

Welcome to the June 2008 edition of Pragma's China Newsletter, prepared by Jesa Consulting

## ➔ FOCUS ON: Marketing in China: Back to traditional values



Tai Chi in Shanghai

More and more Western companies are trying to catch the Chinese consumers' interest especially in the period preceding the Olympic Games through the new marketing opportunities opening up.

The wealthier the Chinese consumer becomes, the more difficult it is to get its attention from a marketing point of view. According to a survey performed by McKinsey on a sample of more than 5,000 individuals, although the higher exposure to global products, cultures and habits, Chinese costumers seem to show an increasing interest for traditional values. Differences between Chinese and Western consumers, thus, are not decreasing making the producers confusing about how to approach the Chinese market.

Between 1999 and 2006, the country GDP has been increasing at an average rate of 10%, ratio reflected also in the urban consumption. The number of household with an annual income between 40,000 and 100,000 RMB is expected to increase by 36% between 2008 and 2012, while the number of households with incomes over 200,000 RMB will see an increase of about 14% during the same period of time.

On the other side, more and more Chinese tend to save large parts of their income; in 2006, about 28% of households' income was devoted to savings. Moreover, Chinese are not enthusiastic fans of credit and prefer not to have recourse to debt, trend reflected also in the usage of credit cards that, although an increase between 2004 and 2007, remains very low with a penetration rate of about 4%.

The Chinese consumer is particularly price sensitive, factor that is considered as main discriminating element in purchasing decisions, while brand seems to play only a marginal role. This means that Chinese consumers are resistant to new products and brands and remain conservative.

Other than the difficulties faced by foreign companies in understanding the purchasing behaviour of Chinese costumers, it must be added their tendency to return to traditional values. Which is the reason of this trend? The upcoming Olympic Games are bringing to a new wave of nationalism together with the constant economic growth of the country which stimulates individuals to anchor to traditions in order to keep these values as point of reference among recent and quick changes. This translates in a definite preference for local products and brands especially far from the wealthier costal areas.

While for the consumer electronics and automobiles foreign brands keep high market shares, for those products whose quality is close to the foreign ones but whose price is still competitive, the choice is the local product.

## Contents

### FOCUS ON:

Marketing in China:  
Back to traditional values

What is Jesa?

The voyage of the Dollar

Highlights from around China:  
Chinese per Capita GDP predicted to  
soar by 2030

## What is Jesa?



Jesa's reception desk in  
Shanghai

Jesa is a service company headquartered in Shanghai specialising in facilitating start-up of new industrial productions while providing reliable

management and control solutions. We operate 4 main branches in China and a foreign office in Ulaan Baatar (Mongolia).

Since 1998, Jesa has built a team of 70 specialized employees in addition to 25 technicians following "in loco" projects. Commercial relationships are exclusive and strictly confidential, ensuring the highest expertise on every single commercial and technical issue.

Jesa is a leader in managing manufacturing processes and eliminating any industrial and regulatory problems while helping our clients save financial resources and time.

Jesa is currently expanding its services providing support to those companies seeking to develop distribution network and retail system in China as well as in Mongolia.

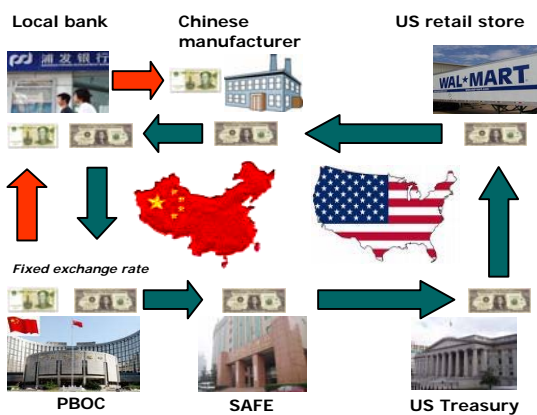
We also perform HR audit and investment analysis (trouble-shot analysis) to verify performances in support to companies already established in China, and we provide tax and accounting consultancy.

Marketing products to Chinese, thus, is more and more complex and requires both awareness of traditional values and a tailored approach. This approach should concern not only the product design (for example, Crest sells only in China green tea flavoured toothpaste with great success) but also its regional value. This second strategy takes into account that marketing instruments tailored to conquer the loyalty of costumers living in first tier cities are not necessarily effective when applied to smaller cities or rural areas. Differently from other countries, in China regional differences at a product, marketing and distribution costs level are huge. Also the purchasing behaviour differs among regions and consequently, a marketing approach by product, segment and region is statutory.

To approach the Chinese market trying to push foreign products into it, thus, is important to invest in the following factors:

- Market researches, to enter into the mind of Chinese costumers;
- Product development, to achieve a result that satisfies the costumers' needs;
- Tailoring marketing messages that must be compatible with the consumers' values and beliefs.

## The voyage of the Dollar



This figure shows the "round trip" of the dollars.

China has a huge amount of reserves in US dollars, but these holdings are considered a state secret, so all numbers come from analyses made by outside experts.

According to these estimates, by 1996 China accumulated its first \$100 billion in foreign assets. By 2001, that sum doubled to about \$200 billion and since then it has increased more than six times. Today China's foreign reserves are the largest in the world. At the beginning of 2008, China is likely to own a total of almost \$2 trillion in USD assets, not far from its 2007 GDP of \$2.6 trillion. China's U.S. dollar assets probably account for about 70 percent of its foreign holdings, the rest are mainly in euros, plus some yen. Most of China's U.S. investments are in conservative, low-yield instruments like Treasury notes and federal-agency bonds. As these are considered the safest investments in the world, they pay

lower interest than corporate bonds, and for the past two years their annual interest rate of 4 to 5 percent have barely covered the 5 to 6 percent decline in the U.S. dollar's value versus the RMB.

An illuminating article by James Fallows recently appeared on "The Atlantic" explains this paradoxical situation: why should China put so many of its holdings into dollars, knowing that the dollar will keep losing value against the RMB? Why should the Communist Party of China carry on a policy that takes wealth from its own country, which needs so much, and gives it to a rich country like the United States? And why the government is imposing such a high saving rate to the Chinese people?

The situation can be better explained by following a U.S. dollar on its journey from a customer's hand in America to a factory in China and back again to the United States.

Let's imagine an American consumer who goes to Wall Mart in Los Angeles. It purchases an Oral-b electrical toothbrush made in China, and pays it \$30. Most of that \$30 stays in America, with Wall Mart and Oral-b, while a small percentage, maybe 3\$, goes back to China to the Chinese manufacturer. The manufacturer cannot use the dollars directly, as it needs RMB to pay workers, suppliers and taxes. So it takes the dollars to the local bank, for example Shanghai Commercial Bank, and trades them for RMB.

This is where the first control is made. In other countries, the local bank can decide what to do with dollars (trade them for euros, invest them in the US, etc.) in order to have the highest return. But Chinese banks cannot: they must turn most of the dollars to the People's Bank of China and receive the equivalent in RMB at the official exchange rate.

In this way, around one billion dollars is accumulated at PBOC every day, which has to do something with this money. The current Chinese doctrine allows it only one option: to give all the dollars to another arm of the central government, the State Administration for Foreign Exchange, who figures out where to invest the dollars: some in US stocks, some in Euros and the great majority in US Treasury notes.

And, thus, the dollars come back home, ready to be re-injected into the US economy and spent again in Chinese-made goods.

According to James Fallow's article, this situation results directly from explicit choices that the Chinese government has made in order to maintain control over an economy that in many other ways has become wide open:

- 1) To dictate the RMB's value relative to other currencies rather than allow it to be set by forces of supply and demand. The government doesn't want to let the market set the value of the RMB, because it thinks it would slow the constant growth of the export-oriented economy. In the short run, it worries that the RMB will appreciate against the dollar and the euro, putting some factories in "expensive" places such as Shanghai out of business. Also, in the long run, the Government views an unstable currency as a problem, since currency fluctuation makes doing business with other countries more complicated: it is harder for companies to predict overseas revenues, negotiate contracts, attract foreign investors and predict the costs of fuel, component parts, and other imported goods.

Once a government decides to set the exchange rate of its currency, it must also control many other aspects of its financial system, through instruments like surrender requirements and "sterilization bonds" (a way of keeping foreign-currency swaps from creating inflation). These and similar tools are the way China's government imposes high savings rate on its people: the result is to keep the buying power earned through China's exports out of the hands of Chinese consumers as a whole.

- 2) The other major decision is not to use more money to address China's needs directly — by building schools and agricultural research labs, cleaning up toxic waste, etc. The government doesn't want to increase domestic spending dramatically, because it fears that improving average living conditions could paradoxically intensify the rich-poor tensions that are China's major social problem. The country is already covered with bulldozers, wrecking balls, and construction cranes, all to keep the manufacturing industry growing. Trying to build anything more at the moment — sewage-treatment plants, for example, which would mean a better life for its own people, or smokestack scrubbers and related "clean" technology, which would start to reduce the increasing pollution — would likely just drive prices up, intensifying inflation and thus reducing the already low purchasing power of most workers. Recently, food prices have been rising so fast that they have led to riots.

This is the bargain China has made with it on its people. They'll keep creating new jobs in the factories, thus reducing China's own social tensions and creating opportunities for its rural poor. The Chinese will increase their living standard gradually and they'll be protected from the risk of potentially catastrophic hyperinflation, which might destroy what the last decades of growth have built. In exchange, the government will hold much of the nation's wealth in assets in the United States, thereby preventing a run on the dollar and sending enough cash back into Americans customer's hands in order to keep them spending.

## Highlights from around China

### Chinese per Capita GDP predicted to soar by 2030

According to official figures, China's GDP in 2007 was 24.66 trillion yuan (\$3.38 trillion) and per capita GDP was \$2,556. The World Bank said last month that China had surpassed Japan to become the second largest economy in terms of "purchasing power parity", a measure of the cost of living based on the goods and services households can buy with their currency.

The forecast by Justin Lin Yifu- head of Peking University's China Center for Economic Research and chief economist designate of the World Bank – is that China's economy could be 2.5 times that of the US by 2030, based on Japan's experience and the yuan's appreciation against the dollar. China's situation in 2000 was in fact very similar to Japan in 1960: Life expectancy, infant mortality, proportion of agriculture in the whole economy, and Engel's coefficient - the proportion of expenditure on food - are also similar. Japan then managed to grow at a high speed for almost 30 years.

Also the pioneer British economist Angus Maddison predicts that China could be reinstated as the world's biggest economy by 2015, after losing the top rank two centuries ago. After analyzing the country's economic data for the past 1000 years, Maddison forecasts Chinese economy to reach \$12,271 trillion by 2015 – 7 percent more than the projected US figure. By 2030, Maddison predicts China's economy will be 138 percent of the US economy.

But other Chinese economists are fewer optimists and insist that factors such as education, healthcare and human resources should be taken into consideration. Chinese economist Ren Ruo'en said that the country's economy may be 40 percent smaller than previously estimated. The World Bank's recent report ranking world economies for 2005 shows China's GDP as \$5.3 trillion and not the \$8.8 trillion previously estimated. The World Bank is now working with Chinese statisticians to re-adjust the figures.

Contributions:

Scott Sun (Supervisor)  
Valeria Gaglioni  
Emma Magrini

For any inquiry regarding this newsletter or for any other concern, please contact us at:

**Saro Capozzoli** [saro@jesa.com.cn](mailto:saro@jesa.com.cn)  
**Mauricio Bottoni** [m.bottoni@interconsulting.mi.it](mailto:m.bottoni@interconsulting.mi.it)  
**Gilberto Gelosa** [g.gelosa@interconsulting.mi.it](mailto:g.gelosa@interconsulting.mi.it)

Please consider the environment before printing this newsletter.