The Effect of Trade Liberalization On China's Retail Sector


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By Peter Moustakerski

China's retail food sector has experienced remarkable growth in the past 10 years, and at the same time undergone profound structural transformation. Although this retail revolution has been more rapid and evident in larger cities like Shanghai, Guangzhou, Dalian and Beijing, the trend is unmistakably present for the whole of China.

The Retail Universe

Food plays a central role in Chinese culture and in personal and business relationships. So it's not surprising that consumer foods have been a driving force behind China's retail revolution. Chinese consumers tend to be savers rather than spenders, so the market remains driven by price–an area where imports usually have a difficult time competing with local counterparts.

The average Chinese city offers consumers a broad spectrum of retail outlets in which to buy food products–not just food-driven outlets, but also traditional department stores, which normally dedicate at least one floor to food items. Most Chinese importers of high-value food and beverage products are either smaller, well-connected state-owned trading companies, or privately owned and/or operated businesses.

Neither type traditionally has import rights or access to foreign exchange, which remain prerogatives of large state-owned import/export corporations. A general distributor employs the services of an import/export corporation, paying for the use of its import license–normally 1-2 percent of the transaction value.

Supermarkets and convenience stores, modeled after popular commercial formats in Western and Southeast Asian countries, have brought more choice and more comfortable shopping environments to Chinese consumers. Another foreign concept, the chain store, has helped to consolidate the sector and reinforce the use of brands.

Supermarkets remain the most widespread retail format. Foreign operators have had little success in this format, as a result of fierce competition from domestic counterparts with access to supermarket technology and management know-how.

Convenience stores are a relatively new phenomenon in China. With their relatively low-cost setup, local neighborhood presence and long hours (often round-the-clock), outlet numbers have expanded dramatically.

Revolution and Rivalry

Turbulent growth and fierce rivalry typify China's emergent retail sector. Trends are sharp and cyclical, starting with the birth of a great opportunity, progressing through cut-throat competition and ending in oversaturation.

For example, the department store boomed in the late 1980s and early 1990s, when everyone with access to financing rushed to build one. But by the late 1990s, department stores had been driven into a corner by modern Western-style supermarket chains.

The hypermarket format, pioneered by such retail giants as Metro of Germany, Makro of Holland, Carrefour of France and Wal-Mart of the United States, is driving the latest phase of the retail revolution. Chinese consumers can get their fresh, frozen and dry groceries, as well as clothes, household goods and electronics, in the same clean, comfortable, professionally managed superstore.

The food area is the core (and the main attraction) of the hypermarket. In addition to extensive arrays of dry and frozen foods, a hypermarket's food area boasts a sizable fresh section, featuring fruits, vegetables, meats and seafood, as well as delis, bakeries, butcher shops and chicken rotisseries.

Leading hypermarket chains owe their success in part to the fact that they have managed to bypass China's inefficient, low-tech (and therefore costly) wholesale system, and are ordering directly from suppliers and manufacturers, charging them exorbitant slotting fees.

Hypermarkets keep prices low by holding down procurement and warehousing costs. Foreign hypermarkets pioneered the concept of regional purchasing centers, bypassing the multi-layered, fragmented and cumbersome purchasing network of wholesalers and distributors that serviced old-fashioned department stores and even supermarkets.

Thanks largely to their low prices, hypermarkets and discount warehouse stores are forcing traditional supermarket chains and convenience stores to restructure, consolidate and cut prices to try to stay competitive.

Penetrating Challenges

Hypermarkets may seem to offer manufacturers and suppliers the promise of consistently large sales volumes and nationwide distribution reach. But in reality, no hypermarket chain has yet achieved national penetration or distribution. And they pose other challenges too, particularly for small- and medium-sized enterprises.

Suppliers must negotiate with, and deliver to, each hypermarket outlet individually. Each store has a large degree of autonomy on procurement and must maintain its own profitability.

Hypermarkets generally buy from manufacturers or large distributors. Imports, which account for 5 percent or less of their stocks, are sourced through established import agents or general distributors. Moreover, hypermarket managers are anything but accessible–particularly to a small- or medium-sized supplier.

In addition to high slotting fees, retailers charge for in-store promotion activities. Most retailers also impose burdensome credit terms on suppliers, commonly demanding payment in 90-180 days. Leading hypermarkets require that products meet certain sales criteria–if they don't, they disappear from shelves in as little as a month. To re-list a product, suppliers must pay the listing fee again.

Constraints and Caveats

Importing and selling foreign-made food products is growing increasingly complicated. China's legal system and infrastructure are underdeveloped, and enforcement is erratic and often biased. Corruption and local protectionism are likely to remain serious problems for some time. High duties are levied on imports, rendering them considerably more expensive than their local counterparts by the time they land on retail shelves.

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New laws and standards have been introduced to prepare China for membership in the World Trade Organization (WTO). While in the long run they will bring transparency and a legal framework to the trade environment, in the short term they are causing confusion among importers and exporters alike. Regulations tend to be either new or ambiguously worded, so enforcement tends to be arbitrary and opaque.

Another challenge that food products face is the myriad of licenses required to sell in the retail market. Any food product must have a hygiene certificate from the government of the locality where it is on sale. Functional or health foods must have health-food certificates.

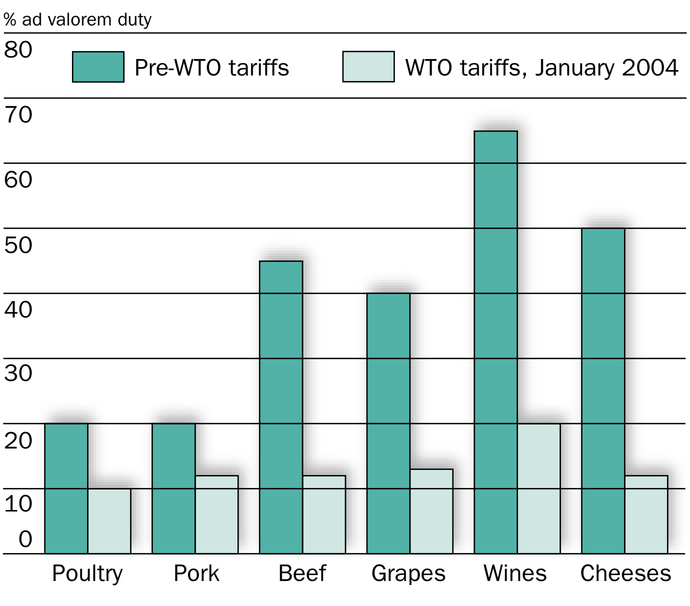
Labeling requirements can be cumbersome. Food products must meet the latest regulations, which usually means developing new labels and packaging in Chinese. Products containing ingredients derived through biotechnology must have biotech safety certificates and be properly labeled.

China's Accession

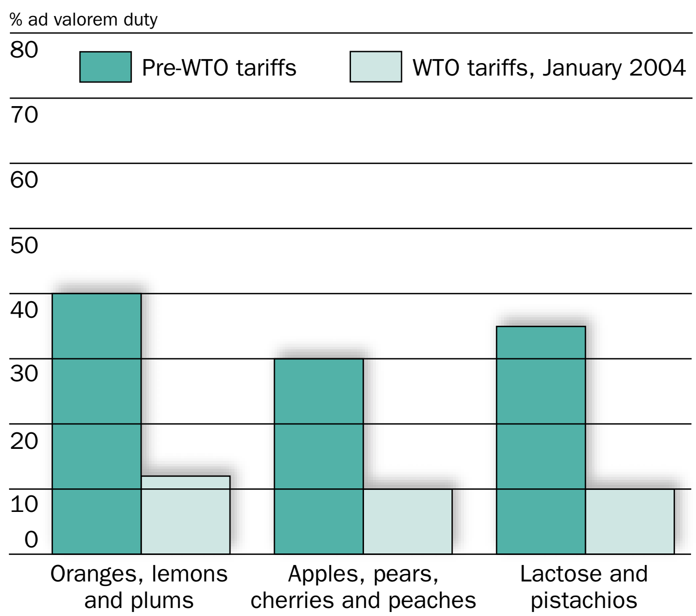
The U.S.-China Bilateral WTO Market Access Agreement of 1999 will significantly reduce China's import barriers on U.S. agricultural products. On average, the overall duty will fall from 22 to 17.5 percent. The accompanying charts show the tariff reductions in greater detail.

Experienced China watchers are quick to point out that Beijing's WTO concessions are the latest milestone in a longstanding path toward deregulation and import liberalization going back to the late 1970s, when China made its first moves to

China's Tariff Reductions on Agricultural Products of Priority Interest to the United States Will Be Substantial



Tariff Reductions on Other Important Products Will Also Be Significant



reduce barriers to economic growth and make its economy more market-oriented.

While confident that China will continue to liberalize its import market in the coming years, these astute observers are also quick to temper expectations for WTO market openings by pointing out the various bumps in the road toward liberalization over the past 20 years, and the political imperative of cushioning China's rural economy against a flood of competing imports.

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While Beijing's WTO concessions are significant, they are not sufficient by themselves to guarantee huge gains in trade. For instance, the agreement provides for import tariffs to fall, but continued restrictions on the availability of foreign exchange (Chinese currency is still not fully convertible) may make it difficult for Chinese importers to pay their foreign suppliers.

The Market's Promise

The penetration of imported foods into the Chinese retail market is still fairly shallow. Although products with well-known brand names are widespread, they are usually produced locally. Imports account for less than 5 percent of stocks in the average supermarket or hypermarket, and are even less common in other retail formats.

But many leading chains are realizing that featuring more and better quality imports is a good way to attract customers. Several chains are either exploring the opportunity or already establishing sourcing operations in the United States and other Western countries to increase their portfolios of imports, particularly dry groceries (such as confectionery items, snacks, bagged and boxed items, canned goods and baby foods), frozen products and ready-to-eat foods.

It is not customary for importers to maintain inventories of imported food products at their own expense. The exporter or supplier must usually shoulder the costs of inventories; secondary distributors and retailers keep small stocks, and reorder only if sales are satisfactory.

A few logistics services companies, some with foreign participation and management, have established themselves in port areas and free-trade zones. They offer a one-stop-shop solution for companies interested in importing and exporting, by arranging customs clearance, shipment handling and storage, bonded warehousing and foreign exchange clearance. They handle product shipments and maintain transparent international-standard accounts. U.S. exporters should consider using logistics providers when planning long-term market strategy.

Recommendations for a Sensible Approach

Everything is different in China–tastes, customs, culture, infrastructure, business rules. Even the most successful, experienced business would be wise to devote ample time and resources to identify and study a target market. Finding the right Chinese partner, establishing a reliable import channel, maintaining an efficient sales and distribution network and breaking into the leading volume-generating retail chains are among the crucial challenges that exporters face. Competition from domestic or joint-venture counterparts is the most serious challenge facing U.S. suppliers and exporters in the Chinese market.

To be successful, exporters must:

- **Find a local Chinese partner and/or distributor:**

This step is crucial. An exporter's success in China hinges on the right local partner, representative or distributor. An exporter with a long-term vision for China should thoroughly investigate the market and establish viable relationships with reputable and effective representatives.

The most important task for an exporter is to identify and sign up with a company specifically designated as an "importer" or "general distributor." The importer must be able to handle all the import formalities (i.e., act as a customs and logistics broker) and have a network of established retail customers.

The U.S.-China-Hong Kong Nexus

The channels that traditionally supplied imported foods to the market (most notably gray channels via Hong Kong) are generally opaque, unreliable and shrinking due to increased scrutiny by the central government in Beijing. In the past, some Hong Kong companies have been able to deliver foods into China at competitive prices by avoiding import duties and fees through smuggling, or by reducing duties and fees through under-invoicing (declaring lower quantity or unit price than that in the actual shipment).

Since 1998, when Beijing began cracking down on illegal gray channel activity, many exporters have invested effort and capital into building legitimate import channels directly through mainland ports, such as Shanghai, Dalian, Qingdao and Tianjin. As a long-term strategy, exporters should move away from gray channels, which are likely to prove increasingly risky and unreliable, and explore legitimate channels with reputable importers in China.

Above all, the importer must be able to pay for the imported products by remitting hard currency to the exporter. Exporters should choose representatives slowly and carefully. Hastily made partnerships are perhaps the most common cause of failure in China.

- **Focus on a market audience, segment or niche:**

Faced with the enormity of the Chinese market, some exporters attempt to diversify too much, too early, trying to cater to the entire market spectrum. Often this is a recipe for disaster.

- **Go slow in the beginning, concentrating on gradual but sustainable growth:**

Consequences for stretching resources across vast, disparate areas–ignoring the preferences and requirements of each local market–can be severe. Any sudden weakening of demand or appearance of competition usually proves fatal.

- **Adapt your product to the individual market–labels, flavors, package size and price:**

Exporters are better off devoting resources to each local market and basing expansion solely on tangible successes and real demand. Testing every attribute of a product (flavor, packaging, pricing, shelf life) with consumer focus groups is highly recommended. All marketing is local.

- **Invest wisely in market promotion through trade shows and in-store promotions:**

Attending only quality trade shows is a good way to start. Once in the market, in-store promotions have proven to be a cost-effective way to establish sales. ■

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