention the season, the weather and so on before coming to their request.

A pragmatic representation of communication behaviour of both cultures can be shown as follows:

The important part of the message for a western business man lies in the first half of his mail after a short introduction. The second part is often comprised of a short private part („…by the way how is your family?"). If two western people communicate together they automatically fall into their communication pattern leaving the „unimportant part" to the end. Therefore, people often interrupt the previous speaker.

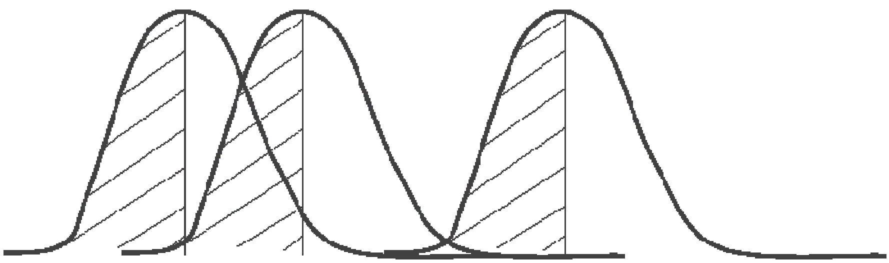


Fig. 2. Western Communication Style.

The Chinese, however, put the important part of their message towards the end of their statement, while they often express thanks for good cooperation etc. in the first part. If two Chinese people communicate with each other, they automatically keep to the given communication scheme. The important part located at the end has to be processed first. Extended conversation breaks can result from this.

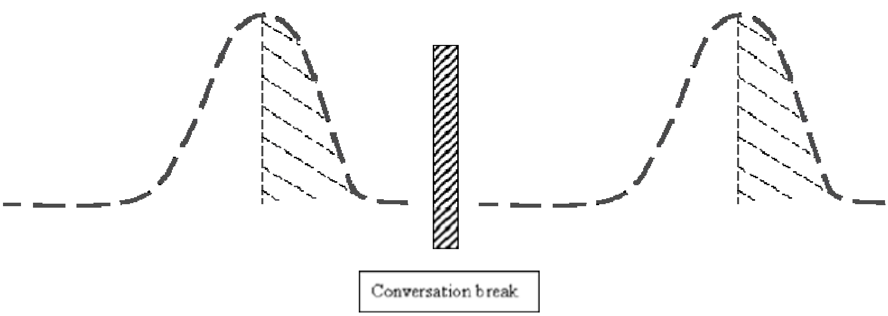


Fig. 3. Eastern Asia Communication Style.

During conversation between western and Chinese people the following can happen:

Western people again and again interrupt the Chinese and therefore miss the important part of his information:

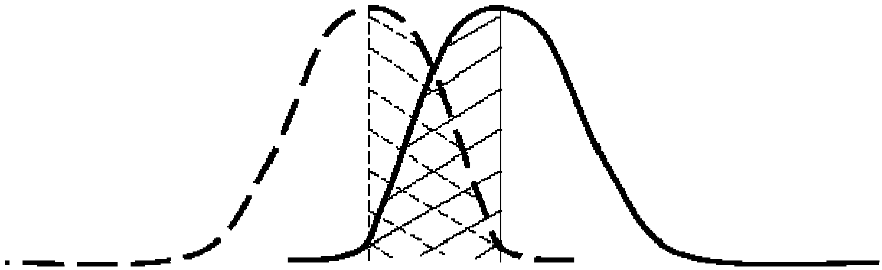


Fig. 4. Eastern Asian versus Western Communication Style I.

Or extended breaks arise (up to one minute – In Japan even longer compared to China), which are hard to bear for a westerner. It can also happen that a Chinese starts to listen seriously when all information of his western partner is already said long ago.

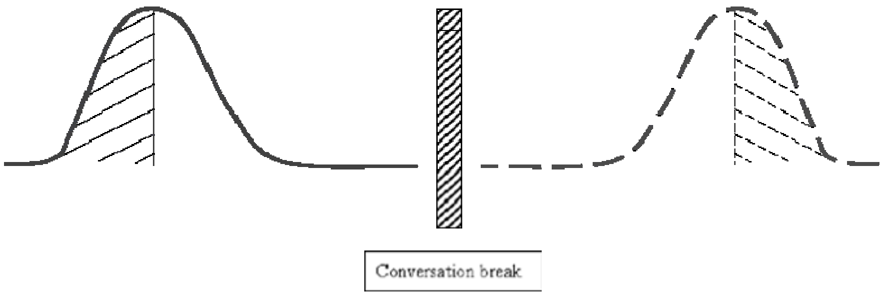


Fig. 5. Eastern Asian versus Western Communication Style II.

Of course this scheme is very simplified, but it shows that western people simply have to be more patient and have plenty of time while communicating with the Chinese.

Another confusing item can be the repetition of facts by the Chinese. Constant repeating can have the following reasons:

The facts are really not yet understood and the issue is extremely important – however, a direct question is avoided.

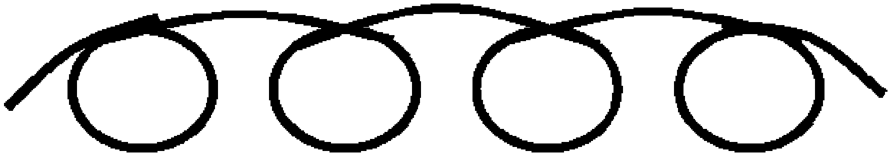


Fig. 6. Repeating.

In general it can be assumed that redundancy means relevance.

Saying Yes

Great misunderstandings during communication occur with the Chinese „Yes". Western people often understand this „Yes" as agreement. Let us compare e.g. a long telephone conversation, during which mainly one side talks. Here as well, the listener at the other end of the line will once in a while give signs of agreement, which do not mean anything else than:
- I'm still here
- I'm listening
- Attentiveness
- Confirmation or even
- Agreement

The Chinese „Yes" during meetings and in all communication can be understood in the same way.

Saying No

The Chinese rarely express a direct or open „No". This is considered impolite and too direct.
Rather the following is applied:
- The issue is avoided, the topic changed
- The mentioned items are confirmed, but the topic is avoided
- The whole issue is postponed or postponed indefinitely until it is no longer relevant
- Responsibility is denied and another person in charge is mentioned
- You will hear: „It's difficult"

Example: If a western person is offered snake and he does not like it, he may well mention the famous and excellent Beijing Duck, which he has never had the chance to taste. A Chinese person will certainly understand this hidden hint.

5 Separation of Facts and Person

In the western world it is easy for us to separate facts and person. For example: two colleagues have been sharing their desk for years and they both respect each other's work. However, personally they have never got closer and have never had a drink or lunch together outside work.

On the other hand, there are people who get along very well privately, but could never share their desk with each other, because they do not like the other's working style. We can see that there is a clear separation between work and private life.

In Asia this is different. If people work together, they also go out together for dinner or a drink. Taking care of one's social network during meals or drinks is part of business life. Work and leisure belong together. Cooperation will only be good with people with whom one has a good relationship. And vice versa. Criticism of a person's work in the presence of others can indirectly lead to criticism of him as a person, since facts and person are not separated.

6 Setting up Business Connections

Usually initial meetings in China are arranged by a middle man. This can be a Chinese associate of one's own company who already has contacts with the future business partner, or it can also be arranged via contacts provided by the chamber of commerce or contact fairs. Once the contact has been established, there are two requirements in China to build up a good business relationship: lots of patience and lots of time.

Those who expect an agreement after one or two visits will leave China disappointed. Months of negotiations, visits from both sides and many dinners are often necessary to come to corresponding agreements. As a matter of fact, special emphasis is put on how visitors are taken care of during business trips and the related dinners. Most important is an excellent (human) relationship, the so-called „Guanxi" between the negotiating partners. Without good Guanxi there will be no trustful and lasting business.

For the first visit the delegation should be comprised of representatives from all levels (Managing Director, Vice President for Sales/Purchasing, etc.). Please also refer to chapter 1.1 – hierarchies.

Discussion Topics

In general, the intention is to find as many commonalties as possible during a first encounter, e.g. common friends or former colleagues. Very important is family, especially small children. It is very common for the Chinese to ask questions regarding marriage, number of children etc. These questions may be asked of them, too. Other good topics are e.g. European cars, Chinese history, travel destinations in China, and of course, again and again, the extensive issue of Chinese food.

Taboo Topics

The following topics are strictly to be avoided: the seizure of Tibet and the Taiwan issue. The cultural revolution and the Falun Gong sect are also not suitable topics for discussion. In general, political comments regarding both Chinese internal affairs and foreign politics should be avoided. Do you have experience and knowledge of Japan? Do not talk too much about it in China, this will not make friends. China suffered a lot under Japanese occupation during World War II.

7 Keeping Business Relations Alive

For long lasting business relations with the Chinese it is necessary to provide both partners with a long term opportunity for profit – „live and let live".

Frequent personal visits to stay in touch are another possibility of keeping a relationship alive. Opening one's own personal network for the partner by establishing contacts to interesting people is highly appreciated and will not be forgotten. In general, favours in business life are like paying into an account without expiry date to be reimbursed with a certain interest rate at a given time later.

8 Leadership Culture

In principal, Asians lead with authority internally, but, to the outside representatively, combined with a strong sense of care for their associates. This sense of care taking is essential. It is usual, for example, for a superior to call the home of his associate to ask about his well-being if he reported sick. It is also usual behavior to attend funerals of associates' parents as a superior.

On the other hand, nobody will contradict to a superior in public and he will always be the one to make decisions. This is often a reason for the long decision-making process. Chinese delegations always have to ask for approval from their superior before deciding anything. If they are abroad during this time, different time zones cause additional delays.

During a reception at a president's or company director's office usually business is no immediate topic. Rather, tea is served and people get to know each other by means of light conversation. The host takes care of his guests, but never forgets to get an impression of their personalities and intentions. Operational issues are discussed at corresponding hierarchical levels.

China has two generic types of managers:

The „Western" Manager

He is usually at most 40 to 45 years of age and has had a western education, often an MBA. He speaks excellent English, often even a third language. Through his education he has mastered western manners, thinks and acts entrepreneurially and thus enjoys good relationships with foreigners. Usually this type of manager is responsible for joint ventures, e.g. as a General Manager.

The „Traditional" Manager

He is usually about 50 years of age or older, is an agricultural or mechanical engineer with a career of several years in the communist party. He seldom speaks foreign languages, thinks and acts rather traditionally, i.e. as a communist. However, he has the extremely important connections with public offices and government agencies. Often he is responsible for HR issues, including redundancies if necessary.

9 The Six Faces[2]

Most readers will have heard the expression to „loose face". However, there are some details worth having a closer look at.

---

[2] According to Hu, Hsien Chin, 1944, The Chinese concepts of „face".

To have face

Everybody has face. This face shows current social status, position and level in hierarchy

To strive for face

Asians, in particular, strive for a higher position and the corresponding higher social status and reputation. This can be seen in business cards, which show slightly exaggerated titles.

To give face

Asians are extremely good at this variation. To give face includes praising people for little things, such as great knowledge of Chinese for being able to say „hello". However, this is not to be mixed up with praise for individuals in front of their peer group. This would be embarrassing for every Asian.

To provide face

Face is provided, when a middle man is engaged. Either to establish contacts via a middle man or to solve conflicts.

To leave face

Leaving face to someone is the great art of behavior in Asia, e.g. criticizing people in front of others or giving someone the possibility of correcting mistakes by himself. If somebody made a mistake, he is not to be criticized in front of others or corrected, but rather he is told personally and discreetly - again dinner would provide a suitable setting – what he did wrong. This way he has the possibility of recognizing the mistake himself and taking corrective action. If an associate becomes unbearable for the company, he is expected to recognize the situation and to leave the company by himself. Meanwhile, he will not be given any new tasks.

To loose face

Loosing face is the worst event for any Asian. This means nothing less than the total loss of reputation and status before other people and society, often even social isolation. In any case, this will result in an associate ashamedly leaving a company.

If a western business man is able to give and leave face, he will operate more successfully in Asia. Someone who is not able to give face is about to loose face himself. The most difficult part for us western business people, however, is to leave somebody face as we grew up in an environment where unclear or illogical issues are clearly pointed out and, if necessary, criticized in open discussions.

10 Negotiations

Chinese are masters of negotiating. During international business negotiations, however, it has often been observed that the Chinese delegation lacks important technical, economical and legal details. Instead more emphasis is put on personal relations and the trustworthiness of their partners. In the first negotiation phase the Chinese, therefore, keep a low profile regarding content and spend a lot of time assessing their negotiation partners as well as their role and influence within their own group. The western delegation has to show they have the backing of their own decision makers. Special emphasis has to be put on building personal relations during this phase. Attentiveness and friendliness in all fields, especially in invitations and during visits, are taken special note of and appreciated.

During the following phase of substantial discussions the Chinese usually try to hold back concessions as long as ever possible. In the search for arguments for this, they come up with tactics such as lamenting about the alleged backwardness and third world status of China, hints on extreme difficulties caused by Chinese authorities, or simply playing for time. Here, it is important to be under no time pressure oneself. Flexibility, i.e. the possibility of postponing a return flight from China by one or two days is recommended. After an agreement has been reached, the Chinese partners are usually ready for quick decisions and swift implementation.

Once a relationship of trust has been be established, Deng Xiao Ping's tenet of „becoming rich together" in the sense of a win-win partnership between the parties is valid. Should this trustful relationship not come about, the Chinese „partner" will do everything to make sure his side benefits. Continuing the talks then, if at all, only makes sense from a position of strength.

To avoid constant renegotiations, writing meeting minutes, printing them right after the meeting and having them signed immediately by every participant is recommended. This way it is easy to keep track of what was negotiated each day.

11 Conflicts and Conflict Management

Reasons

There are many reasons for conflicts between western and Chinese partners. Many conflicts arise because of the western separation between facts and person, e.g. by criticizing part of someone's job and so indirectly the person himself as well.

Also a „No" spoken too directly appears too strong for the Chinese – almost like a smack in the face. This often leads to confusion or even insult.

Finally, the reason for conflicts is often a neglect of relationship or hospitality. Joint ventures in Asia e.g. often have an entertainment budget similar to their R & D expenses. Of the same importance for the relationship is the exchange of gifts during official events, which must not be neglected. Leaving the impression of having no time for your partner and rushing from appointment to appointment can give the impression of visiting him only „en passant" and can finally be another source of conflict.

Consequences

The first obvious result is often a reluctance to offer hospitality such as no more dinner invitations or even no business invitations at all. Appointments are constantly postponed, phone calls not returned. It is common behavior for Asians to even stop communicating completely in such a situation, which is the end of the relationship.

How to Overcome Conflicts

There are a number of strategies to possibly overcome existing conflicts. If still possible, the easiest way is hospitality, i.e. dinner invitations and drinks to solve the conflict on that occasion. The next stage is an invitation to a business trip with an excellent itinerary, including e.g. golfing. Here, it is important to convey to your partner your serious willingness for reconciliation. Another suitable possibility is to engage a middle man. This can be either a western or a Chinese mediator, as long as he enjoys a good and trustful relationship to both conflicting parties. Usually, this mediator is of higher rank than the other parties.

12 Dos and Taboos for Restaurant Visits

As already mentioned eating and drinking is of enormous importance for business in Asia.

Eating in China

The Chinese usually have dinner rather early, often around 6 p.m. Official dinner invitations usually happen at places with round tables. Since „8" is a lucky number in China, mostly 8 people are seated at one table. At round tables hosts and guests are seated alternately next to each other. The most important guest is seated to the right of the host, the second most important to his left.

Food is always shared in China and there are no separate single servings. One after the other, different dishes are put on the table plate, a central rotating board, which will then be turned, usually so that the most important guest can reach the best morsels first. In China a dining table must never become empty. An empty table shows meanness or a poor host who is not able to treat his guests properly. You will receive food until you eventually give up and leave something on your plate. This alone is a signal for your host that you have finally eaten enough.

In China there is a rice/noodle border. In the north (Beijing and beyond) the staple food is mainly noodles, whereas in the south (Shanghai and further south) the cuisine is based on rice.

Chop Sticks

The Chinese avoid always touching food with their bare hands. Never stick your chop sticks into your rice bowl. This is part of a funeral ceremony! Neither should you pass food on from one pair of sticks to the other. Your hosts will instead place the tasty morsels on your plate. However, chopsticks often realigned by knocking them tip down on the table. After finishing your meal or during breaks you can either place your chopsticks flat across your bowl or simply put them back in the position you found them in before. Good restaurants provide „chop stick benches", similar to our western knife benches.

Rice

Do not ask for rice! Rice is only staple food and is served at the very end of each meal to make sure that all guests really have eaten enough. It would be disastrous to ask for rice during a good meal. The host would be embarrassed, thinking he had not provided enough food. Rice is always cooked without salt, all over East Asia.

Soup

Soup is served either at the same time or after meals. The Chinese think that soup thins gastric juices and should therefore better be eaten after meals.

Beverages

During meals, tea, beer, or water are served. The water temperature varies with the season, cold in summer and warm in winter. Better restaurants also serve wine. Never fill your own glass in East Asia! This might look greedy. Let your neighbour or vis-à-vis do the job and also be very careful to make sure their glass never gets empty. As your own glass also never empties this way, you might not be able to keep track of how much you are actually drinking. The slower you drink, the less can be poured into your glass.

The further north one travels in China, the bigger the glasses get and the higher the alcohol content of your drink becomes.

Be careful with the Chinese toast „Ganbei". This means „bottoms up" and obliges you to empty your glass fully (and show the empty glass afterwards to the others!). While toasting, take care that your glass is always held lower than those of people higher in rank. This a sign of respect towards them.

When the party becomes funnier and more relaxed you can use the opportunity to mention some kind of criticism, praise, feed back or problems. This is the right moment to do so. However, the next day everything that was said as well all kinds of drunken behaviour are absolutely taboo. It is fine to thank yours hosts for the nice evening, but discussion topics must not be mentioned again, and comments about people present at the dinner should be not made.

Exchanging Gifts

A dinner spent together, e.g. after a successful agreement, is a good opportunity for the two delegation leaders to exchange gifts. Only these two gifts are exchanged in front of everyone. The other participants might receive a small gift after the meal when leaving.

Wiping One's Nose, Spitting, Slurping

Blowing one's nose is frowned upon all over East Asia. In a restaurant this is even worse. Gentlemen must never use handkerchiefs since their purpose in East Asia is to dry your hands. Socially acceptable, however, are slurping, burping, or spitting small pieces of bones back on the table. Something which is just as strange for Westerners to as blowing one's nose for Asians.

Dog, Cat, Mouse

The Chinese eat many things which are considered strange or even disgusting in the Western world. If you are served food you really cannot eat, do not refuse it, but simply leave it on your plate. If necessary, all kind of sickness like an upset stomach or allergies can be a good excuse.

Bills

There are no separate bills in China. Payment is at the table. Be careful with tips. In some state-owned restaurants this might be considered a bribe. It is better to ask a Chinese colleague if and how large a tip is appropriate.

Eating with the Chinese in the West

The Chinese often eat western food with the same unease as Westerners eat Chinese food. Often they find it too heavy or too salty. Never pay attention when the Chinese say „No" when you are filling their plate. This is usually pure politeness and they will be disappointed if you take this seriously. Just wait until they do not finish everything on their plate anymore. This is a sure sign they have had enough.

Soups and Starters

Western soups are mostly too salty and sometimes too creamy for the Chinese. If possible order food without salt in restaurants. It is easy to add salt afterwards. For starters serving platters with a choice of dishes from which everybody can serve himself, is recommended. The Chinese are not used to having portions only for themselves.

Main Courses

The Chinese fight with knives and forks the same way we do with chop sticks. Therefore, it is better to avoid poultry and meat with bones like duck or pork knuckles. Light meals like fish, rice etc. are preferred. Do not forget to fix the order of courses for them. Just imagine you are sitting in China in front of a Chinese menu!

Dessert

A good choice is fruit or ice cream. Avoid very sweet or creamy desserts like Mousse au Chocolate and the like.

End of the Meal

Usually the Chinese do not stay long in a restaurant after a meal. They prefer to go to a bar. A meal is finished after the delegation leader stands up shortly after the last dessert (mostly water melon) and thanks everybody for joining or for the invitation. This is the sign for everyone that the official dinner is over. If the Chinese are invited to a dinner in Europe and it goes on too long for them, here as well, the delegation leader will stand up and thank his hosts for the invitation. For his associates this means either going to their hotel rooms or moving to a bar.

Dress Code

Business people wear dark suits, a tie and black shoes. A 3-day beard is considered rather unhygienic.
Ladies wear a dark dress or trouser suit, stockings, and long hair is tied back.

Waving

Please do not use your lifted index finger or finger tips facing upwards to signal someone to come. This is very impolite. The correct way to attract the attention of a waitress, a taxi, a parking car, a bus etc. is to wave with the back of one’s hand up and finger tips down.

Part Three

Practical Insights from China

The Insurance and Banking Sectors in China

Heinz Dollberg

Allianz AG, Munich

1 China – a Growth Market

A lot is written these days about China and the success of its economy. I will therefore restrict myself to consideration of the insurance and banking sectors – as indicated in the title – and will look in particular at the examples presented by Allianz and Dresdner Bank, which are both represented in China.

Our attention is focused on the changed situation in which people find themselves. Individuals have to take more responsibility for themselves and are consequently adjusting to their new circumstances. New patterns of behavior regarding consumption and savings can currently be seen in cities like Shanghai or Beijing. Owning your own home or your own car have become real possibilities. People are saving in order to make major purchases.

Savings are also being seen as a form of provision, as reserves to draw upon during education and training, or in retirement. Private provision is a question of necessity, as the days of comprehensive state provision are long gone.

Private savings are primarily invested in deposit accounts with state banks. Chinese banks hold savings valued at more than one trillion dollars, or approximately 1,000 Dollars per person. This means that private savings constitute an entire year's income, which is more than in western countries.

Thus deposit accounts put all other forms of investment in the shade.

Many people are afraid of the risk involved in investing in equities, and consequently stocks constitute less than one fifth of the money invested at banks. Private equity holdings per person are worth somewhat less than 200 dollars. [1]

---

[1] Generally speaking, Chinese citizens only have access to the Shanghai and Shenzhen stock exchanges, which have a joint market capitalization of around

Accumulation of assets via insurance policies is only just beginning.

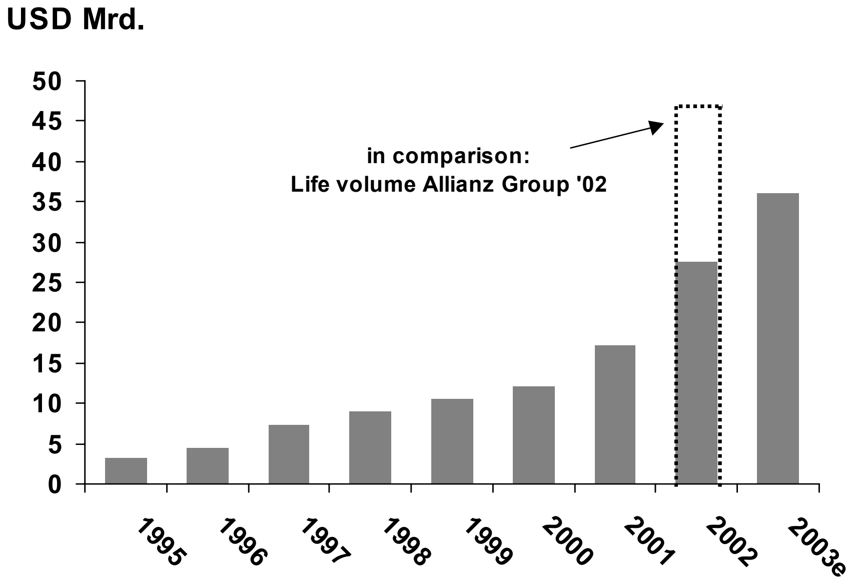


Fig. 1. Life Premium in China.

In the past year, Chinese life insurers received well over 20 dollars per person in premium, or total premium income of 27 billion dollars based on the entire population. In comparison, Allianz Life Insurance's customers in Germany alone accumulated reserves of over 40 billion Euros last year.

A further comparison will make the relative size of the market clear.

With 27 billion Dollars of premium income, the insurance market on the Chinese mainland is roughly the size of that in Taiwan. However, this position will not be maintained in future. In the last two years alone, premium income doubled – a dramatic development which is definitely expected to continue.

For foreign insurance enterprises, China is a small but strongly growing market. Social change and stable economic growth will make the country into one of the most important markets, if not the most important market, for life insurers in the near future.

500 billion US dollars. Only one third of the stock is privately owned, either directly or indirectly, with the remaining two thirds belonging to the State. Equities in free float, valued at around 167 billion US dollars are therefore equivalent to around 150 US dollars invested in stock per person.

2 Barriers to Financial Services Providers

China has been gradually opening up to foreign investors for over 25 years. However, unlike the industrial sector in which licenses were issued in the early 1980s, insurance enterprises and banks initially went round in circles while trying to set up their operations.

The process of opening up the economy to foreigners began in 1980 with the special economic zones along the coast, and above all Shenzhen, close to Hong Kong. Foreign investors were allowed to establish themselves in the special economic zones, which rapidly developed into major industrial centers, particularly for light industry. However, the financial services sector remained absent.

2.1 Delays in Liberalization

For many years, it was impossible to obtain licenses for our banks and insurance enterprises.

Despite some promising cooperation agreements with local financial services providers, the situation did not really change until the 1990s, when foreign financial services providers were given the right to apply for licenses. We set up our operations with the goodwill of the authorities, which was not always easy to obtain.

– In 1993, Dresdner Bank commenced operations with a branch in Shanghai, the first German bank in China.
– In 1997, Allianz set up a life insurer together with a local partner, also in Shanghai.
– At the beginning of 2003 P + C business started in Guangzhou.
– In June 2003, this was followed by the establishment of an asset management company in cooperation with a local partner.

The Allianz Group's four key sectors have therefore only been established in China for a relatively short time.

2.2 Limited Liberalization

Although licenses have been available for some time, there has not been a real opening up of the Chinese market. We are still faced with numerous restrictions, which means, our business is „limited".

Rather like an 'approved' list, the licenses specify precisely which types of business are permitted. Activities not specifically listed in the license are not allowed. Licenses also only grant access to certain sub-markets, excluding the most attractive sectors. The practical implications of this can be seen in the Allianz Group companies in China.

– Dresdner Bank's license permitting loans to be made in domestic currency only apply in the nine „open" cities and two provinces. We are not allowed to provide Renminbi loans in the majority of the country.
– Our life insurer's current license restricts us to business in Shanghai. We would need an additional license to do business in other locations, which in reality is not easy to obtain.
– The license for Allianz's P + C operations in Guangzhou (in the south of China) only allows us to transact business with industrial clients in Guangzhou itself. We are barred from the so-called statutory business (e.g. motor), which counts for ca. 85% of the total market. We are only allowed to accept clients based elsewhere in China in exceptional circumstances.

These regional restrictions are typical for China, and are unknown in other major markets like India or Indonesia.

Further barriers exist. For example, our executive managers on assignment to China generally have to pass exams in Mandarin before they can be granted approval by the supervisory authorities.

The market is also further subdivided. Additional restrictions apply to clients and products.

– Dresdner Bank is only allowed to hold accounts in local currency for foreign companies. Clearly, the market for domestic customers is more important.
– Our life insurer in Shanghai is only allowed to sell policies to individuals. We do not have the right to sell group policies or health insurance, which naturally makes it difficult to do business with entire companies and thereby obtain large numbers of customers quickly.
– Outside Guangzhou, Allianz P + C only has a license to underwrite policies with a sum insured exceeding 25 million Euro. Policies with lower sums insured cannot be accepted.

In view of such restrictions, it is hardly surprising that foreign owned companies have a total market share of less than 2%. The market share of foreign insurers and banks even declined last year.

At almost 2%, the market penetration of non-Chinese providers is lower than those in other emerging markets.

– In India, foreign insurers have a market share of almost 10% only two years after the market was opened up to foreigners.
– In Indonesia, foreign carriers are firmly established with a market share of over 40 %.

A similar situation applies to banks.

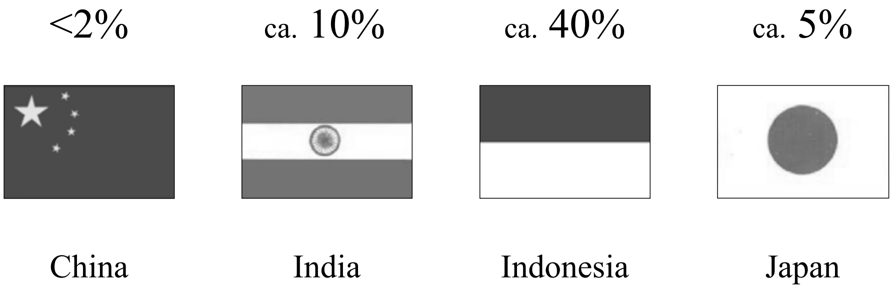


Fig. 2. Comparison of Market Share.

The figures specified above demonstrate China's reluctance in opening its financial markets to free trade.

However, we should not jump to conclusions. For example, in Japan foreign insurance carriers also only have a market share of almost 5%.

Looking at Japan's figures, it is clearly insufficient to wait for the market to 'mature'. A comprehensive liberalization process will be necessary for larger market shares to be obtained.

I mentioned earlier that China will in future be a significant market. Emphasis needs to be given to the caveat 'in future'.

3 Causes of the Barriers

From time to time, critics joke that the Chinese market has a lot of potential, and will keep that potential for ever. Such critics claim that the Chinese dream is just an illusion for most foreigners, and all too often a lot of fuss is made about nothing.[2]

Taking foreign investors as a whole, this position is not or is no longer justified. From Dresdner Bank, which has connections with European companies, active in China, we know that a growing number of companies are doing profitable business there. Volkswagen and OBI are good examples of this. Profit margins are sometimes particularly attractive. In addition to household names, there are also SMEs who are proving to be successful in China as a result of their specialist knowledge.

[2] The argument that China is an illusionary market is made for example by Studwell, Joe, „The China Dream – The Elusive Quest for the Greatest Untapped Market on Earth", London, 2002.

3.1 Historical Causes

Why do different conditions apply to foreign insurers and foreign banks?

Why can we not really tell a Chinese success story like that of Volkswagen?

The causes of the slow pace of market liberalization are complex. It is certainly the case that the Chinese authorities have or had a certain distrust of foreign competitors.

The tendency to bundle foreign companies together in regions has a long history in China. The special economic zones at the beginning of the 1980s were a continuation of the tradition of free ports established in the 19th century. Even Allianz's 'island markets' in Shanghai and Guangzhou follow this trend to a certain extent.

3.2 Economic Causes

The principle reasons for the slow start to market liberalization are not historical but are rather based on the inherent instability of the Chinese financial system.

The Chinese financial system has had to face an enormous challenge in the past 25 years as a huge number of investments and state development measures had to be funded via loans.

Undoubtedly, most investments in China are made by private companies, but it is often politicians who initiate and implement these projects. There is a political vision behind these projects.

Particularly here in Germany we tend to admire the speed at which infrastructure projects are carried out, how houses and roads are built in record time.

However, we should consider that business principles do not always apply to these projects. We should note that little use is often made of such projects, and that profit margins from them are unacceptable.

Providing loans for political reasons naturally creates problems servicing those loans. After 25 years of exposure to this, the Chinese financial system is stretched to the limit.

The financial position of the banks is weakened by them having poor quality loans in their portfolios. The investments they have helped to finance often never become profitable, or only do so far too slowly.

Some local banks even admit that non-performing loans could constitute one quarter of all loans made. Foreign analysts come to even more pessimistic conclusions.[3] Standard & Poors' and Moody's estimate that 50% of all loans are at acute risk of default.

In view of this perilous situation, the risk of a crisis of confidence in the Chinese financial market is obvious, and the risk that the situation will become uncontrollable must be taken serious.

It is therefore not surprising that local banks and of course local insurers are protected against serious competition.

The State has provided help in recent years by repeatedly recapitalizing local banks. Recapitalization primarily took place through purchase of loan portfolios from banks at their full nominal value, which was very good business for the banks as the market value of these portfolios was lower than their nominal value.

In addition, the State provided further protection by keeping interest rates for deposit accounts low and by practically eliminating competition on price. Nationally, banks only pay 0.72 % interest on immediate access deposits.

Insurers have to guarantee a maximum return of 2.5% on premiums. However, the actual returns attainable are barely over 3%, which is very little when one considers that Allianz Life Insurance in Germany manages to provide almost double this return for its policyholders, despite the downturn in the capital markets and a stagnating economy.

Competition is also limited on the quantity side. State-owned banks have preferential access to savings, and in spite of the low interest rates on offer, other forms of investment hardly seem more attractive to consumers.

Local equity markets are unstable and rather over-valued, leaving many investors afraid of taking the risk.[4] Until very recently, life insurance played a subsidiary role, and diverting funds abroad is illegal.

Given the strong supply of capital deposits and the lack of options to invest abroad, Chinese banks enjoy a strong liquidity position despite their non-performing loans. This results in the paradoxical situation that banks are on the one hand undercapitalized but on the other hand have good liquidity.

The barriers in the Chinese financial system are not helpful for Allianz's business, and can be extremely frustrating. However, these barriers are part

---

3 A study which is often cited in relation to poor bank balance sheets is that by Lardy, Nicholas, R., „China's unfinished economic Revolution", Washington, 1999, p 59 et seq.

4 A particular risk factor is the high valuations assigned to local equities. Chinese stock issued with tranches in US dollars or Hong Kong dollars is generally traded at considerably lower prices than the local remninbi tranches.

of a comprehensive system of protection and possess their own logic. They are by no means the product of long-established traditions.

4 Getting Past the Barriers

Efforts have been made in China to move banks and insurance enterprises on to a free-market basis for years. These have been focused in particular on improving the quality of credit approval decisions and reducing the risk of making poor investments. A significant amount of progress along the road to a modern financial system has already been made.

In recent years, the State has established specific supervisory authorities which are to work according to international standards.

- The China Insurance Regulatory Commission commenced operations in 1998.
- The China Banking Regulatory Commission was set up in the beginning of this year.

Market players are better monitored and are expected to make a profit. In some cases, newly established banks have sold minority equity stakes to the public and have even gone as far as describing themselves as private banks.[5] The three largest Chinese insurance enterprises have either gone public already or plan to do so.[6] For example, Ping An Insurance will probably arrange for its shares to be traded on the Hong Kong stock exchange this year.

Even if stock is privately owned, the State is always involved as well and retains overall control. Although no provider can really be described as private, competition between them is flourishing. Given this background of competition, in the past few years standards of quality have improved. Greater efficiency and improved customer service have taken place.

4.1 WTO Membership

Just under two years ago, China took a further step in the direction of market liberalization. On December 10, 2001, it joined the World Trade Organization (WTO).

[5] Minsheng Bank in particular is known for promoting itself as a private bank even though the State retains overall control.

[6] Specifically, they are (i) the People’s Insurance Company, (ii) China Life and (iii) Ping An.

Membership of the WTO will lead to major simplifications for foreign insurance enterprises and banks in the next few years. The same rules will apply to local and foreign financial services providers as from 2007.

As a result of WTO membership, Allianz will be able to expand its product range and will receive the right to sell insurance products throughout the country. However, restrictions as to scope of business remain (e.g. statutory business). Nevertheless, this is a major step when you consider that at the moment, Allianz is restricted to Shanghai and Guangzhou.

The licensing system will by no means disappear. The regional expansion of our business remains an expensive undertaking. Licenses for new bank branches require a high initial level of liquidity which cannot be justified on grounds of the bank's future liabilities. The levels of equity capital prescribed for insurance enterprises are also high, even though they have been reduced significantly in comparison to those demanded in the past.

China's membership of the WTO will certainly lead to more transparency. The criteria for market entry will become clear and the costs more predictable.

Membership of the WTO will, however, not resolve all the country's problems.

- As long as the problem of non-performing loans continues to exist, local banks will need help and protection. Protection against foreign competitors will remain necessary in one form or another.
- As long as Chinese banks have to refinance non-performing loans, they are dependent on unrestricted access to savings held on deposit. This reduces the chances for foreigners.

Complete convertibility of the currency, i.e. the option to invest money abroad without being subject to restrictions, will take a long time to achieve. The ability to freely swap Chinese Renminbi for US Dollars or Euros will not be on the agenda for the foreseeable future.

Only when bank balance sheets are healthier and capital can flow abroad more freely will the situation of foreign financial services providers improve significantly.

4.2 Liberalization of the Capital Market

Liberalization of the capital market would mark a major turning point for China.

- Allianz could invest premiums internationally, depending on returns, and spread risks between markets.

– We could use our own Group network of European and American asset management companies to best effect.

Encouragingly, discussions are taking place about how the capital market could be liberalized in the coming years. Chinese politicians are also participating in this debate.

For some time now, the Chinese government has been considering whether domestic investors should be allowed to buy stock other than on the Chinese mainland. The key concept here is that of the Qualified Domestic Institutional Investor, QDII. Initially, permission could be restricted to the Hong Kong stock exchange, and it would certainly be the case that narrow maximum thresholds would be imposed.

However, the discussion over QDII is a hopeful sign, as the system has the potential to become an important step in the reform process, if individuals were granted the right to invest outside the Chinese mainland.

Initial consideration is also being given to allowing American or European multinationals to list their stock in China. Rather like American Depository Receipts, one could introduce so-called Chinese Depository Receipts (CDRs). The CDR system would allow Chinese investors to invest in international stock via their local stock markets. This would also be a step in the right direction.

The QDII and CDR systems would offer foreign banks and insurers the chance to make better use of their international expertise, their comparative advantage.

5 Strategic Options

Which strategic options are open to our sector?

As long as the Chinese capital market remains largely closed to outsiders, foreign insurers and banks will concentrate on sub-markets.

There are already good options for insurers in industrial property business, and banks can do lucrative business in the international transfer of funds. However, mass market business will probably remain with national providers.

It is certainly the case that progress has been slow, and some market players have suffered disappointments in recent years. A number of insurers and banks have even withdrawn from China.[7]

---

7 Dai-ichi Mutual Life and Gerling recently ceased operations in China.

5.1 Doing Business Under Our Own Brand

Most international players, including Allianz, are following a long-term strategy of transforming representative offices into operative entities, and developing the business under their own brand.

Depending on the legal situation, we will complete our entry into the market in the form of a regional head office or a subsidiary company. When we work with joint venture partners, we retain our brand name, and if possible, also control over management of the operation. Important milestones on the road laid out by this strategy have already been reached.

Since this year, all of the Allianz Group's core business sectors have had a presence on the ground in China, focusing primarily on Shanghai, which constitutes almost 10 % of the national market. We have a platform from which to establish networks and build trust. The entities on the ground are the basis on which we will be able to capitalize on future market opportunities.

Looking at the sheer size of the country and the lack of trained staff, cultivating alternative distribution channels forms an important building block in our strategy. This might include the ever-improving possibilities of the internet for e-banking and e-insurance. Distribution agreements with Chinese banks are a further option, although most local banks are already bound by agreements with our Chinese competitors.

Our strategy of entering the market under our own brand means that we are restricted to a relatively small customer base for the foreseeable future. This makes it even more important to operate in the so-called „premium" segment of the market.

5.2 Stakes in Local Providers

In addition to placing our own brand in the market, the second strategic option is to take stakes in local providers. Major international banks in particular have followed this route.[8] The disadvantage with such stakes is the lack of management control, as a single stake may generally not exceed 10%, and the total participation may under no circumstances be larger than 25%. The costs of a stake are also extremely high, if they are even avail-

---

[8] HSBC and Citibank are the market leaders here. HSBC acquired an 8% stake in the Bank of Shanghai. HSBC also bought a 10 % stake in Ping An, the second largest Chinese life insurer, for 600 million dollars. Citibank acquired a 5% holding in the Shanghai Pudong Development Bank for 67 million US dollars, and is alleged to be looking for an insurance partner.

able for sale, as there are only very few local companies with whom such cooperation is conceivable.

The advantages are equally enlightening. The major Chinese insurers and banks have national networks and therefore offer economies of scale. The strengths of local and foreign partners can be combined well, as Chinese partners know the local market and foreigners can add value through their expertise in process standardization and training. Help could be provided for example with regard to the actuaries needed in insurance business.

When the Chinese capital market is liberalized in a few years time, cooperation could be extended to international asset management. The current restrictions on stakes of 10 or 25% could also be relaxed.

All of this means there is a convincing business case for the local stake model.

6 Prospects for the Future

What prospects for the future does China offer our business?

Judged on our experience in the last few years, it is hard to come to a definite conclusion - the glass can be perceived to be half full, or half empty.

Our experience in China has been both disappointing and encouraging in parts.

- It is disappointing that some restrictions remain even after China joined the WTO, and that foreigners have recently lost market share.
- On the other hand, it is encouraging to see a certain degree of liberalization taking place as a result of WTO membership, and that the market is growing as a whole. The increasing strength of links between China and other countries is also a positive sign. In the end, this will lead to an opening up of the capital market, paving the way for increased opportunities for competition.

Allianz is keeping all its options open in China.

We are optimistic that the country is on the right track, and will become a major market. Further growth will lead to above-average growth in the need for financial services.

As an international financial services provider, Allianz takes China very seriously. We are clear that China forms a part of our worldwide strategy.

Automotive Dragon Power in China

Markus B. Hofer, Bernhard Ebel, and Jana Schmutzler de Uribe

Simon - Kucher & Partners, Bonn

1 Market and Growth

The Chinese automotive market and industry were covered quite extensively in the media in the recent past. Expressive headlines predict a great development and a shining future: “China’s Automotive Market Is Gaining Speed”, “On the way to El Dorado”, “Premiere: China is Net-Exporter for Cars”. And there is no doubt: China represents the great hope of the automotive industry – an industry currently facing stagnant sales numbers in its major markets. It has a population of 1.3 billion, low vehicle penetration rates, and economic growth rates topping all other countries. The already great expansion of the Chinese automotive market showed potential for even higher growth rates when the government of the People’s Republic began to slash import limitations after their entry into the World Trade Organization (WTO). Many believe that China will even surpass the biggest automotive market, the U.S.A., in 20 to 25 years.

According to World Bank reports, the Chinese attained a per-capita income of USD 4,200 in 2002. This suggests that China has reached a threshold at which strong growth in the domestic automotive market can be expected. Another strong indicator of further growth is the average penetration rate: for the total population, the average is little more than 10 vehicles per 1.000 inhabitants and 100 vehicles in urban regions. In contrast, industrialized countries average more than 500 vehicles per 1.000.

Household income and economic growth are not the only factors which explain the increasing demand for automobiles. A developed street network with sufficient parking, public transportation, a sales network with corresponding service stations, car financing and insurance possibilities, uniform and clear regulations for registration and annual inspections, a gas station network throughout the entire country – each of these positively influence the public’s demand for automobiles. Therefore, it is no surprise, that the future is foreseen positive, passing 4 million by 2008.

The difficulty in predicting the growth and volume of the Chinese automotive market is revealed in the studies from the 1990s. In 1994, it was estimated that about 1.3 to 1.6 million vehicles would be sold in 2000. The actual number sold was around 650,000. Not only is this forecast connected with uncertainty and influenced by industry expectations, all estimates are based on the Chinese government's statistics, for which doubts about its validity have been raised in the past. Consequently, the current estimates range from 1 to 9 million passenger cars in 2005, 2 to 14 million in 2010 and 17 to 40 million in 2020.

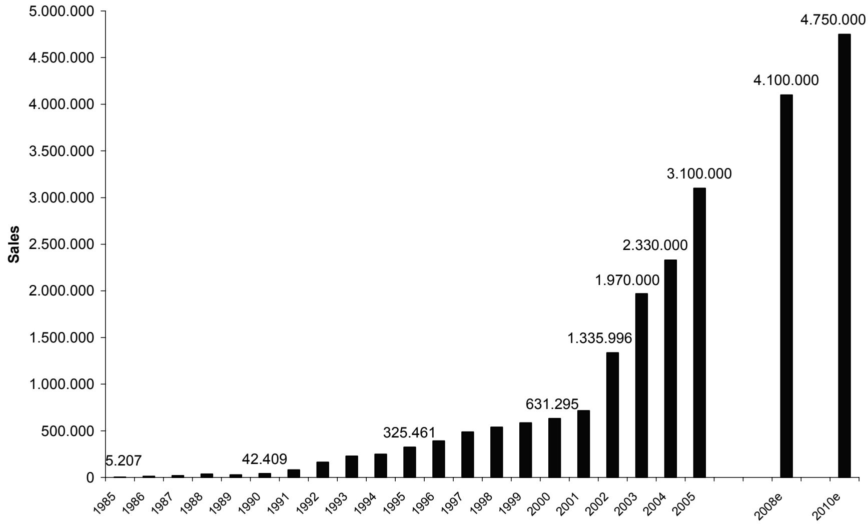


Fig. 1. Sales of Passenger Cars in China.[1]

Along with the fast development of the market, other changes have a huge impact on the demand for cars: New brands are entering the Chinese market, attractive models are offered, prices are dropping due to tax decreases

[1] Quelle: Audi AG (1985-2002); Autohaus Online Newsletter vom 22.09.2004; DPA - AFX, 13.01.05, Neuer Autoabsatzrekord im ersten Quartal, 2006-04-25, http://de.ce.cn; http://www.businessweek.com/print/autos/content/mar2006/bw20060309_374401.htm, http://online.wsj.com/article_print/SB113962105158871453.html; Auto sales expected to hit 4 mln units in '06, www.chinaview.cn 2006-04-10 15:42:35; VR Chinas Kfz-Markt weiter auf Wachstumskurs, Datum: 07.03.2006, http://www.bfai.de/fdb-SE,MKT20060306105744,Google.html; Passenger car sales to hit 4.1m by 2008, (Agencies), Updated: 2005-04-28 16:44, http://www.chinadaily.com.cn/english/doc/2005-04/28/content_438345.htm.

and intensified competition. It is obvious that it is becoming more and more important to better understand the Chinese customer. Regional differences and the growing experience of Chinese automotive customers, which in turn influences their needs and requirements, complicate the segmentation of the Chinese market. Consequently, it will no longer be possible to successfully sell old models in China. Product adaptations are necessary – and they will be successful only if the customer's requirements are known. Due to the country's immense size and its enormous regional differences, an economically realistic, countrywide sales and service network is one of the biggest challenges automotive manufacturers face in China. Characteristics of the Chinese market make creating such a network even more difficult. Many Chinese customers purchase their cars in automotive supermarkets. There, they can find a nearly identical Chinese model of a foreign brand car sometimes marked down by 50%. Brand perception as found in other countries is nearly impossible in this environment. Yet foreign automotive manufacturers have little choice, they cannot abandon this distribution channel. The alternative of building their own sales and service network absorbs huge amounts of money and time. The special relationships between the Chinese and foreign manufacturers also render a brand positioning very difficult. Each one of the big three Chinese manufacturers – Shanghai Automotive Industry Corporation (SAIC), China FAW Group Corporation and Dong Feng Motor Corporation – has several foreign partners. This not only increases the danger of more similar cars, but it also fosters confusion among the customers because they see two logos and brands for the same car. Ultimately, each joint venture must build up its own sales and service network, thus thwarting a bundling of market power and brand strength.

2 The Automotive Industry in China

The gradual opening of the economy has challenged a Chinese industry that has been unprepared for the rapid changes. Since the People's Republic was founded, both the supply and demand have been regulated by the state – through measures like the ban on private ownership of passenger cars. The Chinese government's attempt to form an independent automotive industry resulted in the creation of many small, inefficient car manufacturers. As a consequence only a few of the nearly 120 manufacturers produce more than 100,000 units per year. Due to an exceedingly low production volume, many of the manufacturers achieved zero profit. The technological level of many Chinese OEMs lagged behind the international competition. A functioning supplier industry was practically non-existent. At the same time, domestic production was safeguarded through extremely high import tariffs and very limited import licenses so that the product prices were far above the international level, yet below the prices of imported vehicles.

Topic	Pre-WTO	Post-WTO
Import Tariffs	80 - 100% on passenger cars	Reduced to 25% by July 2006, reduced for auto parts up to 25%
Import Licenses	Requirement for the car imports, 1999 limited to 27,000	Upon entry, raising to a value of USD 6 million; annual raise of 15%, elimination by 2005
Import Limits	Foreign companies not allowed to directly import cars	Import rights within three years after entry
Local Content Regulations	Various incentives to increase the local content	Elimination of local content regulations upon entry
Sales, Retail, After Sales Service	OEMs have to rely on Chinese dealers/companies for sales and after sales service of their cars	Sales, retail and service rights within three years after entry
Financing	Foreign companies not allowed to offer car financing	Foreign non-banks allowed to offer unlimited car financing

Fig. 2. Pre-WTO and Post-WTO Situation.

By entering the WTO, China agreed to submit itself to WTO regulations. It agreed, for example, to reduce and finally abolish trade barriers for the automotive industry over the course of five years after its entry. Although the loosening of import restrictions also increases the pressure on international OEMs that have joint ventures on the Chinese market, those seem to be the beneficiaries of the induced changes. The OEMs' opportunities to run their own business, to offer service and to enter car financing (like Volkswagen and DaimlerChrysler recently did) will also give them the chance to submit a complete automotive offer to the Chinese customers. The dismantling of import restrictions would allow the international OEMs to import state-of-the-art vehicles at prices lower than those offered today.

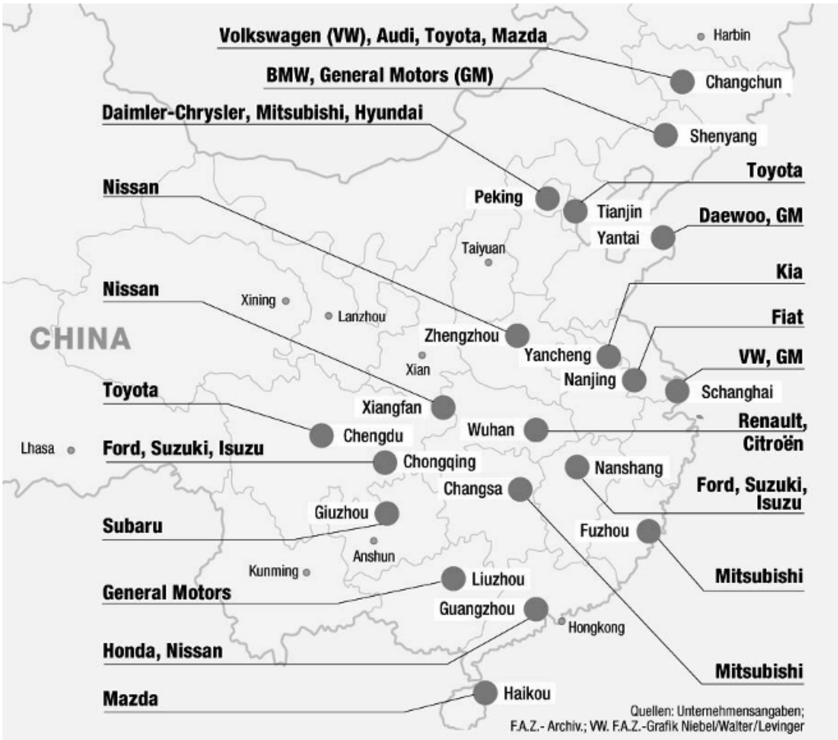


Fig. 3. International Manufacturers in China (Source: Frankfurter Allgemeine Zeitung, September 16, 2004).

However, the opportunities for international automotive manufacturers will not be as fantastic as originally thought. Japan and South Korea for example – also members of the WTO – make use of various non-tariff options to protect their domestic market, an option that China might find appealing. Both the 10th 5-year plan and the recently published draft of the new "Industrial Policy for the Automotive Industry" exemplify the will of the Chinese government to safeguard its domestic market as much as possible. According to this plan, the automobile manufacturers lack the ability to develop their own vehicles, the supplier industry is underdeveloped and fragmented, the various safeguard mechanisms of local governments have led to a large number of low-efficiency OEMs with little economies of scale, and there is a weak orientation towards the Chinese customer. The

Chinese government wants to change this. Two to three major automobile manufacturers are supposed to be formed with sales and service areas that match the international standard. At the same time, the government will support the formation of 5 to10 major supplier groups that will also be internationally competitive. The OEMs as well as the suppliers should cover 70% of the Chinese demand while also exporting products abroad. A concentration process and the strengthening of the research and development competence should be pushed. Furthermore, the currently insufficient general conditions for a surge in demand must be improved.

The 5-year plan reveals that the Chinese government still plans to play a major role in structuring the domestic automotive industry and intends to leave the international OEMs little room on the market. Although this draft has not been officially adopted, it still demonstrates the direction in which the development of this market will be driven. If this policy goes into effect, the international OEMs' and suppliers' possible courses of action will be drastically curtailed:

- It limits foreign ownership rights of OEMs to a 50% share of the JV.
- Every foreign company that has a share of 10% or more of a joint venture has to share its R&D, production and sales know-how with its Chinese partner.
- It requires that, by 2010, Chinese OEMs are technologically independent from foreign companies and that they comprise 50% of the total market.
- It declares that suppliers must export 40% of their production.

While this draft may be vaguely formulated and contains no hints as to how these targets should be reached, it reveals the absolute will of the Chinese government to create national giants. The position of foreign OEMs and suppliers in the future Chinese automobile market will strongly depend on the Chinese government. But the Chinese consumers also should not be underestimated, and global players should take advantage of the Chinese consumer attitude: Western brands remain strong status symbols.

3 Strategies of the Chinese and Multinational OEMs

The dominant strategy among the biggest Chinese automotive manufacturers in the past has been to form joint ventures with one or several of the multinational OEMs. For more than twenty years, Volkswagen has had joint ventures in China. BMW works together with the Brilliance Group, DaimlerChrysler will start corporations with the Beijing Automotive

	Tianjin Automotive Industrial Group	Sanjiang Aerospace Group	Guangzhou Auto Group Co.	Shanghai Automotive Industry Corp. (SAIC)	Chang'an Automobile Group	Beijing Automotive Industry Co. (BAIC)	Dong Feng Motor	Brilliance Group (CBA)	First Automotive Works Corporation (FAW)
Audi									◎
BMW								◎	
Citroen							◎		
DaimlerChrysler						◎			
Ford					◎				
General Motors				◎				◎	
Honda			◎				◎		◎
Hyundai/Kia						◎	◎		
Mazda									◎
Nissan							◎		
Peugeot							◎		
Renault		◎					◎		
Toyota	◎								◎
Volkswagen				◎					◎

Fig. 4. Selected Joint Ventures/Cooperations (partially not yet realized) (Source: IHK-Gesellschaft zur Förderung der Außenwirtschaft und der Unternehmensführung mbH; press news; annual reports; internet).

Industry Holding Company (BAIC), the China Motor Corporation and the Fujian Motor Industry Group. Figure 4 gives an overview of partnerships and joint ventures in the Chinese market. It is obvious that the bigger Chinese manufacturers start corporations with several competing manufacturers. The Shanghai Automotive Industry Corporation (SAIC), for example, has founded more than fifty joint ventures since 1984.

The government, however, has the explicit goal to create local companies which do not depend on foreign cooperation. Up to now, the strategies of the big players in the industry show that they still seek cooperation with foreign companies. But the Chinese partners will try to focus more on technology and knowledge transfer than in the past. China's number one motor vehicle company announced that they are looking for a close cooperation with multinational manufacturers in order to build common supplier plants, develop a common automotive platform, and jointly develop new models. Dazhong Motor Vehicle (China) Holdings Ltd. wants to transform its cooperation with foreign OEMs from pure production into a complete automotive manufacturer where production, sales and service are handled by one single source. Yet the multinational automotive manufacturers will try to avoid this situation, because they are afraid to reveal too much of their precious know-how.

Joint ventures with foreign partners are only one part of the strategy of the big Chinese OEMs. Chinese-Chinese cooperations and Chinese-M&As are playing a bigger and bigger role. A good example of a purely Chinese cooperation is the Chevy – a joint product between a national investment fond and the Shanghai Automotive Industry Corporation (SAIC). In 2002, this was the car with the highest growth rates. Furthermore, the consolidation of the Chinese automotive manufacturers has already started: First Automotive Works (FAW), a JV partner of Volkswagen and Audi, took over the majority of Tianjin Xialin in June 2002. As the Chinese industry giants grow stronger, their Chinese products become more important. Yet this is not necessarily true for all local manufacturers. Many of the more than 100 local OEMs will remain to produce less than 100,000 vehicles without technological support from foreign companies. It is doubtful whether these companies will be able to survive the increased competition without the help of a foreign partner. It is, however, possible that small Chinese companies are in the position to become successful in certain local market niches for a period of time.

The multinational manufacturers are confronted with the same modified conditions as their Chinese competitors. Nevertheless, they have to respond to these market challenges in a different way due to their still limited possibilities. All big companies are already present today. The accumulation and expansion of production capacities is combined with imports, particularly of new models, for the Chinese market. At the same time, many multinational OEMs are expanding their sales network. Since China's entry into the WTO, Ford (with Changan Automotive Group), Fiat (with Chunlan Automobile in Jiangsu), Nissan (with Dong Feng Motor Company), Toyota (with First Automotive Works), BMW (with Brilliance) and DaimlerChrysler (with Beijing Automotive Industry Corp. and Southeast Fujian Motor Corp.) have announced plans to create new production facilities. Other manufacturers such as Porsche and Ferrari will concentrate on importing their vehicles into China.

Up to now, the global OEMs' engagement in China seems to be quite valuable for some cases. For every Honda Accord, for example, a net profit of USD 3,000 could be realized in China. This is three times the net profit of a comparable US vehicle. Volkswagen also announced that the margins in China are higher than in Europe. Still, higher margins cannot be achieved by all foreign production joint ventures. This is mainly due to the extremely high production costs compared to international standards and the low utilization (partly below 70%) of production capacities. It can be expected that the margins will decrease as China opens up more, the competitive pressure increases, and the price war strengthens.

Despite the high investments and the increasing production capacities in China, hardly any of the foreign joint ventures plan to export vehicles into other countries on a large-scale basis. A member of the board at a German OEM admitted, "We are dreaming of it," when talking about such a strategy. General Motors exported about one hundred of their Buick GL8 Minivans in 2002 and plans to extend the export into other Asian countries. Because of the low export numbers, exports are not yet a reliable pillar for the Chinese strategy. Honda is the only manufacturer that has announced its plans to open a production facility in China exclusively for export vehicles.

4 Conclusion and Outlook

At the moment, China is one of the most important players in the automotive market: Dongfeng and FAW are among the three biggest manufacturers of commercial vehicles (above 6 tons). Only DaimlerChrysler still produces more trucks. The Chinese supplier market is expected to grow by 10% to 11% annually, up to 33 trillion US $ in 2010. Chinese manufacturers are starting to expand their own international activities even if the planned offers for the European markets will not be available before late 2006. The Chinese market is flooded with many new passenger cars and is experiencing a relentless price war. In recent years, prices of cars were cut by 10% to 15% – heartily welcomed by the Chinese customers.

OEM	Product	Status
Jiangling Motors	Landwind, SUV	Delayed to autumn 2006
Great Wall Automotive	Pickup, SUV	Delayed to autumn 2006
Happy Emissary	Minicar	Abandoned
Brilliance Jinbei Automobile	Zhonghua sedan	Delayed indefinitely
Geely Group	3 sedans	Still unannounced

Fig. 5. Today's International Cars from China (Source: Automotive News Europe, April 17, 2006).

Based on SKP's experience in many world markets, OEMs must observe the following aspects to be successful in the Chinese market:

- Play the brand game well. Brand is not all, but China's automotive market is developing towards a function and value-oriented market.
- Get to know the customer and their requirements better.
- Align the product strategy to these findings in segment-specific approaches.
- Get pricing right the first time to secure profitability but also to offer attractive customer prices.
- Improve financial, sales and after-sales services to an efficient and effective level.

The fact that more cars will be produced in China than demanded can be felt throughout the industry and dampens today's euphoria. Predictions see the gap closing again but leaving enough room for international expansion. This scenario is reminiscent of the developments in the South American automotive industry in the 1980s and 1990s. Automotive manufacturers can only try to make sure that such mistakes are not repeated in the "land of the dragon". But another parallel scenario comes to one's mind when discussing the future of the Chinese automotive industry. Just as with Japan in the 1980s, China's first show cars at the IAA 2005 in Frankfurt received only little attention from the international OEMs. But exporting China's overcapacities to the US and European markets is a far bigger threat for the established OEMs that deserves their serious attention.

References

Anonymous (2001): “China – Auto Industry to sell 2.4M vehicles”.
Anonymous (2002): „China – Nicht zu bremsen”, in: OAV-Report.
Anonymous (2002): “First Anniversary of Entry to WTO: Auto Market Thriving”.
Anonymous (2002): “GM’s China unit to focus on domestic growth”, October 22 2002; in: www.chinacars.com.
Anonymous (2003): “Chinese and foreign businesses compete for China’s Auto Parts Market”.
Anonymous (2003): „Mit Macht will Daimler die Marke Mercedes-Benz nach China bringen”, in: Frankfurter Allgemeine Zeitung, May 5 2003.
Anonymous (2003): „VW legt in China rasant zu”, in: www.tagesschau.de.
Anonymous (2004): „In China verdüstert sich die Stimmung der Automobilhersteller”, Frankfurter Allgemeine Zeitung, September 16 2004.
Chengtao, W.; Ming, Ch.; Schuetzle, D.; Zu, W.: An Engineering Study for the Development and Marketing of Personal Use Cars in China.
China National Automotive Industry Consulting and Developing Corp. (CAC): China’s Automotive Industry: Its Past, Present and Future.
China National Automotive Industry Consulting and Development Corp. (CAC): Excerpt of the Tenth Five-year Plan for Automotive Industry.
China National Automotive Industry Consulting and Development Corp. (CAC): Excerpt of the Tenth Five-year Plan for Auto Part & Component Industry.
China National Automotive Industry Consulting and Development Corp. (CAC): Industrial Policy for Automotive Industry Promotes the Development of Automotive Industry (Part I).
China National Automotive Industry Consulting and Development Corp. (CAC): Industrial Policy for Automotive Industry Promotes the Development of Automotive Industry (Part II).
Chinese Academy of Engineering; National Research Council (2003): Personal Cars and China.
Chunli, L (2001): „Chinas Automobilindustrie in der Globalisierung”, Berichte des Arbeitsbereichs Chinaforschung, Nr. 15, Bremen.
Eschment, W.; Rother, F. (2003): „Wir geben keinen Millimeter preis”, in: Automobilwoche 6, p 3.
Fan, Z. (1999): WTO Entry and its Impact on China’s Automobile Production.
Gao, P. (2002): „A tune – up for China’s auto industry”, in: The McKinsey Quarterly, p 147, March 2002.
Gapinska, J.; Schmitt, N. (2004): „Entwicklung der Automobilindustrie in der Volksrepublik China“, Präsentation, Europa Universität Viadrina, Frankfurt/Oder.
Haak, R.: Der chinesische Markt im Fokus international tätiger Automobilhersteller.
Harwit, E. (2001): „The Impact of WTO Membership on the Automobile Industry in China”, in: The China Quarterly, Volume 167, 2001, pp 655-670.

Hein, C. (2004): „Gefährliche Fallen in Fernost”, Automobilwoche, September 27 2004.
Hofer, M. B.; Ebel, B. (2006): Automotive Dragon Power.
IHK-Gesellschaft zur Förderung der Außenwirtschaft und der Unternehmensführung mbH (2004): Marktbericht Automobilzulieferindustrie Volksrepublik China.
Krix, P. (2002): „Unterwegs nach Eldorado”, in: Automobilwoche, October 28 2002.
Lardy, N. R (2002): Integrating China into the Global Economy.
Liu, Z. (2001): “Issues Relating to Personal Vehicle Expansion in China”, Symposium: The Future of Personal Transport Vehicles in China.
Meck, G. (2004): „Gute Geschäfte mit schweren Lastern“, Frankfurter Allgemeine Sonntagszeitung, September 19 2004.
Mercer Management Consultants (2004): Studie „Automobilmarkt China 2010“.
Nee, O. D. Jr.; Coudert Brothers LLP (2002): “Automotive Industry in China”, China Auto Conference 2002.
Rae, S.: The WTO drives big changes in China’s auto industry.
Rawski, T. G. (2001): What’s Happening to China’s GDP Statistics?
Reuters (2002): GM’s China unit to focus on domestic growth.
Roland Berger Strategy Consultants (2001): 10 Mega Trends of the Chinese Automotive Industry after WTO Entry.
Rongliang, H. (2002): “China’s Market Sees Medium & High Grade Cars Locked in Price War”, in: www.english.peopledaily.com.cn.
Sturm, T. (2002): „Automobilmarkt China: Unternehmen Zukunft”, in: Länderanalyse VR China/Hongkong des OAV.
Sun Hung Kai Research Ltd. (2001): China Automobile Sector – The Wheels are the Wings of China.
Weider, M. (2004): China – Automobilmarkt der Zukunft? Wie nachhaltig und zukunftsorientiert sind die Strategien der Automobilhersteller in China? Discussion Paper SP III 2004-105.
Xiaohong, Y.: “China’s Automobile Industry”, in: www.twlcic.com.

Business Development in China: Volkswagen's Involvement in this Emerging Market

Johannes Wyrwoll and Ralf Hanschen

VOLKSWAGEN AG, Wolfsburg

1 Introduction: China's role in the Context of Internationalization of Companies

Increasingly, companies have had to realize that in today's competitive world we are dealing with global issues. Especially in the times we live in, it is therefore vital for companies' survival to focus on sustained growth which, besides an increase in effectiveness and efficiency, also envisages further national as well as in particular an international business development.

In this context, it is especially the Chinese market which can be attributed a key role in the internationalization of business ventures. Radiating a „World Factory" character, the market creates special interest for foreign companies to use it as a cost effective production base. A further attraction to international enterprises is exerted by its domestic market as well as export-oriented Chinese neighboring-market potential and the increasingly better educated human resources, which have a central impact on the competitiveness of foreign manufacturers.

However, at present, China has a two sided character: it is one of the most interesting and promising growth markets for companies, while at the same time involving a great deal of risk.

It is particularly these risks that often lead to an evaporation of many companies' initial euphoria, resulting in China being a partially negatively-slanted, recurring subject on the supervisory board and management agendas of large enterprises. Blinded by the incredible possibilities and potential the market offers, companies have obviously had to acknowledge that this involvement is no self-starter and runner. It is often underestimated at the beginning that the greatest exertions are indeed necessary to operate successfully in this ever-changing and difficult environment.

2 China's Diversity and its Magnetic Effect on Investors as well as the World Wide Importance of the Chinese Automobile Market

2.1 China: A Country of Many Different Aspects – Influences on the Management

China's diversity becomes apparent through various factors; in this manner it enables one additionally to get a feeling for the influence of the differing environments on business activities in China.

After Russia and Canada, China is the third largest country in the world with an area of approximately 9.6 million km². Different geographical characteristics as well as varying climatic conditions exercise an influence on the choice of location as well as the actual production, the variety of products, sales and marketing, etc. As a result, high standards of a concerted/balanced countrywide management are required.

With approx. 1.3 billion people (in 2004) living in China, it is home to one fifth of the world's population. The population density is quite unevenly distributed and decreases from the east to the west of the country. Compared to the sparsely populated western regions, the densely populated areas in the coastal regions are almost over-populated and still attract with their economic strength a great number of countryside people year after year. Admittedly, apart from the growing economic power and a multitude of wealthy customers, the constantly growing rich-poor-divide with its resulting differences in the social population also plays a not to be neglected, important role for business in China.

Furthermore, above all, it is the dynamics in politics and economy that make themselves felt to companies. The reforms introduced in 1978 to mark the transformation from a centralized economy to a social free market economy are associated with many changes in general conditions and regulations, which actually make business more difficult. Even though the Government is forcing economic opening-up, promoting private industry and by entering the WTO is successively reducing limitations for investment for foreign firms, foreign companies still have to be conscious of the Government's economic influence which will vary according to different lines of business.

A further essential characteristic of the market is the existence of a range of forms of enterprise whereby along side joint ventures (JV) and wholly foreign-owned enterprises (WFOE), also state-owned companies play a major role on the market.

China does not represent one large homogeneous market. Instead companies actively involved in China have to consider that the market is divided into smaller and larger provinces at different stages of development and, in addition to that, with local peculiarities of legislation. This not only leads to difficulties with sales and marketing, but above all to challenges in the management of different locations to some extent covered by varying legislation.

Despite the introduction of Western values into China which is always a by-product of rapid industrialization, the influence of roughly 5,000 years of history on cultural and social factors is still always present: consequently, needless to say, in business activities. Apart from Chinese pictography, it is in day-to-day business dealings and style of negotiation that most of all the Chinese philosophies of Confucianism and Taoism are exhibited. The cultural influence is still present because elements such as Personal Contacts (Guanxi), the Middle Man (Zhongjian Ren), Social Status (Shehui Dengji), Interhuman Harmony (Renji Hexie), Holistic Thinking (Zhengti Guannian), thrift (Jiejian), Saving of Face/Standing (Mianzi) as well as Perseverance and Indefatigability (Chiku Nailao) are being kept alive. (Graham and Lam, 2004: 44-55)

By and large, it is therefore only at first glance that China looks like one homogeneous market. By contrast it is rather like a lot of colored beads (a multitude of provinces, languages and different cultures etc.) which, put together, make up one big colorful mosaic. This is what has to be born in mind for a successful involvement with the Chinese market and should be considered by managers not only in the opening stages of involvement, but all along in every phase of their project being a guideline to their actions at all times.

2.2 Growing Importance of the Chinese Market and China's Dynamic Economy – A Magnet for Investors

With an incredible economic growth rate of 9.5% (GDP) in 2004, China remains one of the fastest growing countries in the world. Ever since introducing the well-known reforms in 1978, which include the transformation to a market system and the opening of the economy through an „Open Door Policy" in 1979, China's economic development has been distinguished by high growth rates.

Even in times of the Asian Crisis in 1997, involving economic downturn, worldwide recession, the SARS-epidemic and bird flu, these growth rates have remained at a relatively high, constant level.

Whereas, even before 2001, the economic upturn was characterized by a wide range of direct foreign investment, joining the WTO in December 2001 has had an even more magnetic effect on foreign investors to this very diverse and radically changing country. With over 60.6 billion US-Dollars, China was the biggest recipient of foreign direct investment in 2004.

Above all, companies are lured by the size of the domestic market together with the favorable production conditions inducing sustained competitiveness. Although from a sales point of view the market does not comprise the entire population of 1.3 billion Chinese, even a small percentage still represents a big attraction. A further factor is the emergence of a middle class with growing spending power; in a market that, because of its enormous consumer backlog, possesses big potential for the future.

To sum it up, the magnetic attraction to investors from all over the world becomes apparent if we look at the picture of a China that has a rapidly growing economy, a large domestic market with increasing spending power and export opportunities, a relatively cheap workforce-potential with an increasingly better educated background, and particularly when we study the general endeavors of the „Open Door Policy". If companies here are trying to profit from these factors, in their planning they should consider that Chinese firms themselves are steadily gaining a growing worldwide importance. Nowadays, China is the leading manufacturer of TV's, mobile phones, cameras, bicycles, etc. (Sieren, 2005: 13) and Chinese companies are increasingly becoming strong competitors with attractive brands for the customer.

Long-term planning is made difficult by changes in customer behavior, the legal requirements, and the emergence of new additional regulations, often making it necessary to work on many hypotheses and suppositions. In order to take full advantage of the potential of this dynamic market and to get a share in the astonishing rates of growth companies will have to find a middle way by being flexible: somewhere between an uncertain forward planning and a short-term reactive intervention. When dealing with the challenge of everyday business in this „foreign" country and in joint ventures involving co-operation with a Chinese partner, changes are the order of the day. These have to be handled with a certain caution and improvisational flair in order to stay successful in the market.

2.3 Increasing Importance of the Chinese Automobile Market

Compared to other markets, the automobile market in China is highly dynamic. By 2010, China will have developed into the second largest sales market for vehicles after the US (with Japan, Germany, and France being relegated to the lower ranks), whereby the sales will have risen to almost 6 million vehicles (please also see figure1).

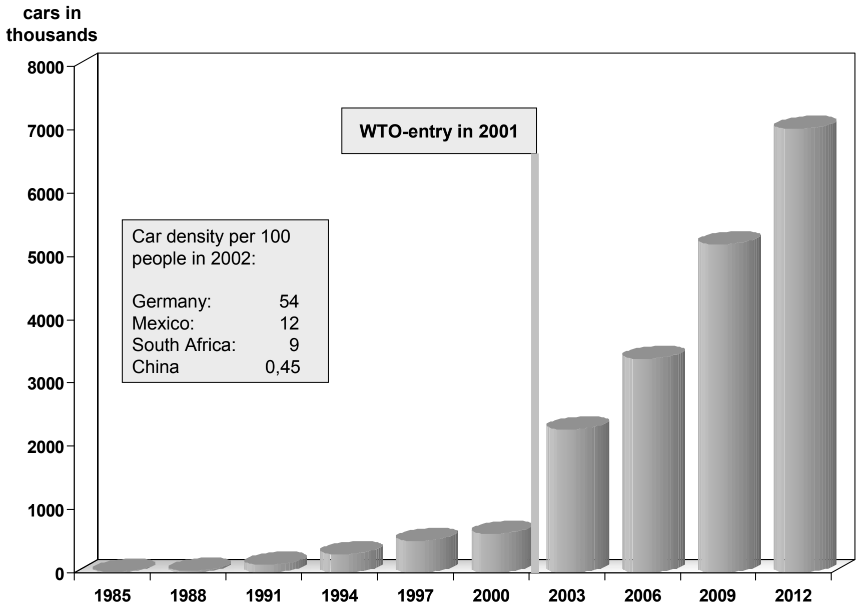


Fig. 1. Development of the Automobile Market in China from 1985-2012 (Source: Volkswagen Group China).

This development is grounded in the general growth of the economy and falling prices which add to the fuelling of public demand. Vehicle density can be used as a highly significant indicator to illustrate market potential.

Whereas in Germany, in 2002, there were 54 cars for every 100 people (therefore, slightly more than every second person owns a vehicle, including children and older people) in China the ratio was only 0.45 out of 100 (meaning that roughly 220 people share one car). The forecast ratio of about 5/100 by 2020 indicates another rapid rise in mobility for China in the future, which at the same time represents still a very low vehicle density compared to other countries. If we look at this potential and the increase in public demand resulting from higher incomes, the picture for car manufacturers looks very rosy indeed.

However, the mass motorization in China should also be viewed rather critically with consideration of increasing energy-shortages and environmental problems. A comparatively high vehicle density as in the industrialized nations would lead to a rise in world wide vehicle numbers of approximately 70 to 100% – which, under the current conditions, would also lead to environmental collapse. Alongside environmental programs initiated by the government, the automotive industry itself is increasingly tackling the subjects of fuel consumption and emissions in order to meet government guidelines of environment policies and also to push forward an ecologically sustained development.

Since 1994, the government has explicitly followed the long term goal of establishing an independent and autonomous Chinese automotive industry. To this end and to support economic growth, the Chinese government has identified the car industry as one of five key industries in order to use its potential as a driver for growth. The strategy for reaching this goal, apart from consolidating a large number of relatively small manufacturers as well as the widely diversified indigenous automobile industry, mainly consists of involving the international automobile companies. Apart from capital, it is mainly the necessary technology and know-how that is to be passed on to the Chinese partners through joint ventures.

With its new automobile policy, in 2004 the government once more confirmed and strengthened its course. The articles of the policy constitute the guidelines for present and future involvement of vehicle manufacturers, also with restrictive effects on strategic decisions regarding further development. For example, as a result of governmental directives, the joint venture is the form of co-operation that will for some time to come represent the only possible way (along with the unpopular method of granting a license) open to foreign automobile manufacturers for local production in China – with the additional restriction of the shareholding to not more than 50%.

If we look back, we see that the Chinese automobile market has changed fundamentally since joining the WTO. While in 1990 there were just 6 foreign manufacturers present with a production volume of 45,000 vehicles, in 2004 there were already 26 manufacturers (2.34 Million vehicles) trying to operate in the market. Apart from the actual fight for market shares in a previously rather protected market, companies are facing added challenges because although Sino-foreign joint ventures still dominate the market, wholly Chinese-owned car manufacturers are increasingly joining the market as competitors. Trained by the foreign partner, equipped with know-how, and financially strong through the joint venture returns, they advance to be „home-made“ competitors not only on the Chinese market, but also to become so in the near future on the home markets of their Western partners.

Generally, the large number of competitors present in China is leading to an intense price war which in turn is causing significant lowering of prices. This trend which is underpinned by price conscious consumers has repercussions on the success rate. On the other hand, manufacturers have to deal with import quotas, rising wage/salary costs and to some extent still too expensive Chinese component-deliveries affecting production costs. The latter aspect of pricey sub-suppliers is the result of a low volume as well as a too low localization-depth, and therefore a high import-proportion in the case of foreign suppliers operating in China. Another decisive factor for production costs is a certain percentage of problems with quality and the fact that some suppliers are part of the company group of one of the joint venture-partners who view them as a further source of income. All these listed factors add up to an automobile industry whose production is more expensive than German car production. Even if overcapacities, due to increased investment by nearly all manufacturers, have an influence on the automotive industry causing more intense competition, the market potentials justify the endeavor expected during an involvement.

3 Volkswagen's Involvement in China

3.1 Volkswagen in China: Part of a Global Arrangement

Approximately 50 years ago, the Volkswagen group started the transformation from a national manufacturer into becoming an internationally operating enterprise. As a first step towards this globalization strategy, Volkswagen Canada Ltd. was founded in Toronto in 1952. This was followed in 1953 by the founding of Volkswagen do Brazil Ltd. as well as further companies in the US and South Africa.

A few exceptions aside, gradual progress was the adopted method for developing this globalization policy. Initially through exports that were dealt with through independent importers, Volkswagen then expanded its activities, in some cases, by establishing their own distributors in countries with an interesting market potential. The next step of Volkswagen's internationalization was, under due consideration of the risk, to establish in a first move assembly plants; this was then followed by a successive expansion of these activities by turning them into full production plants.

At present, the Volkswagen Group is one of the leading car manufacturers in the world with its brands Volkswagen, Audi, Skoda, Seat, Bentley, Bugatti, Lamborghini and Volkswagen Commercial Vehicles. In the year 2004, the Volkswagen Group achieved a delivery volume of 5.08 million vehicles with its more than 343,000 employees in total (including 164,000 employees outside Germany) and its 47 production plants world wide (as well as additional independent assembly plants). Compared to sales in Germany of approx. 954,000 vehicles in 2004, China represents the most important foreign market to the Volkswagen Group with sales of 648,490 vehicles.

3.2 Time-line of Volkswagen Group‘s Involvement in China

Resulting from the opening policy started under Deng Xiaoping in 1978, Volkswagen began its involvement in China as one of the first international manufacturers.

With the support of the Chinese government which wanted to accelerate its own automobile industry and after a test assembly, the joint venture Shanghai Volkswagen Automotive Co. Ltd. (SVW) was initiated. Despite this support from the government, difficulties which resulted from external general conditions only allowed the business to start-up in 1985 after finally receiving the business license. Together with the challenges of obtaining currency as well as an insufficient infrastructure, to some extent a lack of the basis of law made the development of the joint venture more difficult and delayed it. As „First-Mover" Volkswagen carried out certain pioneer work, made direct contact with the Government and by its own moves, made one after another, leveled the way for other Sino-foreign-joint ventures.

Starting with one factory with a production capacity of 30,000 vehicles, the joint venture has developed for the last twenty years into one of the „Top Ten Joint Ventures in China“ with an equal share (today: 50% VW Group, 50% Shanghai Automotive Group). In 2004, the joint venture already included the largest engine plant in China as well as 3 vehicle plants with a total capacity of 450,000. In April 2002, to continue the successful cooperation, the limited original contract was extended for a further 20 years until 2030 by the signing of the „Amended and Restated Joint Venture Contract“.

Whereas the founding of SVW was driven on strongly by the Chinese government in favor of their industrial development, Volkswagen's strategic interest was the reason for the entry into a second joint venture in China. The resulting cooperation with the First Automobile Works (FAW) then started in 1987 with a license agreement for the production of the Audi 100. The start up of the joint venture FAW-Volkswagen finally launched expansion in the north of China with the granting of the business license in 1991, allowing it to start up its business activity with the production of the Jetta. In comparison to the first involvement (SVW), the start up was, however, more difficult in as much as this very large investment coincided with a slightly stagnating market. A further milestone in the JV-development was the integration of the Audi manufacturing in the joint company in 1995. Finally, Audi AG became third cooperating partner in FAW-VW (30% VW, 10% AUDI, and 60% FAW), and with the opening of a second car plant in 2005, production capacity was increased to meet market demand.

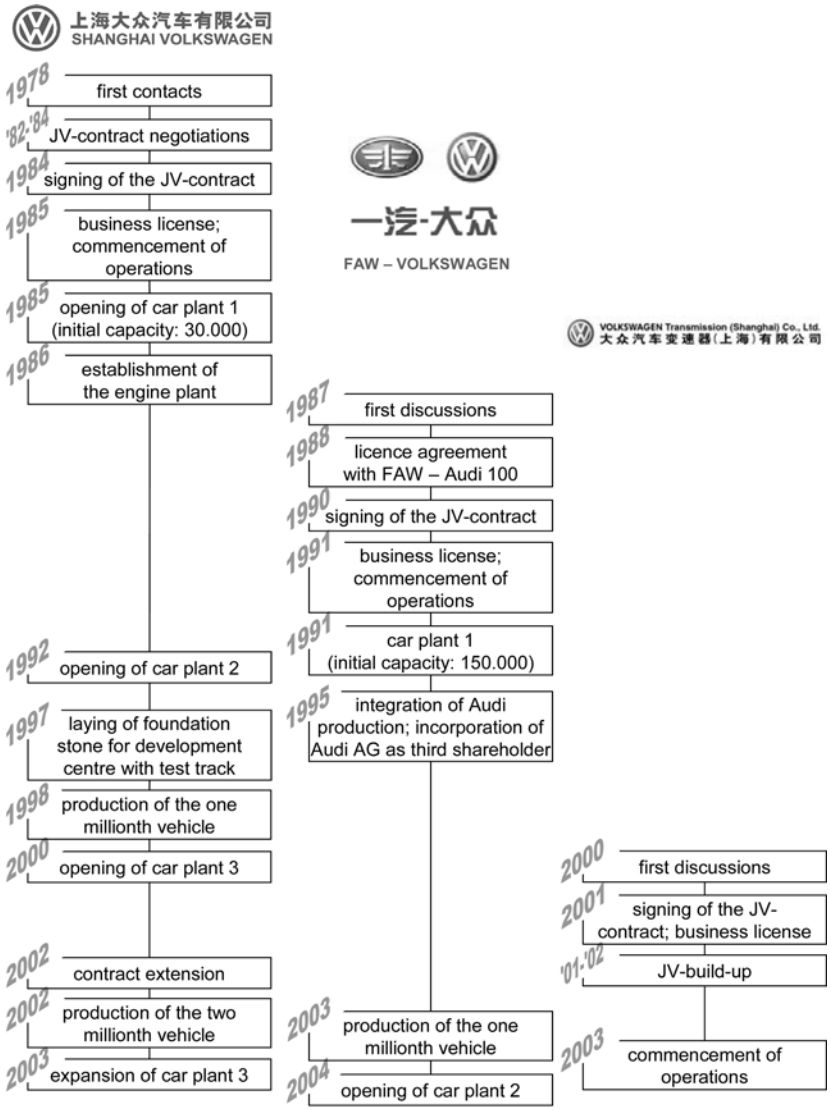


Fig. 2. Historical Development of Volkswagen's Joint Ventures in China (Source: Volkswagen Group China).

In order to strengthen the market position in China, the focus has not just been placed on the two existing joint ventures producing vehicles. In addition, Volkswagen started up a „gearbox manufacturing enterprise" in Shanghai (Volkswagen Transmission (Shanghai) Co., Ltd.) and is establishing further component / engine-joint ventures to expand its involvement.

3.3 Current Projects to Retain and Expand the Competitive Position As Well As Further Activities With Social Responsibility

Resulting from the new local conditions in the Chinese market, Volkswagen also had to re-appraise the targets it had set itself at the beginning and change its own focus within its strategic objectives. Whereas at the beginning of the involvement e.g. the breaking into the Chinese market with attractive vehicles as well as the development of a bridge-head for the South-East Asian market were among the primary aims: at present, under conditions of increasing competition as well as market share reduction, the retention and expansion of Volkswagen's competitive position is one of the central aims. In this connection, together with its joint venture partners, Volkswagen launched in 2003 an investment program with a value of 5.3 billion Euros for the next years up until 2008.

First and foremost, the introduction of new models as well as additionally using a multi-brand strategy will meet and fulfill customer requirements and support planned sales volume. Within the multi-brand strategy, Skoda will be developed as a third brand in the Chinese market alongside the two existing brands (VW and Audi).

Over and above, the strategy is based on changes in the area of production. To keep pace with the market growth Volkswagen is planning a substantial increase of the current capacities of approx. 800,000 vehicles by 2008. Together with its partners, Volkswagen invested in new additional factories for both joint ventures in car production. Furthermore the investment program includes new joint ventures with the future task to produce components and engines for SVW and FAW-VW for strengthening the Volkswagen position.

The new cooperative ventures will serve to support the planned increase in capacity, reduce component import, therefore, achieving a greater independence from exchange-rate variations, and bring about an increase in the local content portion with the benefit of reducing dependence on the Chinese sub-suppliers who are to some extent in the same company groups as the JV partners.

The founding of Volkswagen FAW Platform Co. Ltd. in 2004 and the Shanghai Volkswagen Powertrain Co. Ltd. in 2005 will be followed by the start up of VW Engine (Dalian) Co. Ltd. in 2005/2006. Similar to Volkswagen Transmission Co. Ltd., Volkswagen will be the main shareholder in each new joint venture; they will have a 60/40 share relationship. The development of a Volkswagen Production Network in China (See figure 3) should allow for the dynamic change in the market as well as the increasingly hard competition to strengthen Volkswagen's position as market leader.

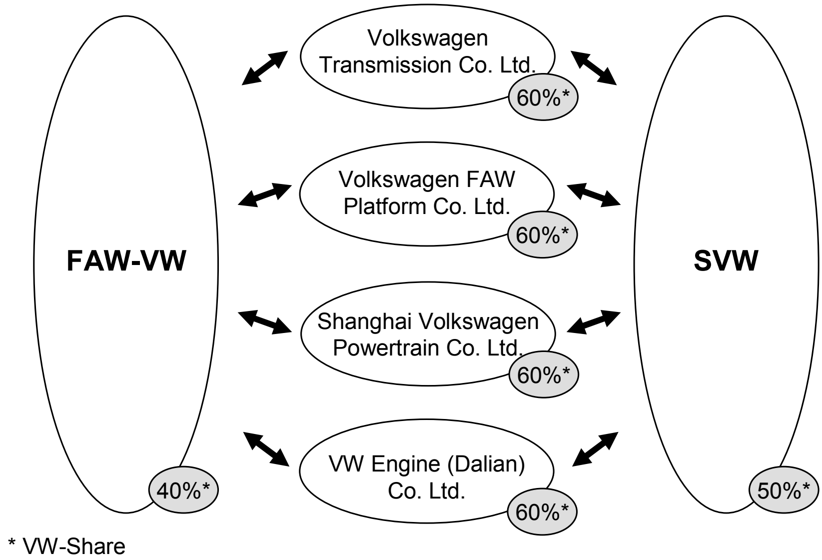


Fig. 3. Volkswagen AG's Production Network in China (Source: Volkswagen Group China).

But Volkswagen's current and future involvement in China should not only be looked at from the point of view of vehicle production, especially since Volkswagen's activities include a major commitment in the field of sporting and cultural events. As a supporter and sponsor, Volkswagen has been involved with the Beijing Music Festival from its very beginnings in 1998 to one of the most esteemed Music festivals in the world. Apart from an intensive cooperation with Tongji University in Shanghai (VW-Tongji Automotive Research Institute), Volkswagen's current additional involvement consists primarily of taking a responsible role as exclusive official Automobile partner of the Beijing 2008 Olympic Games. The main aim consists in the preparation of every type of assistance for the games, to spread the Olympic Spirit in China, and to support inimitable games.

As the largest automobile manufacturer and an important partner to the government in the development of the automobile industry, for Volkswagen in China, it is a matter, of course, to participate in daily life not just by means of the production and sales of automobiles and being a large employer. The understanding of the different cultures and joining in society form part of the basis for a successful international cooperation.

4 Chances and Risks of a Foreign Involvement in China and Joint Ventures As a Successful Form of Cooperation in the Market

4.1 Chances for Foreign (Automotive) Companies in China

The interest of international companies results from a multitude of chances offered by the country. These may be roughly listed out and specified in detail as follows:

- *Average rate of growth of 7-8%*
- *Largest domestic market in the world*
- *Rapid growth of a well-heeled middle class*
- *Consumer backlog with western desires in the population*
- *Economical production conditions*
- *WTO Entry in 2001, as well as an active foreign and economical policy*
- *Negotiations in hand for the development of a free-trade zone between China and the ASEAN countries*

With its **average rate of growth of 7 to 8%,** China is considered as growing market of the future whose positive development takes up the leading position in Asia and the whole world. Even with the government's limiting-measures to avoid over-heating the economy, the positive development continued in 2004, and high rates of growth of approx. 8 % have been forecasted for the future.

Its population of 1.3 billion allows China to have a number of potential consumers which no other country could dream of, and so it is recognised as the **largest domestic market in the world**. Even if only 5 – 10 % of the population possess purchasing power comparable to the industrial west that still means 65 to 130 million people. They themselves represent a remarkable market. (In comparison Germany‘s total population is only 80 million).

Over and above, an additional inducement-factor for foreign companies is the increase in the income of the Chinese people inherent in the country’s growth, which implies **a rapid growth of the economically strong middle class**. Also, a gigantic consumer-backlog particularly among the countryside population as well as increasing **western-orientated desires** represent a considerable trigger for increases in consumer spending.

Its **economical production conditions** promise that, over and above, China has in many cases a world factory character. The presence of ever better educated and relatively cheap employees permits advantages in salary costs. In this connection large concerns transfer not only production but also increasingly research and development projects into this region and are pursuing direct contact with the universities.

Since the **membership of the World Trade Organization** in 2001 further previously closed Chinese markets have opened for foreign companies. As well as the earlier revision and passing of a multitude of laws, the reduction of customs duties, etc., for China the continued fulfillment of the WTO requirements is a primary concern and the starting point for further reforms. The increasing removal of the barriers not conforming to the WTO represents a better chance of successful business for foreign investors.

Finally, it must be mentioned that with the establishment of an integrated market, based on the example of the EU, the most densely populated economic area in the world would be created. The planned **Free-trade-Zone between China and the ASEAN countries** supports the economic network between both parties and therefore offers additional chances for international companies in China, e.g. due to the step by step reduction in customs duties.

A detailing of the branch-specific chances for the automobile industry, e.g. the growth of the Chinese automobile market up to 2010 to the second most important sales market, have already been focused on in chapter 2.3.

Even, if for automobile manufacturers the time of quick successes appears to be past, and the advantages of the „first-mover“ have been reduced or even halted by the „fast followers“ who are increasingly of Chinese origin, the market still offers huge chances in the long term.

4.2 Risks and Challenges for Foreign (Automotive) Companies in China

Even if the chances in the country appear to be an El Dorado for companies, and reams of positive company press-releases fill the newspapers, the risks and challenges may not be neglected. For example, lack of success may have persuaded one or the other companies to withdraw from China, because the chances partly were treated without proper consideration. The following risks and challenges should be taken into account in the context of an involvement in China:

- *Regional disparities*
- *Increasing unemployment*
- *Legal / technological challenges*
- *Shortages of resources / environmental pollution due to large increases in production levels*

– *Ailing banking system*

In regards to **regional disparities**, for the purposes of planning within the involvement in China, the different levels of development from the blooming coastal region as far as the less developed western hinterland should be considered as decision-relevant factors. A strong decrease crosses the land starting from the coastal strip with regard to industrialization, the infrastructure and also purchasing power and therefore the regional prosperity. Intensive support for the interior is at the top of the Chinese reform agenda, in order to at least minimize the constantly increasing rich-poor decline between east and west and to counter social unrest.

The **increasing unemployment** in China is caused by many reasons. On the one hand, the regional differences mentioned above in the levels of industrialization lead to unemployment in underdeveloped and less industrialized regions, on the other hand, the eastern boom regions also have high unemployment, because following the restructuring of the nationalized companies into profitable companies, the government must accept a large number of employees without work when pursuing its reform course. The attraction of the coastal strip, where a large number of itinerant country workers are attracted to the cities also increases this effect additionally. The end-result is an increasing social difference even in the economically prosperous regions with a certain crisis-potential for the future.

Special challenges exist on the **legal and technological** levels. At the moment, due to the reform process, China possesses a legal system which is still partially in development. Many detail problems are not yet reflected in general law and, therefore, require an individual interpretation. Furthermore, in China, protection of proprietary know-how continues to be a particular challenge, even if the government is proceeding more and more against patent infringement. Copying of simple as well as complex items is still quite common (Hachenberger, 2004). The cause of this often lies in a lack of consciousness of the population and in culture: especially building a copy and imitation of special feats shows respect for the originator according to Confucius' teaching.

Additional problems with world-wide effect which must be taken seriously are **shortages of resources** and **increasing environmental pollution**. Parallel to The People’s Republic of China’s gigantic economic growth, its hunger for raw materials also grew with corresponding effects on the world-wide prices (Sieren, 2005: 315-330). Since 2004, China has climbed the rankings to number two oil-importer in the world, and the tendency in the use of oil as well as other raw materials (iron ore, etc) is, with a view to the further rates of economic growth, also expected to increase.

In the meantime, China is also participating in the distribution fight for securing world-wide raw material sources, in which the successive industrialization (also of other developing countries) is leading to alarming future scenarios. In addition to the general shortage of raw materials, in China additionally out-of-date production technologies, which come along with inefficient use of raw materials as well as increasing industrialization, lead to an increase in environmental pollution.

A problem which should be taken seriously is the **ailing banking system**; companies intending to invest in China should indeed be aware of it, because due to years of giving credit to run-down nationalized companies, the state banks are left with gigantic mountains of bad debts. A reduction of these old problems and attempted going-public can only be achieved, if the government forces privatization of the nationalized companies and withdraws subsidies from uneconomically operated companies. On the other hand, the unemployment will in turn increase necessitating the government to perform a tight rope walk on its way to reforms.

Regarding the automobile industry, further risks can be identified about which companies active in China should be quite clear. The currently increased competition resulting from an increase in the number of manufacturers from 6 in 1990 to 26 in 2004 and, therefore, a multitude of new competitors has lead to general tough price competition, causing China to advance to one of the world's most hard-fought automobile markets. (Figure 4 should give an impression of the number of foreign manufacturers in China.)

The price war will continue in the future, particularly with the risks of over-capacity, resulting from the rapid building of additional factories and the associated capacity increases in the case of joint ventures alone (from at present 3.4 up to 7.5 million vehicles). Besides the looming current and especially future ecological problems of the increasing mass-motorization with which automobile manufacturers have to deal with, possibly difficulties could also arise in the management of the joint ventures. Besides cultural and language hurdles, particularly in many cases conflicts of interests can occur between the partners in the joint venture which can lead to tension in the cooperation. In addition, the intention of the government appears to achieve establishment of its own automobile industry using joint ventures as a starting assist. Above all, the Chinese partner's own production will compete in the Chinese market and will also target markets in the industrial countries as they become future competitors.

Companies which, however, are aware of the risks, accept the challenges, and overcome one or two stumbling blocks in the market entry, as well as the market-sustaining, create a good basis to profit from the chances in the market.

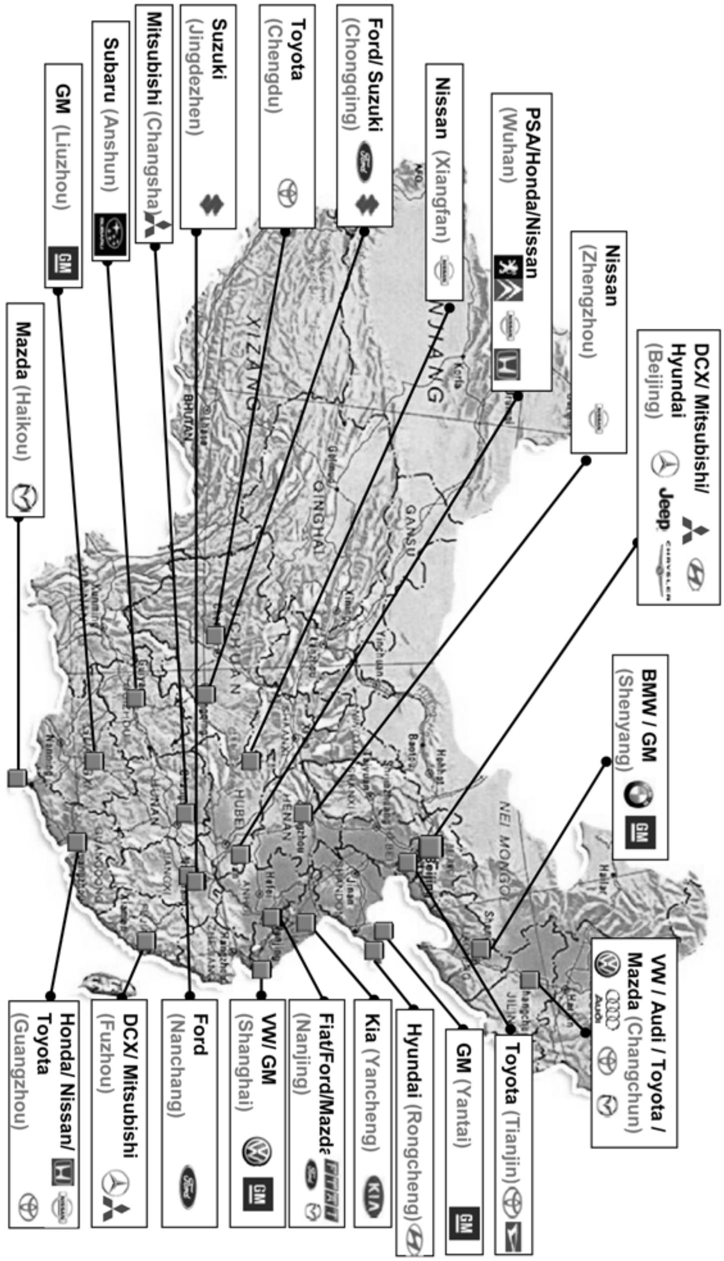


Fig. 4. Foreign Car Manufacturers in China (Source: Volkswagen Group China).

4.3 Between Chances and Risks: Joint Ventures – Still an Interesting Company-type for Foreign Companies in China?

Up until a few years ago, joint ventures were almost the only possibility for foreign companies to do business in the Chinese market, but even after further opening the market and the obvious possibility of establishing wholly foreign owned enterprises, they still have a high importance. Even if the founding of WFOE's is permitted in most branches nowadays and it is the predominant form of new foreign projects, JVs still shape the economic environment.

In addition to the historical JVs, both in the regulated as well as in the already liberalized branches, many JVs are still being started up which is leading to an absolute increase on the Chinese market (even if, due to the liberalization, certainly there is a clear reduction in the growth rate).

The increase makes clear that JVs are thus still seen as an attractive form of cooperation, to participate in the chances of the market and to tackle the challenges as well as sharing the risks with a partner. The new-start-up of JVs in China is not undertaken primarily as a compromise, even after removal of most of the barriers for opening subsidiary companies. Advantages for the founding of JVs in China, like a reduction of the risk, improved access to foreign markets, use of local market knowledge, contact with authorities, grouping of resources, etc. are gaining in importance.

By observing the cooperative ventures that already exist, two directions in development „*JV-dissolution*" and „*JV-continuation*" are recognizable.

„*Dissolution of JVs*" manifests itself in the following alternatives: firstly, the foreign partner leaves the JV, because it has taken on the characteristics of a joint adventure, in which the expected success has not materialized. In the second place there are also foreign companies who have used the opportunity presented by the change in the laws to transform their JV into a WFOE by taking over the share of their Chinese partner.

On the other hand, on the market successful JVs certainly do exist, having grown while both partners are interested in a „*JV-continuation*", meaning they are looking for further expansion of the cooperative relationship. To some extent, a history of long cooperation with the accumulation of large investment in plant, many years of great efforts towards a harmonious inter-cultural cooperation as well as joint successes have a major influence on the continuation of the partnership.

The large number of JVs, as well as their higher rates of increase and the general development of the Chinese market indicate that JVs will continue to play an important role in the Chinese market. With purely Chinese companies coming to prominence in China, foreign subsidiaries are being put under more and more pressure. Therefore, it is advisable for foreign companies to look after their existing JV very carefully in order to be able to successfully stay in the Chinese market and not to be driven out by the rising Chinese firms. Against the back drop of the increasing market dynamics and strength of competition from Chinese companies, the recourse to a „simpler form“ of subsidiary when founding or transforming should be scrutinized most carefully.

Even if latent problems are associated with JVs e.g. due to different country and company cultures, slow coordination processes, contrary objectives between the partners or the danger of giving away know-how, several factors (see above) still exist to justify an involvement in a JV. Over and above, the JV can be seen as a learning instrument and a way of gaining knowledge (Büchel et al., 1997; Schuler, 2001: 4-6, 38-42), with special importance for the Chinese market.

With a view to desired independence, the Chinese partners try to gather and learn knowledge about new technologies, products and production methods. Sometimes, using possible cooperation with several competing foreign firms, a Chinese company can to a certain extent have several streams of knowledge flowing in. Characterized by know-how gained by both partners, JVs are the possibility for foreign companies to get to know current and changing customer requirements and market conditions via their partners as well as to gain further insight into the complex culture and society of the country.

From this perspective, today and in the future, JVs represent an interesting form of presence in the market considering the back drop of the Chinese market's dynamic environmental conditions, and the essential knowledge of the changing customer wishes gained by working together with an experienced Chinese partner, as well as in the current climate of international work-sharing keeping an eye on the global increasingly more competitive Chinese firms.

It should always be kept in mind that intensive cooperation with a partner for the JV management represents a special challenge (due to the shared authority and possible divergence in aims); therefore success does not develop by chance, but much more through both partners working together well.

5 Conclusion – China: A Rapidly Developing Market With Great Potential

In today‘s global world, China is no longer an exotic country in the eyes of many companies for international involvements. As well as the large multi-nationals, which have been in the market for some time, more and more medium-sized companies are daring to take the step of doing business in China to be able to share in the opportunities. In the automobile industry, as well as most automobile manufacturers the majority of the component-suppliers are also represented in China. The general conditions for both manufacturers and suppliers have indeed changed considerably in the most recent years. On the one hand, a gigantic sales potential exists due to the low car density, increasing purchasing power as well as an increasing demand.

On the other hand, however, the time of quick profits and „first mover advantages“ are gone. Therefore anyone taking advantage of the market potential is faced with the difficulty of greater challenges. Among others the increasing dynamic has effects on one‘s own accuracy in planning; the government is forcing the growth of its own automobile industry with additional rules and regulations; and due to a large number of foreign as well as growing local competitors in the market a constantly increasing and almost ruinous competition is developing.

While for the automobile industry the Chinese market has a world-wide importance, this does not automatically mean the same for companies in other branches. Rather every company should consider and evaluate the advantages and disadvantages precisely and not jump blindly onto the bandwagon called China. Bearing in mind the limited resources, other aspiring growth markets should be considered for the purpose of such an investment decision.

In the context of globalization one should not, and certainly cannot, generally close oneself to the aspiring Chinese market. In case of involvement, the understanding and consciousness of the complexity and dynamics of the Chinese market plays a decisive role in success. In order to always have the risks of the dynamic environment in view, a regular internal as well as external chances-and-risk-analysis can be used for evaluating your own situation so as to recognize early areas for action and introduce suitable measures.

Permanent monitoring of its own situation is also an essential part of business activities for Volkswagen AG in China. In this context, Volkswagen AG has taken the change in general conditions in China as a starting point to further develop its own involvement in order to maintain its traditional market leadership in times of increasing competition.

Resulting from its many years of successful cooperation with Chinese partners, start up and growth of various production plants, hiring and training local employees as well as by engagement in culture and society, VW in China sees itself as part of the economy and society of the country. VW wishes to also continue to accompany China‘s impressive rising development path.

As well as further opening of the market, the Olympic Games in 2008 in Beijing as well as the World Fair (EXPO) in Shanghai represent milestones on the Chinese road to development with an additionally attractive magnetism for investors.

To sum it up, it is to be emphasized that China – not only today, but also in the future – is a fascinating, highly dynamic country that offers companies great opportunities according to their potential of facing challenges and risks.

References

Büchel, B., Prange, C., Probst, G. and Rüling, C.-C. (1997) „Joint Venture-Management: Aus Kooperationen lernen”, Haupt, Bern et al., 1997.

Graham, J. L. and Lam, N. M. (2004) „Geschäfte mit Chinesen”, Harvard Business Manager, 26(1), p. 41-55.

Hachenberger, J. (2004) „Technologieabfluss und Produktimitationen auf dem chinesischen Markt”, in: M. Nippa (ed.), „Markterfolg in China: Erfahrungsberichte und Rahmenbedingungen”, Physica, Heidelberg, p. 69-86.

Schuler, R. S. (2001) „Human resource issues and activities in international joint ventures”, International Journal of Human Resource Management, 12(1), p. 1-52

Sieren, F. (2005) „Der China Code: Wie das boomende Reich der Mitte Deutschland verändert”, Econ, Berlin 2005.

Engineering Business in China

Savas Tümis, Bin Shen, and Daniel Mohr

Tongji University, Shanghai and Plumento Corp., Shanghai

1 Introduction

"Machine tools are essential for the equipment manufacturing industry and modernization of the equipment manufacturing industry depends on the development level of our country's machine tools. Priority should be given to vigorous development of the machine tool industry in order to vigorously develop the equipment manufacturing industry. We must spare no efforts to develop the domestic CNC machine tools."

Wen Jiabao, Chinese Premiere

In many statements of the Chinese government we perceive the commitment of Chinese leaders to the importance of technological development for this fast growing economy.

China is one of few countries in the world committed to manufacturing technologies as the backbone of industrial development. This does not surprise since China has more politicians with an engineering background in key governmental positions than other countries in the world.

At a national conference on science and technology in Beijing in January 2006, Chinese President Hu Jintao outlined major strategic tasks for building an innovation-oriented country. Hu said China will spend 15 years to achieve this goal which includes broad and profound social reforms.

President Hu emphasized that China will embark on a new path of innovation with Chinese characteristics. The core of this is

- adhering to innovation,
- seeking leapfrog development in key areas,
- making breakthroughs in key and common technologies,
- arranging for frontier technologies and basic research with a long-term perspective.

With this approach China wants to raise innovation capability and the nation's competitiveness. The practice of the world's scientific and technological development shows that a country can only win initiative in international competition with a strong capacity of innovation.

Real core technologies can rarely be purchased outside or abroad. They have to be achieved in innovative processes, for this reason, virtually all scientific and technological work in China aims at a high degree of innovative potential. Chinese political leaders consider encouraging the innovation vitality of the entire society and turning the scientific and technological achievements into productive forces, as being paramount for building up an innovation-oriented country.

The Chinese government plays a leading role in the scientific and technological innovation process, while the basic role of market is given a full play in the allocation of scientific and technological resources. Industrial companies play a principal part in practical, applied innovation, while research institutes and universities across China assume a key role in the analytical and more experimental aspects of innovation.

Chinese research institutes and universities are more and more encouraged to build joint laboratories and research centers with overseas research institutions. The Chinese government supports enterprises to increase export of high-tech products and to establish research and development (R&D) bases overseas. On the other hand multinational corporations like ABB, BASF, Ciba, GE, IBM, Infineon, Intel, Microsoft, Motorola, Nokia, Philips, Samsung and Siemens have already set up R&D centers in China, which encourages future innovations in this huge economy.

China increasingly supports scientists who take part in or play a leading role in international and regional key scientific projects and join international scientific organizations.

2 Engineering Education in China

During the Cultural Revolution under Mao Zedong (1966-1976) university and vocational education were severely restrained which still today leads to a gap of qualified personnel in the middle management. Furthermore China had a rather traditional mode of engineering education, which had paralleled the approach for training researchers. A particular problem is that theory is overstressed while practical training is somewhat overlooked. There are some structural problems at educational institutions such as the old and not sufficient laboratory equipment, which is a major bottleneck in practical education and gives students few chances to do applied research. As a result, there is a substantial shortage of professional engineers with integrated capabilities of theory and practice. Similar to many western countries there is a lack of management education in engineering, since engineering education does neither include management and business administration training nor cost control subjects.

In recent years China has remarkably invested in engineering education and today 50% of its about 14 million students in approximately 1900 universities and colleges in China study engineering subjects, whereas the corresponding figure in Germany is only 15%. A Bachelor Degree takes four years and a Master Degree another 2.5 years. Nearly 500 universities and colleges have set up engineering departments, accounting for more than 25% percent of China's total higher education institutions.

The monthly salary of Chinese engineering professors is about 5 percent of their western colleagues, which leads to a big frustration and results in a brain drain of high potentials to the industry.

According to the Chinese Ministry of Education, more than 580,000 Chinese went to study overseas from 1978 to 2002, of which 150,000 have returned. The actual number of Chinese studying abroad is much higher, as only students with a government grant are listed in the official statistics while many students finance their overseas studies with the aid of their families. In 2005, more than 50 business parks have been established China wide, with favorable policies introduced to encourage returning students to set up their own enterprises.

There is a paradigm shift these days in Chinese companies: While there was little interest to cooperate with external consultants in the past they now increasingly take advice from outside, such as universities and consultants, especially in engineering. More and more, university departments and their staff will be involved in new product development for industrial corporations.

3 R&D Activities in China

China coordinates its science and technology activities in five-year plans. The main purpose of the tenth five-year plan of P. R. China (2001 - 2005) was to establish and to implement a program for international science and technology (S&T) cooperation projects to promote national S&T innovation capabilities.

In the year 2003, the R&D intensity in China reached 1.31% of China's GDP. This was less than the 1.93% R&D intensity of European countries. It has to be considered that R&D expenditures in China increased annually by 20% from 2000 to 2003. With this growth trend China would overtake the EU in its R&D intensity by the year 2010 at the latest.

Between 1997 and 2002, European R&D expenditures in the USA increased by 54%, during in this period US R&D expenditures in EU increased only by 38%. The USA concentrate 8% of their annual R&D resources in the EU, but up to 25% in China.

Because of efficiency reasons, after a certain amount of time R&D follows production. Since China has not only labor cost advantages but also rapidly growing number of well educated engineers, the process of R&D transition to China will speed up in the next years.

A 2005 survey of the German Chamber of Industry and Commerce found out for what reasons enterprises outsource their R&D activities to other countries (Figure 1).

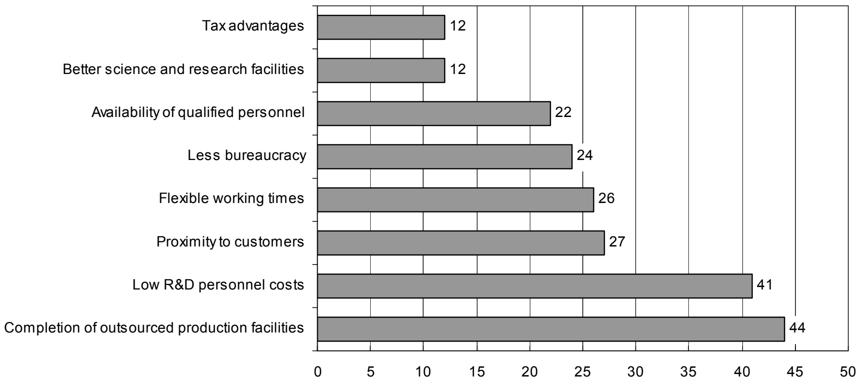


Fig. 1. Motivation of R&D Investments in Asia and Eastern Europe (Source: DIHK-Survey, 2005; Answers in Percentage, multiple answers possible).

China has all of these advantages to attract foreign R&D investments and additionally offers a strong commitment of the Chinese government.

Engineering activities in China are organized by various institutions. The Ministry of Science and Technology (MOST) has the patronage of the main R&D activities in China. Engineering business in China is coordinated at national level by the Chinese Academy of Science (CAS) and the Chinese Academy of Engineering (CAE) with its 8 Societies (Mechanical & Space, Information Technologies & Electronics, Chemistry & Metallurgy & Material, Energy & Mining, Building & Water & Architecture, Agriculture & Textile & Environment, Medicine & Hygiene, Management) on the one side and the Chinese Mechanical Engineering Society (CMES) with its 34 sub technical specialized institutions and 31 engineering societies at provincial level on the other side.

National and international specific research programs are supported by the National Natural Science Foundation of China (NSFC) at national and also at province level.
Key Research Programs like the Chinese High Technology Research and Development Program 863 are allocated at corporate level.
National Key Laboratories with their 168 specialized laboratories have focused specialized programs on national level, located at universities or as independent institutions.
There are also several research institutes which are totally independent; some of them are even private institutes or belong to CAS or to universities or private companies.
The protection of intellectual property rights is one of the high priority goals of Chinese governmental institutions. By improving the protection system and the laws and regulations involved China is on the right way, while severely cracking down on violations of the law.
According to the World Intellectual Property Organization (WIPO) China made 2.452 international patent applications in 2005 and became the world's 10th largest user of the Patent Cooperation Treaty (PCT). China's number of international patent applications grew by 43.7 percent as compared to 2004. It should be pointed out that between the years 2000 and 2005 the number of Chinese applications at WIPO has risen by 212 percent.

4 Competitive Intelligence

"Competitive Intelligence (CI) applies the lessons of competition and principles of intelligence to the need for every business to gain awareness and predictability of market risk and opportunity. By doing so, CI has the power to transform an enterprise from also-ran into a real winner, with agility enough to create and maintain sustainable competitive advantage."

Arik Johnson

Competitive intelligence, as it is defined by the Society of Competitive Intelligence Professionals (SCIP) is “a systematic and ethical strategy tool for gathering and analyzing information about one’s competitors’ activities and general business trends to further one’s own company’s goals”. SCIP declares that about 80%-90% of all information can be considered as public knowledge.

Since Asian companies and their players have a different value system than their western competitors, they are less ethically inhibited in their actions. Their understanding of CI is much broader and therefore it is much easier for Asian technology-oriented companies and their engineers to fulfill tasks, which in some cases would not be acceptable by western standards, although they are within a legal framework.

The western engineering education system encourages individuals to develop their own specific solutions, even if they 'reinvent the wheel'. Asian education systems however differ substantially and support the use of the best invented existing solutions. This approach is efficient and economic.

There are various options to realize competitive intelligence in a company and Chinese companies use this important strategic tool very effectively (Figure 2).

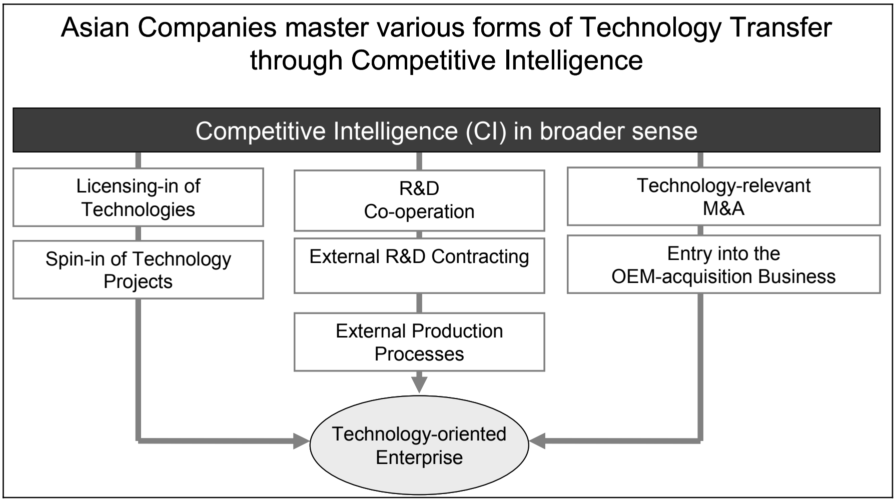


Fig. 2. Options of Competitive Intelligence.

Western partners of Chinese companies tend to be surprised about the engineering business practices of their Chinese partners. Chinese companies know well how to master a rapid technology transfer to their companies in a legal way.

Although these CI activities are within a legal framework, western competitors cannot appreciate these courses of action in their own value systems. On the other hand the frequent violation of intellectual property rights in Asian countries including China cannot be concealed.

Since December 11th, 2001, after China joined WTO, the Chinese government has been strongly committed to take serious steps in order to protect intellectual property rights in China and to fight these illegal practices.

5 Development of the Chinese Machine Tool Market

While foreign Machine Tool Builders are already using potentials of low labor costs in China in order to increase their worldwide competitiveness, Chinese enterprises have not yet transformed this advantage to increase their exports massively. But they are starting to increase their exports especially in order to escape growing local competition.

Since 2002, China has been the biggest importer and consumer of machine tools in the world. According to statistics compiled by the China Machine Tool and Tool Builders' Association (CMTBA), China had somewhere over 2,000 machine tool enterprises in the year 2005. Of these, 56% were state-owned, 30% were private firms and 14% were foreign-invested (including the wholly foreign-owned enterprises). Employing over 500,000 people, these organizations produced some 5,000 types of products.

The total output value of metal processing machine tools in China stepped up about 25% to RMB 40 billion (approximately US$5 billion) in the year 2005, ranking fourth in the world after Japan, Germany and Italy. China's import increased by about 13% to US$6.7 billion, its export up about 48% to US$0.8 billion and its consumption up about 15% to US$10.9 billion.

From 2001 to 2005 the Market share of Chinese machine tool sales in China has constantly been about 40%, which shows the high effort of the machine tool builders to catch up with the overall growth of the industry of yearly 25%. We can see an improvement in the product portfolio of Chinese machine tools. The label "Made in China" has lost its negative image as cheap products of inferior quality in many industries. Many high-tech products sold in industrialized countries are made in China. This development can now also be seen in the machine tool industry.

China's automobile industry remains the major user of machine tools, ahead of other attractive growth industries like shipbuilding, aerospace, energy and construction machinery. The entire machinery industry also maintains a stable growth rate at the same time.

Consequently it will be expected in the next years that China's growth in machine tool consumption will further decelerate to 7% and production to 10%-15%. Imports will increase by a single-digit percentage. China's export of machine tools, however, will maintain a growth of 20% or higher. In the last years, consumption has soared at an annual rate of over 20%. Numerically-controlled machine tools form the bulk of China's machine tool consumption, which has more than doubled in the past years, exceeding that of ordinary machine tools by more than 20%.

According to a report of CMTBA of January 2006, the structure in Chinese Machine Tool & Tools industries is changing positively:

– State owned Chinese machine tool builders are getting more and more privatized. Private and joint venture (JV) companies grew by 58.6% in 2005 and their turnover increased to 38.5% of the total GDP of the machine tools and tools industry. The industry itself increased by 25% in 2005.
– In 2005, oligopoly structures in Chinese machine tool industry further stabilized. The largest 10 machine tool builders in Chine now hold a share of 46.6% of the overall machine tool turnover in China.
– In 2005, both the Dalian Machine Tool Group (DMTG) and the Shenyang Machine Tool Group (SMTCL) were among the 15 biggest machine tool builders in the world. These two enterprises produce about 25% of all CNC cutting machine tools in China.
– DMTG and SMTCL started joint projects of reengineering as a technology management strategy.
– Since it is difficult to develop know-how in case of machine tool technologies, Chinese machine tool builders started to buy leading traditional foreign machine tool enterprises as part of their international business strategy (Table 1).

Tab. 1. M&A Deals of Chinese Machine Tool Manufacturers.

Chinese Buyer	**Foreign Company**	**Country**	**Year**
Dalian Machine Tool Group DMTG	Ingersoll Production Systems	USA	2002
Dalian Machine Tool Group	Zimmermann	Germany	2004
Shenyang Machine Tool Group SMTCL	Schiess	Germany	2004
Shanghai Mingjing Machine Tool	Wohlenberg	Germany	2004
Shanghai Mingjing Machine Tool	Ikegai	Japan	2004
Qinchuan Machine Tools	UAI	USA	2004
Harbin Measuring & Cutting Tool Group	Kelch	Germany	2005
Beijing No. 1 Machine Tool	Waldrich Coburg	Germany	2005

China's huge market is becoming increasingly attractive to foreign machine tool companies and they started to set up wholly foreign-owned operations.

The Gildemeister Group of Germany has set up its production plant in Shanghai, South Korea's Daewoo Machinery Co has also set up a factory in Yantai, Makino from Japan and Riello from Italy have set up wholly foreign-owned operations in China and South Korea's TGI has set up its own factory in Qingdao.

6 The Shenyang Machine Tool Group – An Engineering Success Story

The Shenyang Machine Tool Group (SMTCL), being one of the two biggest machine tool manufacturers in China took over the traditional German machine tool builder Schiess in 2004. The top management of SMTCL made a strategic decision to use R&D capacities of Schiess Germany with over 100 engineers to support their 2.600 Chinese engineers in the mother house for new product development. CEO of SMTCL Mr. Hongchen Geng expresses that the success of his group is based on its focus to simplify the machine tool design. In recent years Schiess over-engineered its machine tools which ended in nearly bankruptcy of the company. In SMTCL's engineering philosophy they implemented a 3C-Strategy "Communication, Confidence, Cooperation", understanding the customer needs through communicating with them in a narrow sense, to win the quality confidence in the market and to cooperate with other machine tool manufacturers and research institutions in further developments. SMTCL had in recent years a rapid growth (Fig. 3).

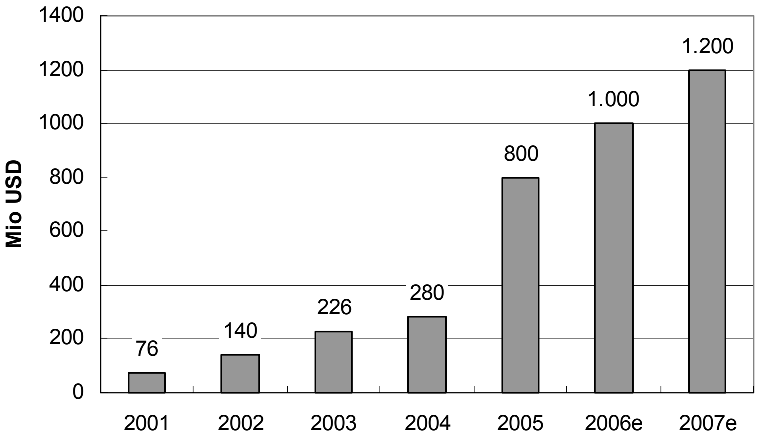


Fig. 3. Development of Turnover of the Shenyang Machine Tool Group (2006 and 2007 Estimated by Top Management).

The authors interviewed General Manager Mr. Xiyou Guan of SMTCL on February 14th 2006 during the China CNC Machine Tools Fair (CCMT) 2006 organized by Chinese Machine Tool & Tool Builders Association (CMTBA). Mr. Guan emphasized the importance to establish basic research activities on machine tool technologies in cooperation with universities.

One of the most important short term goals of SMTCL is to strengthen new product development in China and also to set-up quality and service improvement programs in the group. Since August 2005 SMTCL started to call back 78 machine tools from their customers that had been sold before 2000 and repaired them free of charge. After this unique action many other Chinese machine tool manufacturers followed the same strategy. The fact that this approach is being institutionalized in the Chinese machine tool market shows that there is a tendency to follow best practices.

7 Conclusion

The commitment of the Chinese government, the planned countrywide Focus on innovation, the use of competitive intelligence in gaining technological know-how, improving engineering education, concerted R&D activities and avoiding of over engineering are key success factors of the Chinese Engineering Business (Figure 4).

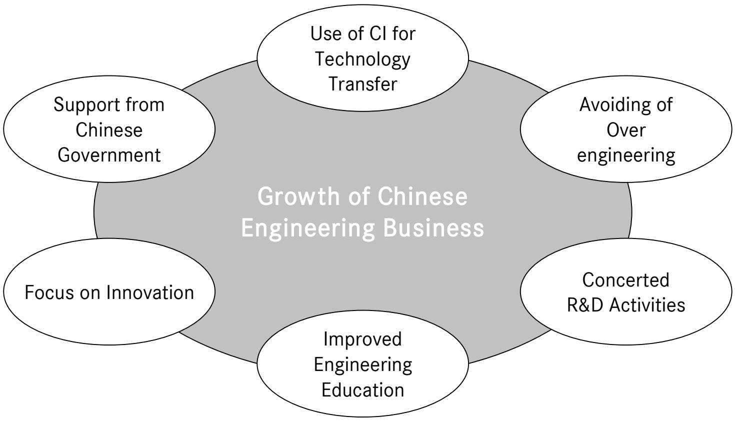


Fig. 4. Success Factors of China's Engineering Business.

Western managers should consider these factors in their China Business Development Strategies and not be afraid of the development but use these factors to their own advantage.

References

Abele, E., Bitzer, A., Universitäre und gewerbliche Ausbildung im chinesischen Werkzeugmaschinenbau, In: ZwF - Zeitschrift für wirtschaftlichen Fabrikbetrieb, Vol. 11 (2004), p. 609-613.

Chen, M., Geschäfte machen mit Chinesen: Insiderwissen für Manager, Frankfurt 2004.

Bitzer, A., Abele, E., Ihrcke, J., Wachstumsmotor in China läuft auf vollen Touren. In: WB – Werkstatt und Betrieb, Vol.7-8 (2004), 10-12.

Dayal-Gulati A., Lee A., Kellogg on China: Strategies for Success, London 2004.

Feldmann, A., China will mehr Werkzeugmaschinen exportieren. In: VDI Nachrichten, Vol. 7 (2006), p. 16.

Feng, T., Shenyang plant große Zukunft für Schiess. In: MM das Industriemagazin, Vol. 6 (2005), p.14.

Fishman, C., China Inc.: How the Rise of the next superpower challenges America and the World, New York 2005.

Foughy, K., Personelle Herausforderung. In: MM das Industriemagazin, Vol. 50 (2004), p.17.

Hirn, W., Herausforderung China: Wie der Chinesische Aufstieg unser Leben verändert, Frankfurt 2005

Holtbrügge, D., Puck, J., Geschäftserfolg in China: Strategien für den größten Markt der Welt, Heidelberg 2005

Höhn, J., Als F&E-Standort wird China immer wichtiger. In: VDI Nachrichten, Vol. 24 (2005), p. 6.

Kaufmann, L., China Champions: Wie deutsche Unternehmen den Standort China erfolgreich für ihre globale Strategie nutzen, Wiesbaden 2005

Koruna, S., Tümis, S., Making the Tacit Explicit – Mastering the Challenge of Creating Explicit Knowledge out of Tacit Knowledge. In: RADMA R&D Management Conference, 2004 in Sesimbra/Portugal.

McGregor, J., One Billion Customers: Lessons from the front lines of doing business in China, London 2005.

MOST, Ministry of Science and Technology of China: International Cooperation, Program Outline for Key International S&T Cooperation Projects during the Tenth Five-year Plan (2001 - 2005) of P. R. China,
http://www.most.gov.cn/eng/cooperation/index.htm. February 27, 2006.

Nippa, M., Markterfolg in China: Erfahrungsberichte und Rahmenbedingungen, Heidelberg 2004.

N.N., Wann überholt China Europa in der Forschung? In: VDI Nachrichten, Vol. 30 (2005), p. 3.

Seeger, C. (Edit.), Harvard Business Manager: China, Frankfurt 2005

Sheff, D., China Dawn: The Story of a Technology and Business Revolution, New York 2002.

Sieren, F., Der China Code: Wie das boomende Reich der Mitte Deutschland verändert, Berlin 2005.

SCIP, Society of Competitive Intelligence Professionals, www.scip.org.

Trommsdorff, V., Schuchardt, Ch., Lesche, T., Erfahrungen Deutsch-Chinesischer Joint Ventures, Wiesbaden 1994.

Tschirky, H., Technologie Management, Zürich, 1998.

Market Entry and Business Success in PR China – The Case of MAN Roland

Markus Rall

MAN Roland China, Hong Kong

1 Introduction

China, with nearly 1.3 billion people and a population growth rate of 0.57%, is the country with the largest population in the world. With such a huge market potential, combined with the positive impacts of the economic and political changes that have been taking place over the last two decades, the country has also become one of the world's most attractive heavens for foreign investments that are looking for colossal returns. Consumption power in China is rising. No wonder there is a multitude of trade and investment opportunities for the business abroad to explore. Naturally, as commercial activities are on the rise, many industry sectors, such as the newspaper industry, commercial packaging and advertising, are also experiencing an exceptionally rapid growing rate.

The demand for printing will further grow in future. The general educational level of Chinese is getting higher and higher and as a result, the need for communication is increasing year after year. In terms of newspapers and books, the demand will grow. For the marketing side, more and more multinational companies have chosen to produce their products in China due to cheaper labor and operating cost. This will come along with the need of packaging and advertising to penetrate the Chinese market. All these factors adding up will again create needs of printing with a series of success factors:

- World class quality product
- Value for money product
- Proven technology leadership
- Quality after sales service
- Customer orientation mindset within every employee in the company
- Passion to excel attitude with all employees of MAN Roland China

Being a key printing system and technology supplier for these fast-growing industries, MAN Roland as the world's second largest printing press manufacturer and the world's market leader in newspaper printing is still able to maintain its edges and currently enjoying tremendous business advantages amid the challenges arising from the increasing competition in the Chinese market.

Fig. 1. Machine (Source: MAN Roland).

2 Nearly 50 Years of Presence in China

The long history of MAN Roland's success in China began in the mid-1950s, at a time when doing business in the communist regime was still considered to be tough and risky. The first customer is usually also the most important customer that will hold the key for the rest of the country. This was also true for MAN Roland. By successfully landing letterpress machines in two of the biggest and most influential state-owned daily newspapers, the „People's Daily" and „Beijing Daily" who still are MAN Roland's customers today, MAN Roland's era in the newspaper industry in China has been expanding ever since. For the next 30 years, MAN Roland's empire continued to extend its reach mainly in the capital of China with new orders for the COROSET, TECTOSET and UNIMAN web-offset presses from Augsburg.

Fig. 2. Presentation (Source: MAN Roland).

The economic reforms in China during the 1980s' and 1990s' became another catalyst for foreign investors like MAN Roland to show the long-term commitment for this potentially affluent market in its provision of all the technology and services the customers needed. Local presence is always important. In 1995, MRCN was thus established as a branch office in Beijing to enable better coordination of local sales and service activities with sales partner VOTRA.

VOTRA GRAHPICS SYSTEMS was founded as a trading company in Zug, Switzerland, in 1951, and taken over in 1974 by the then Dutch VRG Group (later KNP – BT und Buhrmann). In 1994, VOTRA became the first organization operating from Hong Kong to engage in the Chinese market for web- and sheet-fed presses. In 1999, the company was taken over by MAN Roland.

In the same year, MAN Roland China was set up as a sales and service organization of the Group. Much has changed since then: many new and competent people were hired and reorganization into Business Units and Sub-Regions was carried out. This new structure is working fine, covering all web and sheet activities from sales and service through to the business with materials.

After nearly half-a-century of dedicating investments of manpower and resources, MAN Roland China is now operating with seven offices in Beijing, Shanghai, Shenzhen, Guangzhou, Chengdu, Hong Kong and Taipei throughout the Greater China region. This local presence has proved to be helpful in forming many interesting and successful business relationships with Chinese customers.

3 Market Leader in Newspaper Presses

The Chinese newspaper industry is one of the biggest worldwide: the country's 1,200-plus printing companies are producing about 2,000 different dailies and some 8,000 magazines. Since 1999, China has ranked second worldwide, behind the USA, in paper consumption.

The above-average growth of the economy is also causing a rise in the people's standard of living. The GDP growth in 2004 was 9.1%. According to the Development Research Center, under the State Council in „China, the GDP annual economic growth rate will be 8 per cent during the 2006-2010 period, and the country's GDP in 2010 will reach 21.5 trillion Yuan based on the calculation of constant prices in 2004, equal to US$ 2.6 trillion. In consideration of population growth, the per capita GDP will be US$ 1,900 in 2010.

Fig. 3. Information (Source: MAN Roland).

Consequently, demands for a larger supply of newspapers and magazines with enhanced quality are growing day after day. Withstanding these challenges and competitions, currently, every two out of three newspapers in the world are printed by MAN Roland presses. Clearly, this is the strongest proof for MAN Roland's position as market leader in the newspaper printing segment. To elaborate: since 1985, the company has supplied more than 270 newspaper presses of all model lines to 70 customers in China, Hong Kong and Taiwan; most of the leading Chinese dailies are now printed on MAN Roland machines.

4 Strong Position in Packaging Printing

Apart from being the leader in newspaper presses, MAN Roland also holds a leading position in Chinese packaging printing. As in the newspaper printing industry, customers today are looking for packaging designs that can stand out in a crowd. Therefore, not only does the packaging industry need first-rate printing quality, but also they require a printing press that can cater for special packaging requirements that can live up to the increasing demands of customers.

Fig. 4. Information Material (Source: MAN Roland).

The increasing demand for high-performance sheet-fed presses is most apparent simply by looking at MAN Roland's long list of customers over the years. The first ROLAND 710 in 5/5 format in Asia was installed in May 1998 at Wing King Tong Ltd. in Hong Kong. The company has a daily printing volume of 25,000 hardcover books and 80, 000 paper backs. Another Roland, a 705, was sold to this customer in 2000.

The first ten-color Roland 710 in China was installed in 1999 at the Man Sang Group with its head office in Hong Kong and production sites in Dongguan. The production consists of paper bags, envelopes, greeting cards, gift sets of stationery, etc. The Man Sang Group further uses a Roland 706 with two perfecting units and thus a total of 46 ROLAND 700 printing units, a ROLAND 202, a complete PECOM network, and two Multi-CCI-2Ds. This makes the Man Sang Group MAN Roland's biggest sheet-fed press customer in China and Hong Kong.

Other important customers in sheet-fed are the People's Fine Arts/Meihang/Meitong Printing Group (high-quality books, folders and stationery), Humen Colour, one of China's largest printers of cigarette packs and the Shanghai Jielong color printing company (packaging for electric appliances, clothing, chemical products, pharmaceuticals, cigarettes and wine).

In the period from 1997 to 2000 alone, as many as ten double-coating presses were sold in China. In addition, MAN Roland is the technology leader in the sheet-fed press market and has gained on its two biggest competitors by doubling its market share (now 20%) between 1998 and 2000. Practically, the company is present with sheet-fed presses all over China.

5 China – Printing Market with a Future

China's economic growth and its membership in the World Trade Organization (WTO) are no small factors allowing the prediction that the next few years will see an enormous rise of demand for printing presses in the country. In newspaper printing, there has been an increase in page counts, and the desire for more color is greater than ever. Increasing investments from abroad or joint ventures between foreign companies and Chinese printers, coupled with an increasing demand for high-quality magazines, make it very likely that the need for new printing technology will grow in advertising and commercial web printing.

Over the next few years, MAN Roland plans to improve its position in the Chinese press market even further. Technologically, MAN Roland is the pacesetter here with the introduction of the PECOM control system. This is an automation and data management system developed specifically for the newspaper industry to optimize the production process and make it more efficient. Its digital printing system DICO (Digital Change Over) also constitutes a new segment that is quickly conquering the Chinese market. It enables „printing on demand" in all areas of printing, which predictably will become a prevailing trend, as more small and medium-sized companies obtain their share of the market.

Fig. 5. Trade Fair (Source: MAN Roland).

In addition – here as anywhere else –, MAN Roland attaches high importance to the system business, i.e. the combination of trade and service, because it ensures quick, individual and competent on-the-spot service to the customers which are the part and parcel to run a business in China. New development is expected also in the advertising and commercial web printing segments. MAN Roland is confident enough to aim at being the number-one supplier to the printing industry in all segments. In particular, this objective is to be served by first-class after-sales service and highly qualified staff. Setting up training and service centers will establish the corporate infrastructure throughout the region.

The chances of reaching this objective are very good, because – unlike other manufacturers – MAN Roland entered the Chinese market very early and can, therefore, draw on many years of experience. In the current business year, MAN Roland China with some 400 million DM accounts for about 10% of the total MAN Roland turnover. With China, now a member of the WTO, MAN Roland aims at an increase in turnover share to 15 per cent. A perfectly realistic figure as the well-filled order books prove.

Invest in China – How to Find the Right Location

Stefan Herr, James Gong, and Xuyong Shi

Simon - Kucher & Partners, Bonn, and Wujin High-Tech Industrial Zone

1 Introduction

Facing the fastest growing national economy and more than one billion potential consumers, China is without doubt a highly attractive market. In fact, entry into the Chinese market appears more and more absolutely necessary to ensure a global company's international long-term success. Although the opportunities for successful business in China seem favorable, the risks can be high. As a result, market entry in China must be planned in detail within the company's strategic framework and the location has to be well considered. As many foreign companies first settle down in an industrial park when they invest in China, this article focuses on how to find the right industrial park.

In general, the factors that characterize a location can be structured as shown in the figure below.

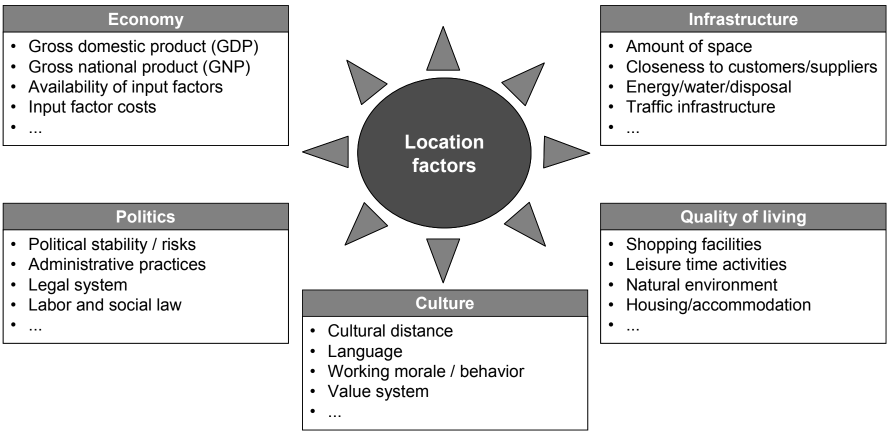


Fig. 1. Location Factors.

Economy, politics, culture, quality of living and infrastructure are the principle factors to be considered when analyzing a location. These aspects also apply when choosing an industrial park. However, certain factors are less relevant. The political situation, for example, is assumed to be the same in all locations of one region in China. Which aspects are most important when choosing the location for an industrial park in China?

Due to the geographical dimensions of China, choosing a location is one of the most challenging tasks when entering the Chinese market. To approach the task, it is extremely important to gather, analyze and evaluate information from different sources. This procedure is a difficult but crucial one, as it is hard to get first-hand information, and second-hand information is often unreliable. It seems almost impossible to get an overview of the many existing industrial parks, let alone to find the right one. In the following, six general location criteria are described:

- geographic location
- infrastructure and lay-out plan
- presence of local and international companies
- cost and tax advantages
- availability and qualification of manpower
- living environment and leisure time activities

These criteria are later used to analyze and evaluate a particular industrial park. Although multinational Big Players tend to prefer the capital Beijing or economic centers like Shanghai or Guangzhou as the location of their presence in China, regions at the periphery of these metropolitan cities could be more interesting for medium-sized companies. As an example, the Wujin High-Tech Industrial Zone in Jiangsu province is assessed in relation to the location criteria listed above.

To fully represent the complexity involved in choosing the right industrial park in China, some data and figures need to be mentioned. Jiangsu province is one of the provinces located in the economically stronger developed East coast region of the country. It covers 102,000 km^2 and has a population of 74 million people. In contrast, Germany is more than three times bigger and has a population of 82 million.

In Jiangsu province there are about 90 different economic development zones, industrial zones and industrial parks. Obviously, not all of those offer the same conditions to foreign investors. 12 of these zones are on a national level but under the administration of city government. The manufacturing business set up in the core area of national level zones and approved as a “high-tech company” enjoys a corporate income tax of only 15% compared to 24% in other zones. The Wujin High-Tech Industrial Zone is on a provincial level.

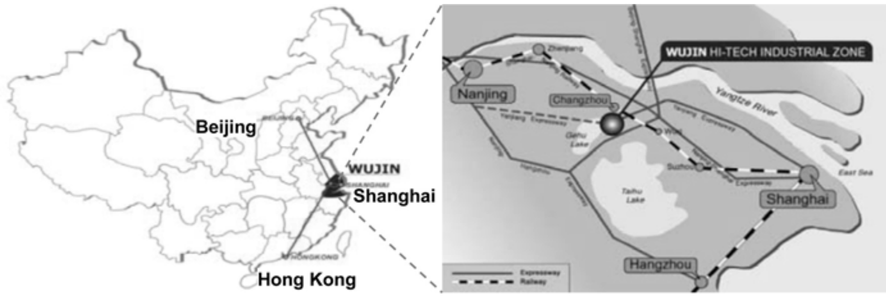


Fig. 2. Location of Jiangsu Province and Wujin High-Tech Industrial Zone.

2 Analyses of Location Criteria

2.1 Geographic Location and Its Economic Evaluation

In general, the geographic location has to be considered from two different perspectives. The macro-perspective takes account of where the industrial park is situated in China. In contrast, the micro-perspective has a more specific focus and assesses the geographic location in relation to the most important economic centers in the surrounding area.

Thus, economic developments, production supply factors, accessibility and the size of the potential market volume have to be evaluated. Corporate strategy and objectives guide the choice and the weighting of these criteria.

To illustrate how these factors are evaluated, Wujin High-Tech Industrial Zone is rated in the following. At present, there are two top economic regions in China. One is the Pearl River delta in the south of China with cities like Shenzhen, Guangzhou and Zhuhai. The other region is located in the Yangtze delta in the eastern part of China with cities like Nanjing, Hangzhou and Shanghai.

Wujin High-Tech Industrial Zone is situated in the center of the Yangtze delta in the south of Changzhou city in Jiangsu province. Despite the fact that Wujin is not in the immediate vicinity of the three biggest cities in this region, the distances are rather short. For years Jiangsu province has been ranked in top positions concerning gross domestic product (GDP), annual economic growth and value of production output. In 2004, the GDP of the province reached CNY1,551.2 billion Yuan (US$186.9 billion), which is the second highest in China. Furthermore, Jiangsu belongs to the most prosperous regions in China, with a 50% higher GDP growth rate than the national average.

The overall economic environment is positive and even more attractive due to the fact that most foreign direct investments in China went to the Jiangsu province in recent years. The result was a high density of foreign companies and thus a well developed infrastructure.

2.2 Infrastructure and Lay-Out Plan of the Industrial Park

The dimensions of China are immense. Proper transportation connections to all economically relevant regions and foreign countries are essential for an investment. Communication facilities, water and energy supplies, disposal of waste, sewage and recyclable materials must also be considered in the evaluation of a location.

Changzhou, the city where the Wujin High-Tech Industrial Zone is located, lies between Shanghai (160km), Nanjing (110km) and Hangzhou (150km), and it has a direct junction to expressways leading in each of these three directions. The two major cities Shanghai and Nanjing have international airports which are important in times of globalization and international markets. A harbor approved for international trade is also close to the industrial park. Furthermore, the Wujin High-Tech Industrial Zone has been designed by the planner of the well-known Singapore Suzhou Park. Consequently, experiences gained from his former projects have been applied during the planning process of the park in Wujin. This industrial zone covers an area of 100 km^2 and is designed according to an integrative concept which combines production, administration, shopping facilities, restaurants, residential areas and even a golf course. Energy supply and telecommunication connections are also ensured.

2.3 Presence of Local and International Companies

Just-in-time delivery is becoming increasingly important in China, and proximity to suppliers makes this easier. It enables a non-stop production chain and simplifies cooperation in research and development.

For suppliers of industrial goods it is important to know if and how many potential customers are located in their region. Yet the evaluation should not only consider the number of potential suppliers and customers. Their qualitative characteristics such as product quality, potential for innovation, willingness to cooperate, competitive strengths, etcetera have to be taken into account as well. A general recommendation for assessing suppliers and customers cannot be given, as they depend on the corporate strategy and objectives.

The high amount of foreign direct investments in the area of Changzhou city is certainly one of the significant reasons for its rapid economic development. With more than 3,000 foreign investors and 20,000 local companies, there is an attractive supplier and customer structure. But this sort of structure does not occur in all industries. As 60% of both local and foreign companies are related to the engineering or textile industries, this area would be more suitable for companies from these industries than from others. For companies from the electronic industry, for example, locations such as the Singapore Suzhou Park might be more appealing because of the local presence of the branch's big names.

2.4 Cost and Tax Advantages

Due to the flexibility of local authorities, a general evaluation of the cost and tax advantages of a specific location is difficult. Depending on the individual case, experiences vary. As foreign investments are considered the most important booster for local economic development, the competition among the industrial parks to gain investors through favorable policies has also strengthened. Thus, cost and tax advantages are very often used as instruments to attract more foreign investors. Experience shows that the final prices for land use and rental fees do not always conform to the official prices. Nevertheless, the latter is still good evidence of a location choice.

In terms of cost advantages, medium-sized companies should take a look at industrial zones in the areas surrounding bigger cities and well-known industrial parks. Cost advantages of up to 50% in comparison to large cities like Shanghai or Shenzhen are quite common. This can be decisive when choosing a location in a less prominent place, assuming that all other critical factors have been positively assessed. The official real estate prices of Wujin High-Tech Industrial Park have been assessed and compared to Shanghai, the cost advantage is approximately 50%. In contrast to Singapore Suzhou Park, it is still about 30%. Wages, social security contributions and living costs are about 30% lower than in Shanghai and its suburbs areas.

2.5 Qualification of Manpower

To successfully recruit qualified employees, the overall educational level of a region is crucial. Well-trained workers and managers are in great demand by foreign investors and consequently good candidates are wooed by many companies. The existence and reputation of colleges and universities can indicate the educational level of a region. Furthermore, a high concentration of companies of a certain industry usually hint at the level of technical education. Nevertheless, the existence of such facilities and industries is not a guarantee for successful recruitment in China. Cultural differences between Germany or Europe and China are visible, especially in the apprenticeship system. As a result, it is often necessary for foreign investors to give additional training to their Chinese staff, in order to fulfill their own requirements and expectations.

In China, elite universities are mostly situated in Beijing and Shanghai. It is not easy for foreign investors to recruit well-educated and trained graduates to work outside of these two cities. Yet the growing number of students enrolled at the universities and colleges in Jiangsu makes this province one of the top addresses. The universities and colleges of Changzhou are currently being integrated into a newly created college town located directly next to the Wujin High-Tech Industrial Zone. The new Changzhou University Town consists of six institutions with 70,000 teachers and students. It is the first university town in China focusing on vocational training. One aim of this university town is to bundle research capacities. Due to the closeness of research and educational establishments, research cooperation can be easily arranged. Furthermore, skilled workers with a machinery background are available due to their traditionally strong presence in the area.

2.6 Living Environment and Leisure Time Activities

Today employees consider living environment and leisure time activities to be very persuasive factors when accepting a job offer. An attractive environment makes it easier for German employees with good qualifications to decide whether to move to China. Once they decide to work abroad an already existing international community is usually helpful to adapt to such an exotic place like China. Facilities like international schools or kindergartens are also important factors. For the so-called “expats”, incentives such as a higher income or promotion within the company are usually not sufficient motivation to move to China. Consequently, the family aspects and conditions of the living environment should not be overlooked.

Despite its 3.4 million inhabitants, Changzhou is not a cosmopolitan city like Hong Kong, Shanghai or Beijing. The international flair found in those cities does not yet exist. But Changzhou is also not a small provincial town in the inland. Two lakes are next to Changzhou - one of them, the Taihu Lake, is one of the biggest fresh-water lakes in China, which significantly increases the appeal of this location. Moreover, schools and hospitals with Western standards are available. Residential areas planned on the lake waterfronts are additional advantages of an investment in this location.

3 Evaluation of Location Criteria

As mentioned before, the location criteria should be analyzed systematically in order to find the right industrial park for an investment in China. Some factors might be more or less important, and their effects on the final choice are different as well.

To structure the location factors, a scoring model is helpful. In such a model, the different factors should be rated depending on their importance for an investor. The following example illustrates:

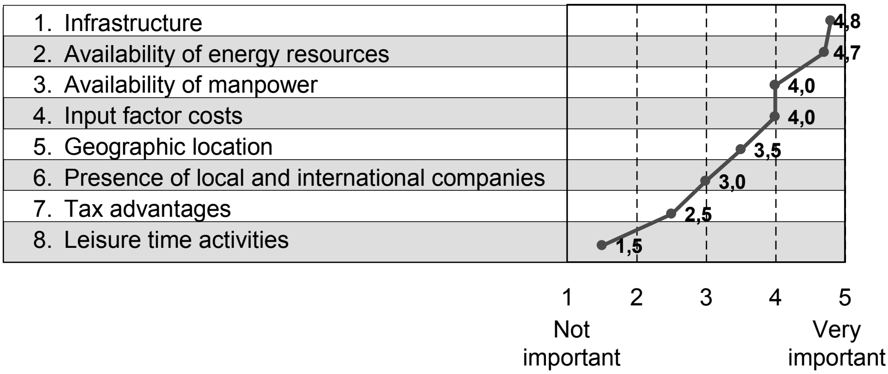


Fig. 3. Scoring of Location Factors and Criteria.

Obviously, more or less criteria can be taken into consideration; the criteria in the figure above are only used as an example. According to their importance, these criteria can be structured into critical, differentiation, hygiene, nice-to-have and irrelevant criteria. Afterwards, the individual performance of (maybe 5 or 6) industrial parks should be rated concerning the criteria listed in the scoring model above.

Based on the values of the criteria importance and the performances of different industrial parks, it is possible to create a matrix of competitive advantages for each industrial park. The matrix combines the importance of the decision criteria and the relative performance of relevant locations. The matrix of competitive advantages is a helpful tool to evaluate the shortlist of locations systematically.

The relative importance of a predefined location criterion is the difference between its importance rating and the importance ratings average of all criteria. A relative importance rating is calculated for each criterion listed and is shown on the Y axis of the matrix of competitive advantages.

The relative performance of an industrial park is defined as the performance of this park in a specific criterion compared to the performance of its strongest competitor in that criterion. This is shown on the X axis.

Hence, the matrix of competitive advantage for an industrial park could look like this:

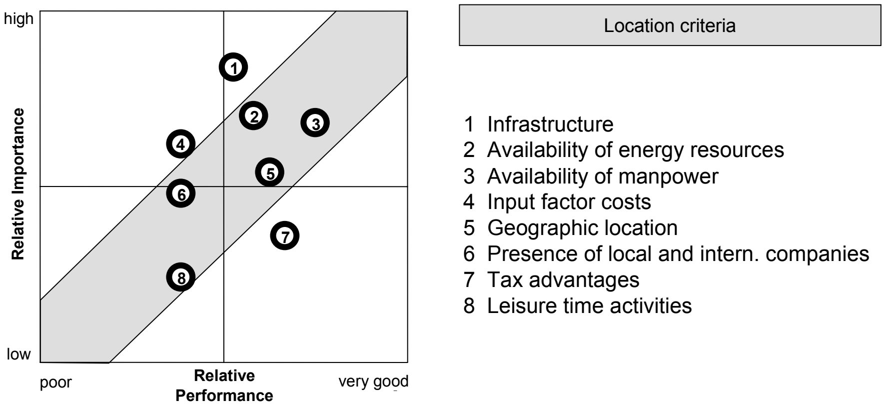


Fig. 4. Matrix of Competitive Advantages.

The matrix can be divided into four areas:

- Strategic competitive advantages (upper-right box): superior performance in the most important attributes
- Strategic competitive disadvantages (upper-left box): inferior performance in the most important attributes
- Consistency (lower-left box): inferior performance in the least important attributes
- Over-performing (lower-right box): superior performance in the least important attributes

A consistent profile, which is indicated by the grey diagonal bar, is defined by superior performance in the most important attributes and acceptance of inferior performance in the less important attributes.

In the example shown above, the criteria of infrastructure, availability of energy resources, availability of manpower and geographic location are the competitive advantages of the particular location. The performance of input factor costs should be improved. The criteria "presence of local and international companies" and "leisure time activities" are consistent. Regarding tax advantages, the particular location in the example even over-performs. In total, the industrial park evaluated above seems to be quite suitable; however, the competitive advantages of the other industrial parks have to be regarded as well.

4 Conclusion

Due to the geographical dimension of China and the amount and density of the industrial parks in certain areas, it is not easy to obtain a sufficient overview, not to mention a comparison of the locations. Using the criteria presented, investment locations can be structured and systematically analyzed. To illustrate this kind of approach, the most important location criteria have been specified and evaluated for the Wujin High-Tech Industrial Zone (WIZ). If WIZ was positioned in the matrix of competitive advantages discussed before, the result would be quite positive.

The final choice of an industrial park strongly depends on the corporate strategies and objectives. The evaluation process introduced here should be seen as a decision-making guideline.

Authors

Helen Beveridge
COMPASS Asia Training & Consulting, Ludwigsburg

Prof. Dr. Shen Bin
Chinesisch-Deutsches Hochschulkolleg (CDHK), Tongji University, Shanghai

Chin-Ning Chu
Asian Marketing Consultants, Antioch, CA

Dr. Bernhard Ebel
Simon - Kucher & Partners, Bonn

Heinz Dollberg
Allianz AG, Munich

Prof. Dr. Hubert Fromlet
Swedbank, Stockholm; Blekinge Institute of Technology and Baltic Business School, Kalmar

Dr. James Gong
Wujin High-Tech Industrial Zone

Stefan Herr
Simon - Kucher & Partners, Bonn

Ralf Hanschen
VOLKSWAGEN AG, Wolfsburg

Dr. Markus B. Hofer
Simon - Kucher & Partners, Bonn

Dr. Kang Gang Hu
GE-AS Co. Ltd., Shanghai

Sylvia Knoss
COMPASS Asia Training & Consulting, Ludwigsburg

Dr. Stefan Lippert
Simon - Kucher & Partners, Tokio

Daniel Mohr
Plumento Corp., Shanghai

Fan Oswald-Chen
Simon - Kucher & Partners, Bonn

Dr. Markus Rall
MAN Roland Greater China, Hong Kong

Jana Schmutzler de Uribe
Simon - Kucher & Partners, Bonn

Dr. Matthias Schramm
THINK!DESK China Research & Consulting, Munich

Xuyong Shi
Wujin High-Tech Industrial Zone

Frank Sieren
Wirtschaftswoche, Beijing

Prof. Dr. Jonathan Story
INSEAD, Fontainebleau

Prof. Dr. Markus Taube
THINK!DESK China Research & Consulting, Munich, and University of Duisburg-Essen

Prof. Dr. Savas Tuemis
Tongji University, Shanghai

Dr. Sven-Michael Werner
TaylorWessing, Munich

Prof. Dr. Peter Williamson
INSEAD, Singapore

Brigitte Wolff
Abacus Corporation Ltd., Shanghai

Johannes Wyrwoll
VOLKSWAGEN AG, Wolfsburg

Ying Yang
Simon - Kucher & Partners, Bonn

Prof. Dr. Ming Zeng
Cheung Kong Graduate School of Business, Bejing