

China's Rapidly Growing Market: Issues and Suggested Responses

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From a short-term perspective, the Chinese economy has experienced unstable factors such as a financial environment of overheated investments. However, the mechanisms supporting high growth in a mid- and long-term perspective are fully functioning. Positive approaches to investment in China should definitely be maintained.

In the past one or two years, the upper-middle class (with an annual household income of 50,000 yuan to 100,000 yuan), which is just below the wealthy class, has increased its significance as the stratum involved in purchasing real estate and durable consumer goods. If the wealthy class and the upper-middle class were combined, the estimated size of the resulting market would be 70 million persons.

Chinese companies that have acquired capabilities in small towns and rural areas are increasing their assertive moves into large cities by targeting the upper-middle class. Because of these moves, the market share of foreign capital companies in large cities for some products has been dropping rapidly.

In contrast with the move of some Chinese companies from rural to urban areas, some foreign capital companies have begun to enter small towns and rural areas to find new growth opportunities. However, because the business structures and expertise are totally different from those for urban areas, additional knowledge is required to successfully move into small towns and rural areas. Accordingly, an accelerated trend has been seen among foreign capital companies to establish partnerships with private local companies that are strong in sales as well as in low-cost production.

With progress being made in market expansion as well as an intensification of competition, Japanese companies must quickly make management decisions with respect to complex problems, such as withdrawal from business operations having no prospect of winning, strategic alliances to establish the foundations of business operations, measures to deal with risks including feelings towards Japan and measures to secure competitive personnel.

To properly respond to these complex problems, Japanese companies must be able to reach decisions in China as a whole, not individually at each office and not in Japan, which is distant from reliable sources of information. In other words, it is necessary to reestablish a structure to manage all business operations in China on a comprehensive basis.

I Continuing Favorable Conditions Seen in China's Economy

1 Overheating of Investment and Soft Landing

From the spring on into the summer of last year, the issue of severe acute respiratory syndrome (SARS) cast a serious shadow on China's economy. As shown in Table 1, the growth in the real GDP (gross domestic product) for the second quarter dropped to 6.7 percent and consumer spending fell substantially, while a favorable tendency continued in exports and investments.

However, once the SARS issue was put to rest, an explosive spurt of growth again started as if magma, which had so far been restrained, began to flow. In particular, the growth of investments in fixed assets (investment in real estate also falls under this account category in China) is significant. While a tendency to overheat has been observed in investments in fixed assets since last year, as soon as the SARS evil that served as a suppressing factor was eliminated, such investments grew 43 percent in the first quarter of this year.

In China, where growth is assumed as supreme, some suspected in the past that all economic statistical data might have been overestimated. Now, however, some suspect the opposite, that the recent data that is being reported may be underestimated as compared to the actual status. This means there is a possibility that the actual status is overheated to a degree greater than these data indicate.

The background factors behind overheated investments in fixed assets can be broadly divided into two types of booms.

The first phenomenon is the construction boom in the urban areas. Spurred on by the structural reforms implemented in the past four to five years, urban residents have started to acquire housing on a large-scale basis. Accelerated by increases in income, a surge in condominium sales has been taking place in major cities such as Shanghai.

The second phenomenon relates to energetic moves towards investing in the construction of factories by for-

eign capital companies in making China the "factory of the world." In particular, this phenomenon is concerned with the construction boom in the industrial development districts of rural areas. While competition among rural areas in terms of economic development has been politically instigated in the past several years, such intensified competition has been partially reflected in these overheated investments.

In May of this year, as part of an effort to prevent such reckless development projects in rural areas that could not be overlooked, the Ministry of Construction of the central government issued an administrative order for compulsory cessation of development programs at 3,000 out of 6,000 planned development sites. In addition, since not all of the 3,000 remaining sites have been approved by the central government, the ministry announced that additional cancellation orders might be issued depending on the results of detailed examination. The administrative power that had accelerated growth is now conversely cooling the overheating that is occurring in rural areas.

If excessive investments for the expansion of production that neglect a supply and demand balance are left as is, the huge volume of products and components that cannot be absorbed in the domestic market is likely to be exported to neighboring areas at unreasonably low prices, which might cause substantial damage to the industries of those economies. Companies in Southeast Asia and Taiwan have already been experiencing a threat to the continuity of their business by the overflow of products from China. The overheating of the Chinese economy is likely to exert a substantial influence on its neighbors without being confined within the Chinese economy itself.

In order to deal with such an economy in an overheated status, the central government has been launching macroscopic measures one after another to avoid any major economic fluctuations. For example, in April, in order to control excessive loans, the central government raised the reserve requirement ratio of commercial banks. This was the third increase since September of last year.

In addition, compulsory measures have been taken for the four business categories of steel, aluminum, cement and real estate, which constitute the primary causes for such overheating. These compulsory measures include banning new loans and imposing strict restrictions on

Table 1. Macroeconomic Trends in China

| | 2000 | 2001 | 2002 | 2003 | 2003 (on a quarterly basis) | | | | 2004 |
|---|------|------|------|------|-----------------------------|----------------|---------------|----------------|---------------|
| | | | | | First quarter | Second quarter | Third quarter | Fourth quarter | First quarter |
| | | | | | Real GDP growth | 8.0 | 7.5 | 8.0 | 9.1 |
| Growth of nominal fixed asset investments | 10.3 | 13.0 | 16.1 | 26.7 | 27.8 | 31.1 | 30.5 | 26.7 | 43.0 |
| Increase of consumer prices | 0.4 | 0.7 | -0.8 | 1.2 | 0.5 | 0.7 | 0.8 | 2.7 | 2.8 |

Note: The above figures indicate changes as compared to the same term in the previous year. With respect to the growth of nominal fixed asset investments, these figures indicate percentages as compared to the same term in the previous year in terms of the amount of accumulated investment from the beginning of the year.

Source: Nomura Securities Financial & Economic Research Center.

borrowers. The central government has been taking measures that are focused on specific business categories that are involved in causing investment overheating, rather than taking measures having far-reaching effects on all business categories such as raising interest rates. It is assumed that the central government may be concerned about jeopardizing good business conditions by a policy of excessive money tightening.

These overheated investments and the implementation of remedial measures are likely to exert influence on the business activities of Japanese companies in China. For example, if their customers or the customers of their customers fall under the above four overheated business categories or related business categories, there is a possibility of a sudden cancellation of support from a bank. It should be especially noted that such a risk is high for companies that have grown with the support of local governments.

However, the NRI research team in which I participate does not think that such an unstable status quo will become destructive. For example, unlike the so-called bubble economy experienced by Japan around 1990, the current trend of overheating in China is confined to specific business categories and certain areas and is not affecting the entire country. While real estate prices have certainly risen in Shanghai, such an extreme trend has not been observed in Beijing. Regarding the investment boom as well, a reckless condition will not continue for long because of new compulsory measures and the strengthening of penal regulations. These factors suggest that a soft landing is a definite possibility.

2 Mechanisms Supporting Sustainable High Growth

Some people in Japan say that the growth of the Chinese economy will continue until the Beijing Olympic Games or the Shanghai World Expo. Undoubtedly, various problems facing the Chinese economy surface from time to time, and the inherent risks are greater than are those of other economies. There are a number of issues that can be pointed out, such as regional gaps in economic development, unemployment in urban areas, and bad loans of commercial banks. However, we do not think that economic growth, which has been continuing for a long time in China, will collapse so easily.

In the China of today, it may well be considered that “two economic systems exist in one country.”

The coastal urban areas continue to enjoy a rapid increase in affluence by receiving the benefits of reforms and an open policy. The export industries have been fostered through the introduction of foreign capital, and the market for large durable consumer goods such as automobiles and housing has been expanding rapidly along with the expansion of individual income. Private companies have grown to assume a major position in the economy, giving birth to many individual

entrepreneurs who have achieved business success. The introduction of a market economy has brought about high economic growth. We call these areas “seaside China.”

In contrast, the aspect of a planned economy still remains in the inland areas. Unlike the coastal areas, it is difficult for the inland areas to achieve independent economic growth. Accordingly, “planned-economy-like growth” has been pursued in the inland areas through the expansion of fiscal spending, such as providing political protection to industries and companies and stimulating demand through investments in public work projects such as the “Great Development of the West.” Recently, the reforms of “agriculture, agricultural villages and farmers,” which are called the three agricultural issues, have been implemented.

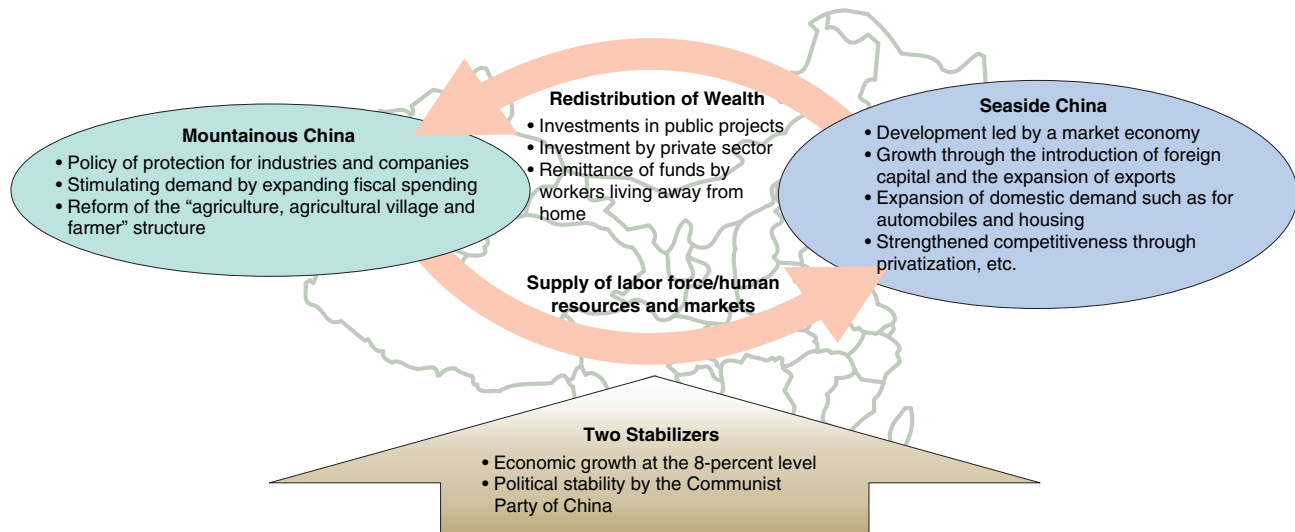
As such, the two economic systems of a market economy and a planned economy coexist in China. The fact is that this coexistence serves as a driving force of China’s long-lasting economic growth. For example, the funds collected in the form of taxes in the coastal areas are used for investments in public projects in the inland areas. Companies that achieve success in the coastal areas construct and/or invest in factories in the inland areas. Furthermore, workers who came from the inland areas to work in the coastal areas remit money to the inland areas. In these ways, the wealth accumulated in “seaside China” is constantly flowing back to the inland areas, or “mountainous China.”

At the same time, inexpensive labor is being supplied from “mountainous China” to “seaside China.” The reason behind personnel costs remaining low in the face of an overheated economy in the urban areas is the supply of labor from “mountainous China,” which consists of some 800 million people. In addition to ordinary workers and factory workers, people that received a higher education are also being supplied to “seaside China,” constituting a framework in which personnel costs are not easily raised. In addition, the attractiveness of “mountainous China” as a market has also recently been provided to companies in “seaside China.” As such, both the labor force and the markets are being supplied from the mountains to the sea.

The population of 1.3 billion residing over such a vast land form the “two Chinas” and generate a positive “win-win” cycle providing benefits to both (Figure 1). This structure behind the high rate of growth since the 1990s will not be easily lost.

From a short-term perspective, there are side effects inherent in this structure. These include a trend of expanding gaps between the sea and the mountains, and the issues of concessions and corruption in the flow of funds from the sea to the mountains. However, as long as a social stabilizer called the Communist Party administration functions well, economic growth as seen from the long-term perspective will remain stable. In such a sense, investment in China should be made with confidence

Figure 1. “Win-Win” Cycle between the Sea and the Mountains



even if a number of difficulties are encountered on a daily basis.

3 Olympic Games and World Exposition Bringing about Special Demands

The Beijing Olympic Games in 2008 have a significant meaning as a turning point for all of China to jump from a developing country to a semi-advanced country. A variety of shadows are making their appearance in Chinese society behind the light of economic maturity, such as economic gaps among regions and jobless people resulting from the reforms of state-owned companies. A politically tense relationship continues with Taiwan where the independence-oriented Chen Shui-bian administration was reappointed. The Beijing Olympic Games are positioned as a stabilizer against these domestic and overseas political situations.

However, a pitfall does exist. China had a bitter experience in relation to the Asian Games held in 1990 in China for the first time. At the preparatory stage for the opening of the games, concessions and corruption involving the development projects triggered student movements. This constituted an underlying cause of the Tiananmen Square incident in 1989. In the next four years, a number of large-scale development projects will be implemented one after another, principally within Beijing. While it is said that the market related to the Olympic Games is worth 1.5 trillion yuan (about 20 trillion yen), the industries related to infrastructure and real estate will flourish. However, careful attention must be given to a pitfall that is latent behind such prosperity.

The Shanghai World Expo in 2010 will be the venue to show both domestically and to the world that Shanghai (including neighboring cities), rather than China, definitely stands ready to jump into being an advanced country. While the current per-capita GDP in Shanghai is about \$5,000, the goal is to reach \$10,000 in

2010. Shanghai, Zhejiang and Jiangsu, which constitute a major economic block called the Yangtze River (Changjiang) Delta, are pursuing the achievement of living standards that are equivalent to those in advanced countries by around the time of the exposition. This is the reason behind the adoption of “Gracious Living for a Model City” as the main theme for the exposition.

The Shanghai Municipal Development and Reform Commission projects that the investment in public projects such as the construction of facilities related to the exposition and the development of a traffic infrastructure will amount to 300 billion yuan (about 3.9 trillion yen). While the real estate market in Shanghai has already prospered, the exposition will accelerate this prosperity, which may lead to concerns over the emergence of a real estate bubble. However, there is no doubt that the Yangtze River Delta with Shanghai as its center will continue to prosper by targeting this exposition. This economic block with its attractiveness as a consumption market will provide further business opportunities to many foreign-capital companies.

While the Beijing Olympic Games will only bring about business opportunities to specific business fields such as infrastructure construction and real estate, the exposition is expected to provide opportunities to foreign-capital companies in more extensive markets covering a wide range of fields (Table 2).

4 Business Opportunities Brought by Northeast Revitalization

Under the name of the “Great Development of the West,” the former administration implemented public investment worth 250 billion yuan (about 3.3 trillion yen) by issuing additional government bonds for the purpose of bridging the economic gaps generated in comparison to the coastal areas. The industries related to the construction of infrastructure such as transportation and

Table 2. Comparison of Beijing Olympic Games and Shanghai World Expo

| | Beijing Olympic Games (2008) | Shanghai World Expo (2010) |
|----------------------|--|--|
| Goals | <ul style="list-style-type: none"> • Jumping from a developing country to a semi-advanced country • “Weight” for social stability and solidarity | <ul style="list-style-type: none"> • First step toward “a jump to an advanced country” • Demonstrating the significance of the Yangtze River Delta economy |
| Economic effects | <ul style="list-style-type: none"> • Concentrated in Beijing under the initiative of the central government | <ul style="list-style-type: none"> • Further prosperity of the entire Yangtze River Delta economy |
| Principal industries | <ul style="list-style-type: none"> • Urban infrastructure development, real estate construction | <ul style="list-style-type: none"> • Products and services necessary to achieve a comfortable lifestyle |
| Pitfalls | <ul style="list-style-type: none"> • Spiraling of concession businesses | <ul style="list-style-type: none"> • Real estate bubble • Hollowing-out of industry in Shanghai |

Table 3. Comparison of Inland Area Development and Northeast Revitalization

| | Inland Area Development Program | Northeast Revitalization Program |
|-----------------------|---|---|
| Leader | <ul style="list-style-type: none"> • Former Premier Zhu Rongji; now concerns over the absence of a leader | <ul style="list-style-type: none"> • Being promoted under the strong leadership of Premier Wen Jiabao |
| Goals | <ul style="list-style-type: none"> • Bridging gaps as compared to the coastal areas by distributing a large amount of funds through expanded fiscal spending | <ul style="list-style-type: none"> • Vitalizing the economy by promoting industries/companies and eliminating social unease |
| Supporting industries | <ul style="list-style-type: none"> • Public infrastructure industries such as energy and transportation | <ul style="list-style-type: none"> • Implementing 650 priority large-scale projects principally in the manufacturing industries • Developing new industries in place of draining energies |
| Support methods | <ul style="list-style-type: none"> • Fiscal investment and loan programs worth 250 billion yuan through issuance of government bonds | <ul style="list-style-type: none"> • Preferential loans (establishment of the Northeast Revitalization Bank) • Tax credits, preferential treatment for foreign capital |
| Pitfalls | <ul style="list-style-type: none"> • Economic ripple effects are limited to infrastructure-related industries. • Unlawful conduct and corruption involving public work projects | <ul style="list-style-type: none"> • Moral hazard of state-owned companies |

Note: 1 yuan = about 13 yen.

energy have certainly been beneficiaries. However, as issues such as awarding concessions have been coming to the fore, at the current stage it cannot be said that such measures have fully generated the anticipated results.

On the other hand, the current administration is exerting focused efforts on a strategy to revitalize the old industrial bases in the northeast. For these measures, a sum of 10 trillion yen is about to be injected into 650 large-scale projects to promote industries in the three northeastern provinces of Liaoning, Jilin and Heilongjiang.

Unlike east China (the Yangtze River Delta area centered on Shanghai) and south China, the three northeast provinces are behind the trends of reforms and open policy. However, these provinces offer many attractive features. These features include untapped markets extensive basic industries that can support the manufacturing industries of machinery, automobiles, etc. and talented personnel from top-level universities as represented by the Harbin Institute of Technology.

In addition, the Chinese government appears to be deeply interested in the participation of Japanese companies in the northeast revitalization due to such factors as historical backgrounds and geographical proximity. There are risks in establishing partnerships with companies in the northeast area such as the possibility of incurring a major burden if an unreasonable relationship is established with a state-owned company that is having

difficulties in implementing restructuring. However, it is also true that many chances that are not available in inland area development exist in the northeastern revitalization in terms of markets, technology and the acquisition of human resources (Table 3).

II Rapidly Expanding Markets and Intensification of Competition

1 Expansion of the Bottom Layer of the Wealthy Class and the Rise of the Upper-Middle Class

According to a survey conducted by the Institute of Sociology, Chinese Academy of Social Sciences (CASS), the number of people earning an annual income of 100,000 yuan or more exceeded one million in Shanghai last year, and accounted for 7 percent of the total population. Converted to Japanese yen, the annual income of 100,000 yuan is about 1.3 million yen. However, as the prices of daily necessities are extremely low in China, this annual income corresponds to an equivalent purchasing power of 4 million yen to 5 million yen in Japan.

At this income level, people are able to purchase a home and automobile with the help of housing and automobile

loans, and they are able to spend money for education, travel and leisure. Moreover, they are also enthusiastic in investing and opening savings accounts. These consumption behaviors are more or less similar to those of the so-called middle-class households in Japan. This stratum is assumed to account for several percent of the population in urban areas, and include approximately 20 million people throughout China. We call this purchasing stratum the wealthy class.

Table 4 lists some brand shops that have aggressive plans to open outlets in China in 2004. Because the targets of brand products were only foreigners and the limited privileged class in the past, it was adequate to have several outlets on major streets in Beijing and Shanghai. However, as the bottom layer of the purchasing stratum has rapidly expanded during the past one or two years to include white-collar workers at foreign-capital companies and owners who are in business for themselves, it has become necessary to open many more outlets.

Table 4. Year 2004 Seeing a Rush of Outlet Openings by Brand Shops

| Brand name | Number of outlets opened in 2003 | Number of outlets planned to be opened in 2004 |
|---------------|----------------------------------|--|
| Louis Vuitton | 9 | 4 |
| Gucci | 6 | None |
| Cartier | 3 | 3 |
| Prada | None | 15 |
| Armani | 4 | 8 |

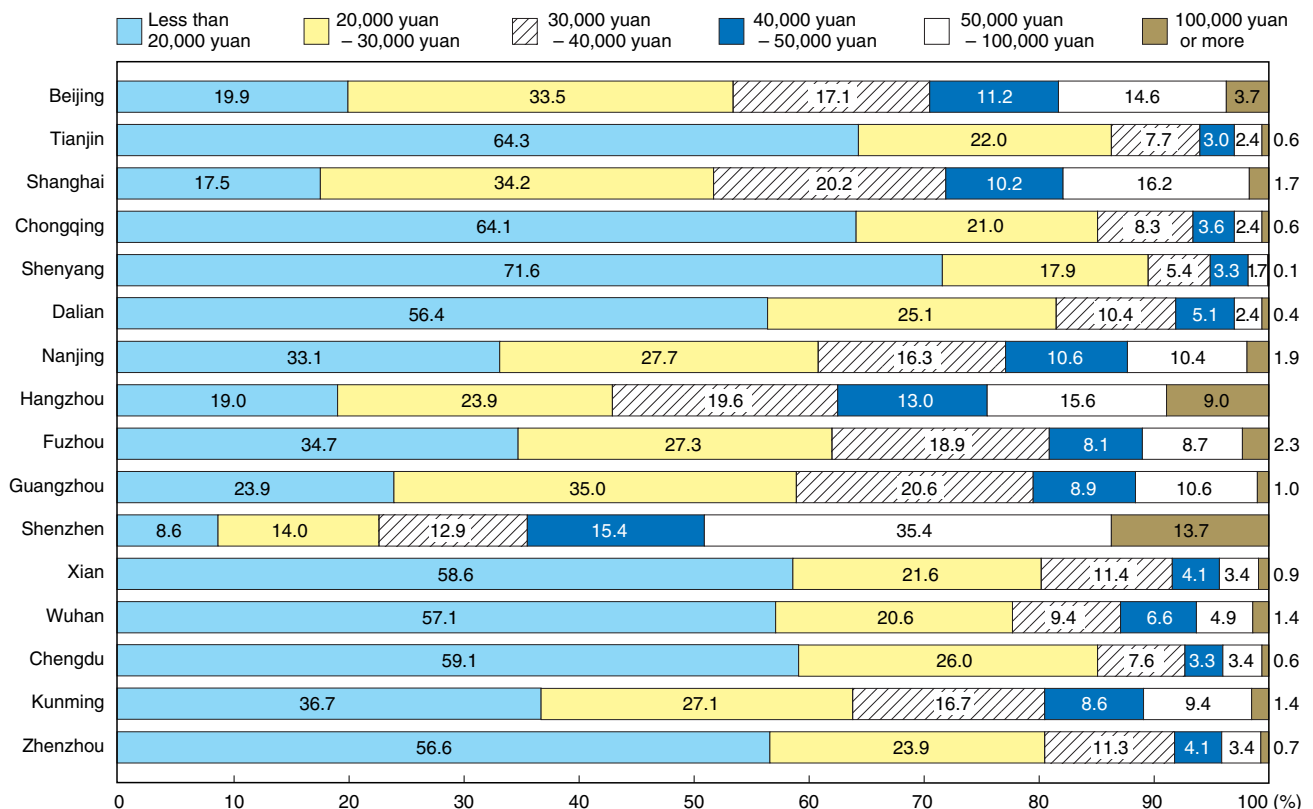
In our interviews with the owners of some brand shops, many said, “as the bottom layer of customers has recently expanded and the number of people visiting our store has rapidly increased, sales have consequently increased even though the sale amount per customer has declined.” This is evidence of a rapidly expanding wealthy class.

Incidentally, possession of private assets such as real estates and financial assets has become widespread among people under the housing system reform for the past five or six years. Recently, in addition to the wealthy class, the households that come just below the wealthy class in terms of earned income have become able to assume a leading part in a boom of asset acquisition. Typically, these householders are in their 20s to 30s and are earning an annual income of 50,000 to 100,000 yuan per household. They purchase their housing using housing loans and take the lead in purchasing the latest electric home appliances and digital information devices by giving priority to consumption over savings.

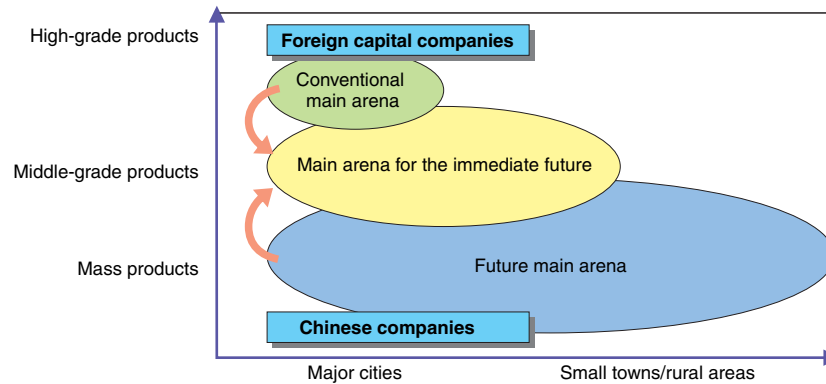
We call this purchasing stratum the upper-middle class. Until just a few years ago, China was a country of the proletariat where most people were without property. However, some of them started to acquire property. This class of people with property has been expanding rapidly and now constitutes a purchasing stratum that cannot be ignored.

Figure 2 shows the findings of the “Survey of 10,000 Consumers in China” conducted by us last autumn.

Figure 2. Household Income Composition Ratio for Each Major City



Note: The number of samples for Beijing, Shanghai and Guangzhou is 1,000, and the number for other cities is 700.
Source: NRI, “Survey of 10,000 Consumers in China,” November 2003.

Figure 3. Middle-Grade Product Market Segment Becoming the Main Arena

When we look at the composition ratio of citizens with an annual income of 100,000 yuan or more, it already exceeds 10 percent in Shenzhen. However, the ratio of this category in other cities is still at a level of several percent. With respect to a household income of 50,000 yuan or more, the ratio is 10 percent to 20 percent in the coastal areas and approximately 4 percent to 5 percent in the inland and northeastern areas. In a rough estimate, we consider that the number of people who fall under the upper-middle class amounts to about 50 million throughout the country. As the income of the members of the upper-middle class grows at a rapid pace, it is highly likely that they will develop into members of the wealthy class, probably after 3 or 4 years, or around the time of the Beijing Olympic Games.

The emergence of the upper-middle class has created a new market segment in urban areas. In the past, markets in urban areas were divided into two extreme groups, one of super high-grade products aimed at the privileged class and wealthy class and the other of mass products aimed at ordinary people. Foreign capital companies have exclusively specialized in the high-grade product markets, and adopted the marketing method of giving value to a high-grade brand image to produce greater profit margins even though the number of products sold was limited. In contrast, Chinese companies adopted strategies focused on differentiation by means of low prices and attentive service although the design and function leave something to be desired. The main arena for these companies included the low-grade product markets in small towns and rural areas where no foreign capital companies participate.

During this period, separation between high-grade and low-grade products was possible, and no head-on competition occurred between foreign capital companies and Chinese companies. Rather, up to the 1990s, competition took place among foreign capital companies and among Chinese companies. However, in the past few years, a market segment that belongs to neither of these groups emerged. Accompanying the growth of the upper-middle class, the middle-grade product market, which is situated between the high-grade and low-grade product markets, rapidly expanded.

In this new market segment, substantial Chinese companies specializing in low-grade products can be fully competitive. At the same time, foreign capital companies cannot ignore this middle-grade product market as it is rapidly growing in the major cities that constitute their territories. Consequently, the middle-grade product market is seeing increased competition involving both foreign capital companies and Chinese companies (Figure 3).

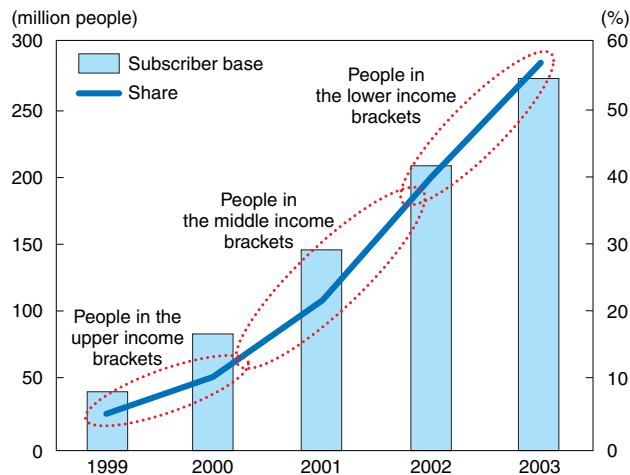
2 Chinese Companies Extending Their Coverage of Rural Areas to Include Urban Areas

A new middle-grade product market that is created by the upper-middle class may bring about a major change in the industrial structure. A representative example is the market for mobile phones. As shown in Figure 4, the net increase in the number of mobile phone subscribers in China was about 60 million last year. The total number of subscribers reached 260 million, and it appears that the total number exceeded 300 million at the end of May of this year. About four to five years ago, mobile phones were super high-grade products and owned by only a limited number of people in the wealthy class and privileged class in major cities. However, in the past several years, the bottom layer of subscribers has rapidly expanded to include the upper-middle class in urban areas and recently to cover small towns and rural areas.

Thus, the leading players of the market have suddenly changed in only four to five years from the major cities to small towns and rural areas, and from the wealthy class to the upper-middle class. Under these trends, a major structural change is also taking place in the mobile phone industry.

Around the time when the wealthy class in the major cities assumed a leading role, the four leading foreign capital companies of Motorola (the United States), Nokia (Finland), Siemens AG (Germany) and Ericsson (Sweden) formed an oligopolistic market. Therefore, in 1999, the market share held by domestic manufacturers was only 5 percent. With the market demand shifting to

Figure 4. Mobile Phone Subscriber Base in China and Market Share of Chinese Manufacturers



Note: Share is calculated in terms of the number of mobile phones.
Source: Compiled based on material issued by the Ministry of Information Industry.

middle-grade products, the market share held by domestic manufacturers has rapidly expanded. In 2003, they reached the stage of accounting for slightly less than 60 percent of the market. As indicated in Table 5, Chinese companies ranked 1st, 3rd and 5th in 2003 in terms of the number of telephones.

When the competition is viewed in terms of the selling prices of telephones, the products manufactured by foreign capital companies account for almost all of the high-grade products priced at 3,000 yuan (about 40,000 yen) or more. The so-called middle-grade products that range from 1,000 yuan to 3,000 yuan constitute the category involving fierce competition among foreign-capital companies and Chinese companies. The products manufactured by Chinese companies account for almost all of the low-grade products with prices of 1,000 yuan or less.

The strategies adopted by Chinese companies establish the mechanisms in which business becomes feasible even with low margins in rural areas where there are many users who opt for low prices despite limited functions, and create grass-roots sales channels covering all corners of these rural areas. After accumulating their business capabilities in the rural areas and by estimating when the middle-grade product market will grow in the urban areas, they are able to start advancing into the urban areas with a powerful weapon of low cost. These strategies bear a close resemblance to Mao Zedong’s strategy of advancing into large cities after acquiring strength in small towns and rural areas.

One option open to foreign capital companies would be to resolutely limit their arena to the market of the wealthy class as this class is expanding within itself. However, if middle-grade products in large cities are placed under the control of the advancing Chinese manufacturers, the result might be a scaled-down equilibrium.

The establishment of a partnership by Siemens with Ningbo Bird Co. (Zhejiang Province), which acquired the top market share last year, represents moves to advance

Table 5. Share of Mobile Phones in 2003 (Based on the number of telephones)

| (Unit: %) | |
|-------------------|----------------|
| Manufacturer name | Domestic share |
| Ningbo Bird Co. | 15.0 |
| Motorola (US) | 14.2 |
| TCL Corp. | 11.6 |
| Nokia (Finland) | 9.7 |
| Konka Group | 6.7 |

Source: The Ministry of Information Industry.

into rural areas from large cities with the support of this private company. The background considerations behind this decision by Siemens would be that if business activities continue to be targeted only at the wealthy class in the large cities, Siemens would only be able to hold out against advances by private companies. Ultimately, they would be able to absorb its business operations.

Ningbo Bird controls a sales network linking 30,000 shops throughout the country under a direct sales staff of 2,000. While Siemens can sell its own products through these sales channels, Ningbo Bird plans to use Siemens’s global sales network and to receive support for development of the next-generation mobile phone technology. This partnership is advantageous for both sides.

In May of this year, Alcatel, a leading communications equipment manufacturer in France, established a joint venture with TCL Corp., a major electric home appliance manufacturer. Alcatel moved all personnel, technology/patents and customers of the mobile phone department of Alcatel China to this joint venture.

TCL has 20,000 sales outlets extending over the entire country and is equipped with superior production capabilities with low costs. However, it also has had some problems such as falling behind other manufacturers in the start of selling mobile phones with a built-in camera due to delays in technological development. Accordingly, TCL has relied on Alcatel for its technology. Although Alcatel has the technology, it has outsourced production within China to an exclusive production company and does not have a nationwide sales network. It is assumed that this decision of Alcatel came from its concern over being unable to survive future battles in the market centered on middle-grade products without the help of TCL.

3 Foreign Companies Have Begun Taking Aggressive Approaches in Small Towns and Rural Areas

In meeting the challenge of Chinese companies doggedly making inroads from small towns and rural areas, foreign capital companies have not simply stayed in large urban areas as their defense. Conversely, they have started to make bold moves to advance into small towns and rural areas.

For example, under its “camera seeding” project, Eastman Kodak Co. of the United States is selling a set of

four 36-shot rolls of film and a camera for only 99 yuan (about 1,300 yen). The film is fast (ASA 400), and the camera is a compact model, not a throwaway type. If compared to the price of film sold in the coastal areas, these operations are practically the same as giving the camera away free.

Kodak's market share in China is said to be close to 70 percent, principally in urban areas. It appears difficult to further increase the market share, and high growth can no longer be expected in business operations centered on urban areas partly due to the popularization of digital still cameras. However, looking at rural areas with a population of 800 million, the rate of penetration of cameras is still only 20 percent. Kodak set its eyes on this *golconda* (a source of great wealth). While Kodak already has 7,000 DPE (developing, printing and enlarging) outlets in urban areas, the company plans to open 3,000 DPE shops in rural areas within the next three years.

The Coca-Cola Co. of the United States has also actively embarked on participation in rural communities. Similar to the situation with Kodak, the growth of the company's sales in urban areas has slowed down. Although a slowdown of growth was also observed in the urban areas of Fujian Province where Coca-Cola already has close to a 70 percent share of the beverage market, sales in the province grew by 15 percent compared to the previous year after the company started to tap the market in the rural areas. While Coca-Cola sells its products in cans and plastic bottles in large cities, the company sells cola in glass bottles in the rural areas at a price of 2 yuan (about 26 yen). Since Coca-Cola returns 1 yuan to the customer for each empty bottle, the actual cost to the consumer for cola is 1 yuan.

Coca-Cola also attempted a direct sales system in marketing cola in the rural areas, a system that has so far been considered too risky. The company has repeated tasting campaigns in each small town and has achieved success in sales promotion by word of mouth. Based on its success in the rural areas, Coca-Cola plans to establish bottling plants in the inland areas.

III Issues Facing Japanese Companies in a Rapidly Changing Market Environment and Suggested Responses

1 Taking a Comprehensive Approach to "Selection and Concentration"

In addition to its reputation as the world's factory, China is augmenting its attractiveness with markets in the large cities in the coastal areas. Moreover, the markets in the rural and farming areas have recently started to attract increased attention as locations for new business opportunities. However, the large city markets,

which have been impregnable strongholds for foreign capital companies, are seeing increasingly intensified competition as Chinese companies that have built up their capabilities in rural areas begin to mount formidable challenges.

In response to such changes in the market structure and competitive environment, it has become necessary to restructure businesses being developed in China. The increasing number of products that could easily win a competition with technological ability and brand name power several years ago can no longer easily win such a competition due to the vigorous chase being waged by Chinese companies. In addition, it will be also difficult for businesses that were forced to locate in undesirable sites or establish affiliations with less than preferable partners due to regulations or restrictions to survive the coming era of unprecedented competition. What is required under such circumstances is to concentrate on products and businesses that have a good chance of winning, and to withdraw from products and businesses that have no prospects of winning.

As China is also implementing measures for deregulation such as relaxing restrictions on investment ratios and participating areas, an environment for business restructuring is emerging. However, there are many cases in which a decision on business restructuring that should be implemented is being deferred. There are many reasons for this such as being reserved in consideration of a decision maker at the time an entity was established in China. Little impact is imposed on the consolidated income and expenditure of a department even if a business is in the red. Consideration is also given to the issue of the employment level in the participating area.

It is true that if a decision were made on withdrawal today, the withdrawal cannot be implemented tomorrow if the complexity of the individual situation is considered. However, business restructuring is not impossible if the following two steps are kept in mind. First of all, top executives should set forth an explicit policy on business restructuring. Second, following the policy decision, action to resolve the problems should be taken in a timely manner.

2 Strategic Partnerships with Private Companies

If it is assumed that the main arenas in the future will shift to the middle-grade product market encompassing large cities, rural areas, and farming communities, foreign capital companies that have so far known only strategies confined to large cities must examine new strategies. A most effective option in such an examination is to establish a partnership with a private company.

Many growing private companies are winning the competition by the strength of their sales, rather than by means of their technology and products. Conversely, foreign capital companies have confidence in their

technology and products, but are unfamiliar with a sales network linking rural areas and farming communities. For such foreign capital companies, private companies are the most suitable partners. Moreover, private companies have their own cost reduction expertise and are capable of responding to invisible regulations. At the same time, the heretofore fragile management foundation of private companies, which stemmed from a lack of support of the central government, is significantly improving as a result of environmental changes such as the protection of private property rights and the participation of private company executives in politics.

Under these circumstances, besides the cases of mobile phones previously mentioned, recent trends have frequently seen cases of establishing an affiliation between a foreign capital company and a private company as well as cases of acquisition. For example, Kao Corp. established a joint venture with Zhejiang Transfar Group in 2002. Zhejiang Transfar is a private company that has grown to become the largest chemical manufacturer in Zhejiang Province in only ten years after the company was established by Xu Guanju as a family factory. While Kao has achieved full success for high-end products in the large cities, it appears that Kao decided to rely on Zhejiang Transfar for its low-end product portfolio including a sales network of evolving business activities in rural areas and farming communities.

In April 2004, Japan's leading manufacturer of instant noodle products, Nissin Food Products Co., took an equity stake of 20 billion yen in Hebei Hualong Food Group Co., a private company that started from a small village factory in Hebei Province. Now, its 14,000 employees are working throughout the country to build a grassroots-type sales network. The company has a cost structure that enables them to produce a profit by selling a package of instant noodles for 1 yuan. It is impossible for a foreign company to create such a sales network along with such a low-cost production system.

While Nissin Food Products has already acquired the top share of the instant noodle market in Shanghai, it is planning to expand its share in other cities and rural areas by acquiring the strength of a private company through this capital investment. From the perspective of Hualong, it can learn the means of developing cup-type noodle products from Nissin as well as modern management techniques as its business activities expand. As such, both parties can complement each other with respect to their respective management resources.

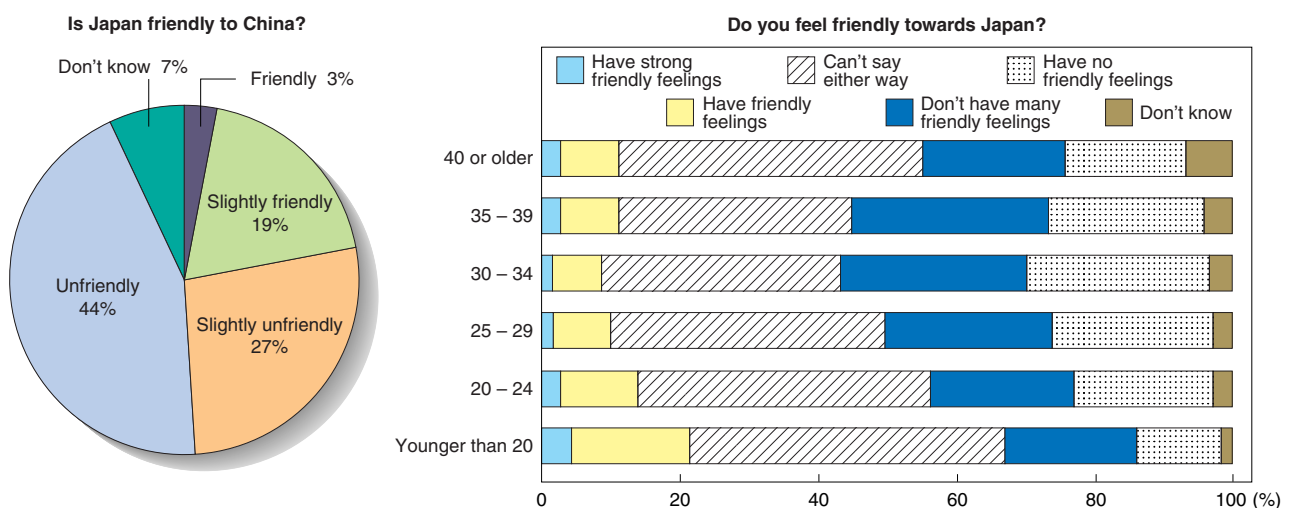
As foreign companies move from "points" (large cities) to "lines" (coastal areas) and further to "planes" (inland areas and rural communities), their needs for strategic alliances with private companies will increase. From the perspective of private companies, while they could achieve rapid growth under the leadership of an owner, there are many cases in which a business does not move forward smoothly because the business operations and organization have grown too rapidly. Accordingly, such affiliations will bring about major advantages to the private companies as well, rather than simply being pursued to benefit the foreign capital companies.

3 Responding to Risks Involving the Issue of Feelings towards Japan

While opportunities to expand business operations are increasing and business coverage is expanding in China, it must be noted that there are a variety of hidden risks. In particular, the issue of feelings toward Japan must be handled with the greatest possible care. The historical relationships of Japan and China lie dormant, and a number of problems that could become political issues have recently emerged such as the issue of Prime Minister Junichiro Koizumi's visits to Yasukuni Shrine honoring Japan's war dead.

Figure 5 indicates the results of a survey by Searchina Research Institute on feelings toward Japan. These findings reveal that the feelings toward Japan have worsened

Figure 5. Feelings about Japan



Source: Searchina Research Institute, "Actual Living Conditions of Chinese Consumers: Searchina China White Paper 2004 - 2005," 2004.

in the younger generation in their 20s and 30s. Why the younger generation? It is frequently pointed out that the implementation guidelines of nationalism education started in 1994 for young people are attributable to this phenomenon. However, the underlying factor is considered to be a manifestation of the Sino-centrism ideology. In other words, a contrast between the strength of the current China having deepened confidence in economic growth and the weakness of Japan with its continuing economic confusion for the past several years is fostering a sense of superiority over Japan among the younger generation and is creating a mood that is apt to ignite anti-Japanese sentiment.

Japanese companies developing business activities in China should take adequate measures to deal with this issue. Even in cases where there are no explicit faults, small unintentional incidents might provoke hostility. This issue must be recognized as one of the risks of being a Japanese company.

First of all, a structure should be established to accurately analyze local information, such as how a company and its products and services are accepted in China. Moreover, a structure should also be developed that enables local, quick decision-making in China and that permits the taking of remedial measures immediately to respond to any problems. Because word of an incident is likely to spread quickly due to extensive use of the Internet, it is important to quickly implement appropriate measures immediately after a problem occurs. It is also important to build a network of daily communication with related organizations and news media, and to create and follow in-house management manuals.

Additionally, strategies must be worked out in pursuit of the realization of matters such as measures to improve the corporate image in China, contribution to local communities in China, management localization, and coexistence and mutual success with Chinese partners.

4 Rearranging Human Resource Strategies

(1) Delays in management localization

The localization of management or, in specific terms, the issue of human resources such as the appointment of local personnel to management positions, has long been discussed as an issue facing Japanese companies operating in China. However, in many companies, this issue has not yet been resolved.

For example, there are still cases in which Japanese companies in China require Japanese language ability as a condition of employment. Such companies have many employees who graduated from courses in Japanese language, and priority is given to an employee's language ability rather than to expertise. Accordingly, a tendency is seen to shun Japanese companies by many people who have expertise in fields such as economics, law, physical science and engineering.

Of course, there are persons who are good at Japanese language and who also excel in their particular professional field. However, because the quantity of such persons is limited, if this dependence on human resources with Japanese language ability continues, Japanese companies are likely to experience the problem of not being able to keep up with the need for management-level personnel in the face of rapidly expanding business operations. This may result in a vicious circle of forever being unable to get out of a management structure centered on Japanese.

Establishing factories is what motivates many Japanese companies to go into China. If their activities were confined to manufacturing, the guidelines of such activities already exist in Japan. In such a case, it is rather important for Japanese people to play a central role, because they have the necessary expertise of production processes and can carefully supervise the work processes. If the only business activity in China is to manufacture products, localization is not necessarily desirable.

However, if business activities cover sales, development and management, real people, rather than mechanical objects, must be managed and conversation with markets (information gathering) becomes necessary. To meet these requirements, it is more efficient to leave the business activities to Chinese who are well versed in the Chinese way of thinking and local situations. The Japanese side should be strictly devoted to checking results. In actuality, however, managerial positions are still assumed by Japanese and, consequently, in many cases, business activities remain sluggish.

A variety of effects can be expected by appointing local personnel to executive positions. Since such action provides incentive to local staff to work hard in anticipation of a promotion, it has the effect of dissuading competent personnel from quitting their jobs. Moreover, the methods and procedures suitable for Chinese can be adopted with respect to personnel evaluation and wage levels. Complicated negotiations concerning management policy with a joint venture partner can be facilitated and drastic measures such as the replacement of sales agencies can be resolutely implemented. While simply appointing local personnel to management positions does not necessarily mean that all problems will be resolved, the issue of management localization still remains a major problem among Japanese companies.

(2) Expanding gaps in competitiveness with Chinese and Western companies

Western and Chinese companies place the highest priority on human resource strategies.

With respect to management localization in China, for example, Siemens and General Motors Corp. in the United States compulsorily require the appointment of local personnel to management positions by limiting the assignment term of personnel dispatched from the head office to three years. Although IBM Corp. in the United

Table 6. Outline of Haier Group's Human Resource Strategies

| |
|--|
| <p>Establishment of Haier Human Resources (HHR) in 2003</p> <ul style="list-style-type: none"> • Persons in charge of personnel affairs are dispatched from HHR to each group company, and a uniform personnel management system is applied in all group companies. • Because persons dispatched from HHR handle recruitment, "connection" can no longer influence personnel affairs. • Discovering and accumulating the best practices to improve business efficiency and providing guidance to group companies • Strengthening employee training functions by establishing Haier University |
| <p>Determining personnel appraisal standards and applying such standards</p> <ul style="list-style-type: none"> • Promotion is not possible if a successor has not been prepared. • A successor to a vacant position is selected from among employees meeting the required conditions by openly inviting in-house candidates. • Assessing the variable portion of a monthly salary in proportion to performance by evaluating performance on a monthly basis |

States doubled the number of local employees to 3,800 in the past six years, the number of dispatched employees was decreased by half to 150. Moreover, Chinese Americans account for 90 percent of all remaining employees dispatched from the head office. As such, these companies are taking all possible measures to promote management localization.

Chinese companies also give the greatest importance to human resource strategies. Table 6 outlines the procedures adopted by Haier Group, a leading electric appliance manufacturer, which is noted for its excellent personnel system among Chinese companies. Haier spun off its personnel affairs department to become an independent company. Measures launched under this move include the formulation of a policy on personnel affairs that is consistent among all group companies on a group-wide basis, the elimination of unfair handling such as connection at the time of recruitment and appraisal, the sharing of best practices in personnel affairs among group companies and the establishment of Haier University to develop and train personnel within the group on an across-the-board basis.

Among Japanese companies, management focus on human resource strategies has begun to emerge as represented by cases in which good business performance has been achieved. This is usually accomplished by appointing local personnel as the heads of business operations in China and hiring the best of these for worldwide operations.

However, from an overall perspective, Japanese companies lag behind Chinese, European and US companies in their focus on human resource strategies. Looking at a list of companies popular among job-finding university students, the Japanese companies listed in the top 50 included only Sony Corp. and Matsushita Electric Industrial Co., last year, and the ranking of both of these companies went down this year (Table 7).

(3) Rebuilding trust between management and employees

Table 8 outlines conversations by university students that I personally experienced in Shanghai. While young

Table 7. Ranking of Companies Popular among Job-Finding University Students in China

| 2004 | 2003 | Company Name |
|------|------|--|
| 1 | 1 | Haier Group |
| 2 | 2 | IBM Corp. (US) |
| 3 | 5 | Procter & Gamble Co. (US) |
| 4 | 9 | China Mobile Communications Corp. |
| 5 | 3 | Microsoft Corp. (US) |
| 6 | 4 | Lenovo Group |
| 7 | 8 | Huawei Technologies Co. |
| 8 | 6 | General Electric Co. (US) |
| 9 | 10 | Siemens AG (Germany) |
| 10 | 12 | China Telecom Corp. |
| 11 | 14 | Samsung Electronics (South Korea) |
| 12 | 11 | TCL Corp. |
| 13 | 7 | Motorola (US) |
| 14 | 20 | China United Telecommunications Corp. |
| 15 | 13 | Intel Corp. (US) |
| 16 | 23 | Unilever (UK and the Netherlands) |
| 17 | 15 | Nokia (Finland) |
| 26 | 17 | Sony Corp. (Japan) |
| 46 | 32 | Matsushita Electric Industrial Co. (Japan) |

Note: Valid answers from 28,716 respondents in more than 600 universities and postgraduate schools.
Source: ChinaHR.com Corp.

Table 8. Conversations by University Students on a Main Street (Huaihai Road) in Shanghai

| |
|---|
| <p>A: From their reputation, products made in Japan are way cool.</p> <p>B: I want it.</p> <p>A: Well, if you enter a foreign company, you can get it.</p> <p>B: Would you work for a Japanese company?</p> <p>A: No, I would like to work for a European or US company. Japanese companies are good at manufacturing but they don't have good personnel policies.</p> <p>B: I agree. The ideal would be working at a European or US company and buying products made in Japan.</p> |
|---|

Chinese people are fascinated by Japanese products, they do not have much interest in Japanese companies. The more competent prospective employees are, the more carefully they examine companies to see if the companies help them to develop their abilities. Japanese companies in China are rated low in terms of investment in and development of human resources. In many cases, employee needs are mismatched with the management thinking concerning human resources.

Table 9. Good and Poor Regional Management Functions

| “Good” Regional Management Functions | “Poor” Regional Management Functions |
|---|--|
| (1) Can establish optimal strategies for all business operations in China (2) Can quickly play a role in risk management (3) Can promote the tapping of rural and agricultural markets (4) Can assume a central role in personnel recruitment and training (5) Can undertake optimum management of all financial affairs (6) Can improve and strengthen the efficiency of sales channels | (1) Limited to the management of “business operations in local areas” (2) Limited to information gathering with decision-making dependent upon the head office (3) Trying to confine business operations to Beijing (or Shanghai) (4) Allowing each office to set policies for its own personnel affairs (5) Limited to playing a role of collecting dividends from each company (6) Passively managing sales without taking an active approach |

Japanese employees assigned to work in China often complain about Chinese employees as “always demanding wage increases,” “do not work overtime when it is unavoidably required,” “their work is rough and not careful” and “even if training is provided, they soon quit.” Conversely, local employees are dissatisfied with Japanese management in many aspects as represented in remarks such as “trying to hold down wages,” “do not trust us with certain work,” “there is no means for promotion even if we work hard” and “do not adequately train and support employees.”

As such, there is a general lack of mutual trust between management and employees. Even if excellent strategies are formulated with respect to products, services, technology and sales, such strategies alone do not lead to improved performance if the human resource strategies do not function well.

Nevertheless, there are a number of successes in human resource strategies among Western and Chinese companies. While the development of human resources is considered to be the most important target of advance investment, Japanese companies fully understand what they should do in this regard. It would be possible to consider that the rest depends entirely upon how well they do what they know they should do.

IV Need for Strengthening Regional Management Functions

In addition to the need to win the competition that is now underway, it is also necessary to formulate and implement appropriate steps by taking a bird’s eye view of major changes in the market structure. These changes include diversification of market segments (emergence of the middle-grade product market) and regional expansion to include rural areas and farming communities. On the one hand, markets and businesses are growing while, on the other hand, business risks are increasing, such as the economic policy to cool down overheating, etc., the

issue of feelings about Japan, the infringement of intellectual property rights and the issue of information security. Accordingly, it has become necessary to develop far-reaching market strategies that take into account strategic alliances or to launch measures to avoid risks by carefully scrutinizing the moves occurring throughout China.

Strategies covering all of China, rather than just those for individual offices, are also required in terms of human resources development. Moreover, comprehensive studies covering all of China are needed in examining the selection and concentration of management resources.

While the need for functions to manage all business operations in China on an across-the-board basis is increasing, in many cases the current regional integration functions provided by Japanese companies are only nominal at best (Table 9). There are even cases in which the regional integration functions are not vested in the local business entity in China, but in the head office in Japan.

Real estate advertising featuring objects suitable for a head office has frequently been seen in Beijing. On Changan Avenue, a principal thoroughfare in Beijing, a twin-tower head office building is being constructed by the LG Electronics group of South Korea.

With progress being made in market expansion as well as an intensification of competition, Japanese companies are finding themselves pressed for quickly making decisions on a variety of complicated problems. To meet these requirements, an optimal decision must be based on the needs within China as a whole rather than each office making individual decisions. The restructuring of China’s head-office functions has come to the forefront as an important issue.

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