



By Jack Perkowski

CHINA'S TWO MARKETS



The vast numbers of people at the bottom of China's income ladder keep China's local market alive - and growing - in lockstep with the development of China's market for high end products

2008 may be known as the year of the Olympics in China, but it also has another significance. It was thirty years ago this year that Deng Xiaoping, China's beloved leader, opened up the country to the outside world and set it on the path

to economic reform. 1978, the year it all began, ranks as one of the three most important dates in China's modern history, right up there with 1949 when the People's Republic of China was founded and 2001 when China joined the World Trade Organization.

Before China instituted its economic reform program, the country's domestic market for goods and services was a purely local affair. Few foreign goods were imported into the country, and there were no foreign invested companies in China to produce the higher priced, higher technology products and brands commonly found in developed economies. The trucks, industrial equipment, household fixtures, consumer items and other products used in everyday life in the Chinese economy were produced by local, Chinese companies that did not have access to more advanced technologies from the West. Income levels in China were uniformly low, so prices also had to be kept low, and a centrally planned economy stifled innovation. For all of these reasons, the China market at the onset of economic reform consisted of local consumers, local suppliers, and products at the low end of the price and technology scale.

When Deng took the economic handcuffs off the Chinese, he touched off a tsunami of entrepreneurialism that created the economic miracle of the twentieth century and catapulted China to the top of the list of world economies. Under Deng's new system, it became glorious to be rich, and many Chinese took up his call. By starting new businesses; securing high paying jobs with the thousands of foreign companies eager to gain a share of the China market; and benefiting from the tremendous growth in real estate values across the country,

over 400 million people are now making incomes they would not have dreamt possible thirty years before.

With higher incomes, the newly affluent portion of China's population became more discriminating, demanding higher quality Western products, or at least products that had more Western features. As their appetite for higher quality, higher technology and higher priced products increased, they created a new market that was differentiated from China's purely local market and layered on top of it. One only has to look at the streets of any major city in China and see the vast number of modern, foreign made vehicles, or stroll through any one of the many new department stores that have sprung up all over the country, to understand that China has become a major market for high end products. Big ticket items like cars, for example, were well beyond the reach of most Chinese barely ten years ago. Today, China is the second largest car market in the world, second only to the United States.

And the Chinese are not just buying cheap cars. Alongside the new Regent Hotel in Beijing, dealerships selling Rolls Royces, Lamborghinis and Ferraris are lined up, all three in a row. The China market, including the market for luxury goods, has become one of the largest in the world. Brands like Louis Vuitton, Prada, Jaguar and Starbucks are just as familiar in Beijing and Shanghai as they are in London, Paris or New York.

As the Chinese economy developed, the presumption was that the country's local market would begin to shrink or disappear in the face of competition with higher quality, higher technology goods from abroad. That has not happened. Instead, the estimated 900 million people living in China's rural economy, whose average incomes may be as low as \$500 per year, continue to shop for their goods in China's purely local market, in much the same way as they did before China's economic reform program began. The vast numbers of people at the bottom of China's income ladder keep China's local market alive -- and growing -- in lockstep with the development of China's market

for high end products. Uneven economic development and the vast disparity of income levels in China have perpetuated this market segmentation. Though there may be a greater variety of goods from which to choose, prices, quality and technology levels continue to be at the low end of the scale in China's local market.

As a result of this pattern of economic development, the China market for any product is actually two distinct markets: the "foreign/local" market and the purely local market. The foreign/local market isn't necessarily dominated by foreign companies; rather, it's simply the segment of the China market with price and technology levels that are most familiar to them. In this segment of the market, foreign invested enterprises compete with all the global players, as well as with the best of the local Chinese companies.

For example, China will produce over 10 million vehicles in 2008. But that is merely the foreign/local market. Every year, over 40 million gasoline and diesel engines are manufactured for use in transportation. The 30 million motorcycles, agricultural vehicles and vehicles that combine a one cylinder diesel engine with a chassis constitute the country's purely local market for transportation.

Most foreign companies don't believe the local market is a battleground on which they can be successful -- the price levels are too low. As a wise Chinese businessman once told me, "People who wear shoes shouldn't try and fight with people who wear sandals."

However, my long experience in China tells me though that understanding this local market -- and perhaps even making a serious effort to tap into it -- is important, for several reasons.

First, it's big. It is the part of the market where the vast majority of the country's 1.3 billion population shop. Because of this, the local market is where the ultimate economies of scale in China will come from.

Second, as income levels continue to rise over time, the local market will merge up technologically. Price levels between the two markets will also merge, but will settle somewhere in between the two -- at levels lower than most companies would accept in markets outside of China. This creates an interesting dilemma: Should a company maintain global price levels, give up the China opportunity and risk losing out to lower-priced Chinese competitors down the road? Or, should it compete in China, recognising that with global pricing mechanisms in place, the "China Price" may soon be the "Global Price?" I would argue that the latter is really the only option if you have any hopes of long-term global competitiveness, not to mention competitiveness within China itself.

Finally, China's vast local market makes it a fertile breeding ground for future competition. Due to its vast income disparities, the China market tolerates all levels of technology and quality. Any company, no matter how low its quality or level of technology, can find a market for its products somewhere in China. In a familiar environment where they can compete the Chinese way, local companies have opportunities to gain scale

in the large, local market. While many of these companies will ultimately fall by the wayside, others will manage to survive, pull themselves up by their bootstraps, improve their quality and become battle hardened, low priced competitors. With the glint of global domination in their eyes, the next step for China's local companies as they successfully compete with the best of the foreign companies in China is the global market.

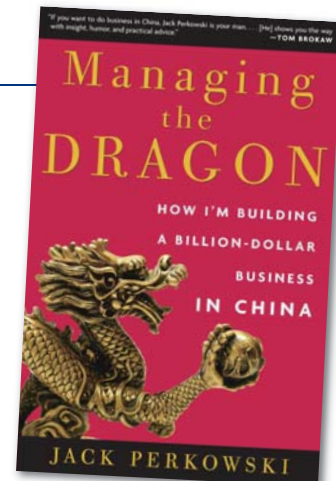
Geely is a case in point. In 1996, this privately-owned, entrepreneurial company produced motorcycles for China's purely local market. When its chairman announced that it would begin producing passenger cars, everyone in the world laughed, including everyone in China. How could a countryside manufacturer of motorcycles compete with the likes of Volkswagen and General Motors in the high end market for passenger cars? But that is exactly what Geely is doing. And in 2006, Geely reached an agreement with Manganese Bronze, owner of London Taxis, to produce the cabs in Shanghai.

Foton, one of China's largest truck makers, is another example. From its roots as a producer of low priced agricultural vehicles for China's rural population, the company entered China's truck market in the 1990s and began moving up market. A new joint venture with Cummins will provide more environmentally capable engines for the China market, but it will also enable Foton to penetrate markets outside China. There is no question where the company is headed.

The progression from China's purely local market to its foreign/local market, and then to the international markets, by previously unknown Chinese companies is one you are likely to see in industry after industry and product after product in the years ahead.

Depending on the industry and the level of technology required to participate in it, the market share split between foreign-invested enterprises and the purely local companies in China varies. But make no mistake: the battles for market share being waged in China today will ultimately determine the fate of just about every global industry.

My advice: pay attention to China's purely local market. That's where your next, and perhaps toughest, competitors are likely to come from. ❖



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