July–September 2011

The China Business Review

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THE MAGAZINE OF
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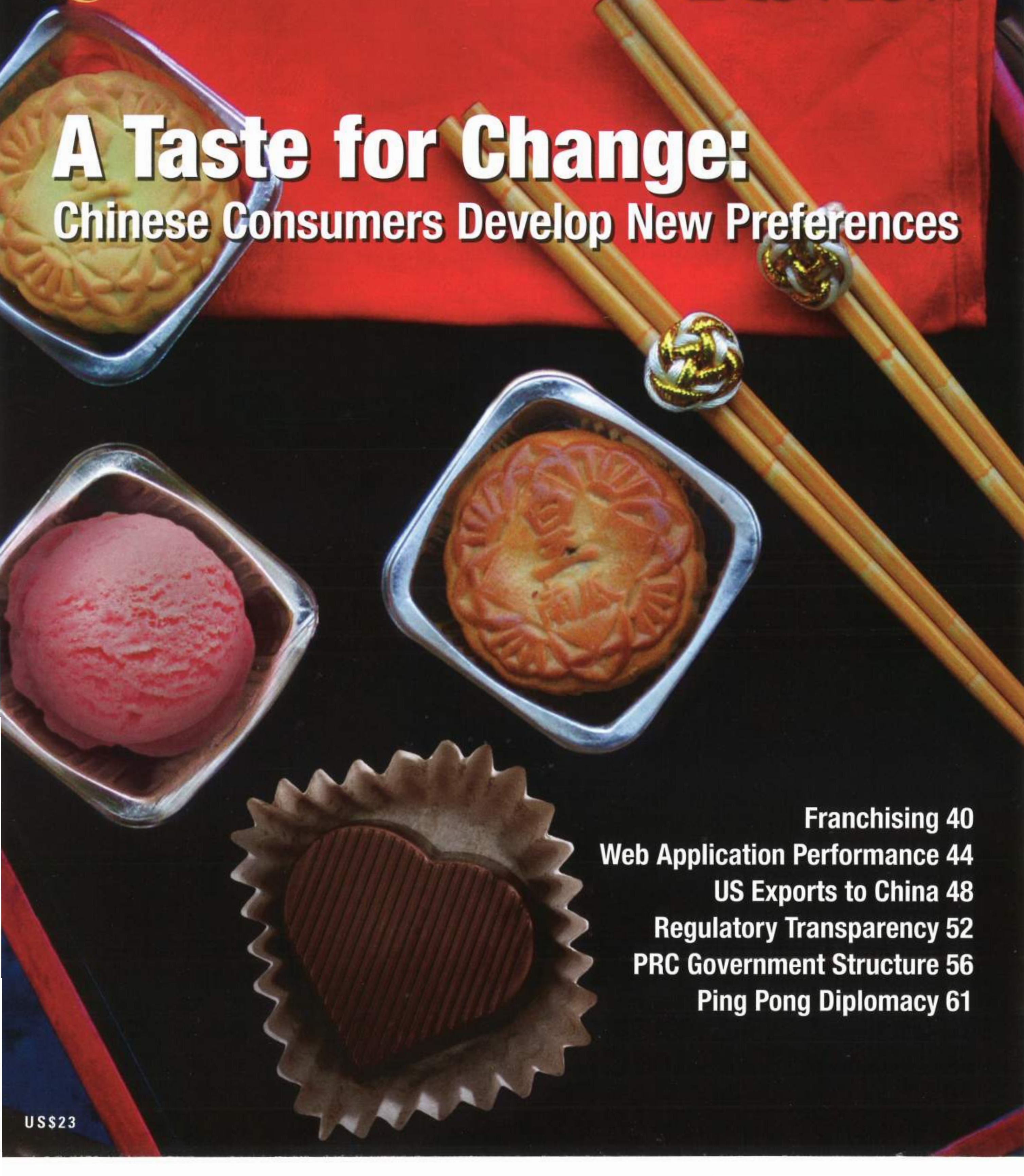
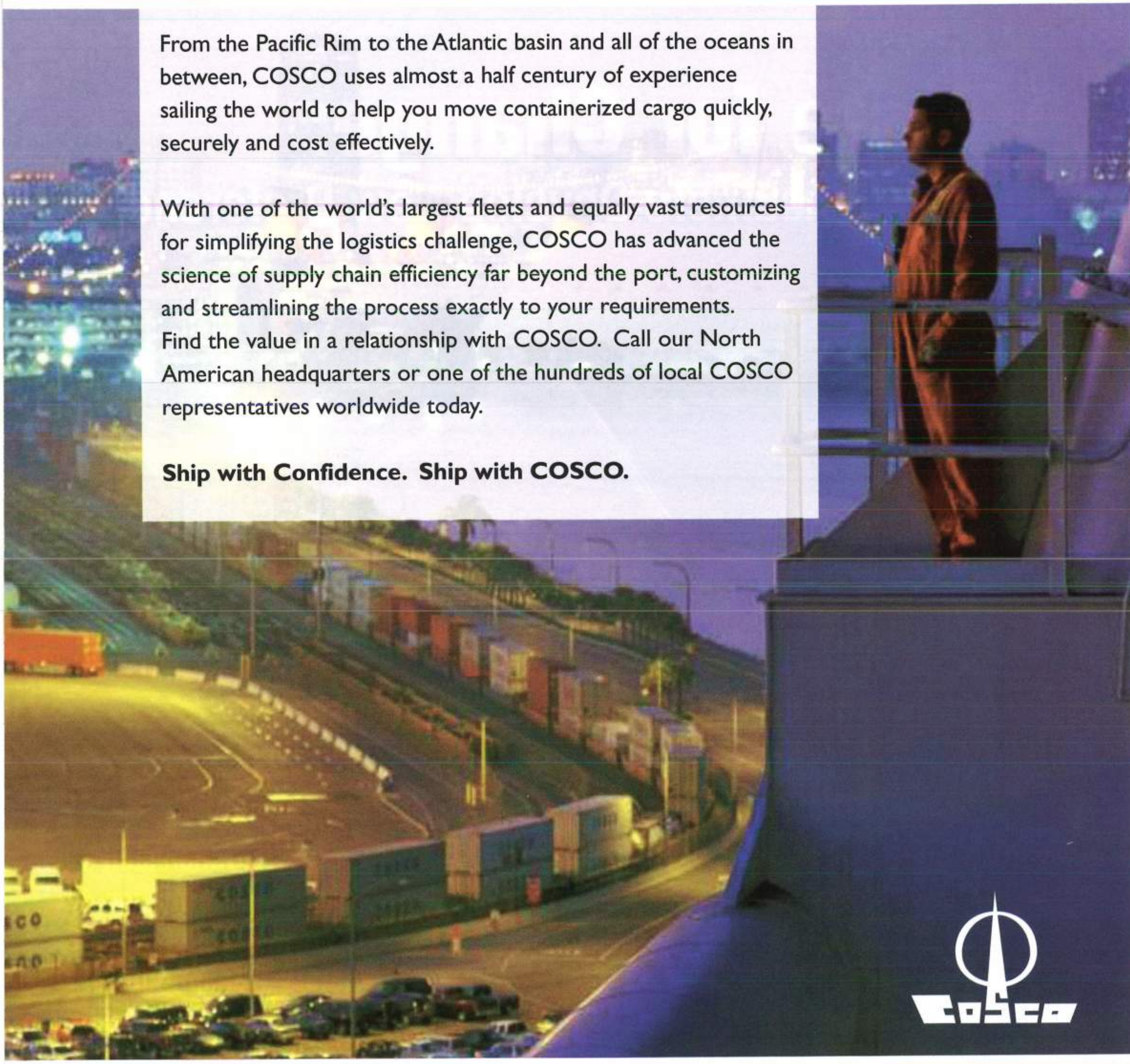


A Taste for Change:
Chinese Consumers Develop New Preferences





China Foto Press

Higher incomes and access to more goods have transformed Chinese consumers' shopping habits.

The China Business Review

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Focus: Changing Tastes

Features

Departments

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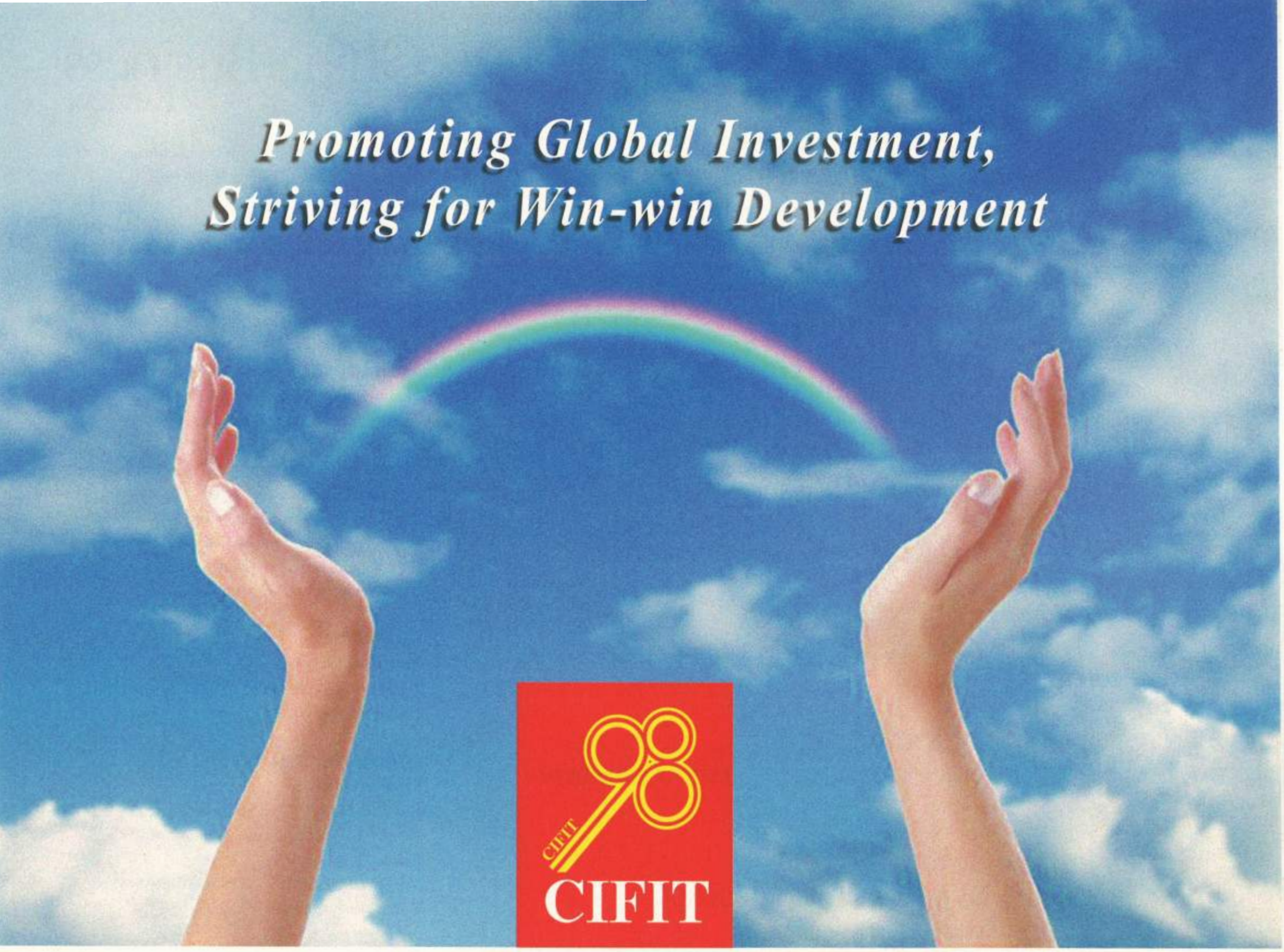

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Short Takes

Entertainment

The US entertainment industry is seeking ways to expand in China, according to a *Los Angeles Times* report. Representatives of the Motion Picture Association of America (MPAA) and the Office of the US Trade Representative have entered into talks with PRC authorities to expand the number of foreign movies distributed in China to about 40 films per year, an increase from the current limit of 20 films. The talks follow a 2009 World Trade Organization ruling that China's restrictions on foreign media violate international trade law. MPAA Chief Executive and former US Senator Christopher Dodd has made increased access to China a top industry priority, and he attended the Shanghai International Film Festival in June to further relations with PRC entertainment officials.

Some foreign entertainment enterprises have already expanded operations in China. Canada-based theater company IMAX Corp. recently reached an agreement with China's largest theater operator, Wanda Cinema Line Co., Ltd., to jointly open 75 theaters throughout China over the next three years. China's domestic entertainment industry has also begun expanding internationally. US-based theater company AMC Entertainment, Inc. recently signed an agreement with China Lion Distribution, Inc. to deliver up to 15 Chinese films per year to AMC theaters in North America.

Separately, the Walt Disney Co. in April broke ground on a Disney resort in Shanghai. Disney, which holds a 43 percent stake in the project, will share ownership with three PRC state-owned enterprises. Japan-based Sanrio Co., Ltd. in May also announced plans to build a 60-hectare, $215-million amusement park based on the popular "Hello Kitty" franchise. The park is slated to open outside Shanghai in 2014.

Foreigners in China

The number of foreigners living in China is increasing. According to the PRC National Bureau of Statistics (NBS) census results released in April 2011, nearly 600,000 foreigners were living in mainland China at the end of 2010. Including citizens of Hong Kong, Macao, and Taiwan, the number increased to more than 1 million people. The cities with the highest foreign populations were Guangzhou, Guangdong, with about 316,000 foreigners; Shanghai, with roughly 209,000 foreigners; and Beijing, with roughly 107,000 foreigners. The countries with the largest expatriate populations in China were South Korea, the United States, and Japan, with about 121,000, 71,000, and 66,000 residents respectively.

China's rapid economic expansion and strong job market for foreigners have boosted immigration. The PRC State Administration of Foreign Experts Affairs (SAFEA) in May held its eleventh job fair for foreigners, which attracted 1,200 to 1,500 foreign workers, according to *China Daily*. SAFEA official Xia Bing noted that about half of job seekers at SAFEA events hold advanced degrees. The top fields of interest for foreign workers are education and technology.

The number of legal cases that involve foreign workers has increased 30 percent in the past three years, according to a recent *People's Daily* interview with Shanghai-based labor law expert Wang Huayu. The newspaper noted that PRC labor regulations do not contain provisions that pertain specifically to foreign workers. This omission has made resolving disputes that involve foreign employees difficult.

Green Tech

Green technologies have become a key component of China's economic growth. According to a recent World Wide Fund for Nature report, China is the world's largest producer of green technology, with 2010 sales of more than €44 billion ($64 billion)—about 1.4 percent of China's gross domestic product.

The PRC government has sought to encourage the development of "environmentally friendly" technologies. The PRC Ministry of Finance in late April announced plans to introduce special funds and subsidies for local governments and enterprises that attempt to develop green-energy sources. China's 12th Five-Year Plan (2011–15) calls for the country to build 235 million kW of clean-energy power generation capacity by 2015.

Wind power accounts for a significant portion of China's clean-energy production growth. China's domestic wind-power production increased more than 60 percent to 18.8 billion kW hours in the first quarter of 2011, according to the PRC National Energy Administration. In 2010, China exported 13 wind turbines with a combined production capacity of 15.55 MW, according to Xinhua News Agency. China's wind turbine industry may undergo significant changes in the coming months. The draft of the revised 2011 Catalogue Guiding Industrial Restructuring released in April includes only manufacturing of turbines with capacities over 2.5 MW in the encouraged category—though PRC regulators may make further revisions to the final version.

China is also seeking to expand its solar and hydroelectric power capacity. Rural hydroelectric power—defined as power generated by stations with a capacity of 50,000 kW or less—is expected to expand production to 74 million kW by 2015, according to PRC Water Resources Minister Chen Lei. *China Daily* also recently reported that solar power production capacity is expected to increase from 1 gW to 10 gW by 2015.

Prices and Inflation

Prices continue to rise in China as inflation exceeds government targets. According to NBS, food prices in April 2011 were up 11.5 percent from the same period in 2010. Clothing prices in April 2011 jumped 1.4 percent compared to March, the biggest single-month gain since 1997, and non-food inflation in April was 2.7 percent. The inflation rate also dropped slightly to 5.3 percent year on year—exceeding the PRC government target of a 4 percent annual increase.

Related to inflationary pressure, basic food commodity prices have risen as a result of a severe drought in China that has affected 7 million hectares of farmland. Analysts project that the drought may lead to continued price increases through the end of summer.

The PRC government has taken measures to reduce inflation fears and limit price increases. The PRC Ministry of Commerce in May auctioned 250,000 tons of state sugar reserves to help stabilize commodity prices.

China Conference Calendar

China-related events near you

July–September 2011

Please confirm dates and venues with the organizer prior to attending events. To suggest an entry for the next issue, send an announcement to Julia Zhao (jzhao@uschina.org). You can also post listings and view additional entries on the *China Business Review* website at www.chinabusinessreview.com/conference-calendar.php.

China International Rail Transit Exhibition, August 23–25

China International Consumer Electronics Show

JULY 7–10

Location: Shandong: Qingdao International Convention Center
Organizers: China Chamber of Commerce for Import and Export of Machinery and Electronic Products; Qingdao Municipal People's Government
Tel: 86-532-8197-8693
yan_liu@sinoces.com
www.sinoces.com/en/index.aspx

Hong Kong International Education Expo

JULY 9–10

Location: Hong Kong Convention and Exhibition Center, Hall 3G
Organizer: Neway International Trade Fairs Ltd.
Tel: 852-2561-5566
info@newayfairs.com
www.newayfairs.com/EN/EventFrame.asp?eventID=12

Mobile Payment China

JULY 12–13

Location: Ramada Plaza Pudong Shanghai
Organizer: IGVision International Corp.
Contact: Tina Tian
Tel: 86-21-5161-5300
tina@igvision.com
www.mobilepaymentchina.com

Aluminum China

JULY 13–15

Location: Shanghai New International Expo Center
Organizer: Reed Exhibitions Ltd.
Tel: 86-10-5933-9000
alu@reedexpo.com.cn
www.aluminiumchina.com

China International Building Energy Saving & Renewable Energy Utilization Fair

JULY 21–24

Location: Shandong: Qingdao International Convention Center
Organizer: Qingdao Haichen International Expo Co., Ltd.
Tel: 86-532-8395-1011
qdcese@163.com
www.qdcese.com

China (Guangzhou) International Electric Heating Technology & Equipment Exhibition

AUGUST 11–13

Location: Guangzhou, Guangdong: China Import and Export Fair, Pazhou Complex
Organizers: Guangdong Enterprises Association for Foreign Economic Cooperation; Guangdong Household Electrical Appliances Trade Association
Tel: 86-20-2896-9933/2207-1822
sales7@grandeurhk.com; marketing@grandeurhk.com
www.gehe.cn

Shanghai International Energy-Saving & Advanced Building Materials Exhibition

AUGUST 17–20

Location: Shanghai New International Expo Center
Organizers: Shanghai Building Materials Industry Association; World Expo Group Shanghai Modern International Exhibition Co., Ltd.
Tel: 86-21-6328-8899
kavana@chinamie.com
www.expojc.com/en/index.asp

Bioprocess International China Conference & Exhibition

AUGUST 22–23

Location: Shanghai: Grand Hyatt Hotel
Organizer: IBC Life Sciences
Contact: Rita Parasurum
Tel: 65-6508-2482
rita.parasurum@ibcasia.com.sg
www.ibclifesciences.com/bpichina

China International Rail Transit Exhibition

AUGUST 23–25

Location: Shanghai New International Expo Center
Organizers: China Civil Engineering Society; PRC Ministry of Housing and Urban-Rural Development; Urban Rail Transit Technology Promotion Committee
Contact: Anna Sun
Tel: 86-21-6173-7672
anna.sun@hnzmedia.com
www.hnzcrts.com/en

Control China: Trade Fair for Quality Assurance

AUGUST 23–25

Location: Intex Shanghai
Organizer: PE Schall GmbH & Co. KG
Contact: Hermann Bohle
Tel: 86-21-3218-0566
controlchina@dragon-invest.com
www.control-china.cn/en/index.html

Shanghai International Green Food & Organic Food Expo

AUGUST 23–25

Location: Shanghai New International Expo Center
Organizer: Shibowei International Exhibition Co., Ltd.
Contact: Wendy Wei
Tel: 86-10-8578-5006 x628
foodexhibition11@163.com
www.gnfexpo.com.cn/en/index.html

Electronics Assembly & Packaging Technology Expo

AUGUST 30–SEPTEMBER 1

Location: Guangdong: Shenzhen Convention and Exhibition Center
Organizer: Reed Exhibitions Ltd.
Contact: Jimmy Yang
Tel: 86-21-5153-5155
jimmy.yang@reedexpo.com.cn
www.atexpochina.com/en

Nepcon South China

AUGUST 30–SEPTEMBER 1

Location: Guangdong: Shenzhen Convention and Exhibition Center
Organizers: China Council for the Promotion of International Trade (CCPIT), Electronics and Information Industry Sub-Council; Reed Exhibitions Ltd.
Contact: Chris Qian
Tel: 86-21-5153-5164
chris.qian@reedexpo.com.cn
www.nepconchina.com/nepconsouthchina2010/eng

Government Affairs Forum

SEPTEMBER 1

Location: Beijing: The Capital Club, Capital Mansion
Organizer: PublicAffairsAsia Ltd.
events@publicaffairsasia.com
www.publicaffairsasiaevents.com

Wireless China Industry Summit

SEPTEMBER 1–2

Location: Beijing: Landmark Hotel and Towers
Organizers: InfoEx-World Services Ltd.; Radio Association of China
Contacts: Peter Lee; Isabel Shi
Tel: 852-2865-1118/86-10-6277-1798
peter.lee@infoexws.com; isabel.shi@infoexws.com
www.wirelesschina-summit.com

China Jilin-Northeast Asia Investment & Trade Expo

SEPTEMBER 6–11

Location: Jilin: Changchun International Conference and Exhibition Center
Organizer: PRC Ministry of Commerce (MOFCOM)
Contact: Juan Du
Tel: 86-431-8276-5550
louise@jl.gov.cn
www.neasiaexpo.org.cn

Medtec China

SEPTEMBER 7–8

Location: Intex Shanghai
Organizers: UBM Canon; Shanghai CCPIT Expo Co., Ltd.
Contact: Keith Tsui
Tel: 852-2186-6939/86-21-6135-7160
keith.tsui@ubm.com
www.canontradeshows.com/expo/shanghai10

International Conferences on Active Media Technology & Brain Informatics

SEPTEMBER 7–9

Location: Gansu: Lanzhou University, Feiyunlou Building
Organizers: IEEE Task Force on Brain Infomatics; Web Intelligence Consortium
Contacts: Zhang Xiaowei; Jingzhi Yan
zhangxw@lzu.edu.cn; yanjingzhi@lzu.edu.cn
http://wi-consortium.org/conferences/amtbi11

China International Fair for Investment & Trade

SEPTEMBER 8–11

Location: Fujian: Xiamen International Conference and Exhibition Center
Organizer: MOFCOM
Tel: 86-59-2266-9825
xian@chinafair.org.cn
www.chinafair.org.cn/english/index

China International Exhibition on Financial Banking Technology & Equipment

SEPTEMBER 9–12

Location: Beijing Exhibition Center
Organizer: China Financial Computerization Corp.
Tel: 86-10-6465-0497
cif@ciftee.com.cn
www.ciftee.com.cn/english

China International Optics Fair

SEPTEMBER 14–16

Location: Beijing: China International Exhibition Center
Organizers: China Light Industrial Corp. for Foreign Economic and Technical Cooperation; China Optometric and Optical Association
Tel: 852-2789-3220
orientex@netvigator.com
www.ciof.cn

China International Nuclear Power Equipment Expo

SEPTEMBER 19–21

Location: Beijing: China International Exhibition Center
Organizers: China Energy Sources Association; China Machinery Industry Federation
Contact: Li Shiyou
Tel: 86-10-8586-3245
lsy_zl@vip.163.com
www.cine010.com.cn/en/index

Advanced China Summit on Mergers and Acquisitions

SEPTEMBER 20–21

Location: Shanghai: Le Royal Meridien
Organizer: American Conference Institute
Contact: A. Morgan
Tel: 1-212-352-3220
a.morgan@americanconference.com
www.americanconference.com/chinamanda

International Exhibition on Electric Power Equipment & Technology

SEPTEMBER 21–23

Location: Shanghai World Expo Exhibition and Convention Center
Organizer: China Electricity Council Expo Center
Contacts: Eric Shew; Celine Jiang
Tel: 86-21-5187-9766
www.epchinashow.com

Aviation Expo China

SEPTEMBER 21–24

Location: Beijing: China National Convention Center
Organizers: AVIC International Holding Corp.; China Aviation Industry Corp.; China Aviation Supplies Holding Co.; CCPIT, Aviation Industries Sub-Council; China International Exhibition Group Corp.; China Promotion Ltd.; Commercial Aircraft Corp. of China Ltd.
Tel: 86-10-8773-0641
bj@beijingaviation.com
www.beijingaviation.com/en

China International Small & Medium-Sized Enterprise (SME) Fair

SEPTEMBER 22–25

Location: Guangzhou, Guangdong: China Import and Export Fair Complex, Area A
Organizer: Bureau of China International SME Fair
Contact: Dennis Deng
Tel: 86-20-8313-7628/7636
denis1999@hotmail.com
www.smefair.org.cn/en

Revised Catalogue Brings Few Changes to China's Foreign Investment Regime

Kyle Sullivan, Joie Ma, and Caitlin Clark

Foreign companies will not see significant market access openings as a result of China's draft of the revised Catalogue Guiding Foreign Investment in Industry, updated from the 2007 version and released for comment on April 1, 2011. Despite numerous statements from senior PRC leaders that the revised catalogue would present substantial investment opportunities for foreign companies, the draft retains nearly all the restrictions that have raised concerns among many US companies. Specifically, the draft retains restrictions on investment in many services sectors and imposes new constraints on manufacturing processes in various sectors such as new energy and agriculture. The draft revised catalogue was not yet finalized as *CBR* went to press, however, and PRC regulators may make further revisions to the final version.

Revised catalogue reflects broad economic, industry goals

The draft revised catalogue aims to support China's overall economic and industry policy goals, as outlined in the 12th Five-Year Plan (FYP, 2011–15) and other major policy documents (see p.13). The draft directs more foreign investment toward high-tech and environmental protection sectors—in line with government plans to move industrial capacity up the value chain, create a more energy-efficient industrial base, and foster advanced technology development. In particular, many investments added to the encouraged category appear to fit within China's strategic emerging industries—seven industries the PRC government expects will drive economic growth over the next decade. For example, the draft adds under the encouraged category resource recycling, pollution treatment, and waste processing technologies—key subsectors in the energy efficiency and environmental conservation industry.

The draft lifts few restrictions on investment in new-energy technologies and equipment—also a strategic emerging industry—despite the strong demand for alternative energy sources and technologies needed to meet stringent energy-reduction targets set in the 12th FYP. Moreover, the draft retains most ownership caps on encouraged, large-scale investment projects in new energy that were introduced in the 2007 catalogue.

The draft also includes higher thresholds and more specific technology requirements for investment projects. In many cases, it has increased project approval thresholds for a broad range of catalogue items to promote large-scale production and industry consolidation. These changes show that the government is becoming more selective in the types and scale of investments it seeks to encourage. For example, the catalogue encourages foreign investment in manufacturing key equipment for new-energy power projects that generate at least 3 MW of electricity, up from the 2007 catalogue's 1.5 MW threshold.

The draft also introduces other notable changes from the 2007 version.

Agriculture

The draft expands restrictions on foreign investment in processing of edible soybean and rapeseed oil to include cottonseed, peanuts, and tea seed oil.

Auto and transportation equipment

The draft makes some significant changes to auto assembly and research and development (R&D). The draft

- Removes manufacturing of complete autos and establishment of auto R&D institutions from the encouraged category, though ownership caps and other foreign investment limitations may remain in place;
- Adds manufacturing of special equipment used to produce car batteries to the encouraged category; and
- Adds key components of new-energy vehicles to the encouraged category but restricts foreign ownership to 50 percent of projects that develop key components for new-energy vehicles (previously, no restrictions had been in place).

Chemicals

The draft makes several revisions to the encouraged list of chemical and chemical fiber manufacturing industries and adds new technical requirements for encouraged projects. The draft

- Raises the annual production threshold of encouraged enthylene manufacturing from 800,000 tons to 1 million tons but still limits foreign investment to a Chinese majority-controlled entity;
- Broadens restrictions on manufacturing of paints and dyes that contain harmful materials and use outdated technology; and
- Adds high-performance fluorine resin, fluorine rubber, fluorine-coated materials, fluorinated intermediates for medical use, and environmentally friendly refrigerants and detergents to the encouraged category.

Financial and "modern" services

Despite previous PRC government plans and statements that imply greater opportunities for foreign companies in China's services sector, financial services industries—such as banking, insurance, and securities—remain in the restricted category, with foreign investment in joint ventures (JVs) limited to a minority share. But the draft removes financial leasing from the restricted category and adds venture capital, a sector unmentioned in previous catalogues, to the encouraged category.

Fossil fuels

The draft narrows the scope of encouraged foreign investment in large-scale coal and chemical product manufacturing to coal-based oil, methanol and dimethyl, and olefins—each with varying annual production thresholds. The draft still limits foreign investment to a minority share.

The 2007 catalogue restricted foreign investment in construction and operation of refineries with annual production levels of less than 8 million tons. The revised draft catalogue breaks down this category into oil refineries with atmospheric and vacuum units, catalytic cracking, continuous restructuring, and hydrocracking—each with varying production thresholds.

Healthcare and pharmaceuticals

The draft makes few significant changes to the pharmaceutical and healthcare product manufacturing industries with the exception of permitting wholly foreign-owned medical facilities to operate on a pilot basis. In addition, the draft removes from the catalogue biomedical material and product manufacturing, which was previously encouraged.

Logistics and transportation

The draft removes restrictions on foreign companies engaged in retail and wholesale auto distribution, but foreign investment in freight and passenger train transportation remains restricted.

Media

The draft still prohibits foreign investment in culture-related websites, e-commerce, news, websites, and web-streaming audio-visual services, but it explicitly excludes music-related content from that prohibition.

New energy

The draft maintains ownership caps on new-energy power-generation equipment—including geothermal, methane gas, nuclear, oceanic, solar, and wind power equipment—and limits foreign participation to equity and cooperative JVs. The draft also adds to the encouraged category manufacturing of bearings for wind turbines that generate 1.5 MW of power or more and gear transmissions manufacturing for wind and nuclear power.

Background on the Foreign Investment Catalogue

As the PRC government's long-standing mechanism for managing foreign investment, the Catalogue Guiding Foreign Investment in Industry directs foreign capital to industries the government has targeted for economic development. The government generally places under the catalogue's "encouraged" category sectors in which it aims to accelerate manufacturing and technological development. Sectors on the encouraged list generally benefit from favorable policies such as forms of incorporation, social benefits, and tax incentives. Industries in which government officials believe domestic enterprises may face intense foreign competition—or in which there are already well-established state-owned enterprises—are typically categorized as "restricted" and face stricter policies and investment limitations. Industries that involve natural resources, national security, and traditional Chinese medicine are categorized as "prohibited" and are closed to foreign investment. All unlisted investment types are permitted by default. The revised draft catalogue includes 464 investment types, 350 of which are encouraged, 78 restricted, and 38 prohibited.

—Kyle Sullivan and Joie Ma

New materials

In line with national goals for developing strategic emerging industries, the draft adds to the encouraged category manufacturing of "extreme materials," such as multi-functional windshield glass, and manufacturing and R&D of light-weight, eco-friendly new materials for aviation and aerospace. The draft retains ownership caps on rare earth smelting and separation projects, however, and prohibits foreign companies from mining and extracting rare earth materials.

Special equipment manufacturing

The draft revised catalogue adds pollution treatment and detection equipment and other environmental conservation technologies to the encouraged category, seemingly in line with strategic emerging industry development goals.

Finalizing the catalogue

The US-China Business Council has submitted to the PRC government comments on the revised draft catalogue. When the catalogue will be finalized and issued remains unclear. 完

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Event Wrap Up

BEIJING

April

Breakfast Briefing with US-China Business Council (USCBC) President John Frisbie

Frisbie briefed members on meetings with PRC government officials, updates from Washington, DC, and the state of the US-China commercial relationship.

Luncheon Honoring US Ambassador Jon Huntsman

USCBC, the American Chamber of Commerce (AmCham) in China, and the US Information Technology Office co-hosted a luncheon honoring outgoing Ambassador Huntsman, who spoke about the future of US China commercial relations. Huntsman left his post as the US ambassador to China on April 30.

Briefing with US House Representatives

USCBC and AmCham-China co-hosted a breakfast briefing with US House Representatives Rick Larsen (D-WA) and Charles Boustany (R-LA), co-chairs of the US-China Working Group. The representatives were part of a delegation that visited China to discuss security issues and military-to-military relations.

June

China Operations Conference

See p.16.

ONLINE

May

Webinar on M&A in China

Barry Chen, director of M&A advisory for InterChina Consulting, and Bing Ho, a partner with Baker & McKenzie in Shanghai, discussed how companies can use M&A to augment their growth in China.

PALO ALTO, CALIFORNIA

April

Luncheon on Current Issues in US-China Trade

Frisbie, Morrison & Foerster Partner Charles Comey, and Bay Area Council China Committee Co-Chair Dick Kramlich spoke about the US-China commercial relationship at a luncheon hosted by the three organizations.

SHANGHAI

April

Luncheon on Collective Bargaining

George Qi, shareholder at Greenberg Traurig, LLP's Shanghai office, discussed current trends in collective bargaining and labor relations and implications for companies.

May

Luncheon on China's Demographic and Urbanization Revolution

Jeff Walters, principal at the Boston Consulting Group's Shanghai office, discussed how demographic and urbanization trends in China will affect corporate decisionmaking across business functions.

June

Luncheon on the PRC Social Insurance Law

Susan Deng, registered foreign lawyer at Mayer Brown LLP, and John Domeika, president and CEO of WellPoint, Inc., discussed the law and how it may affect employee benefit packages.

ST. LOUIS, MISSOURI

June

Luncheon on Current Issues in US-China Trade

USCBC Vice President Erin Ennis and USCBC Shanghai Chief Representative Julie Walton discussed the operating environment for US companies in China and recent developments in US-China trade politics.

WASHINGTON

April

Briefing on Mergers and Acquisitions (M&A) and Antitrust Rules in China

Leon Greenfield, partner at Wilmer Cutler Pickering Hale & Dorr LLP, and Michael Han, partner at Freshfields Bruckhaus Deringer LLP, discussed new security review rules for foreign M&A and their impact on foreign companies in China.

US Secretary of the Treasury Timothy Geithner discusses US-China relations with the *Atlantic's* James Fallows at a May 3 event hosted by the US-China Business Council (USCBC) in Washington, DC.

USCBC President John Frisbie meets with PRC Vice Premier Wang Qishan at a dinner on May 10 following the US-China Strategic and Economic Dialogue.

Briefing on the US-China Investment Forum and the Strategic and Economic Dialogue (S&ED)
USCBC, the Coalition of Service Industries, and the US Chamber of Commerce hosted a briefing on the US-China Investment Forum and a preview of the S&ED. The briefing included senior officials from the departments of Commerce and Treasury and the Office of the US Trade Representative (USTR).

May

A Conversation with US Treasury Secretary Timothy Geithner on the S&ED
The Atlantic National Correspondent James Fallows led a discussion with Geithner on US expectations for the S&ED. The event, hosted by USCBC, was open to the public and members of the media.

Briefings on Congressional Delegations to China
USCBC hosted US Representatives Larsen and Boustany for a briefing on meetings during the US-China Working Group's trip to China. The delegation met with PRC officials, including Vice Premier Wang Qishan, to discuss economic and security issues. Mike Castellano, Majority Leader Harry Reid's (D-NV) counsel and senior policy advisor on trade, also briefed USCBC members on the Senate delegation's trip to China. The delegation, led by Reid, visited Beijing, Hong Kong, Macao, and Chengdu, Sichuan, and discussed economic issues with PRC officials.

Briefing on US-China Innovation Dialogue
USTR officials briefed USCBC members and other industry representatives on the US-China Innovation Dialogue. The discussion covered US and Chinese approaches to innovation, including implementation of indigenous innovation commitments made by PRC President Hu Jintao during his January visit to the United States.

US-China Environment, Health, and Safety Briefing
Managers from the Institute for Sustainable Communities discussed their work with Chinese partners to establish the Environment, Health, and Safety Academy at Lingnan University in Guangzhou, Guangdong, and opportunities for company involvement.

USCBC's 38th Annual Membership Meeting
See p.16.

June

USCBC Board of Directors Meeting
US Secretary of State Hillary Rodham Clinton and House Ways and Means Chair Dave Camp (R-MI) met with USCBC's board of directors during its semiannual meeting to discuss bilateral relations and trade issues. The directors reelected Coca-Cola Co. Chairman and CEO Muhtar Kent as chair of the board.

Upcoming Events

WASHINGTON, DC

Intellectual Property Rights (IPR) Update with Chinese IPR Attaché Chen Fuli
July 8, 2011

Gala 2011
December 7, 2011

For more information on USCBC or its events, visit www.uschina.org.

Briefing on China Tax and Regulatory Issues
Lilly Li, partner at KPMG Advisory (China), discussed PRC tax and regulatory compliance, tax incentives, transfer pricing, and other tax issues that affect companies operating in China.

Jin Peng

USCBC Vice President of China Operations Bob Poole speaks to outgoing US Ambassador to China Jon Huntsman at a luncheon honoring Huntsman's service.

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Frisbie and USCBC Chair and Coca-Cola Co. Chairman and CEO Muhtar Kent speak to US Secretary of State Hillary Rodham Clinton at USCBC's board meeting on June 1.

Speakers Discuss Economic and Political Trends at USCBC Annual Membership Meeting

US-China Business Council (USCBC) members met May 31 for the 38th Annual Membership Meeting in Washington, DC. Speakers discussed economic, political, and labor trends, as well as China's operating and government affairs environment.

Ellen Hughes-Cromwick, chief economist at Ford Motor Co., provided an update on economic trends in China. The conference included a panel discussion on China's operating and government affairs environment with Roger Lindsay, president of Rail and Latin America at the Timken Co.; Devry Boughner, director of International Business Relations at Cargill, Inc.; and Jennifer Thompson, senior vice president of Crisis, Issues, and Risk at Edelman. The panelists shared their experiences and advice for building operations in China. Dana Shay, senior consultant at Towers Watson, discussed human resources trends and best practices. Bruce Dickson, professor of Political Science and International Affairs at George Washington University, discussed the implications of China's upcoming 2012 leadership transition.

The program concluded with a keynote address on US-China relations from Michael Froman, deputy national security advisor for international economic affairs and deputy assistant to the president.

Members gather at the St. Regis for the annual meeting in Washington, DC, to learn about key issues facing companies in China.

Deputy National Security Advisor for International Economic Affairs Michael Froman delivers the keynote address at USCBC's annual meeting.

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Ford Motor Co. Chief Economist Ellen Hughes-Cromwick speaks about economic trends in China.

USCBC President John Frisbie discusses the China operating environment with Timken Co.'s Roger Lindsay, Cargill Inc.'s Devry Boughner, and Edelman's Jennifer Thompson.

USCBC Hosts Beijing China Operations Conference

USCBC hosted its annual China Operations Conference in Beijing on June 2. Key US and PRC government officials and industry representatives addressed economic and political trends, labor and human resources best practices, and other operating and policy challenges for foreign businesses in China.

Kong Linglong, director general of foreign investment and outbound investment utilization at the PRC National Development and Reform Commission, updated USCBC members on investment-related policies and regulations. Chang Xiaocun, director general of the PRC Ministry of Commerce's Market Supervision Department, discussed China's special intellectual property rights (IPR) campaign and government efforts to combat IPR infringement. Robert Wang, chargé d'affaires at the Embassy of the United States, delivered the luncheon address.

In addition, industry representatives discussed supply chain issues, human resources challenges and China's labor law, social media and public relations, strategies for tapping inland and lower-tier markets, and best practices for protecting IPR in China.

When the World's Factory Hikes Prices

Julie Walton

US-based executives have been streaming into Shanghai for global strategy meetings this year. Because China is increasingly the market in which US-China Business Council (USCBC) member companies see significant growth—more than 90 percent of membership survey respondents said that the China market was a top priority for their company last year—executives meet here to see what dynamic economic growth looks like in practice.

I often speak to these groups about China's operating environment. Despite the diverse composition of the company delegations, the executives often ask similar questions:

- How well are other US companies performing in China?
- How serious are rising costs and inflation in China?
- Because of rising cost, are companies relocating investments to interior provinces, or even to other countries?

Though USCBC does not have a crystal ball, the increased availability of market-focused information and the generosity of USCBC members in sharing their own experiences make it easier to identify trends in China's business environment for executives.

Past performance and future prospects

Most USCBC members tell us their China sales outpaced their global sales in 2010, and first quarter 2011 numbers indicate that companies may be on track for a repeat performance. Because China plays a big role in certain business units' overall profitability, some companies are relocating senior management of those units to China, often to Shanghai. Many of these business units have already experienced tremendous growth in emerging markets, especially in China, and thus want to run their businesses from the place of greatest growth. Many companies are also developing new products for the China market and exploring ways to leverage China as an incubator of ideas for products that can be sold in other emerging markets.

Of course, market expansion in China is never guaranteed, and the question of rising costs seem to weigh heaviest on executives' minds as they consider their companies' future in China.

How much?

The costs of various materials and business factors—from iron ore to human resources—are rising in China, and companies are feeling the pinch. Minimum wages in Beijing have increased almost 21 percent since last year, and wages in Tianjin and Shandong have each risen 26 percent (albeit from low levels). Many companies have told USCBC that they have had to raise white collar salaries roughly 20 percent recently to stay competitive. Fuel costs have also risen, affecting logistics and supply chains. And China's consumer price index inflation in the first quarter of 2011 rose nearly 5.5 percent, surpassing the central government's official goal of 5 percent. China is no longer a low-cost environment for many primary inputs, and companies must rebalance corporate expectations about costs and new investment to better match China's economic conditions with company plans for regional growth.

Given that most USCBC companies have invested in China to serve the China market, relocation to other areas—especially to Southeast Asia or India—is difficult. Therefore, companies are thinking more critically about managing expansion and new investment throughout the region. One executive noted that if China accounts for less than 50 percent of a product's sales, the company adds new capacity to its facilities in India instead of China. According to this executive, India is a less expensive manufacturing option for their product segment when China is no longer the primary sales market.

Meanwhile, many companies are considering moving inland. USCBC sources suggest that companies often move to China's interior provinces to tap new markets in addition to seeking lower costs. Though Foxconn Technology Co., Ltd. acknowledged that lower labor costs played a role in its decision to open plants in Anhui and Chengdu last year, HSBC Holdings plc's opening of branches in Chengdu and Chongqing to expand its customer base a few years ago is more typical of most companies' desires.

USCBC members tell us that, depending on industry and business needs, China's central and western regions might not be less expensive than the coast once costs related to transportation networks, proximity to supply chains, and talent recruitment are taken into consideration. At the same time, most companies that are "in China for China" will need to consider westward expansion at some point since demographic and urbanization trends, along with central-government policy goals, indicate that China's interior will be the next "emerging market."

All of this suggests that smart companies should carefully evaluate their cost structures and regional options when plotting future investment and growth trajectories in China. Untapped cost efficiencies may ultimately be the most significant approach to dealing with rising input prices and an increasingly competitive domestic market. 完

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China Foto Press

Young Chinese, who have more discretionary income and brand awareness, will become the main body of consumers in the next decade.

Understanding Chinese Consumers

Older consumers may value price over quality, but younger generations are increasingly willing to pay premiums for higher-end products.

Yujun Qiu

Since China started its "reform and opening" policy in 1978, its economy has expanded rapidly, and most leading international retailers and manufacturers have entered the China market. Some foreign companies are hesitant to enter the market, however, because they do not understand Chinese consumers and their shopping habits. Despite the country's rapid economic rise, China's regions have developed at different rates, and consumer trends vary greatly among different groups and regions. Understanding the preferences and mindset of consumer groups is the key to successfully expanding a retail business in China.

Chinese consumer groups

In the past three decades, Chinese consumers' shopping habits have changed dramatically as incomes have risen and new products and concepts have entered the China market. Consumer habits continue to evolve today, and examining generations of consumers can reveal certain shopping trends. Planet Retail has found that the older generation generally maintains "traditional" spending habits, middle-aged Chinese oscillate between tradition and new trends, and the younger generation is becoming more Westernized and quality conscious.

Generally, Chinese consumers develop shopping habits in their youth and keep these habits through adulthood. Though increased wealth can change some preferences, such as beverage and snack food preferences, most Chinese consumers' habits are identified by their objective living conditions and limited earnings. The current Chinese consumer population can be separated into several groups with distinguishing characteristics.

Quick Glance

- Most older shoppers in China are frugal, but the new generation of consumers is willing to pay more for high-quality and foreign brands.
- As incomes rise, Chinese consumers will spend more on nonessentials, such as cosmetics, snack foods, and toys.
- Successful retailers in China must understand consumers' changing tastes and sensitivity to packaging, price, and product safety.

Frugal retired

Born before 1960, most of these Chinese consumers grew up in tough political and economic times, did not receive systematic education, and worked at state-owned enterprises. The difficult environment during their early lives made these individuals frugal and sensitive toward changes in consumer goods prices.

Wealthy retired

This group experienced difficulties similar to the frugal retired consumers, but wealthy retired individuals primarily worked in government and government-funded enterprises that provided higher wages and better retirement benefits. Though many of these consumers are frugal, they are less price-sensitive and often value quality more than cost.

In the next 5–10 years, spending habits of Chinese consumers who are older than 50 will change slightly. These consumers will increase spending on groceries as the government raises retirement pensions in line with inflation rates. Though they will consume healthcare and entertainment products, their children will likely buy these products for them.

Frugal forties

These consumers, who grew up during the Cultural Revolution (1966–76) and early stage of the reform era, swing between tradition and new trends. They work in various companies—state-owned, private, and foreign-invested—and earn modest incomes. These consumers generally save a large proportion of their earnings to take care of their children and parents.

Wealthy forties

These consumers share the same background as the frugal forties, but they work for the government or large state-owned enterprises and have slightly higher incomes. Though they must also raise children and look after their parents, they are willing to pay premiums for quality products.

In the next decade, consumers in their forties will have fewer childcare responsibilities and expenses. These consumers will thus increase spending on entertainment, groceries, travel, and high-quality and healthcare products.

Thirties

Many consumers in this group are well-educated and grew up in a more open environment than their parents. Compared with older generations, Chinese in their thirties save less, spend more on entertainment, and often shop online. They also pursue value and quality rather than low prices. These individuals will become the most important consumers in the next decade, buying for their parents, children, and themselves.

Twenties

Consumers in the first generation of the one-child policy have opposite shopping habits from their parents. These consumers barely save and spend most of their income on entertainment, advanced electronics, and other trendy products. They often shop online and look for products that help distinguish their personalities. They can also be impulse buyers. As consumers in their twenties age and start new families, their shopping habits may become slightly more conservative, though they will still favor high-quality and convenient products and spend more on groceries than previous generations.

New generation

The new generation of consumers (under the age of 20) is the most Westernized and open to new products. These consumers pursue individualism and often use the Internet to follow global trends. Though most in this group do not yet earn an income, they significantly influence their parents' decisions on food, clothing, electronics, and other purchases. Social media is an effective marketing tool to reach this group of consumers (see the *CBR*, January–March 2011, p.28).

Migrant workers

Migrant workers (generally 25–45 years old) are rural residents who moved to the cities for jobs starting in the 1990s. They can be even more frugal than elderly consumers, buying only the necessities and saving money to send remittances to their families in rural areas. Many migrant workers are expected to see a big increase in incomes and move their families to the cities in the future. They will significantly increase spending on groceries once they receive city household registration, or *hukou*, status and fully integrate into city life. Migrant workers' consumption levels are unlikely to match that of their urban peers, however.

The rich

There are more than 1 million Chinese with assets over \$1.5 million, and the number is increasing rapidly. Rich consumers (generally 20–60 years old) are fairly concentrated in large urban areas, with Beijing, Guangdong, and Shanghai housing about half of this group. These individuals are successful entrepreneurs, top managers, and business owners. They pursue the best products available, particularly imports, and are the perfect candidates for marketing new products. Premium supermarkets have already emerged in China to provide high-quality products to wealthy consumers (see p.22).

Fast-growing consumer product categories

As incomes increase and the young generation becomes the main body of consumers, the Chinese will gradually turn from buying only basic necessities to leading comfortable, high-quality lifestyles. Planet Retail expects the following consumer product categories to expand rapidly in the next 5–10 years.

Toys

The younger generation of parents is more willing than older generations to pay for toys. New parents tend to buy Western brands for their children, as they perceive those toys to be safer than Chinese ones.

Convenience foods

The young generation spends significantly less time cooking than their parents and instead turns to restaurants and convenience foods, such as microwave meals and instant noodles. Many Chinese do not consider Western convenience food appetizing, though it is generally easier to prepare than Chinese convenience food. Many local companies are researching how to make Chinese food more convenient.

Pet products

Many Chinese consumers own pets—mostly cats and dogs—but few spend money on pet products, such as food and toys. Instead, they make these items at home. The new generation, however, is wealthier and has less time to make "do-it-yourself" products. As this generation ages, the consumption of pet products will rise.

Personal care products

The consumption of personal care products in China remains low, but this market has great potential for growth. For example, most Chinese men do not wear cologne and most Chinese buy shampoo without conditioner. As incomes increase, more Chinese consumers will be able to afford non-essential personal care products—especially cosmetics and men's personal care products.

Wine and whisky

Wine and whisky have broken traditional alcohol preferences in China, as the young generation seeks alternatives to strong traditional spirits, such as *baijiu* (see p.24). Wealthy consumers often flaunt their status by drinking high-end wine while lower-income consumers drink local beer. Though traditional alcoholic drinks will

Figure 1: Grocery Store Preferences of Chinese Consumer Groups,* 2010

	Wet markets	Hypermarkets	Supermarkets	Convenience stores	Premium supermarkets	Online stores	Specialty stores	Shopping malls	Department stores
Frugal retired (>50 years old)	5	4	2	0	0	0	0	1	3
Wealthy retired	4	4	3	1	1	0	1	4	4
Frugal forties	5	4	2	0	0	0	0	4	3
Wealthy forties	4	5	3	2	1	0	1	4	4
Thirties	2	5	4	3	2	3	3	4	2
Twenties	1	4	3	4	3	5	3	4	1
New generation (<20 years old)	1	4	3	4	3	5	2	4	1
Migrant workers (25–45 years old)	5	3	1	1	0	1	0	1	3
The rich (20–60 years old)	1	2	3	3	4	1	3	4	1

*Based on a scale of zero to five, with five being the highest likelihood that the consumer will shop at the store.
Source: Planet Retail

still dominate the China market in most places, big cities and their young wealthy consumers will contribute to a fast rise in wine and whisky sales.

Snack foods

The young generation will spend more than their parents on snacks for themselves and their children. Traditional Chinese snacks, such as roasted sunflower seeds and dried sweet potatoes, are generally made by small local factories. But recent food and product safety scares have led some Chinese consumers to view food products made by such factories as unsafe or unclean. The market for Western snack foods, such as chocolate products and potato chips, will expand as young consumers fancy these snacks more than traditional Chinese ones (see p.28).

Health food and products

Though health food and products are still generally expensive, Chinese consumers are paying more attention than ever to their health. Most elderly and low-income Chinese consumers turn to natural solutions and Chinese herbal medicine while younger and wealthier consumers often look to Western products, which are generally pre-prepared.

Baby products

Older generations raised their babies with self-supplied products—such as cotton diapers and homemade baby food—but younger generations will rely on disposable diapers and canned baby food. New parents and grandparents hope to buy the best products possible for their children, especially given recent food safety concerns. For example, after the Sanlu Group melamine-tainted milk incident in 2008, most parents interviewed said they no longer trusted local brands of infant formula and would buy imported brands if they can afford them. In addition, many new parents will turn to Western baby products because the variety of traditional Chinese baby products is limited. Many young parents are already buying baby products online from US and European producers.

Auto products

Personal car ownership in China remains low but is rising quickly. Many Chinese consumers cannot afford expensive cars, but they will spend money on products—such as cushions, gadgets, and tinted window films—to improve their cars' appearance. In addition, short car trips are gaining popularity as many Chinese drive out of the city on weekends for picnics, hikes, and other leisure activities. As a result, consumption of related products, such as disposable silverware and convenience food, will also rise.

Products for the elderly

In the next 5–10 years, China's population of senior citizens will reach 250 million, close to the entire population of the United States (see the *CBR*, April–June 2011, p.32). Though these elderly consumers' incomes will not increase significantly, their children will look after them and buy them health food and elderly care products.

Mid-range products

Because of high consumer demand for low prices, many retailers in China stock cheap products and have little space for mid-range or high-end items. Though retailers have tried to fill the gap with private labels, few have done so successfully. Consumers are concerned about the safety of cheap goods and are willing to pay slightly more for safe food products, but many shoppers think the private labels and other mid-range products they have tried are not

Figure 2: Food Product Preferences of Chinese Consumer Groups,* 2010

	Fresh produce	Packaged food	Convenience food	Health food	Organic food	Private labels	Environmentally friendly products
Frugal retired	5	1	1	3	0	3	0
Wealthy retired	5	2	2	4	1	2	1
Frugal forties	5	1	1	3	0	3	0
Wealthy forties	4	2	2	4	1	2	2
Thirties	3	3	4	3	1	2	2
Twenties	3	4	4	2	1	1	2
New generation	2	5	4	2	1	0	2
Migrant workers	5	2	2	1	0	2	0
The rich	3	3	2	4	4	0	2

*Based on a scale of zero to five, with five being the highest likelihood the consumer will buy the product.
Source: Planet Retail

Choosing the Right Retail Format

Before China opened its market to foreign investment, commodity availability was limited. Department stores, state-owned distribution points, and wet markets dominated the retail market. International retailers were allowed to enter the market in 1992, but only if they held a non-controlling stake in a joint venture with a local company. Today, China has a wide range of retail formats, from hypermarkets and shopping malls to wet markets and online stores. Choosing the right format can be critical to business success.

Hypermarkets and shopping malls

Hypermarkets generate a steady cash flow for retailers and are popular with Chinese consumers, who like to spend time shopping with their families on weekends. Hypermarkets that include a shopping gallery with specialty stores and restaurants are particularly popular. As a result, many operators in this channel tend to build large shopping complexes with hypermarkets as their anchors and invite clothing retailers, restaurants, and entertainment operators to create a small shopping mall.

Hypermarkets will continue to be successful in China. Though Chinese incomes may increase significantly, consumers will still opt to buy groceries at hypermarkets because of the low prices and one-stop shopping experience. As urbanization continues, hypermarkets will find new opportunities in smaller emerging cities, and an increasing number of big box chains may emerge.

Supermarkets

Ordinary supermarkets are fairly unprofitable in China because they face fierce competition from hypermarkets and wet markets. Wealthier Chinese cities are saturated with supermarkets, but consumers in smaller towns are often too poor to support a profitable supermarket chain.

As the number of wealthy consumers rises in first- and second-tier cities, a demand for better quality lifestyles has emerged. These affluent consumers favor imported products, which are associated with high social status and a more leisurely lifestyle. Though most Chinese shoppers perceive hypermarkets as the place to find bargains, premium supermarkets, which offer more high-quality and imported products, are expanding rapidly in larger cities. Premium supermarkets are likely to open near high-end office buildings and in shopping centers in central locations and affluent residential areas. Many local retailers—such as Beijing Hualian Department Store Co., Ltd. and China Resources Enterprise, Ltd.—have already started testing this retail format.

Convenience stores

Some larger cities—such as Beijing; Guangzhou, Guangdong; and Shanghai—are saturated with convenience stores. Planet Retail expects that consumers in rapidly expanding second-tier cities will also accept convenience over low prices soon.

Most local convenience store chains operate as small supermarkets with fewer stock-keeping units, higher prices, and no fresh produce. Modern convenience stores are likely to develop in second-tier cities, but they face high rent and competition from local "mom and pop" stores. It will take time before a convenience store chain can increase in scale, build an efficient supply chain, and become profitable.

Foreign companies are looking to tap the expanding convenience store market. For example, Japan's FamilyMart Co., Ltd. has announced plans to move from Shanghai to other first- and second-tier cities—such as Chengdu, Sichuan, and Hangzhou, Zhejiang—this year. The retailer aims to operate 8,000 stores in China by February 2021, up from 600 stores currently.

Shopping malls

Hypermarket and department store operators have taken advantage of the popularity of their brand to develop freehold shopping malls, leasing the remaining space to complementary retailers. International and local retailers have announced plans to open more shopping malls in first-, second-, and third-tier cities. For example, Japan's AEON Co., Ltd. has announced plans to operate 10–15 shopping malls in China by 2015. The retailer is also looking to open outlets in smaller cities where there is more space on centrally located streets. In general, more shopping malls are likely to open in suburbs of major cities.

Neighborhood stores

Neighborhood stores, located in populous areas, are similar to small supermarkets. They sell more groceries than convenience stores but charge more than hypermarkets. Typical neighborhood stores include Wal-Mart Stores, Inc.'s Smart Choice and Tesco plc's Tesco Express. These stores enjoy moderate sales but still operate at a loss because of their small scales of operation and inefficient supply chains. As incomes rise, however, more Chinese shoppers are expected to buy products from neighborhood stores for convenience than from hypermarkets.

Discount stores

This format should theoretically be popular among Chinese consumers, but private labels have yet to gain consumer acceptance—a prerequisite for this retail channel's growth. Discount stores are unlikely to thrive in China in the short term.

Online stores

Roughly 8 percent of the Chinese population currently shops online, and the e-commerce market reportedly totaled ¥263 billion ($40 billion) in 2009 (see the *CBR*, January–March 2011, p.22). Online grocery stores are still developing, however, and most of their sales come from consumer-to-consumer platforms, such as Taobao. Online grocery stores face several obstacles, such as poor distribution networks, competition from hypermarkets and supermarkets, impersonal shopping experience, poor online store design, higher prices, and limited product options.

Despite these difficulties, the online grocery sector in China can be successful, particularly as the population becomes more affluent. Younger city dwellers are willing to pay a fee for delivery as they have less time to grocery shop. Retailers must be willing to make an upfront investment to improve the look and range of their online merchandise, advance their supply chain, and shorten delivery times to meet consumer needs.

—Yujun Qiu and Julia Zhao

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worth the premium prices, according to a 2009 China Chain Store and Franchise Association survey. Retailers must use effective marketing, accurate pricing, and consistent quality to build trust among consumers and sell more higher-priced items.

Tips for retailers in China

Foreign companies must understand certain factors to successfully sell to Chinese consumers.

Some consumer habits can change

Wine provides the best example of changing Chinese consumer habits. Spirits once dominated China's alcohol market, but wine consumption has skyrocketed in the past decade. Many Chinese consumers now prefer wine because it is less potent than spirits, less bitter than beer, and promoted as a healthy drink.

In contrast, some companies have had to adjust their products to better suit Chinese tastes. For example, McDonald's Corp. tried to promote its beef burgers when it first entered China in 1990. After realizing that chicken and pork are more popular in China, the company adapted to consumers' unchanging habits and launched a menu of chicken burgers.

"Face" matters

Chinese greatly value "face"—a quality associated with dignity, honor, and pride—and will pay more to save face. For example, when purchasing gifts for important friends and family during Chinese New Year, consumers generally buy gifts that are of the appropriate value for the receiver and pay particular attention to product packaging. Consumers that cannot afford a higher-quality gift will buy the product with the nicest packaging within their price range. In addition, consumers will pay more for gifts with fancier packaging, even if the product is of equal quality to a less expensive item.

Chinese consumers generally favor foreign brands

Product safety incidents and lax government supervision have scared Chinese consumers away from certain domestic products. Consumers will often pay a premium for foreign brands to ensure quality, particularly for important items such as infant formula. To increase their products' appeal, many Chinese companies register an office in the United States or Europe and brand their products as "foreign." This has made it increasingly difficult for consumers to discern domestic from foreign brands, and they thus turn to famous and leading brands instead. Foreign companies should devote resources to ensure Chinese consumers know their products' true origin.

The biggest change in Chinese consumer behavior comes from the young generation's rising wealth and increasingly Westernized lifestyle.

Small discounts are better than none

Many Chinese consumers, particularly elderly shoppers, wish to save as much as possible. Retailers, especially hypermarkets, often cut prices of basic produce and price-sensitive items, such as eggs, pork, seasonal products, and local specialties. Retailers limit the amount of those products consumers may buy at a time to encourage shoppers to visit the stores more frequently. These types of promotions have proven effective as many Chinese consumers are willing to wait for half an hour to save on a particular item.

Product safety mistakes can be devastating

Food and product safety problems exposed in the media can strongly influence Chinese consumers. For example, media reports in March revealed that clenbuterol, a drug that accelerates growth, was found in pork from the Shuanghui Group, a local leading pork manufacturer. The following month, Shuanghui's retail sales dropped 45 percent, and many consumers interviewed would not buy its products.

Pricing is a sensitive issue

Pricing a foreign brand in China can be tricky. On one hand, Chinese shoppers believe the higher the price, the better the quality or the higher the status. If a foreign brand is priced lower than a local one, shoppers may suspect that it has defects. On the other hand, the premium Chinese consumers are willing to pay varies by product category and by consumer groups. For example, Planet Retail finds that young shoppers are willing to pay double for foreign-branded infant formula or five to seven times more for foreign bottled mineral water, but older consumers are not. Most modern retailers in China implement a high-low pricing policy. To create a low price image, hypermarkets and supermarkets price frequently purchased products low to match and compete against rivals while charging a premium on impulse purchases and other price-insensitive products.

Understand the government

Foreign players have found China's complex legislative and political system difficult to navigate, especially if they

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Women are embracing wine because it reflects their aspirational lifestyles and is considered healthier than many other alcoholic beverages.

Opportunities in China's Alcoholic Beverage Market

Led by an expanding base of female drinkers and health-conscious consumers, China's wine market is taking off.

Saritha Pingali

China's unprecedented economic growth has led to increased disposable income, which has caused a rise in consumption and changes in eating and drinking habits. In terms of the country's alcoholic beverage market, many consumers could afford only locally made alcoholic drinks prior to the economic boom. But the rise of China's middle class and increases in discretionary income have allowed many consumers to afford foreign-made and foreign-branded alcoholic beverages.

Changing social and cultural factors have also strengthened the potential of China's alcoholic beverage market. China's expanding pub culture has offered more avenues for people to consume alcohol. In addition, a rise in the number of women who consume alcohol—especially wine—has expanded the China market. Overall, Chinese consumers are increasingly willing to try new varieties of alcoholic beverages.

To successfully tap China's alcoholic beverage market, companies must overcome certain obstacles. For example, companies must determine how to alter or market their products to appeal to Chinese consumer tastes and increasing health concerns. They must also maneuver through a changing regulatory environment. Companies that closely track market developments are on the path to success.

Drinks of choice

Grain-based alcohol used in spirits is the earliest known alcohol found in China. To this day, grain-based alcohol, such as *baijiu*—a high-strength alcohol typically made from sorghum, rice, wheat, or barley—is most commonly served during traditional occasions, such as holidays and formal events. Being the traditional (and indeed, the national) drink of China, *baijiu* accounts for almost the entire spirits market. For most Chinese men, it is strength that qualifies an alcoholic beverage as a "man's drink." This explains why *baijiu*, which typically has alcohol by volume (ABV) of 50–60 percent, remains the preferred drink among Chinese men during private and business drinking occasions.

In recent years, beer, hard cider, and flavored alcoholic beverages (FABs, which are sweet, relatively low-alcohol content beverages such as wine coolers) have dominated the Chinese alcoholic beverage sector, however, accounting for roughly 90 percent of the market's sales by volume in 2009 and 2010. Standard lager is the preferred beer in China, but sales of low- and no-alcohol beers are rising faster than those of lager.

Spirits and wine share the remaining 10 percent of China's sales volume, with spirits contributing the larger proportion, according to Datamonitor Group's Market Data Analytics (MDA). In terms of spirits, *baijiu*, brandy, whiskey, and vodka have the highest sales volumes. Recently, an expanding elite consumer segment in China has boosted sales of premium spirits such as whiskey. Datamonitor estimates that whiskey sales will increase by 24 percent in the next five years. Rising demand for premium whiskey is also prompting companies such as Diageo plc to boost its sales through exclusive retail stores in upscale areas of major Chinese cities. The sales volume of brandy and rum may rise twice as fast as the overall alcoholic beverage sector until 2015, and gin and tequila may also experience a surge in demand.

Wine has recorded big increases in sales volume growth rates, with a 32 percent jump during 2008–09 and an estimated 24 percent jump during 2009–10. In comparison, the sales volume of China's beer, cider, and FABs market and spirits market expanded about 6 percent and 3 percent, respectively, during 2008–09 and 2009–10. Red wine contributes nearly 62 percent of total wine sales by volume, and white wine contributes another 38 percent.

Globally, China ranked first in overall alcoholic beverage sector sales volume in 2009 (see Figure 1). The country's beer, cider, and FABs market was the largest globally in terms of sales volume that year, according to MDA data. China's fast-growing wine market ranked ninth globally in terms of sales volume. According to Datamonitor estimates, the rankings were similar in 2010.

Quick Glance

- China's alcoholic beverage market is changing; more consumers are venturing beyond domestic beer and *baijiu* and trying foreign wine and spirits.
- Middle-class consumers and women are leading the purchasing trends.
- Foreign companies must evaluate how to market or alter their products for the China market.

Consumption drivers

Over the past decade, several economic and social changes have driven rapidly increasing market volumes in China's alcoholic beverage market.

Economic boom

The country's fast-paced economic development has led to rapid urbanization and changes in beverage consumption. For example, many middle-class consumers were able to afford only local alcoholic beverages—primarily beer and *baijiu*—prior to China's recent economic boom. The boost in income has enabled Chinese consumers to buy more expensive types and brands of alcohol—including foreign. It has also enabled consumers to go out more, which has led to the development of more pubs in China. Furthermore, an increasing number of big-city consumers with rising incomes are embracing wine, which many Chinese consider a fashionable Western drink.

Government regulation

Though alcohol consumption has long been considered an integral part of China's traditions, it has also gone through several periods of government regulation. Chinese history reveals that laws against wine production were enacted and repealed 41 times between 1100 BC and 1400 AD.

In the late 1980s and 1990s, the PRC government took measures to promote responsible and healthier drinking habits among Chinese consumers and reserve more grain for food consumption by encouraging fruit-based alcohol instead of grain-based alcohol. The government launched campaigns to encourage the consumption of grape wine and beer rather than stronger grain-based *baijiu*. In the late 1990s, the government also increased the tax rate for imported spirits, limited the import of high-strength alcohol into China, and refused to extend new production licenses for domestic and foreign spirits manufacturers—leading to a decline in China's spirits market during that period. China's 2001 World Trade Organization entry led to reduced import duties on foreign alcohol, and rising consumer demand led to increased imports and sales of imported spirits and wine.

Female consumers

China's wine market sales are looking stronger than ever, with the sales volume projected to increase at a compound annual growth rate of 14 percent from 2009 to 2014. Increased consumption among female consumers is fueling this strong growth.

Though it is socially acceptable for men to consume high-strength alcohol, the concept of women consuming high-strength alcohol such as *baijiu* is still not fully accepted in Chinese culture. Changing social conditions in recent years have led to the wider acceptance of drinking among women, however. Datamonitor has found that gender roles have been blurring, and women and men are more equally attending events and participating in drinking in most social occasions in China. Moreover, the new generation of working women in China is socially compelled to consume alcohol to stay "equal" in the eyes of their male colleagues. Female consumers' financial independence may also explain the rise in alcohol consumption among women, particularly in the past five years.

Within the alcohol sector, Chinese women appear to have primarily embraced wine, largely because it reflects their aspirational lifestyles. In addition, many consumers believe that drinking wine is good for one's health and that it promotes beautiful skin. Wine manufacturers may find the fast-growing consumer base of women wine drinkers interested in pre-mixed drinks and fruit-based alcohols as well.

Sector challenges

Health and safety concerns

Given the country's preference for high-strength *baijiu*, health and safety issues associated with alcohol are a concern. In the last 10 years, China's alcohol consumption patterns have changed dramatically, from strong demand for the highly potent *baijiu* to the increased popularity of low- or no-alcohol beer. According to MDA data, between 2000 and 2009, the per capita consumption of low- or no-alcohol beer increased by 11 percent a year, compared to an annual increase of 7 percent for alcoholic beverages overall.

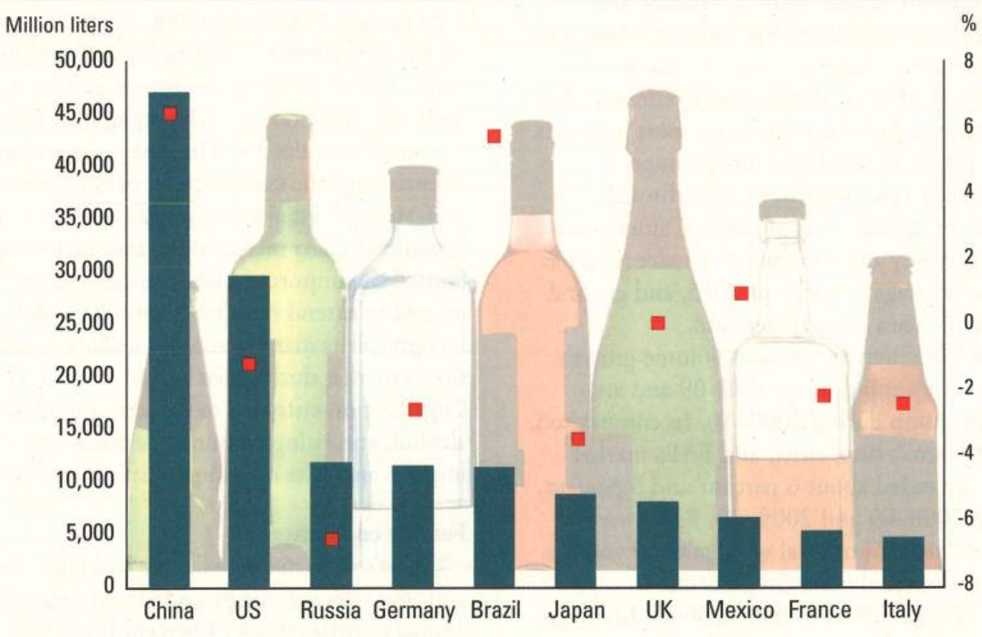
The PRC government only recently enacted a minimum drinking age and laws that prohibit the consumption of alcohol among children. In 2006, the government introduced a law that bans the sale of alcoholic beverages to consumers below the age of 18. In addition, the government in August 2009 increased the base tax and consumption tax rates on high-strength alcohol, including *baijiu*. Increased taxes on spirits and other high-strength alcohol, coupled with media and industry promotions for healthier drinking habits, have affected consumer choices, and more consumers are choosing lower-strength alcohol.

New alcoholic beverage launches reflect this trend toward healthier alternatives, as wines made up more than half of new products launched in China's alcoholic beverage sector in 2009 and nearly 40 percent of such new product launches in 2010.

Competition

China's alcoholic beverage market is dominated by major companies such as SABMiller plc, Tsingtao Brewery Co., Ltd., Anheuser-Busch InBev SA/NV, Molson Coors Brewing Co., and Beijing Yanjing Beer Group Corp. According to MDA data, these top five companies together controlled 57 percent of market volume in 2009. Interestingly, the top five players in China's alcoholic beverage sector are also the top five players in the beer, cider, and FABs category, suggesting that this category drives the overall alcoholic beverages sector. The top five wine companies in China are domestic firms: Yantai Changyu

Figure 1: Leading Countries in the Global Alcoholic Beverages Sector, 2009



Source: Datamonitor Group's Market Data Analytics (MDA)

Group Co., Ltd.; China Great Wall Wine Co., Ltd.; Tonghua Grape Wine Co., Ltd.; Dynasty Fine Wines Group Ltd.; and Yantai Weilong Grape Wine Co. Ltd.

Though the beer and wine markets are highly concentrated—with the top five players commanding market shares of 81 percent and 62 percent, respectively—the spirits market in China is more fragmented. In 2009, the top five players contributed a meager 2 percent of total spirits sales. This is because the spirits market reflects the local market for *baijiu*, which is primarily produced by smaller local companies, rather than by large international companies.

The top players in China's alcoholic beverage sector are consolidating by acquiring smaller firms to gain market share and access to lower-tier cities in China. A few merger and acquisition deals have occurred among alcoholic beverage companies in recent years. In the first half of 2009, four out of five deals involved large market players such as Anheuser-Busch InBev, Carlsberg Breweries A/S, and Tsingtao Brewery. That year, Denmark-based brewer Carlsberg increased its stake in Xinjiang Lanjian Jianiang Investment Co., Ltd., the company that owns the Xinjiang market leader Xinjiang Wusu Brewery Co., Ltd. Following the deal, Carlsberg held a 63.4 percent stake in the brewery.

Companies will also face competition from counterfeit brands, which generally target lower-income consumer groups. Counterfeit alcohol brands are so prevalent in the country that some alcoholic beverage manufacturers have been forced to take special measures to preserve their brand images and market shares. For example Diageo, the parent company of the premium whisky brand Johnnie Walker, has located special teams at bars and pubs to spot-check bottles to ensure their authenticity. The Australian wine industry, which is a large exporter of wines to China, and Canadian ice wines, which are one of the most coveted wines in Asia, are being counterfeited and sold at lower price points.

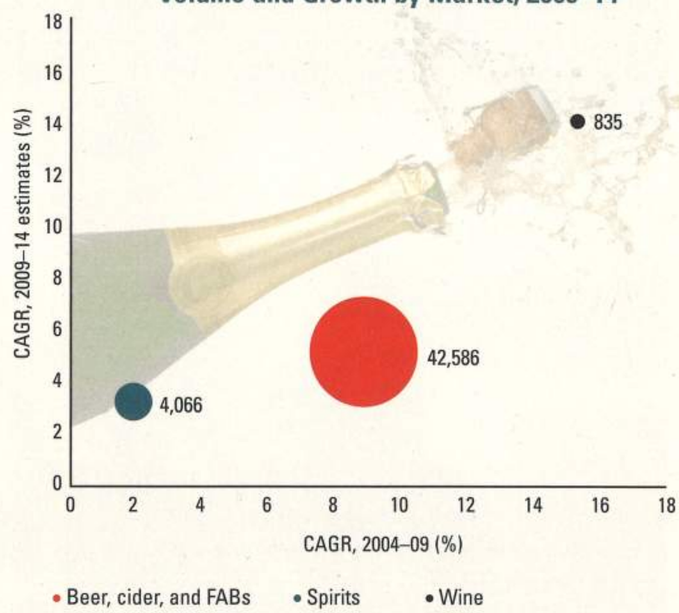
Local tastes

Akin to most other food and beverage sectors, China's alcoholic beverages sector attracts many popular international brands. To reach target consumers, many foreign players attempt to localize their products to suit Chinese preferences. For example, the French alcoholic beverage company Pernod Ricard SA has not only localized its staff and operations through a vineyard in China, but it has also customized the way that its Chivas Regal Scotch whiskey is consumed. Observing that Chinese like green tea as a mixer in their spirits, the company began promoting canned green tea as a mixer with its whiskey products instead of encouraging Chinese consumers to drink Scotch neat, straight up, or on the rocks.

Wine to boom ahead

Because of its large customer base, China's beer, cider, and FABs market will likely experience moderate growth over the next five years (see Figure 2). In contrast, the wine market, with its smaller base, is expected to rise at a much faster rate. The spirits market may suffer from various government measures to reduce the consumption of high-strength alcohol, especially *baijiu*. The brandy and rum markets may rise twice as fast as the overall alcohol sector until 2015, however, and gin and tequila may experience a rise in demand.

Figure 2: China's Alcoholic Beverage Sector Sales Volume and Growth by Market, 2009–14



Notes: Bubble size = sales volume in million liters; CAGR = compound annual growth rate; FABs = flavored alcoholic beverages

Source: Datamonitor MDA

Chinese consumers are changing their drinking preferences. The country's alcoholic beverage sector is benefitting from consumers that are increasingly eager to experiment with Western brands and lower-strength products. And women are an expanding consumer group that is boosting wine sales.

Amidst various challenges in the country's alcoholic beverage sector, companies should focus on consumer education. As nascent markets for most foreign brands, China's spirits and wine markets abound with counterfeits and fake brands. Massive marketing campaigns along with consumer education on the product's quality credentials may help companies tap their target consumers and combat competition from counterfeit brands. Furthermore, considering Chinese consumers' rising incomes and aspirations, companies may choose to brand their products as "premium" or "upscale," a claim that is expected to attract many wealthy consumers in China. 完

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China Foto Press

To succeed in China's chocolate market, foreign companies should take advantage of their brands' credibility and their marketing and retailing experience.

Chocolate Fortunes

Lessons learned by leading chocolate companies can help firms succeed in the China market.

Lawrence L. Allen

China's transformation from an isolated economy to a global economic powerhouse has turned hundreds of millions of its 1.3 billion people into eager consumers of everything from candy to cars. Thirty years ago, most Chinese had never eaten a piece of chocolate; their taste for chocolate was ready to be shaped by whichever company entered the country with a winning combination of quality, marketing savvy, and manufacturing and distribution acumen. For chocolate companies, China was the next great frontier—a market of almost limitless potential to be unlocked through a battle between the world's leading chocolate companies for the hearts, minds, taste buds, and ultimately the wallets of China's consumers.

Even today, the amount of chocolate sold in China is relatively small, accounting for less than 2 percent of total global consumption. Most Chinese would not be able to find chocolate in their vicinity even if they were willing to buy it.

When assessing the China market, the key for the "Big Five" chocolate companies—Cadbury (now owned by Kraft Foods Inc.), Ferrero SpA, the Hershey Co., Mars Inc., and Nestlé SA—has been identifying "accessible" consumers (see p.30). Such consumers are those to whom the product could be sold with relative ease through China's challenging distribution infrastructure and those with adequate disposable income who are receptive to foreign foods. How the Big Five executives applied the experience, management skills, and leadership capabilities they brought to China determined their companies' approach in the country and whether they succeeded.

Lessons learned from selling chocolate in China

The battle for China's chocolate consumers holds lessons for anyone doing business in the dynamic China market. There is no single path to business success in China, however; the country is too big, too complex, and evolving too quickly for simple, one-size-fits-all business formulas. Nevertheless, the story of the "chocolate war" is highly instructional for food, beverage, and other companies that plan to enter China.

Cultural considerations

Western and Chinese cultures evolved separately, and the cultural divide between the two reaches down to fundamental values, including beliefs about food. Western cultures have evolved on the principle that "man does not live by bread alone," whereas many Chinese believe that *min yi shi wei tian*, "for people, food is heaven." This world view is still alive and relevant for most of China's population. Big Five chocolate company executives needed to grasp the significance of these fundamental cultural differences to formulate successful plans for introducing their products to Chinese consumers.

When chocolate was first introduced to the fledgling China market in the 1980s, most Chinese viewed it as a foreign and exotic curiosity. Imported chocolate was considered a luxury and the expense was more easily justified for a gift than for self-consumption. Gift giving, therefore, became the gateway for chocolate's initial entry into China, and chocolate gifts from abroad influenced how the Chinese initially viewed the product.

Even Chinese beliefs such as *yin* and *yang*—the division of the natural world into two opposing but complementary forces—affected how and when the Big Five would bring a product to market. Chinese pharmacognosy is an ancient form of pharmacology that calls for balancing *yin* and *yang* forces within the body. *Yin* is described as the body being in a "cool" condition, and *yang* in a "hot" condition, both of which can be regulated by the kinds of foods consumed. To keep the body in balance, many people avoid consuming "heating" foods such as chocolate during summer months. Consequently, chocolate company executives in the late 1990s planned their business operations around significantly lower sales volume in the summer.

Quick Glance

- Lessons learned by the Big Five chocolate companies can apply to anyone that enters or expands in China's chocolate market.
- China's evolving retail sector is introducing chocolate to millions of new consumers in second- and third-tier cities.
- Chocolate companies that offer different products at various prices are best able to meet the needs of China's multitier market.

Logistical hurdles

Because chocolate requires storage and transportation temperatures from above freezing to 61 degrees Fahrenheit (16 degrees Celsius), China's lack of chilled distribution channels dramatically affected how the Big Five formulated their China strategies. The chocolate companies' problems began the moment their shipping containers arrived on the dock. Bureaucracy and frequent shortages of suitable delivery trucks in China during the 1980s and early 1990s meant containers would often sit for days or sometimes weeks at the port. Once chocolate was unloaded in China, a supply chain of make-do solutions put the product at constant risk of heat damage. For example, a band of workers on a warm day would unload a truck containing cases of chocolate, bucket brigade-style, up fire escape stairs into a second-floor apartment with a window air-conditioner and newspapers taped to the windows to block the sun. From such makeshift warehouses, distributors would pick up and deliver stock to retailers using small non-air-conditioned vans, cars, tricycle carts, and even bicycles. For the Big Five, China's supply chain amounted to a gauntlet that their products had to run to enter retail stores. Though companies rarely worried about delivery conditions in developed markets, China's supply chain became a major preoccupation for chocolate company executives.

Food stores in China throughout the 1980s were, for the most part, open-air wet markets filled with tanks of live fish and baskets of fruit, vegetables, and rice and other grains. Chocolate did not fit into the merchandising scheme of China's wet markets. There was almost nothing the Big Five could do to influence the distribution and merchandising of their products in China's retail environment. China's retail sector would need to evolve before modern-day merchandising techniques could be applied.

Evolution of China's retail sector

Remarkably, China's retail sector obliged, though only in its largest cities. By the early 1990s, small privately owned neighborhood kiosks and "mom and pop" stores emerged throughout the country. Though large in number, these shops presented limited opportunities for chocolate, given chocolate's relatively high price and the stores' lack of air-conditioning. Modern-trade retail stores—air-conditioned hypermarkets, supermarkets, and convenience stores—emerged in the mid-1990s (see p.22). It was only then that the Big Five started applying impulse-purchase merchandising techniques in retail stores to make their products more visible and accessible. Though China's retail environment developed rapidly, development did not occur evenly throughout the country (see the *CBR*, May–June 2010, p.16). Managing a national business in a large country with various stages of development and income became one of the more complex aspects of selling chocolate in China.

To keep things manageable, companies segregated China's cities into tiers defined by geography, actual or potential market size, level of consumers' disposable income and exposure to foreign products, and most important, availability of modern-trade retail stores. Cities such as Beijing; Guangzhou, Guangdong; and Shanghai were classified as first-tier cities—those with the highest level of economic development and the highest living standards. By the late 1990s, these cities had enough accessible consumers and sufficiently developed retail and distribution infrastructure to support a substantial and robust (albeit highly seasonal) chocolate business.

Second-tier cities were more numerous, but provided fewer accessible consumers and far fewer suitable retail outlets. Most third-tier cities lacked air-conditioned supply chains and could support only a seasonal chocolate business. Since chocolate was physically, culturally, and financially inaccessible for the near-billion Chinese consumers who lived in lower-tier cities, they generally did not figure into company executives' plans.

China's distribution infrastructure and quality retail environments have been extending into China's second- and third-tier cities, however, and have progressed significantly in recent years (see the *CBR*, November–December 2010, p.12). Each new air-conditioned hypermarket or supermarket that opens in these locations grants tens of thousands of people access to chocolate for the first time.

The Big Five chocolate companies must therefore push their products ever farther and deeper into China's emerging retail stores in second- and third-tier cities, using the same store-driven approach they used successfully in the first-tier cities. Given the geographic reach of these hundreds of new markets, the challenge will be significantly more complex, however. This trend, which will unfold over the coming decades, defines China as a multitier market: one country with people at distinctly different stages of development.

Managing China's multitier market

To survive and prosper in China's multitier markets, chocolate companies will need to sustain their businesses in first-tier cities, while investing human and financial resources in emerging second- and third-tier cities. Striking the right balance between the competing priorities of current and future opportunities is the crux of any successful multitier market strategy.

Take advantage of established networks

The Big Five companies' past experience in first-tier cities may serve as a guide for doing business in lower-tier cities, and some capabilities developed during the last two decades may prove useful. For example, chocolate companies will no longer need to develop and build their entire local management talent from scratch; there is now a pool of experienced managers to deploy throughout the country.

Mass media makes a big impact

The openness of mass communication is changing lower-tier markets. Nationally broadcast television shows give Chinese in remote locations a look at the modern lifestyle in cities such as Beijing and Shanghai, sparking their interest in all manner of goods, including chocolate. Though mass communication may accelerate the development of future chocolate consumers in lower-tier cities, the battle for these first-time consumers will, in some fundamental respects, be the same as it was in first-tier cities. Most significant, it will still involve introducing an exotic and foreign curiosity to people who are unaccustomed to foreign tastes and textures.

Big Five Chocolate Companies in China

Company name	Year of entry into China
Cadbury	**1995**
	Cadbury's factory began operations in mainland China in 1995.
Ferrero SpA	**Circa 1984**
	Ferrero Rocher chocolates were hand carried into China by Hong Kong family relatives returning for the Chinese New Year holiday shortly after the product's worldwide launch in 1982. Ferrero does not manufacture Ferrero Rocher chocolates in China.
The Hershey Co.	**1995**
	Hershey established a representative office in Shanghai in 1995. In 2007, the company built its plant in China, a joint venture with Hershey's South Korean distribution partner, Lotte Confectionary Co., Ltd.
Mars Inc.	**1990**
	Mars' M&Ms sponsored the 1990 Beijing Asian games. This was the first major active marketing effort for Mars products in China. The company's factory in China began operations in 1993.
Nestlé SA	**1984**
	Nestlé established a representative office in China in 1984 to promote importation of its products into China—including Kit Kat. Nestlé's only confectionery factory in China commenced operations in Tianjin in 1996 to produce Kit Kat products.

Note: Products from all Big Five chocolate companies entered China through Hong Kong, in varying volumes, starting in the 1980s.
Source: *Chocolate Fortunes: The Battle for the Hearts, Minds, and Wallets of China's Consumers*

Embrace the company's foreign heritage

To succeed in China's multitier market, chocolate companies will need to understand and use their competitive advantages—which may include their foreign heritage, product quality, and management depth—and be realistic about their inherent limitations compared to local competitors. Foreign chocolate companies' biggest strength is the credibility that foreign brands have with China's consumers—something local competitors cannot copy. Companies must keep in mind that credibility can be lost, however. For example, Chinese consumers viewed Nestlé differently after it stopped producing high-end chocolate and began marketing a series of lower-priced chocolates, all of which experienced low sales. Product quality has been another competitive advantage for multinational chocolate companies. Local companies, which lack extensive chocolate expertise, must either copy or attempt to out-innovate foreign companies that have been marketing chocolate for more than a century.

Offer different products for different consumers

China's multitier economy demands complex product stratification: various products at a range of prices that meet the needs of different consumers. Companies such as Mars, which offers a wide range of products, are best positioned to compete across China's multitier markets. Mars can meet the needs of China's multitier market through selectively distributing its products according to consumers' stage of chocolate development—their taste for and ability to buy the product. For example, Mars can sell smaller Dove chocolate bars as an introductory offering for emerging consumers in second-tier cities and high-priced Dove boxed chocolates in cities, such as Shanghai, with more sophisticated consumers.

Effectively executing this strategy for a country the size of China requires extensive coordination. Companies must build their business plans—in many cases, city-by-city—based on a complex decision matrix. The matrix should incorporate factors such as geographic location, level of infrastructure development (including the number of air-conditioned stores), strength of the local distributors, level of general economic development, and consumers' taste for and interest in purchasing chocolate. This will be a dynamic process, since companies will need to continuously reassess their priorities as millions of consumers simultaneously migrate through China's multitier market each year.

Capitalize on global retail best practices

Foreign chocolate companies generally have more management experience, particularly in marketing and effective retailing. Therefore, they can better capitalize on the rapid growth of modern retail stores in China by leveraging their extensive global retail experience and introducing global best practices that are new in China. Some foreign chain stores may be more likely to partner with an international company—one that is familiar with their global systems and techniques—to organize and plan the chain's chocolate retail shelf in their China stores.

Consider limitations

Foreign chocolate companies should understand their limitations in China. It is unrealistic for multinational corporations with higher operating costs to compete with local companies on price. In addition, many foreign companies in China are at a disadvantage when locally procuring commodities such as milk and sugar, since local companies often receive more favorable pricing. With higher built-in operating costs, multinational corporations that attempt to compete with local companies on price may jeopardize their sustainability through loss of long-term profitability. To compete in China, foreign chocolate companies must focus on the higher end of the market, embrace their foreign heritage, and guard their competitive advantage.

Succeeding in the chocolate market

China's emerging chocolate market offers a level playing field for all foreign chocolate companies. Chinese consumers view chocolate as an exotic foreign product, so each foreign company enjoys the same level of credibility. Retail prices are relatively high and manufacturing costs low, so no firm is disadvantaged for price or cost reasons. All companies have had to deal with insufficient consumer and market information and have faced the same challenges when dealing with China's rapidly evolving economy and regulatory ambiguity. Therefore, the decisive battle in China's chocolate war is not a universal struggle with China's economic and infrastructure issues, but rather a challenge within chocolate companies to discern their own route to commercial success in China. The greatest challenges for these companies do not lie externally in China's enigmatic marketplace, but internally within each organization.

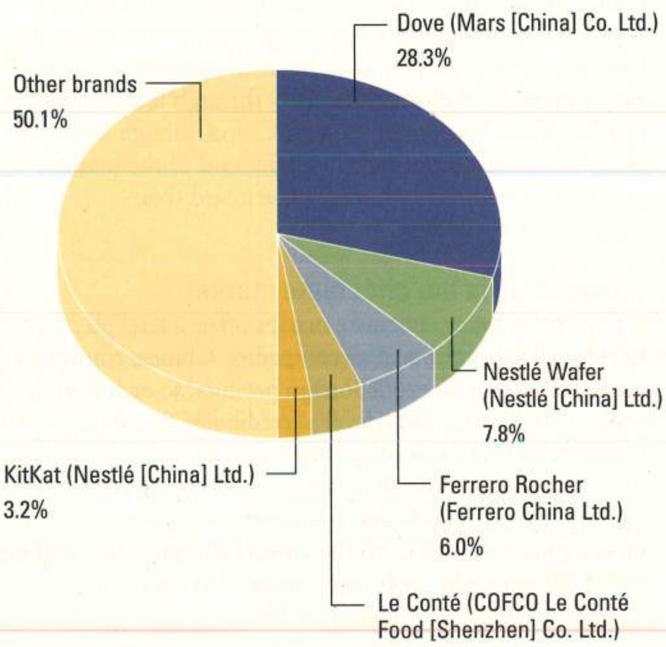
Though China's future chocolate market will present new and daunting difficulties, with tens of millions of new consumers emerging each year, chocolate companies will have more opportunity than ever to build sustainable and profitable China businesses. Winning the future battles in China's chocolate market will demand precisely what was required in the past: the will to sustain a long-term commitment in China and an unrelenting focus on meeting the expectations of China's emerging consumers. 完

Lawrence Allen *(www.chocolatefortunes.net) is a 20-year China-business veteran, leadership advisor, and author of the book* Chocolate Fortunes: The Battle for the Hearts, Minds, and Wallets of China's Consumers. *He is based in Beijing.*

China Acquires a Taste

Four of the top five chocolate brands in China are made by foreign companies.

Market Share of Top Five Chocolate Brands in China, 2009

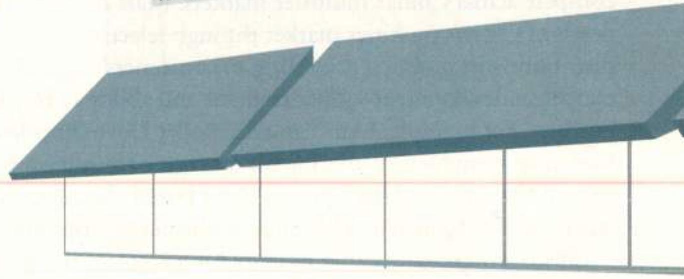


Source: Euromonitor International

The expansion of modern retail outlets introduce

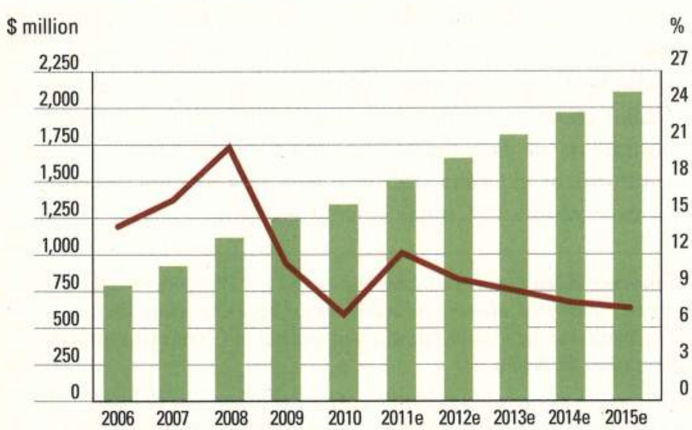
Number of Retail Chain Stores by Business Category

	2005	2006
Building material store	120	82
Convenience store	10,043	13,817
Department store	3,853	5,353
Discount store	NA	NA
Factory outlets center	NA	NA
Franchised store	5,195	18,005
Hypermarket	NA	NA
Specialty store	67,471	63,992
Supermarket	18,924	21,066
Wholesale club	78	48
Other	NA	6,561
Total	105,684	128,924



China's chocolate sales have steadily increased...

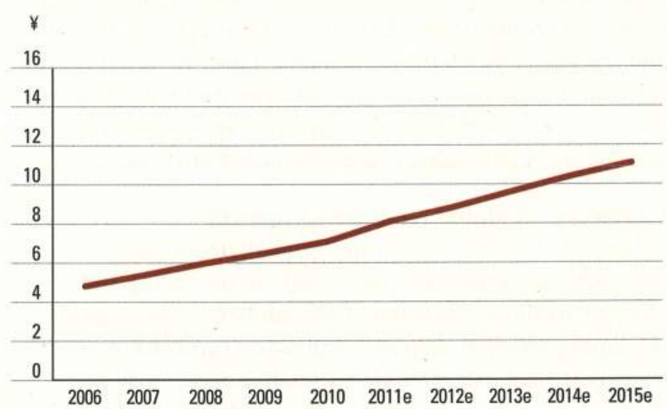
China's Chocolate Market, 2005–15



Notes: Dollar amounts are based on historic and forecast year-on-year exchange rates; e = estimate.
Source: Euromonitor International

...but per capita sales remain relatively low.

Chocolate Retail Value per Capita, 2005–15

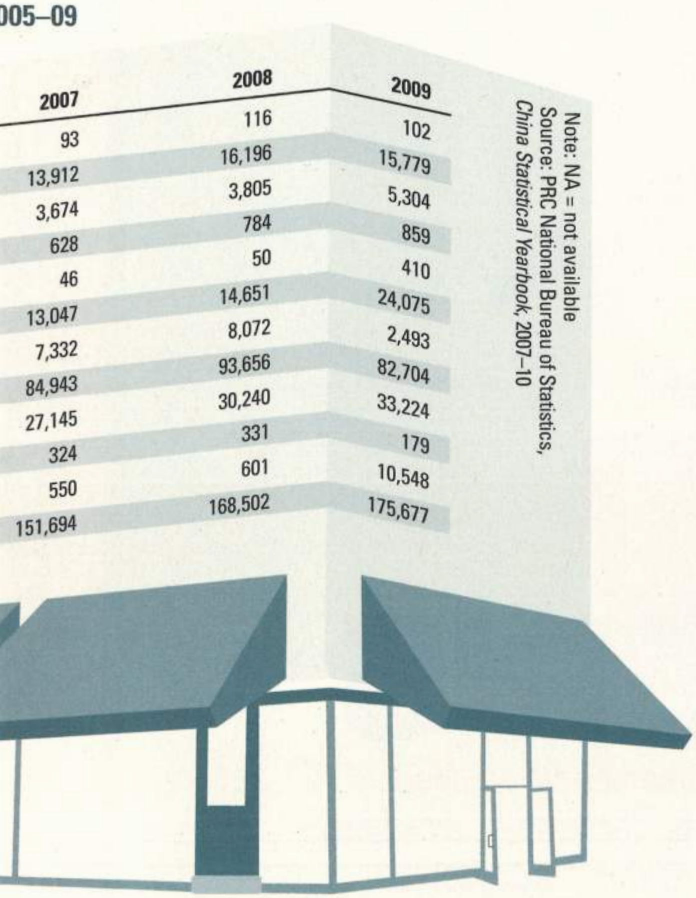


Note: e = estimate
Source: Euromonitor International

for Chocolate and Wine

hocolate to a broader market in China.

005–09

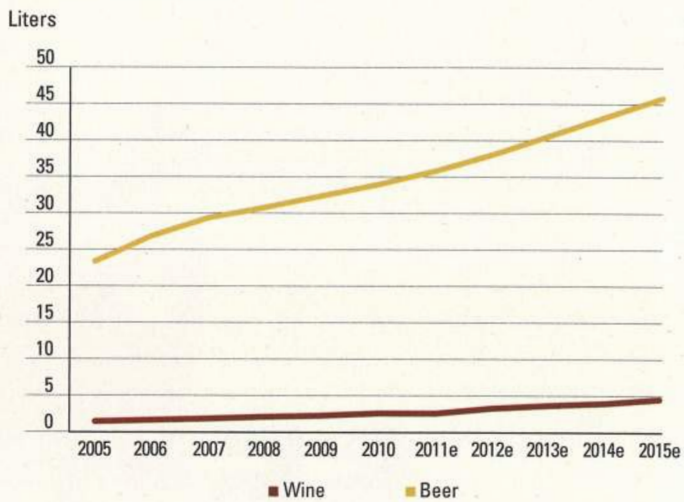


2007	2008	2009
93	116	102
13,912	16,196	15,779
3,674	3,805	5,304
628	784	859
46	50	410
13,047	14,651	24,075
7,332	8,072	2,493
84,943	93,656	82,704
27,145	30,240	33,224
324	331	179
550	601	10,548
151,694	168,502	175,677

Note: NA = not available
Source: PRC National Bureau of Statistics, *China Statistical Yearbook*, 2007–10

Though beer remains more popular in China, wine consumption has slowly increased in recent years.

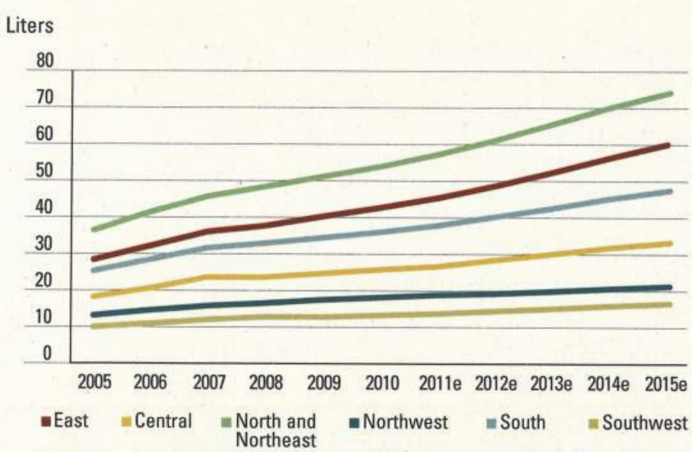
Per Capita Wine and Beer Sales in China, 2005–15



Note: e = estimate
Source: Euromonitor International

Beer consumption varies greatly by region, and it is highest in the North and Northeast.

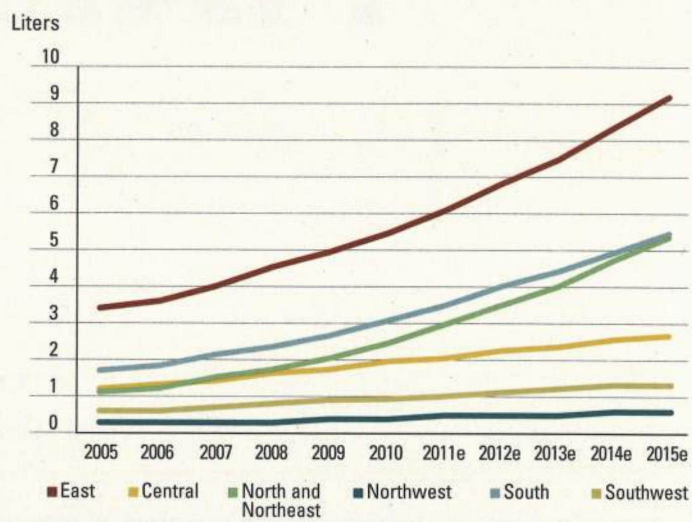
Per Capita Beer Sales by Region, 2005–15



Note: e = estimate
Source: Euromonitor International

Wine sales are highest in eastern China, where consumers earn more income.

Per Capita Wine Sales by Region, 2005–15



Note: e = estimate
Source: Euromonitor International

S1

SELLER'S MARKET

Once upon a time, foreign companies set up shop in China to save on production costs. These days, they have their eyes on the Chinese consumers themselves

If sometime soon you book a nonstop flight to Beijing, bring along a copy of Angus Maddison's *Chinese Economic Performance in the Long Run*. This seminal work by the late British economist will set you straight on China's putative rise to sudden economic prominence. Maddison applied his econometric tools to the year A.D. 1 and found China's share of aggregate global GDP dwarfed that of the Roman Empire. The Asian giant, it turns out, is enjoying a return to economic-superpower status. In the process, the People's Republic of China both beckons and perplexes the American newcomer who hopes to leverage the world's most revved-up economy.

ILLUSTRATIONS BY ERIK MAUSSER


We'll help you get through
CUSTOMS.
Traditional attire
China – Where Chartis insurers have done business since 1995

Since enacting reforms in the late 1970s and entering the World Trade Organization in 2001, China has been an economic dynamo. Its expansion has been unchecked even by worldwide recession in 2009 (when China recorded 8.7 percent GDP growth) and 2010 (when GDP grew 10.1 percent). The country's economy is more than 90 times bigger than when Deng Xiaoping dropped hard-line Communist policies in favor of free-market activity. Within that growth spurt there has been maturation, as first agriculture and then manufacturing shrunk as a percentage of GDP activity. At the same time, the labor market has experienced supply pressures (or at least imbalances) regionally and by industry.

Of course, labor-force behavior that disrupts the profit model for simpler kinds of manufacturing is part of something else—more acquisitive consumer behavior by an emerging middle class. In fact, most foreign companies that set up operations in China nowadays are looking for access to the Chinese market rather than cheap labor. Longtime participants in this marketplace all cite headaches and pitfalls of conducting business there, but China's growth more than offsets those negatives. When battle-tested businesspeople and policymakers craft advice for newer entrants, two themes dominate: Be patient and expect inherent contradictions in the business landscape.

S3

One incongruity involves the activity and pronouncements from China's central and provincial governments. In their attempts to gain operating licenses or start construction projects, Western companies often find local authorities contradicting official Beijing edicts. That's to be expected. "The mountain is high and the Emperor is far away," goes a hoary Chinese saying, referring to geographical limits on China's centralized control of commerce and development. According to Jean-Luc Butel, Executive Vice President and Group President, International of medical technology company Medtronic, one critical area that requires the government's quick attention is consumer health needs.

"Non-communicable, chronic diseases like diabetes and heart failure account for more than 80 percent of deaths due to all diseases in China," says Butel. "This challenge demands industry-government collaboration and innovative ideas."

Medtronic innovates in a robust but deliberate manner well suited to this environment. In Beijing last August, it opened the world's first patient care center that educates patients on medical technology and what it can do. With the growth of chronic disease and limited patient-physician interaction, Medtronic identified the need to act and address both issues by partnering with the health authorities and a cardiovascular professional society. "In China, any major undertaking by a foreign company takes careful preparation," says Butel. "Especially now, I hear of U.S. and European companies saying, 'We've got to get something done in China, that's where the growth is.' If those companies try to move at a fast pace and leave details of their agreements and partnerships to be figured out later, they are guaranteed to regret it."

Among Medtronic's vital building blocks for selling in China are its joint venture with a local device company, Weigao. The venture allowed Medtronic entry to key parts of the healthcare segment in China and to leverage the local knowledge of its partner to help drive local business strategies fully realize the market opportunity.

"Made-in-the-USA has enormous appeal to the rising Chinese middle class."

—Gary Locke

Such local knowledge plays well in China. For example, the American fast-food giant KFC is seen by Chinese consumers as a paragon of meat freshness and hygienic food preparation. China's population knows about American standards, and KFC, by virtue of its penetration, owns a good portion of that imprimatur.

One reason American companies now hurry to begin activities in China is the inherent advantage that comes with being a Western brand.

"Made-in-the-USA has enormous appeal to the rising Chinese middle class," says Gary Locke, U.S. Secretary of Commerce and the only Chinese-American to have served as governor of a U.S. state (Washington). "In 2010 alone, U.S. exports to China grew by 32 percent." In Locke's view, the statistics and rhetoric surrounding U.S.–China trade relations are difficult to follow without running into confusion or outdated beliefs. John Frisbie, president of the US–China Business Council, is a strong proponent of the value of facts over truisms. "In the first quarter of 2011, China ran a global trade deficit," Frisbie points out. "You have to go back to 2004 to find the last time that happened. With the U.S., bilaterally they still ran a large surplus, but globally they imported more than they exported. They will revert to a global surplus the rest of this year, but probably at a reduced level versus before. It may be that China is indeed starting to sustainably boost domestic demand."

This change in balance of imports and exports is part of a plan to advance to a more mature stage for both the economy and the society, observers contend. "The Chinese government wants to rebalance its economic profile through increased consumer spending internally, and, via that process, to lower its trade imbalance with the U.S.," says Locke. "As the Chinese middle class expands, there's a stronger interest in Western culture and Western goods—that augurs well for us."

Critics of China's currency valuation policy have had evidence on their side, but are dishing out rhetoric at odds with current facts and figures, says Frisbie. "There's growing recognition by the Chinese government," he says, "that the exchange rate is a tool to help control inflation. China imports energy, commodities and food, and

LOCKE: SEONGJOON CHO/BLOOMBERG

IT's Alive!

The Liangjiang International Cloud Computing Center is going to be, well, huge

From Hainan Island up through Hong Kong and Shanghai to Beijing, China's coastal crescent has seen most of the country's growth. Aware that economic activity tilted eastward, Beijing planners have long crafted ambitious plans for the central and western sectors. John Frisbie, president of the US–China Business Council, returned from a recent gathering with a relevant comment.

"I was in a roundtable conference with 60 or 70 executives of global corporations," Frisbie says, "and they reported on ramped-up activity far from the coastal centers. China's third- and fourth-tier cities are beginning to be targets of sales growth for multinationals." Thus, American businesses that feel left behind may wish to focus inland, on Henan, Hunan, Shanxi and Chongqing. The latter, pronounced "chong-ching" and poised at China's geographical center, is home to bustling manufacturing, sundry corporate outposts (Ford, Walmart, Honeywell, IBM, Microsoft) and, in development, a financial center and cloud computing center of mammoth proportions. Like most large-scale undertakings in China's interior, the Chongqing Data Industrial Campus, in the Liangjiang New Area, follows a master plan and offers inducements to foreign companies that invest or set up shop there. Incentives include a reduced enterprise income tax rate of 15 percent through 2020 for companies operating in "encouraged industries."

The initial footprint of the Liangjiang International Cloud Computing Center is planned at 135 acres, with a gross floor area in the compound of 2.07 million square meters. Huang Qifan, the mayor of Chongqing Municipality, calls the project "a key step toward building the largest data processing center in Asia." Envisioned over time is a development area of 2,471 acres for cloud computing that would house 200,000 servers and routers. It will initially provide IT infrastructure for the governments and enterprises of Chongqing and other regions of Southwest China, then expand to become a service outsourcing platform. ●

a stronger exchange helps control those price pressures." On that basis, a continued hands-off approach to the currency is likely; the government's target for price inflation is said to be in the range of 4 to 4.5 percent.

A common excuse for delaying entry into China has been concern about placing intellectual property at risk due to factors in the legal system and the industrial culture. It's been observed that, during a long run of success in China, Japanese auto companies take pains to withhold the most valuable technology from the vehicles shipped there. Especially as three-dimensional scanning technology has made it possible to reverse-engineer high-tech products, exporters have feared infringement and piracy. Frisbie, a veteran of two decades in-country, says the problem remains a top concern—especially for software and movie producers—but is showing slow improvement overall.

"We annually survey our members on many questions," Frisbie says. "Consistently, each year more companies say that aspect of China commerce is getting better. Foreign companies can use Chinese courts more effectively to seek redress. But if the government wants China to become an innovative economy, they have to get much better at protecting IP. Their own domestic companies increasingly demand this, too."

Factories mushrooming across China are a natural sign of economic growth, but they obscure the progress of service businesses. Nicholas C. Walsh, Vice Chairman and Chief Distribution Officer of Chartis, is part of the less visible but deep foray of Western firms filling these needs. "As a company that traces its roots to China decades ago, we have been privileged to witness China's astounding growth," says Walsh, "and to see the services sector playing an increasingly important role in that development." When a company like Chartis makes strides in China, it naturally contributes to better safeguards, efficien-

cies and support for industry in general. "Infrastructure, large-scale development projects, manufacturing, trade and exports are all facilitated, if not made possible, by business and financial services," notes Walsh. "Additionally, a globally competitive services sector encourages high-level efficiency and ultimately better products and prices for consumers."

Like any late-industrializing nation, China must clean its smokestack emissions from the day each smokestack goes up.

Observers of U.S.–China diplomacy see particular promise in the combined need for leadership in environmental sustainability. "We're the two leading producers of greenhouse gas emissions," says Commerce Secretary Locke, "and history will judge both America and China on how we address that issue." That's the liability side of the question, but Locke sees an asset as well. "There's a reason why President Obama included $100 billion in funding for clean energy research in the Recovery and Reinvestment Act," Locke says. "This is an area where American technology has excelled and can continue to excel. We need to make our policy more specific regarding R&D tax credits, and that will happen."

For the U.S. and China to make common cause on environmental protection would bode well across many fronts, including technology sharing for reduced dependence on fossil fuels. This will require leadership from younger entrepreneurs and policymakers in both countries.

"China encourages and welcomes American cultural institutions and commercial enterprises to actively engage in and support the cultural exchanges between China and the United States," says H.E. Mme. Zhao Shaohua, Vice Minister of Culture, People's Republic of China. "Together we can help bring about increased understanding and deeper friendship between our two peoples." ●

PORT: THOMAS LEE/BLOOMBERG

两江论坛
LIANGJIANG FORUM

THE 2011 LIANGJIANG FORUM
2011年两江论坛

June 17-19 - Chongqing, China
6月17-19日 • 中国重庆

In the 20th century, China's economy was driven by the development of its coastal areas. However, more recently, the central government has been pushing its 'go west' reform program, and as the gateway to China's western region, Chongqing is sure to thrive from its yet unexploited opportunities.

The 'Liangjiang New Area' in Chongqing will play a critical role in narrowing the income gap between the eastern and western regions of China. 'Liangjiang New Area' is built to meet the increasing demand from the manufacturing, technological innovation, trade, and financial industries in China's western region, as well as direct investment from abroad.

Chongqing Municipality has taken the lead in organizing the first ever international forum in the 'Liangjiang New Area'. This event will gather prominent thought leaders and industry experts from around the world to discuss the unique opportunities that this area can offer.

The Liangjiang Forum is endorsed and supported by the Ministry of Commerce of the P.R. China, the China Council for Promotion of International Trade (CCPIT), the World Trade Centre Association Hong Kong, Bloomberg Businessweek and Tsinghua University.

Confirmed speakers include:

Mr. Bo Xilai, *Member of the Political Bureau of the CPC Central Committee and Party Secretary of CPC Chongqing Municipal Committee*
Mr. Huang Qifan, *Mayor of Chongqing Municipality*
Hon. Mr. Gerhard Schroeder, *Former Chancellor of Germany*
Hon. Dr. Chung Un-chan, *Former Prime Minister of South Korea*
Mr. Hong Qi, *President, China Minsheng Banking Corp., Ltd*
Mr. Stephen Roach, *Non-Executive Chairman of Morgan Stanley Asia*
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Foreign franchises are reaching more Chinese consumers over larger segments of the country.

The Pros and Cons of Franchising in China

US companies must jump hurdles to operate successful franchises in China, but the potential benefits are too great to ignore.

William Edwards

Western and local franchise brands have developed significantly in China over the past 15 years, as the Chinese consumer has become an engine of economic growth and the country's business environment has improved. In the early 1990s, the word "franchise" had still not been directly translated into Chinese; the closest translation was "chain of stores." In addition, the PRC government did not formally regulate franchising. To help develop the industry, the PRC government in 1997 issued the Interim Measures on Regulating Commercial Franchise Operations. The China Chain Store and Franchise Association (CCFA)—a quasi-government nonprofit membership association for Chinese and foreign retailers, franchisers, and well-known foreign brands—also formed. The industry association now has 900 members with 180,000 outlets across China. The total annual sales of CCFA members reached nearly $300 billion in 2010—about 13 percent of total retail sales in China. CCFA has also monitored the top 120 franchises in China to gain a clearer picture of franchise development. In 2010, these 120 companies operated 111,477 franchise stores, an increase of 17.6 percent over 2009. Total sales of the top 120 franchisors reached $52.4 billion in 2010, up 8.9 percent over 2009.

Quick Glance

- China's economic boom has enabled more Chinese consumers to frequent franchises and more Chinese investors to buy franchise licenses.
- Because many foreign brands are viewed in a positive light in China, foreign franchises may perform well—if they cater to the tastes of local consumers.
- Foreign companies must prepare for various obstacles to expansion, however, such as weak intellectual property enforcement and shortages of skilled franchise managers.

Franchising, a business development method for expanding a company and distributing goods and services using an established business system and a recognized brand name, has advantages and disadvantages. On the positive side, franchises give individuals an opportunity to start a business with a proven success rate at minimal risk. The franchisor (owner of the business that provides the product or service) gives the franchisee (independent party) training, support, and marketing programs. In addition, the business can be a highly recognized foreign brand known for quality and service. On the negative side, to open a franchise a franchisee must pay an initial fee to acquire the brand, business system, and other resources; pay on-going royalties; and follow the franchise system. In the United States, unit franchise licenses may run $10,000–$50,000, and country or regional licenses may cost $200,000–$500,000. In China, the fees typically run $250,000–$750,000.

Filling consumer needs

As Chinese consumers earn more discretionary income, they want the quality, brand, convenience, and service associated with Western brands. Consumers often buy goods and services at stores, restaurants, and service establishments that are franchises, thus many US franchises help fill the needs of China's fast-growing middle class. This group is largely a young, upwardly mobile, and aspirational two-income family demographic with one child and considerable discretionary income.

Food service

As with franchise development in other emerging markets, food franchises first came to China from the United States. The Yum Brands, Inc. chains KFC Corp. and Pizza Hut, Inc. entered China in 1987 and 1990, respectively, and have been in the country for more than 20 years. McDonald's Corp. also entered the country in 1990. None of these brands initially franchised their outlets in China, however; they were company-owned and operated, in some cases with a joint venture (JV) partner. KFC began granting franchises in lower-tier Chinese cities in 1992, and McDonald's began franchising in China in 2004. Today, Yum has more than 3,700 restaurants, mostly KFC outlets, in China. McDonald's announced plans late last year to double the number of its restaurants in China to 2,000 by 2013.

Many other food franchises have entered and expanded in China, some of which grant a regional license to a Chinese company, which builds, owns, and operates units by itself. Burger King Corp., which entered China in 2005, has 33 restaurants in the country. Starbucks Corp., which opened its first shop in Beijing in 1999, has roughly 450 stores in China. Papa John's International, Inc. announced plans in fall 2010 to increase the number of its restaurants in China from 155 to 300 in three years. Carl's Jr. (operated by CKE Restaurants, Inc.); Cold Stone Creamery, Inc.; and International Dairy Queen, Inc. are just a few of the other major US franchise brands developing across China, though some brands will license to local companies or sub-franchise, which allows an owner of an area license to sell franchise licenses to other parties.

Business service franchises

US business service franchises, such as AlphaGraphics, Inc. and Sir Speedy, Inc., began entering China in the 1990s, mainly to serve the increasing number of foreign representative offices in eastern cities. Before these US brands entered China, there were few places where Chinese or foreign companies could get printing service; print shops were not fully equipped and staff did not speak English.

After a slow start, many US hotel brands have entered China—some by granting franchise licenses and some through JVs. First, hotel brands built five-star hotels for foreign business travelers in large, first-tier cities. But in recent years, US companies have also been building hotels for

Chinese business travelers in second- and third-tier cities. US hotel brands that grant franchises in China include Hilton Worldwide, Inc.; Howard Johnson International, Inc.; Sheraton Hotels & Resorts; and Super 8 Motels, Inc.

Customer service franchises

Auto, education, and real estate franchises soon followed business services franchises. As Chinese consumers started to buy cars, they began to need professional service centers for car repair and maintenance. And when home ownership boomed in China, real estate firms such as Century 21 Real Estate LLC and RE/MAX, LLC launched franchises.

Helping to boost the popularity and supply of education and fitness programs for children and young adults in China, My Gym Enterprises, a US franchise focused on children's health, entered China in 2008. The Crestcom International, LLC management education franchise, which boosts adults' managerial skills and is especially helpful to young adults who want to improve their careers, entered a few years later. In addition, the Virginia-based Abrakadoodle Remarkable Art Education children's art franchise is setting up in China this year and will cater to the new generation of one-child families who want to supplement their child's education and give them an edge in getting into the best schools.

Foreign franchises face opportunities...

Many trends indicate that the China market is ripe for franchises.

■ **The consumer class is expanding fast.**

The large group of middle- and upper-class consumers can afford to buy more than basic necessities, and many members want to show their wealth through what they buy—for example, by purchasing a cup of expensive foreign-branded coffee and walking around with it. They are purchasing big-ticket, branded items—often on their credit cards.

■ **Western brands are highly regarded.**

Many consumers perceive Western brands as providing quality, convenience, and customer service. This is true especially in the retail and food sectors, where most major food franchises are either already present or are entering China (see p.18).

■ **Western franchises bring new and modern business systems.**

Successful US franchises bring a complete business system, management processes, job training, and the potential for healthy and reproducible bottom line margins. US franchises in China thus have high potential to succeed.

■ **Second- and third-tier cities are open to franchising.**

First-tier cities offer developed infrastructure, business-friendly governments, and a multitude of services and internationally standard amenities. These cities are generally "easy" for newcomers to enter, but labor and real estate prices have risen and competition has intensified in recent years. Second-tier cities have millions of potential consumers and often have lower labor and real estate costs and local governments that encourage the creation of new businesses (see the *CBR*, November–December 2010, p.12). In addition, US food franchisors are increasingly allowing small companies to own franchises—a trend that KFC and Papa John's started in second- and third-tier cities in the last few years.

...and challenges

Foreign franchises must also overcome problems that are specific to the China market.

■ **Intellectual property protection is uneven.**

Weak intellectual property enforcement and an inadequate legal framework are key reasons early foreign brands opened as company-owned stores or JVs, instead of franchises, in China. Many US brands have seen local companies take their name and logo and open fake, unapproved outlets. For example, after a local coffee store chain violated Starbucks's trademark by nearly duplicating its name and logo, Starbucks took the company to court and won the dispute in 2006. China has a range of intellectual property laws, and landmark court cases have defined the right of foreign brands to protect their trademarks and business systems. Intellectual property laws, however, are not uniformly enforced throughout the country.

■ **Local managers lack strong management skills.**

Franchises in China often experience difficulties finding local managers who understand how to run a business. Training costs are high and so is the rate at which good employees quit to take higher paying jobs after they receive Western business training (see the *CBR*, April–June 2011, p.20).

■ **Finding and evaluating licensee candidates is tough.**

The most important part of franchising a brand is finding, evaluating, and signing a qualified company as the local, regional, or country franchisee. Due diligence resources to fully check on a local company are improving,

> The sheer size of China, and its diversity of business and food culture, makes franchise development difficult.

but it is still difficult to find companies with the management skills, business track record, and capital to acquire and properly develop a US franchise business. To help find appropriate licensees, companies can check with various organizations, such as US Commercial Service offices in China, legal firms with US ties, consulting firms, or American Chamber of Commerce offices.

in China. The regulations also state that the Chinese franchisee must own and operate units for at least a year before it can sub-franchise to others. This revision ensures the licensee will learn how to manage the business correctly before it can franchise it to someone else—increasing the chance that the foreign franchise will succeed in China.

Some franchises face difficulties in China when they do not adapt—or are slow to adapt— to the needs and tastes of Chinese consumers.

■ **China has many markets.**
The sheer size of China, and its diversity of business and food culture, makes franchise development difficult. Companies that function well in one region seldom function as well elsewhere in China. Accordingly, franchisors rarely grant companies a country franchise for China. More typically, franchisors grant regional franchises (for a province or group of provinces) or first-tier city franchises (such as for Shanghai). This means the US franchisor must manage multiple licenses in China, requiring more time and energy than for other large countries, such as Indonesia, where it is common to grant one license for the whole country.

■ **The regulatory environment is evolving.**
Unclear and changing regulations have created uncertainty for foreign franchisers that wanted to enter China in the past. The country's regulatory environment for franchising is evolving and improving, however. After releasing the 1997 interim measures on franchising, the PRC government issued the 2005 Administrative Measures on Commercial Franchising. The 2005 measures allowed foreign companies to establish wholly foreign-owned franchises, instead of being limited to joint ventures, thus fulfilling one of China's World Trade Organization commitments. The measures, however, required foreign franchisors to open and operate at least two units in China for more than one year before it could sign a franchisee. Though the regulation aimed to prevent franchisors from selling a franchise and then failing to return or provide support, the requirement proved cumbersome, difficult, and expensive.

In 2007, China released new franchise regulations, which offered more favorable licensing terms to foreign companies. For example, the new regulations require that the foreign franchisor has owned and operated at least two units anywhere in the world, including in its own home country, for at least one year before it can grant a franchise

■ **Franchises must adapt their products to new markets.**
Some franchises face difficulties in China when they do not adapt—or are slow to adapt—to the needs and tastes of Chinese consumers. For example, restaurants should conduct appropriate research before planning their menu and offerings. Sales may increase simply by adding chicken dishes and rice to the menu, or by changing a spice or bread. Adding a trendy "foreign" item to the menu, such as coffee or ice cream, may also increase sales.

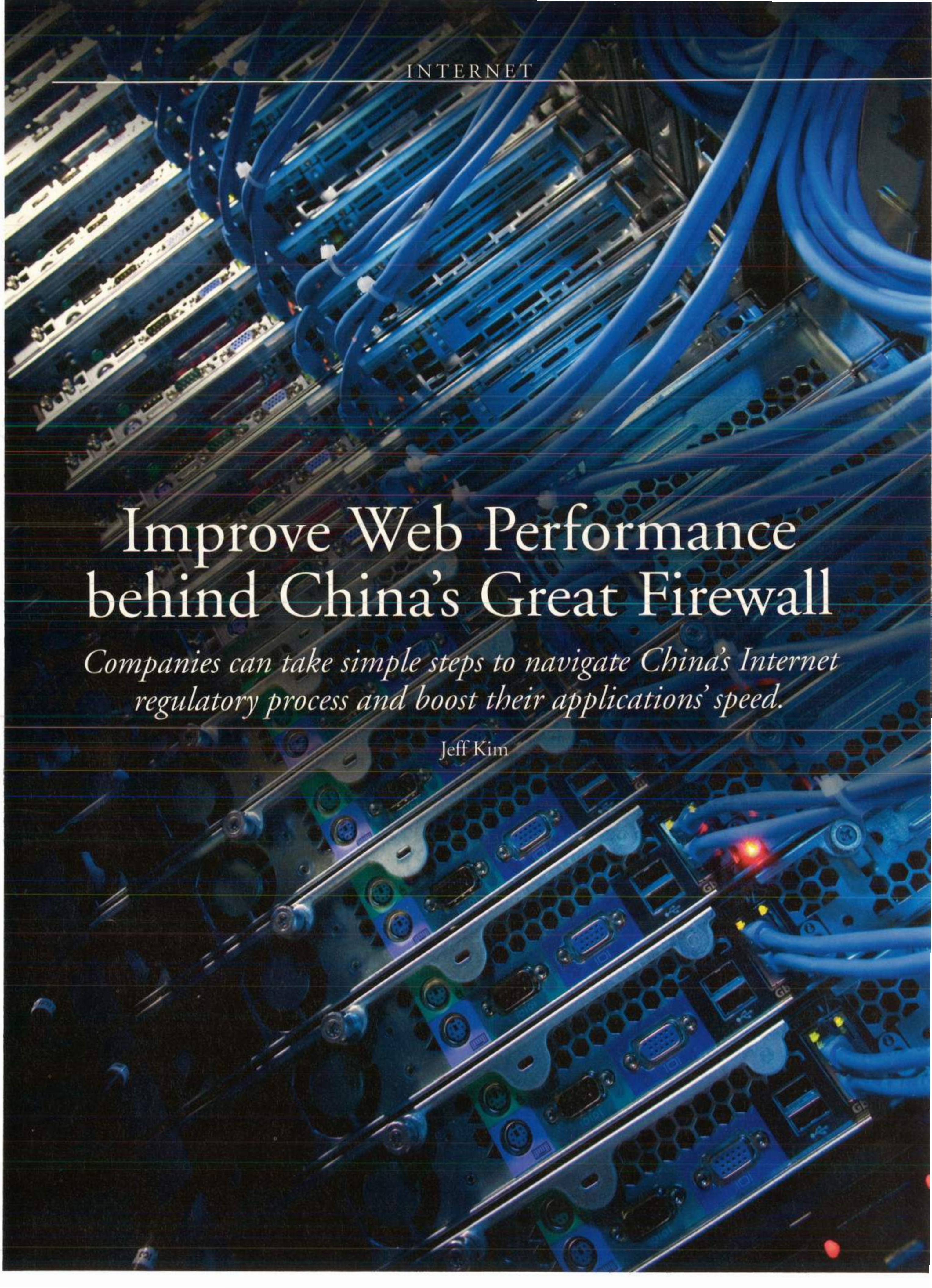
In addition, foreign companies should take care when translating their brand names into Chinese. Ideally, the Chinese name should convey what the brand is and sound similar to the English pronunciation.

The bottom line

Many signs indicate that franchising will become easier in China over the next few years. China's regulatory and investment environment is developing and becoming more transparent. Lower-tier cities are becoming ripe markets for franchises, and China's rapidly rising middle- and upper-class consumer base desires Western brands with their well-known name and association with convenience, quality, and service. In addition, more Chinese are reaching an income and savings level that will allow them to invest in a franchise.

Despite the challenges of the China market, the opportunities are too great to ignore, and US franchisors are entering China in great numbers. Quality franchises will create good business systems, jobs, products, salaries, and services. 完

William Edwards *(bedwards@egs-intl.com) is founder and CEO of Edwards Global Services, Inc. He has been a master franchisee in five countries, including for AlphaGraphics in China in the early 1990s. He is based in Irvine, California.*



Improve Web Performance behind China's Great Firewall

Companies can take simple steps to navigate China's Internet regulatory process and boost their applications' speed.

Jeff Kim

China's fast-developing Internet economy and expanding workforce of highly skilled professionals have made foreign businesses eager to deliver Internet-based content and applications to the country (see Figures 1 and 2). From 2000–08, most Western enterprises leveraged the Internet primarily to extend their brands into China, but in the last two years many companies have shifted the purpose of their China-focused Internet initiatives. Many new initiatives move beyond basic website branding and instead target Chinese consumers for Internet-based sales or to extend enterprise applications, such as enterprise resource planning and supply chain management, to China-based employees and partners. All three types of initiatives—branding, conducting online sales, and managing enterprise applications—are "must do" items for companies with a China strategy.

Yet for all but the most China- and tech-savvy firms, optimizing and managing websites and web applications—such as customer support portals, e-commerce auction functions, and supply chain applications—in China can be daunting tasks. An array of business and government obstacles slow the licensing process, and Internet infrastructure obstacles slow the performance of Internet-based applications to a crawl.

In this environment, companies that seek to introduce their websites and web applications to China must understand best practices that address:

- How to identify and obtain the appropriate Internet licenses;
- How to manage website and application performance over China's unpredictable Internet; and
- When to partner with an external specialist, instead of relying on internal staff.

Though the answers to these questions provide useful tips for a China Internet strategy, they also demonstrate that any Internet-based initiative that targets China must include realistic timelines for project milestones. By preparing for China's Internet-related obstacles, companies can maximize investments in their website and enterprise applications.

Quick Glance

- China's Internet performance and licensing landscape is complicated and can be difficult to navigate.
- Companies that seek to enter China must develop strategies to ensure their Internet applications function properly in the country.
- When deciding whether to partner with a content delivery network or "go it alone," companies should evaluate their resources, technical skills, and experience in China.

Internet content licenses

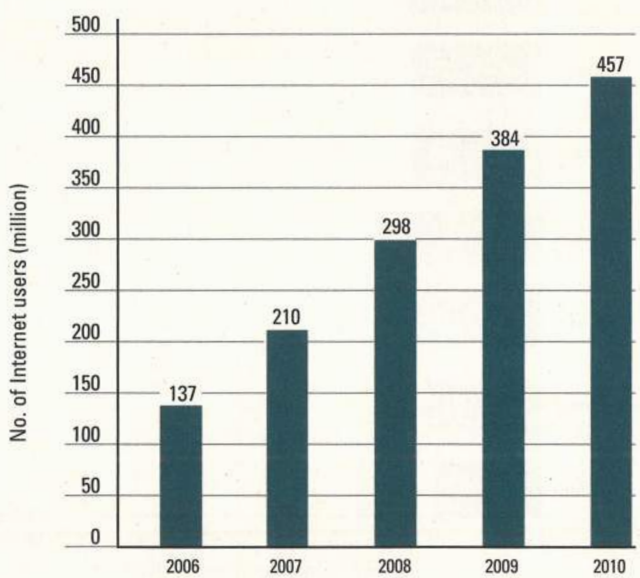
The most common license the PRC Ministry of Industry and Information Technology (MIIT)—the agency that manages licensing—requires is called the *bei an* license. All foreign-based and domestic organizations that wish to register an Internet domain in China must possess this license. Though some organizations may acquire *bei an* licenses 1–12 months after the initial application, the process typically takes 3–6 months (see p.46). To acquire the license quickly, companies should arrange to have a representative in China for the entire licensing period. This individual should be personable and comfortable with managing evolving requirements that may arise when dealing with the PRC government. For example, the government in April 2011 created the State Internet Information Office—a new agency tasked with patrolling the Internet. The agency will likely introduce additional Internet-related rules and regulations.

Companies that receive fast license approval usually rely on a representative with strong Chinese-language skills and a business development background. Managing the licensing process requires in-person meetings, so businesses should plan accordingly before assigning a US-based employee to oversee the process. Companies can assign licensing tasks to a local staffer without in-depth government relations experience, but this strategy has risks if the local employee lacks the skills and contacts to manage key government relationships. Organizations that pursue this strategy often spend considerable time and money to revitalize stalled efforts, and possibly even to repair damaged government relationships.

China's Internet performance landscape

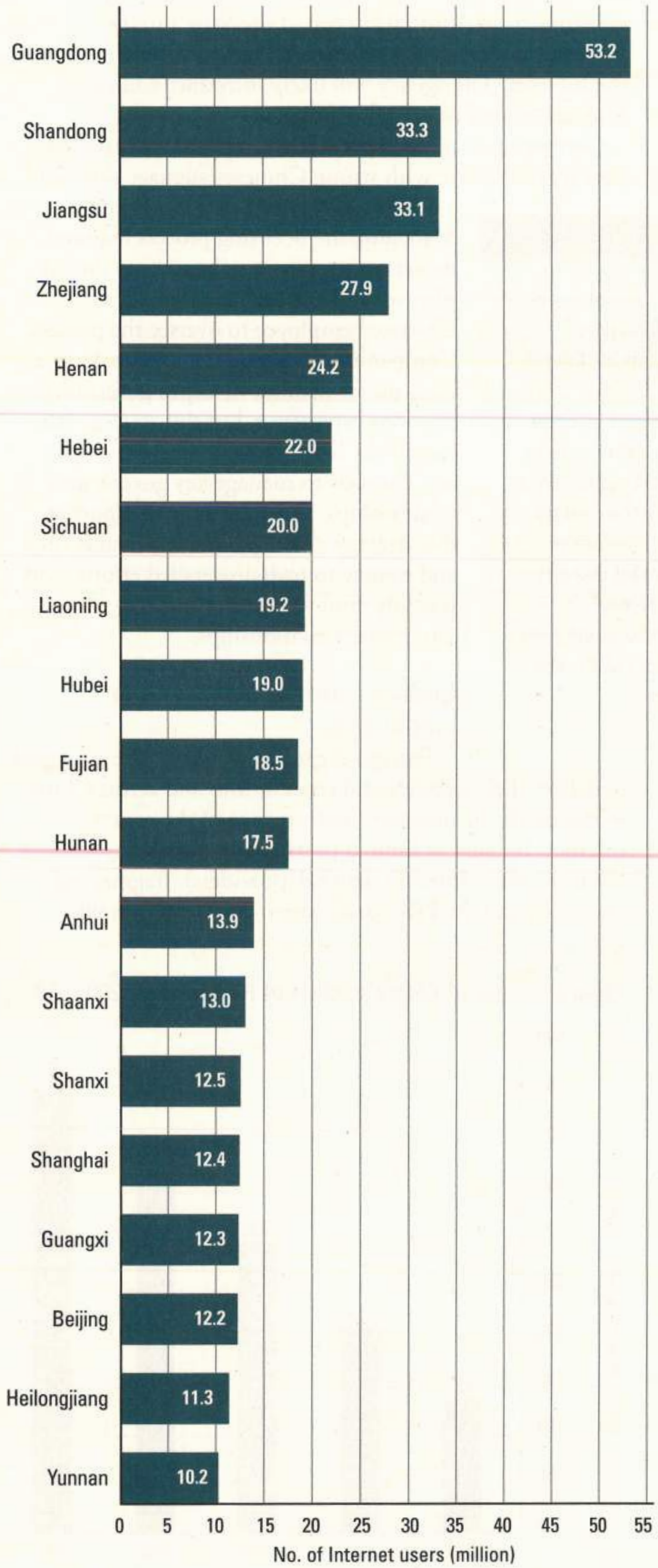
Foreign organizations that have struggled to deliver their websites and content into and across China recognize the inconsistent performance of the country's Internet. Because of limited peering points (traffic exchange points between Internet network providers), fragmented networks, and the PRC government-managed firewall,

Figure 1: Size of China's Internet Population, 2006–10



Source: China Internet Network Information Center (CNNIC)

Figure 2: Provinces and Municipalities in China with More than 10 Million Internet Users, 2010



Source: CNNIC

many Internet initiatives are plagued by slow web page and application downloads, failed web pages, and application timeouts. Companies should thus explore options for overcoming China's Internet performance lapses while they navigate the licensing process.

Local data centers

Because China's Internet is run by a fragmented network of competing telecom operators over vast geographies, China possesses far fewer peering points compared to the United States and Europe. This lack of peering points creates backlogs that lead to slow Internet speeds. Foreign companies should consider making special arrangements to deliver content at rates faster than those provided by the networks' basic peering agreements (standard speeds of data flows between different networks). To achieve faster performance, website owners must purchase peering upgrades at an additional price from multiple Internet service providers. For such service upgrades, companies should plan to pay a premium of 300–800 percent more than the price of basic peering agreements.

Some foreign companies have attempted to increase their website and web application performance and avoid China's bureaucracy by setting up operations elsewhere in Asia.

By locating servers in regions close to China, such as Hong Kong and Singapore, website owners can improve performance in China. But this strategy does not address China's internal peering issues and costs more than hosting a website and applications in Western countries.

Bei An License Application Procedures

Bei an license applications are processed through the PRC Ministry of Industry and Information Technology (MIIT). A company that seeks this license should be prepared to submit to MIIT

- A copy of the company's business license in China, with a company seal;
- A domain name certificate;
- An identification (ID) card and photo ID of a Chinese contact person; and
- Signed license application forms.

Because application procedures and policies change frequently, companies should check the MIIT website (www.miitbeian.gov.cn) before beginning the application process. Specific requirements may vary between companies, depending on industry and the nature of the content the companies wish to deliver.

—*Samuel Birnbaum*

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Content delivery networks

To boost web application performance, companies can also employ a content delivery network (CDN) to deliver content on their behalf. CDNs are companies that own servers and data centers in multiple networks in and outside China and have experience collaborating with PRC government agencies, such as MIIT, to accelerate approval processes. Companies that hire CDNs maintain control of their domestic data centers, forego Asia-based centers, and pass their applications and content directly from their home networks to the CDN service provider. CDNs can streamline companies' entry into targeted markets and save time, effort, and up-front costs. For example, a company that needs to establish several data centers in China can save more than $100,000 in up-front infrastructure costs and several thousand dollars per month in operating costs. Companies' whose CDN provider also possesses global capabilities may leverage a single relationship across multiple countries without changing their home-country infrastructure.

The decision to partner or tackle China's Internet market alone should depend on several factors:

- The company's depth of knowledge on Internet technologies;
- The company's understanding of China-specific Internet infrastructure nuances;
- The company's ability to employ business development experts with Mandarin-language skills; and
- The company's risk profile.

Companies with a high risk tolerance and substantial China market savvy and staff have been known to successfully "go it alone" using their own data center arrangements with local Chinese data center providers. These companies tend to be multinational corporations with longer-term goals and lower short-term expectations. Companies that seek fast entry with minimal up-front investment, however, may find a CDN provider to be the most efficient way to enter China.

Best practices for foreign Internet companies in China

Foreign companies in China can take several steps to promote strong Internet performance and avoid lapses in service.

- When deciding whether content is appropriate for China, companies should seek the counsel of a service provider with experience delivering a broad range of web content into China.
- Firms should comply with PRC requests related to the Internet whenever possible, as non-compliance can result in the permanent black-listing of a website. Companies must carefully monitor changes to PRC government rules, as rules can change frequently.
- When using a CDN, companies should do so on a global basis and incorporate their China strategy into that global view.

Sound strategies

Companies of all sizes should establish market-entry strategies that take into account China's unique Internet environment. A sound strategy should account for stringent and evolving government regulations; the need for in-person collaboration with government agencies; and technical hurdles presented by inefficient network connectivity and China's government-managed firewall.

Organizations that fail to plan their China Internet strategy carefully can quickly find themselves bogged down in government red tape and technical breakdowns. Companies that seek the advice of experienced solution and content providers that have already entered China may benefit from the experiences of others. 完

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Case Study: How One Company Optimized Supply Chains

Historic Futures Ltd. (HF) is a UK-based company that provides supply chain traceability consulting services and solutions. The company's unique Internet-based tracing application known as "String," allows brands and retailers to visualize complete supply chains, from primary production to finished product. The application is used by many major brands, including the Gap, Inc.; Levi Strauss & Co.; and Wal-Mart Stores, Inc. String helps brands learn more about their supply chains and assure customers that product quality matches branding claims.

Poor Internet performance caused String to load at painfully slow speeds when first introduced in China. The application was served by two data centers in Manchester, England, and China-based users experienced average login delays of 25 seconds and slow speeds when using the application. Some suppliers complained that these performance issues made String unusable in China. As a result, HF customers struggled to collect traceability data. HF needed to improve its applications' performance in China—a key sourcing partner country for its brand customers—or risk losing the brands' business.

According to Simon Warrick, HF's chief technology officer, expanding internationally "would have cost thousands of pounds per data center per month. Plus we would have had to deal with the headache of managing globally dispersed facilities."

HF instead chose to use a content delivery network (CDN) partner to improve String's performance in China. The CDN partner was critical to String's performance because String is a dynamic application that requires many database transactions from end users in China to data centers in the United Kingdom. With help from the CDN partner, login times quickly shrank from 25 seconds to 3 seconds on average. The dramatic performance improvements allowed HF to begin developing a more feature-rich version of the String application for the China market.

—Jeff Kim

China remains the third-largest US export market.

US Exports to China Rebound in 2010

Nearly all US states posted triple-digit export growth to China in 2010, and exports performed well in the first quarter of 2011.

US-China Business Council staff

Overall US exports to China rose rapidly in 2010, increasing 32 percent over 2009, when exports dipped slightly because of the recession. According to a recent report by the US-China Business Council (USCBC), publisher of the *CBR*, exports to China are a vital part of the US economic recovery. China remains the third-largest US export market. Only Canada and Mexico—both of which have free-trade agreements with the United States—buy more US goods. China was the fastest-growing export market among the top five US export destinations last year, and total US exports to China reached $91.9 billion in 2010, up 468 percent since 2000. US exports to the rest of the world increased 55 percent over the same period. Since 2000, US exports to China have risen faster than exports to any other market.

The top five US exports in 2010 were computers and electronics, crops, chemicals, transportation equipment, and non-electrical machinery. The top five states exporting to China—California, Washington, Texas, Louisiana, and Oregon—primarily exported these goods.

More states are increasing exports to China, with 47 states registering triple-digit growth in exports to China since 2000 (see p.50). Though the top three states produce roughly one-third of US exports to China, nearly half of US states exported more than $1 billion in manufactured and agricultural goods to China in 2010. Thirty states now count China as one of their top three export markets. Some of the top 15 state exporters are states not usually thought to benefit from trade with China, such as Michigan, New York, North Carolina, Ohio, Pennsylvania, South Carolina, and Tennessee.

The China market also offers significant opportunity for US small and medium-sized enterprises (SMEs). According to the US Department of Commerce's Census Bureau, American SMEs—businesses with fewer than 500 employees—exported $22.6 billion worth of goods, or roughly 34.5 percent of all US exports to China in 2009 (see p.49).

Despite rapid increases in US exports to China, US products made up just 7 percent of PRC imports in 2010, down from 10 percent in 2000. Japan, the European Union, South Korea, and Taiwan exported more goods to China than the United States last year.

US exports to China in the first quarter of 2011 increased 23 percent year on year to reach $26 billion, the second-highest quarterly performance for US exports to China. This number could reach roughly $115 billion by the end of 2011. Agricultural products were the top export to China, with computers and electronics, chemicals, non-electrical machinery, and waste and scrap rounding out the top five exports in the first quarter of 2011.

All 2010 data used in the USCBC study came from the US Census Bureau. For each of the 50 states, the report tracked the annual volume of exports to China over the past 11 years, 2000–10 growth in exports to China, 2000–10 growth in exports to the rest of the world, top five export markets, and top five exports to China. The complete report is available on the USCBC website (www.uschina.org/public/exports/2000_2010). USCBC will release a report on US exports to China by congressional district this summer. 完

Breaking Down Barriers for Small Business Exports

Small businesses made up 97 percent of all US companies that exported goods and services abroad in 2009, but they only generated roughly one-third of all export revenue, according to the US Census Bureau. The US government is looking to boost small business exports with the National Export Initiative (NEI)—an initiative started in January 2010 by US President Barack Obama—which aims to double US exports and create millions of jobs in the United States by the end of 2014.

"To double exports we need to increase the number of small business exporters," said Richard Ginsburg, an international trade specialist with the US Small Business Administration (SBA). Fifty-eight percent of roughly 250,000 US small and medium-sized enterprise (SME) exporters ship to just one market. Ginsburg says one of the key goals of NEI is to help those firms ship to multiple markets.

China has been a growing market for American SMEs—companies with fewer than 500 employees. According to the US International Trade Administration, the number of American SMEs exporting to China increased by 776 percent from 1992 to 2009. But there is still room for growth. Though China is the third-largest market for SME exports, only 10.2 percent of American SME exporters shipped goods to China in 2009.

US Export Assistance Centers

Of the 20 US government agencies involved in export assistance, SBA specifically aims to increase the number of small business exporters through programs delivered through US Export Assistance Centers. Senior SBA trade and finance specialists—along with employees from the US Commercial Service and the US Export-Import (Ex-Im) Bank—staff 20 of more than 100 US Export Assistance Centers in metropolitan areas around the country. The centers help "export-ready" companies begin to export or expand to new markets abroad by providing counseling, training, export insurance and loans to these businesses; conducting market research; and facilitating contracts between US exporters and foreign buyers.

Ginsburg says small business owners usually approach an Export Assistance Center when they want to make a deal with a foreign buyer or when they receive an order from a foreign buyer and have never exported before. The centers can help companies understand payment terms and conditions, help them handle logistics such as shipping, and refer them to translators. These transactions are often simple when doing business in the United States, but they can be complicated when crossing international borders.

Counseling, outreach, and loan programs help break down what Ginsburg calls the "psychological trade barriers" that prevent small businesses from exporting. "There are people who feel they can lose their business if they export," Ginsburg says. "The risks are so much more than shipping across town or across the state or across the country." For example, small business owners sometimes fear that they will not be able to collect payments from overseas buyers.

Companies that want to export face barriers such as language and lack of knowledge of the foreign regulatory environment, and—specifically for businesses exporting to China—fear of intellectual property rights infringement, Ginsburg says.

Export loans for small businesses

In addition to counseling and training, SBA guarantees loans of up to $5 million, while the Ex-Im Bank provides export financing for amounts over $5 million. "It's a success story for SBA when we're working with a small business exporter and they outgrow the small loan amount and need more than the $5 million SBA threshold," Ginsburg says.

SBA runs four loan programs for small business exporters: the Export Express Program, Export Working Capital Program, International Trade Loan Program, and SBA and Ex-Im Bank Co-Guarantee Program. The Export Express Program, formerly a pilot program, was made permanent in 2010 with the passage of the Small Business Jobs Act of 2010 to support the NEI goal of increasing small business exports. The program aims to streamline the export loan process for small businesses. SMEs that have been operating for at least 12 months can receive up to $500,000 to finance export activities, such as participating in foreign trade shows, purchasing equipment, and translating product literature. The law also permanently increased loan limits on export working capital and international trade loans.

Companies can obtain more information on export loans from the nearest Export Assistance Center and apply directly for loans through SBA lenders. Visit www.export.gov/eac to contact the nearest center or www.sba.gov/content/us-export-assistance-centers for a list of centers with SBA representatives.

—Christina Nelson

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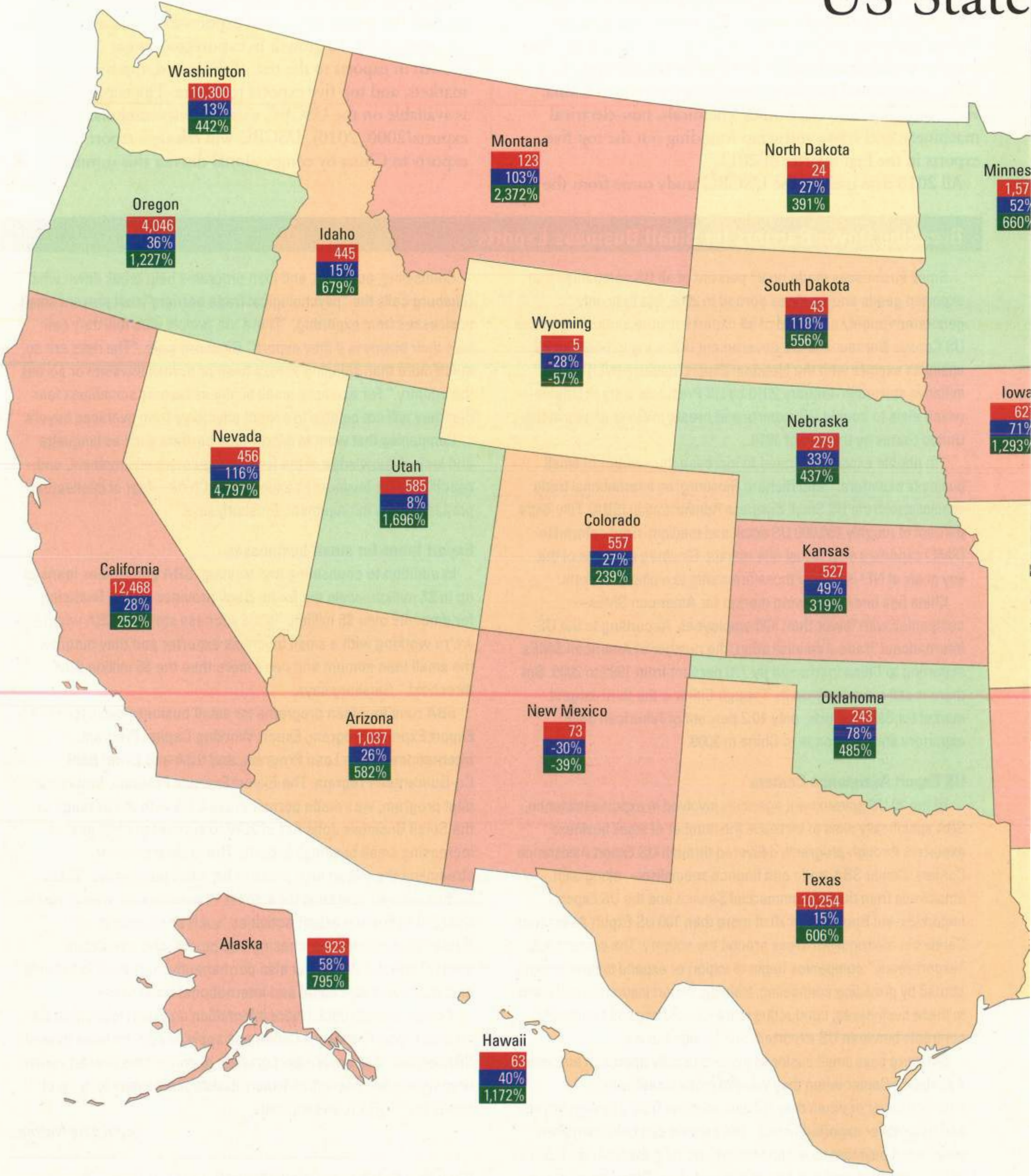
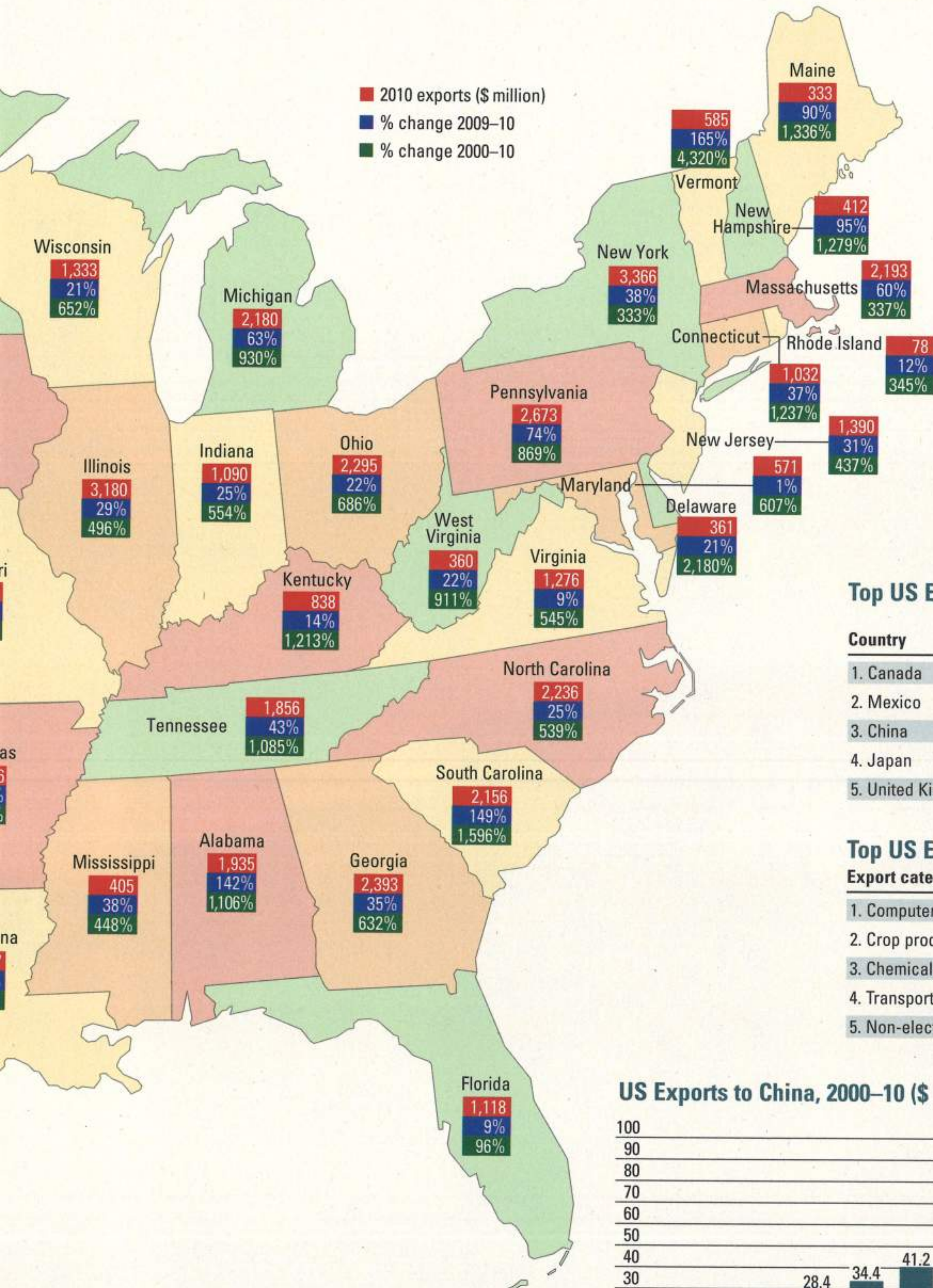
US State



Sources: US Department of Commerce; US-China Business Council, *US Exports to China by State, 2001–10*

Exports to China



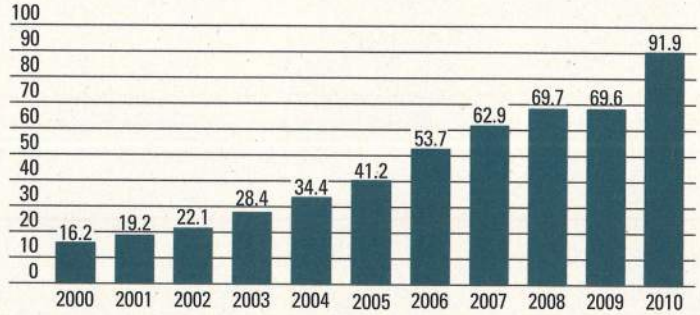
Top US Export Markets, 2010

Country	Volume ($ billion)	% change over 2009
1. Canada	248.2	21.3
2. Mexico	163.3	26.7
3. China	91.9	32.2
4. Japan	60.5	18.4
5. United Kingdom	48.5	6.1

Top US Exports to China, 2010

Export category	Volume ($ billion)
1. Computers and electronics	15.3
2. Crop production	13.8
3. Chemicals	11.8
4. Transportation equipment	10.6
5. Non-electrical machinery	9.3

US Exports to China, 2000–10 ($ billion)



Transparency in China: A Work in Progress

The PRC government has made strides to boost regulatory transparency, but progress remains inconsistent.

Francesca Baruffi

China Foto Press

The PRC government is making slow progress toward a transparent regulatory system.

Regulatory transparency consistently ranks as one of the top concerns of US companies in China, according to annual US-China Business Council (USCBC) membership surveys. Because regulatory and policy-making procedures shape the investment environment for foreign and domestic companies, the degree of transparency in the regulatory system can be favorable or detrimental to the interests of enterprises. Over the past several years, the PRC central government has made a considerable effort to improve transparency and has bolstered policies for soliciting public feedback on new and revised laws and regulations, opened government decisionmaking processes, and boosted the public's ability to access price index and market information.

As part of ongoing bilateral discussions on transparency, China at the 2008 Strategic Economic Dialogue (SED) pledged to release drafts of all economic laws and regulations for 30-day public comment periods. At the May 2011 Strategic and Economic Dialogue (S&ED) in Washington, DC, the PRC government further pledged to publish its 2008 SED transparency commitments as domestic regulations. China's transparency record from mid-April 2010 through mid-March 2011 showed mixed results, however. Though China's recent commitments are a positive step, enhancing regulatory transparency depends on effective implementation.

Quick Glance

- Lack of regulatory transparency is a major concern for foreign companies in China.
- China in 2010 made progress toward meeting its transparency commitments, but further improvements are needed.
- Companies should participate in the formulation of regulations by the State Council and its agencies, including by submitting comments on draft regulations at the government's request.

Tracking transparency

USCBC in 2008 began tracking and reporting on PRC central-government efforts to increase transparency and public participation in government rule-making (see p.55). USCBC's analysis has examined areas in which the central government has stated, either on its own or through bilateral agreements, its intentions to improve transparency:

- Compliance with the PRC National People's Congress (NPC) Standing Committee's April 2008 announcement that it would solicit public comments on most draft laws and amendments it reviews to promote open participation in the legislative process;
- Adherence to the June 2008 SED transparency commitment to "publish for public comment all trade and economic-related administrative regulations and departmental rules" for at least 30 days on the State Council's Legislative Affairs Office (SCLAO) information website comment pages; and
- Other ministry efforts to increase transparency, including policies implemented in accordance with the May 2008 State Council's Regulations on the Disclosure of Government Information.

Findings based on these criteria from mid-April 2010 to mid-March 2011 suggest that the PRC government could further improve transparency efforts, particularly in the formulation of rules and regulations by the State Council and its agencies.

NPC transparency commitments

The USCBC analysis finds the NPC has complied reasonably well with the transparency measures it outlined in April 2008. Most draft laws were released for a 30-day comment period at least once during their standard three rounds of NPC Standing Committee review. Out of 14 laws (including amendments) passed in the period analyzed, 11 were posted to the NPC website for comment, a higher percentage than the State Council and its ministries and agencies.

State Council and SED transparency commitments

In comparison, the publication of trade and economic-related rules and regulations for comment on SCLAO's information website has been inconsistent. According to USCBC analysis, using the broad definition of administrative rules and regulations, less than one-quarter of relevant documents (70 of 338) issued from mid-April 2010 to mid-March 2011 were posted for public comment to SCLAO's dedicated webpage, and only three were posted for the full 30 days.

Using the narrower definition of administrative rules and regulations, less than half of the relevant documents (72 of 165) were posted for public comment on a designated SCLAO website. Of these, 11 were posted for the full 30-day period. An additional 20 percent of these documents (33 of 165) were posted on the websites of their respective drafting ministries (but not the SCLAO websites), with 12 of these posted for comment for the full 30 days. The average comment period for all documents posted to the State Council or relevant ministry websites during this period was 17 days.

These numbers are an improvement from the results of USCBC's 2010 transparency report, which found that roughly one-quarter of the documents issued (51 of 209) between mid-June 2009 to mid-April 2010 were posted for comment on the SCLAO website under the narrow definition (see the *CBR*, September–October 2010, p.38). Only three of these were posted for a full 30 days and the average comment period was 18 days.

The frequency of comment solicitation on draft rules and regulations varies greatly among ministries under the State Council. Two agencies with fairly consistent records of soliciting comments are the Ministry of Transportation (MOT) and the Ministry of Agriculture (MOA).

These agencies posted most of their respective circulated or issued documents for comment on the SCLAO comment pages, with MOT posting four out of five total documents issued on the SCLAO webpage, and MOA posting four out of four total documents issued on the SCLAO webpage.

Recent developments in PRC transparency

The PRC government continues to emphasize its commitment to increase transparency through various statements and regulations aside from the NPC and SCLAO commitments.

Ministries report on transparency efforts

Multiple PRC government ministries under the State Council—including the Ministry of Foreign Affairs, the Ministry of Industry and Information Technology, and the National Development and Reform Commission—published reports on their own information disclosure mechanisms in 2010. The agencies used 2010 statistics to analyze transparency initiatives, including efforts to encourage intra-agency information disclosure, solicit public comments for draft regulations, and pinpoint areas for improvement within the agencies. Each agency indicated that they had improved certain areas, such as media broadcasting of regulatory developments. They also emphasized goals to increase transparency and post more documents for comment in 2011.

Ministry of Health (MOH) adopts information disclosure mechanism

The August 2010 Interim Measures on the Information Disclosure of Healthcare Service Entities stipulate that healthcare services institutions should release information that reflects the functions, rules, and procedures of healthcare institutions; and information that must be publicized under other PRC rules and regulations. Moreover, the measures require healthcare institutions to release to patients information on the medical products and devices healthcare providers use.

SCLAO reports transparency efforts

SCLAO in March 2011 reported that it had expanded efforts to increase transparency, citing 12 press conferences to report regulations, the disclosure of 14 national regulations in 2010 for public comment, and the release of legislation and other regulations through media, local conferences, and television. SCLAO aims to improve legislation to encourage government information disclosure in 2011.

Chinese Academy of Social Sciences (CASS) ranks government transparency

CASS in February 2011 ranked government ministries by their progress on transparency commitments in 2010. The Ministry of Science and Technology, MOA, and MOT were ranked among the most transparent agencies. The CASS report ranked Ningbo, Zhejiang; Fuzhou, Fujian; Dalian, Liaoning; Qingdao, Shandong; and Zhuhai, Guangdong, as having the most transparent local governments. CASS also found that top transparency problems included complicated, malfunctioning, or outdated public comment websites.

State Council pledges to strengthen rule of law

The State Council in October 2010 released the Opinions on Strengthening the Construction of a Law-Based Government, which were implemented in early 2011 at the local level as guidelines for promoting rule of law, including transparency efforts. The opinions encourage local governments to publicize processes and regulations, disclose the conduct of state-owned services and industries, and strengthen government oversight of individual and agency conduct.

State Council releases security review notice without comment period

The State Council on February 3, 2011 announced that all merger and acquisition deals that include a foreign investor would be subject to a review process to assess the transaction's effects on China's national security. Deals found to threaten PRC national security will be terminated or approved conditionally. This notice was released without a comment period, in contradiction to China's transparency commitments. In addition, the PRC Ministry of Commerce, as one of the supporting agencies to the security review, began soliciting comments for provisional regulations while concurrently implementing the regulations.

Though the US government has advocated for increased regulatory transparency and the rights of US companies in China, there remains much room for improvement.

Recommendations

Transparency will likely remain a long-term hurdle for US companies that invest in China. The PRC government's transition to a transparent legal system presents unique challenges without easy or quick solutions. Though the US government has advocated for increased regulatory transparency and the rights of US companies in China, there remains much room for improvement.

Transparency will likely remain a long-term hurdle for US companies that invest in China.

To work as effectively as possible in China's regulatory environment and promote transparent legal processes, companies should

- **Submit public comments and feedback as requested by the relevant PRC agencies** Timely comments from foreign companies will help inform the PRC government about potential issues and reinforce the value of transparent processes.
- **Provide relevant and timely feedback on transparency issues to US government agencies** Useful feedback may include information on recent transparency roadblocks US investors have encountered in China or positive developments that the PRC government has made in regulatory transparency. On-the-ground reports from US companies may serve as useful talking points for US government negotiators in bilateral meetings, as demonstrated at the most recent S&ED.
- **Work with Chinese industry associations and other stakeholders to locate drafts for public comment** Many of these associations have strong ties to key PRC government agencies that can be leveraged to help foreign companies communicate regulatory suggestions. Associations may also have access to drafts or other regulatory information that are unavailable to the broader public.

Meanwhile, USCBC cites a few ways in which the State Council could improve the current submission process and increase public participation:

- Ensure all administrative regulations and departmental rules are posted on the designated SCLAO information website comment page for the full 30-day comment period. An even longer comment period of 60 or 90 days would be preferable and result in better comments for government regulators' consideration.
- Consider requiring other broadly defined documents—such as catalogues, notices, and opinions, which often affect industry significantly—to be posted for public comment, in addition to the rules, regulations, and measures that currently must be posted for comment periods.
- Explain in detail, and within the bounds of confidentiality, the economic methodology and rationale

Continued on page 58

Methodology

To track PRC government compliance with its transparency commitments, the US-China Business Council (USCBC) monitored the drafting and issuance of ministry and State Council government regulations and laws from mid-April 2010 through mid-March 2011 and identified whether they had been posted for comment on the State Council Legislative Affairs Office (SCLAO) comment pages or ministry website pages. Documents that had been issued but not posted for comment were considered documents that did not meet China's 2008 Strategic Economic Dialogue (SED) commitment to transparency. USCBC also tracked whether documents were posted for the full 30-day comment period.

For the purposes of this analysis, USCBC used two separate filters for "trade and economic-related administrative regulations and departmental rules" used in China's 2008 SED commitment:

- A narrow definition that includes only documents explicitly labeled as State Council or departmental administrative regulations, such as "provisions" (*guiding*), "regulations" (*tiaoli*), and "measures" (*banfa*); and
- A broader category that adds other administrative regulations that appear to function as State Council or departmental administrative regulations, such as "opinions" (*yijian*), "notices" (*tongzhi*), and "guides" (*zhiyin*).

—Francesca Baruffi

PRC Government Structure

The China Business Review

CENTRAL COMMITTEE OF THE CHINESE COMMUNIST PARTY

General Secretary
Hu Jintao

Central Military Commission Chair
Hu Jintao

Politburo Standing Committee Members (by rank)
Hu Jintao
Wu Bangguo
Wen Jiabao
Jia Qinglin
Li Changchun
Xi Jinping
Li Keqiang
He Guoqiang
Zhou Yongkang

President Hu Jintao

Vice President Xi Jinping

NATIONAL PEOPLE'S CONGRESS

Standing Committee

Chair Wu Bangguo

Vice Chairs (by rank)
Wang Zhaoguo
Lu Yongxiang
Uyunqimg
Han Qide
Hua Jianmin
Chen Zhili
Zhou Tienong
Li Jianguo
Ismail Tiliwaldi
Jiang Shusheng
Chen Changzhi
Yan Junqi
Sang Guowei

Secretary General Li Jianguo

NPC Committee Directors

Agriculture and Rural Affairs Wang Yunlong

Education, Science, Culture, and Public Health Bai Keming

Environmental and Resource Protection Wang Guangtao

Financial and Economic Affairs Shi Xiushi

Foreign Affairs Li Zhaoxing

Internal and Judicial Affairs Huang Zhendong

Legal Affairs Hu Kangsheng

Ethnic Affairs Ma Qizhi

Overseas Chinese Affairs Gao Siren

CHINESE PEOPLE'S POLITICAL CONSULTATIVE CONFERENCE

Chair Jia Qinglin

Supreme People's Court
President Wang Shengjun

Supreme People's Procuratorate
President Cao Jianming

STATE COUNCIL

Premier
Wen Jiabao

Vice Premiers
Li Keqiang, Hui Liangyu, Zhang Dejiang, Wang Qishan

State Councilors
Liu Yandong, Liang Guanglie, Ma Kai, Meng Jianzhu, Dai Bingguo

Secretary General
Ma Kai

Offices of the State Council*
Legislative Affairs Office Song Dahan
Research Office Xie Fuzhan

MINISTRIES AND COMMISSIONS

- **Ministry of Agriculture** — Han Changfu
- **Ministry of Civil Affairs** — Li Liguo
- **Ministry of Commerce** — Chen Deming
- **Ministry of Culture** — Cai Wu
- **Ministry of Education** — Yuan Guiren
- **Ministry of Environmental Protection** — Zhou Shengxian
- **Ministry of Finance** — Xie Xuren
- **Ministry of Foreign Affairs** — Yang Jiechi
- **Ministry of Health** — Chen Zhu
  - **SFDA** — Shao Mingli
- **Ministry of Housing and Urban-Rural Development** — Jiang Weixin
- **Ministry of Human Resources and Social Security** — Yin Weimin
- **Ministry of Industry and Information Technology** — Miao Wei
- **Ministry of Justice** — Wu Aiying
- **Ministry of Land and Resources** — Xu Shaoshi
- **Ministry of National Defense** — Liang Guanglie
- **Ministry of Public Security** — Meng Jianzhu
- **Ministry of Railways** — Sheng Guangzu
- **Ministry of Science and Technology** — Wan Gang
- **Ministry of State Security** — Geng Huichang
- **Ministry of Supervision** — Ma Wen
- **Ministry of Transport** — Li Shenglin
- **Ministry of Water Resources** — Chen Lei
- **National Audit Office** — Liu Jiayi
- **National Development and Reform Commission** — Zhang Ping
  - **NEA** — Liu Tienan
- **National Population and Family Planning Commission** — Li Bin
- **People's Bank of China** — Zhou Xiaochuan
  - **SAFE** — Yi Gang
- **State Ethnic Affairs Commission** — Yang Jing

OTHER KEY ORGANIZATIONS DIRECTLY UNDER THE STATE COUNCIL*

- **Administration of Quality Supervision, Inspection, and Quarantine** — Zhi Shuping
- **China Banking Regulatory Commission** — Liu Mingkang
- **China Insurance Regulatory Commission** — Wu Dingfu**
- **China National Tourism Administration** — Shao Qiwei
- **China Securities Regulatory Commission** — Shang Fulin
- **Development Research Center of the State Council** — Li Wei
- **General Administration of Customs** — Yu Guangzhou
- **General Administration of Press and Publication** — Liu Binjie
- **General Administration of Sport** — Liu Peng
- **National Bureau of Statistics** — Ma Jiantang
- **State Administration for Industry and Commerce** — Zhou Bohua
- **State Administration of Radio, Film, and Television** — Cai Fuchao
- **State Administration of Taxation** — Xiao Jie
- **State Administration of Work Safety** — Luo Lin
- **State Asset Supervision and Administration Commission** — Wang Yong
- **State Electricity Regulatory Commission** — Wu Xinxiong
- **State Forestry Administration** — Jia Zhibang
- **State Intellectual Property Office** — Tian Lipu
- **Xinhua News Agency** — Li Congjun

Sources: PRC government websites

Notes: *Not comprehensive; **Wu Dingfu will reach traditional retirement age in July; NEA = National Energy Administration; SAFE = State Administration of Foreign Exchange; SFDA = State Food and Drug Administration. This chart reflects appointments as of June 15, 2011.

Understanding Chinese Consumers

Continued from page 23

do not have a local partner. To meet central-government development targets, local governments may provide incentives to attract more foreign investment to their region.

Local regulators may deduct taxes, coordinate with real estate developers to reduce or eliminate rent, offer discount utility fees, speed up approval processes, or help companies find local suppliers and secure loans. In exchange for these measures, local governments sometimes ask foreign retailers to open more stores or establish regional headquarters in the area. In general, such negotiations may be more difficult in larger cities, where the local government has a greater choice of foreign direct investment options.

Localization is key

Facing such a unique group of consumers, foreign companies should focus on localizing operations. Localization does not simply involve opening an office and using Chinese packaging, but it also includes marketing, maintaining patience, and investing in research and development. Though the PRC government no longer requires foreign retailers to form joint ventures with local companies, many foreign retailers still favor partnering with local companies, which have more regional knowledge.

Demand for quality to skyrocket

Chinese consumers demonstrate different shopping patterns depending on their wealth, age, and location. Though many Chinese consumers demand less expensive products, a small but significant proportion is willing to pay a premium for higher quality. The biggest change in Chinese consumer behavior comes from the young generation's rising wealth and increasingly Westernized lifestyle. As time goes on, the demand for higher-quality products, particularly among younger generations, will accelerate and present huge opportunities for foreign brands. 完

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TRANSPARENCY

Transparency in China: A Work in Progress

Continued from page 55

that underpin central government bodies' administrative reviews and decisionmaking, including antimonopoly merger reviews, countervailing duty and antidumping investigations and case rulings, and decisions made based on "national economic security" considerations.

Looking forward

China's remarkable economic development over the past 30 years has resulted in progress on transparency issues, as China has moved toward a rule of law-based system and has built the political, economic, and social systems necessary to promote and govern investment. Despite this progress, inconsistent regulatory transparency has remained a major issue for investors in China and a top discussion point between the US and PRC governments.

Though statistics regarding public comment periods and the number of drafts open for comment to investors did not substantially improve over the past year, the PRC government has shown greater political will to respond to foreign investors' concerns by building on its commitments to increase regulatory transparency and improve implementation of transparency rules. Progress on this issue is not speedy, but it is being made one step at a time—as evidenced by the outcomes of the most recent S&ED. US companies should use existing channels for regulatory transparency and seek opportunities to advocate for their expansion with the goal of promoting an open, transparent environment for Chinese and foreign businesses. 完

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Coca-Cola Extends Partnership with WWF and UNDP to Advance Water Sustainability

LIVE POSITIVELY™

The Coca-Cola Company will donate USD 4 million to the United Nations Development Program (UNDP) in China and the World Wide Fund for Nature (WWF) Yangtze Partnership as part of the Company's long-standing commitment to water stewardship. USD 2 million of this commitment would be provided to support the UNDP's program which helps manage water resource efficiency and drinking water safety in China. A further USD 2 million will be provided for the WWF Yangtze partnership which aims to improve the health of key water source areas in the Yangtze River and the living standards of surrounding communities. These two programs will directly benefit 200,000 residents and replenish 2 billion liters of water back to nature annually. A total of over USD 8 million has been contributed to the UNPD and WWF programs since 2007.

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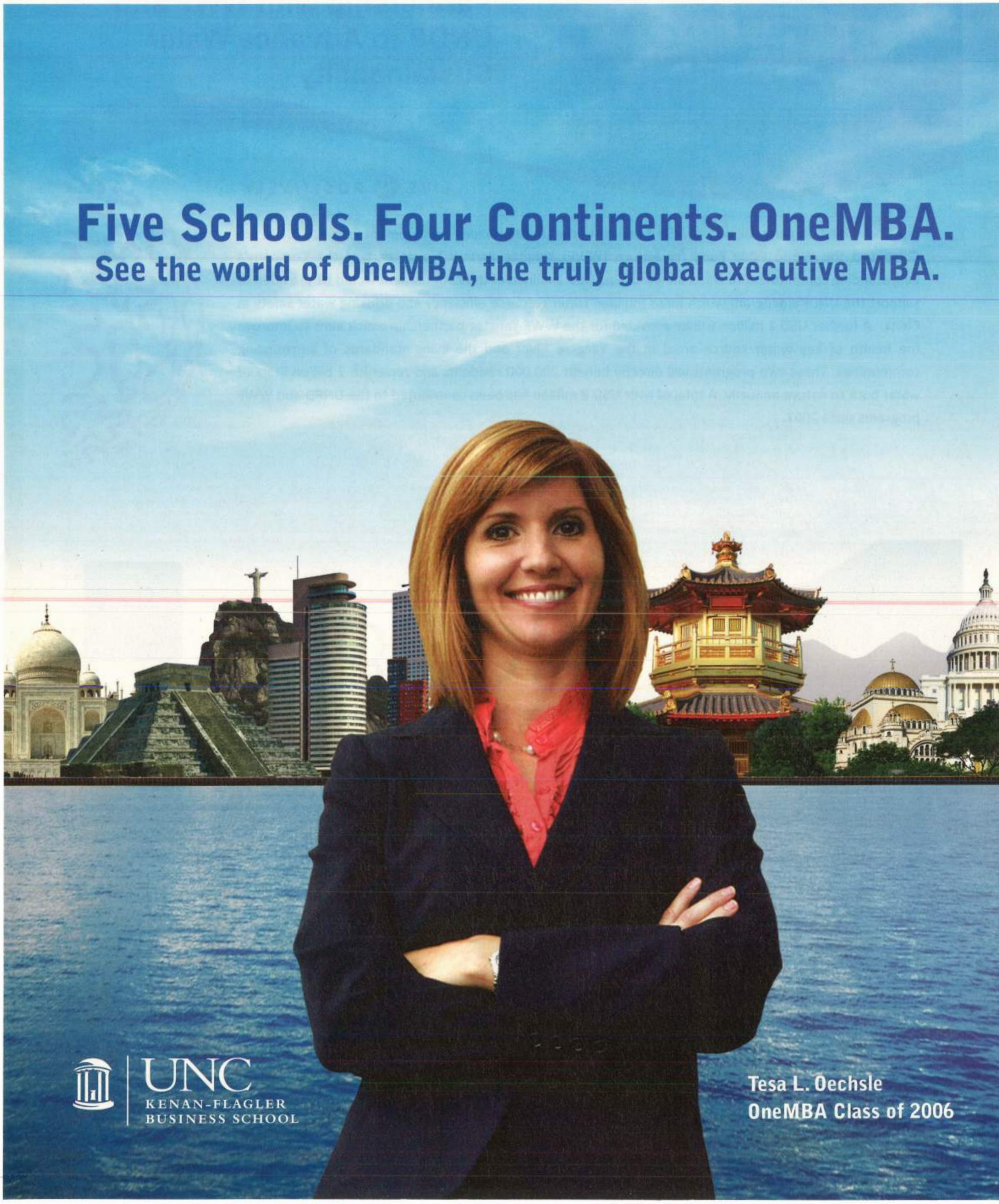

Ping Pong Diplomacy Lives On

Paula M. Miller

PRC Government

The 1971 US table tennis delegation with PRC Premier Zhou Enlai and other officials at the Great Hall of the People in Beijing.

This year marks the fortieth anniversary of Ping Pong Diplomacy (PPD)—a sports and cultural exchange launched when a small group of US table tennis players, on invitation from Beijing, visited China after the 1971 World Table Tennis Championship in Japan. Historians credit the visit for jump-starting US-China relations after 22 years without diplomatic ties and for paving the way for US President Richard Nixon's 1972 visit to China. After the US players' trek to Beijing, PRC players journeyed to the United States on a reciprocal visit in 1972.

To mark the fortieth anniversary of the exchange, USA Table Tennis (USATT) and the Chinese Table Tennis Association—with support from the US and PRC Olympic committees—have arranged celebrations in both countries through a cooperative agreement. A delegation of PRC officials, coaches, and players, including men and women who participated in the 1971 exchange and current elite and junior players, will visit the United States in early July for celebrations at the Milwaukee Art Museum and exhibition matches at the 2011 US table tennis open in Milwaukee, Wisconsin. USATT CEO Michael D. Cavanaugh explained, "The aim of including elite junior players in the celebration is to nurture the legacy aspect of PPD."

The delegation will also stop in San Francisco, California, to take part in cultural, educational, and diplomatic exchanges related to the anniversary, and the US leg of the tour will end at the Richard M. Nixon Library in Yorba Linda, California. The US delegation of officials, coaches, and players will make a reciprocal visit to China in late October to continue the celebration.

Five of the original players on the US team recently spoke to *CBR* about their memories of the 1971 trip, thoughts on the significance of PPD, and the future of table tennis in the United States. All of the players have returned to China—some several times—since their first visit and are stunned by the country's economic and social transformation. These five veteran team members still actively play and promote table tennis.

Their memories of the 1971 trip include meeting PRC Premier Zhou Enlai at the Great Hall of the People in Beijing; visiting the Great Wall; attending the opening ceremony; playing in exhibition matches in Beijing, Guangzhou, and Shanghai; and seeing the China that had been behind closed doors. Judy (Bochenski) Hoarfrost, the youngest member of the 1971 PPD team and the owner of Paddle Palace Table Tennis, recalled additional memories:

"The people wore green Red Guard uniforms and dark colored 'Mao suits,' and women had short cropped hair or tight braids. Political slogans and giant photos of Chairman Mao Zedong were plastered all over buildings and walls. There were bicycles everywhere, and people packed onto buses. The homes we visited looked barren. Learning about the Cultural Revolution [1966–76] and the official political philosophy was educational. We read from Mao's Red Book and went to political opera. I had my picture taken underneath a sign that read, 'People of the World, Unite and Defeat the US Aggressors and All Their Running Dogs.' Being in China at that time was like stepping into a completely different world."

Some people question the degree to which sporting events and cultural exchanges can help improve political ties between countries. Tim Boggan, an original PPD team member who is a writer, editor, and USATT historian, related: "The Olympics—which has a limited number of participants—and major tournaments such as the World Table Tennis Championships—where hundreds of participants from 136 countries recently participated—are conduits for international relations. For a week, players, coaches, and officials from around the world come together on courts or in the stands, at equipment booths or in meetings, and for cafeteria-style meals in huge halls. You can't help but see the large world and know that you're a real part of it. The different powers that be realize they have a common sports goal and must get along with one another."

George Braithwaite, an original PPD team member who is a USATT certified national-level coach and continues to win national titles, added: "Where governments have failed to communicate effectively in a positive way, sports have succeeded. The Olympic games provide the biggest and greatest arenas for improving relations across nations. Though it may be naïve to think that the world could exist simply through sports, sports can help considerably in the same way that PPD brought two of the world's greatest powers together by paving the way for improved relations."

The teams have helped celebrate the anniversaries of PPD and the establishment of US-China diplomatic relations in the past, and they remain enthusiastic about promoting the importance of PPD—and the sport itself—in the future. When discussing the goals of the fortieth anniversary celebration, Hoarfrost related: "The fortieth anniversary of Ping Pong Diplomacy is a continuation of what we started in 1971. It is a way of celebrating the wonderful and unique way that table tennis was able to touch the hearts of people in China and the United States. We celebrate peace, we celebrate sport, and we celebrate moving forward together to build a wonderful and stable world for ourselves and our children."

Boggan remarked: "Peace and friendship are the first goal, and competition is second. Cooperation between the two countries—diplomacy—is the imperative. In my view, the aim is to foster goodwill among the countries, treat each other with respect, and if possible see a meaningful glimpse of different lives and cultures."

Connie Sweeris, a veteran PPD team member who co-hosted the 2010 US Open Table Tennis Championship in Grand Rapids, Michigan, with her husband Dell, commented: "One of the goals is to celebrate Ping Pong Diplomacy's place in history—that it helped to open diplomatic relations. Another goal is to showcase table tennis to America through the exhibition matches."

Since table tennis is more popular in many other parts of the world than it is in the United States, the veteran players helped answer what can be done to boost the sport's popularity in the United States. Braithwaite said: "There was a time when the United States was a world power in table tennis, having won two world mixed-doubles championships in 1948 and 1956, world women's singles championships in 1936 and 1937, and world men's doubles championships also in the 1930s. But a change occurred in the 1960s when the major table tennis powers in the world saw the need for and took measures to construct a national league system in their respective countries—similar to how the United States has a league system for major sports, such as baseball, basketball, and football. Implementation of the league system resulted in the rest of the world moving ahead of the United States, while US players remained as individuals with limited opportunities. We have the talent, ability, and potential, but we lack the main ingredient for success—structure. To succeed, we must establish a US national or international league."

Connie Sweeris remarked: "To improve the sport's popularity, the United States needs a better club system for table tennis players with each club having coaches to help beginners advance. It would also help popularize the sport if we could get table tennis in our school systems where children would compete against other schools in team events. Plus, we need to get higher prize money for our major events."

Dell Sweeris, a veteran player who accompanied the PRC delegation during its 1972 visit to the United States and is president of the US Table Tennis Association Foundation stressed: "The best way to increase the involvement of Americans is for US tournaments to have compatible prize money with ITTF [International Table Tennis Federation] tournaments. We also need to conduct these events as a presentation to the audience rather than conducting them in a multi-event format. In addition, strong clubs and coaching exist in pockets around the country, but the goal should be to make them available all over the country."

Because sports such as table tennis have opened the doors for diplomatic relations in the past, perhaps they will continue to improve relations—and give players and enthusiasts a better understanding of the world. 完

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