China boosts domestic demand in the face of the eurozone financial crisis

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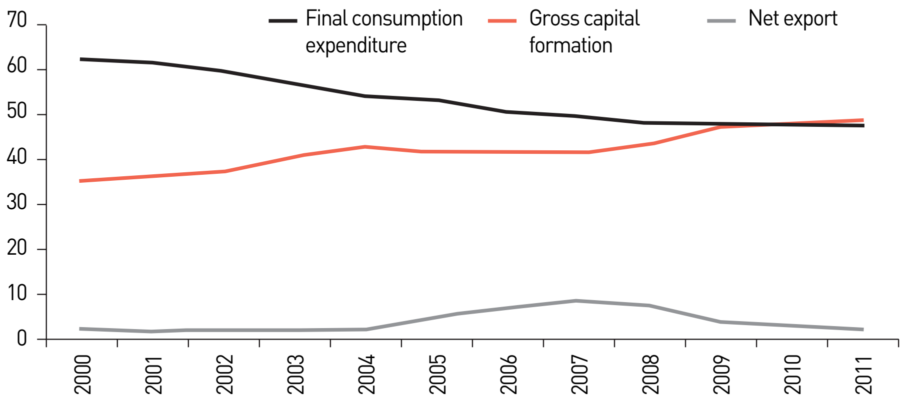
China's economic downturn has lasted for more than two years, since early 2010. In the second quarter of this year, China's growth slowed to a three-year low of 7.6%, amplifying worries of a possible hard landing for China's economy. On the one hand, some people claim that such worries are unfounded. However, this year, China's growth is very likely to hit its lowest point in 13 years, since 1999.

The European financial crisis and local government debts

What are the reasons for China's economic slowdown? There are internal and external factors. The biggest external factor is clearly the European financial crisis. The European financial crisis, which started in the PIIGS countries (Portugal, Ireland, Italy, Greece, and Spain), shows no signs of abating, but rather seems to be spreading to the entire eurozone, despite the stimulus packages of the European Central Bank (ECB) and joint

Contributions of consumption, investment, exports to GDP after 2000

(Unit: %)



Source: National Bureau of Statistics of China

responses by several European countries. The crisis is spreading to Germany and France, the center of the eurozone. There is a possibility that Greece will leave the eurozone.

The European financial crisis has a great impact not only on the global economy, but also on the Chinese economy. Europe is one of China's largest export destinations, receiving 21.8% of China's entire exports in 2011 (22.5% in 2010). Europe's economy was so enormous that it accounted for 25% of global nominal GDP in 2011, showing its great influence over the global economy and China's economy. China's dependence on exports accounted for 26.9% of GDP in 2010. It is no wonder that China suffered a serious shock from the weakening global economy.

Internal factors of China's economic slowdown include government policies. During the 2008 US-led financial crisis, the Chinese government implemented severe policies to prevent an economic slowdown, such as a RMB 4 trillion stimulus package, policies to promote 10 major industries, cuts in interest rates and reserve requirement ratios, and policies to promote consumption of automobiles and home appliances. Side effects, such as inflation and a real estate price surge, appeared from the second half of 2010, and the Chinese government has aggressively implemented real estate regulations and policies to stabilize inflation. China has changed its investment and export-oriented growth to consumption-driven growth under its 12th Five-Year Plan (2011-2015), and cut its goal for annual average growth from 7.5% under the 11th Five-Year Plan (2006-2010) to 7% under the 12th Five-Year Plan. This shows China's strong will to pursue qualitative growth, even if it means sacrificing quantitative growth.

Such changes in China's policies are inevitable. So far, China has been too dependent on investment for growth. The contribution of investment to GDP reached as much as 49.2% in 2011, while the share of consumption continued to decline. Overinvestment resulted in worries about overcapacity and delinquent financial institutes. In particular, since China's local governments took out loans to finance competitive development in 2008, local government debts have become the most significant stumbling block for China's economy. Now, China faces limitations in investment-oriented growth.

A possibility of recovery after stimulus injection

The Chinese government's shift to domestic demand-oriented policy is a necessary step in the right direction. With such great uncertainty in the global economy, a dramatic downturn in China's economy would have a wide-reaching ripple effect. Fortunately, however, optimism is prevailing in China's economic outlook. Economic forecast agencies believe that China will recover in the third quarter of this year, recording an annual growth rate of more than 8%, and will continue to recover next year. This forecast is based on expectations that the stimulus package implemented in May by the Chinese government will start to bear fruits, and the fact that the Chinese government has the capability to defend the economy in an emergency.

Since May, the Chinese government has cut interest rates two times and the reserve requirement ratio once. It has also implemented a series of stimulus packages, such as expansion of approvals for investment in infrastructure, and subsidies for buying energy-saving home appliances and automobiles. China has much more favorable conditions for implementing stimulus packages than other countries. China has a better fiscal balance and less government debt than the USA, Japan, and France. China has as much as USD 3.3 trillion in foreign exchange reserves. With the high level of policy interest rates and stable commodity prices, the Chinese government can implement strong stimulus packages as it wishes. Moreover, with its rapid urbanization, China still has great capacity for development. China has room for growth, given that its gross national income per capita is only USD 5,000. For these reasons, China will be able to maintain high growth for some time.

It seems difficult for the Chinese government to find a silver bullet for the side effects of stimulus packages, while minimizing instability from unemployment.

European and political variables

It is a mistake to be too optimistic about China's economy. The expectation that China's economy will recover in the third quarter of this year is premised on the assumption that the eurozone crisis will not worsen. Currently, Europe's economic conditions are very unstable. Even if things do not worsen, early recovery is most likely unattainable. If the eurozone crisis becomes worse, and so does China's economy, the Chinese government should implement more aggressive stimulus packages. China's leadership is scheduled to change with the 18th National Congress of the Communist Party in November of 2012, for the first time in ten years. With this change of government officials at the nation-level, the government's policy responsiveness could become weaker than ever before. The

Conditions for implementation of stimulus packages

	China	USA	Japan	France
Budget balance (% of GDP)	-1.2	-9.6	-10.1	-5.3
Government debt (% of GDP)	25.8	102.9	229.8	86.3
Foreign exchange reserves	33,050	14,950	12,777	1,716
Policy interest rate	6.31%	0~0.25%	0.05%	1.0%
Increase in consumer price	3.0%	1.7%	0.2%	2.0%

Source: IMF and BOK
Note: Budget balance and government debts based on figures from 2011; China's foreign exchange reserves based on end of March of 2012; other countries' foreign exchange reserves based on end of May, 2012; consumer price based on May of 2012; policy interest rate based on end of June of 2012

government will have to depend on investment-oriented growth in case of emergency. With social stability being all the more important in the face of the leadership change, the Chinese government will be unable to implement aggressive policies that would overheat real estate and trigger inflation. It is also problematic that the incumbent government used every possible stimulus measure, leaving the incoming government no option. China is in a difficult position for making significant policy decisions. The Chinese government proclaimed that it would maintain real estate restraint policies despite a growth rate of 7.6% in the second quarter of this year. This shows the government's determination to preclude real estate prices rising in anticipation of stimulus plans.

A minority in China expect the Chinese economy to continue to slow down. Pan Xiangdong, analyst of China's Galaxy Securities, said, "Due to the prolonged crisis in the eurozone and slowing demand in China, China's GDP growth is expected to be 7.7%-7.8% this year, and to remain above 7% in 2013. There is a possibility that this figure will drop below 7% in 2014." His claim is based on several factors: the government's lukewarm stance on structural reform, labor shortages, an aging population, and other causes of diminishing growth potential. In addition, OECD Composite Leading Indicators (CLI), the HSBC Purchasing Managers' Index (PMI), the stock price index, and other leading Chinese economic indexes, all foretell that China's economy will continue to slow down. For these reasons, one should be wary of optimism in China's economic recovery.

Avoiding side effects from stimulus packages

The Chinese government seems to have the ability to defend its economy. However, China is accepting its economic slowdown half-voluntarily and half without choice. China is refraining from making a massive stimulus injection like the quantitative injection in 2008. China is delaying the easing of real estate regulations, the most effective measure for economic recovery, showing just how prudent China is being this time.

The current external uncertainty seems to be having an impact on China's economic slowdown and employment. Under GDP growth rates between 9% and 10% during 2009-2010, 11.68-12.21 million jobseekers in urban areas found jobs. If the annual GDP growth rate falls below 7%, the number of newly-employed in urban areas is expected to drop by more than 3 million. Increased unemployment worsens the imbalance in household incomes, resulting in increasing social instability. Currently, it seems difficult for the Chinese government to find a silver bullet for the side effects of stimulus packages, while minimizing instability from unemployment. If China fails to respond appropriately, it will face severe troubles. Now, China is suffering a period of ordeals, and needs to implement policies to boost domestic demand in response to the eurozone crisis. C

Chinese and Foreign companies compete independently or in alliances

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In 2009, Taiwan's Yulon Group (裕隆), a long-time local assembler and sales agent of Nissan cars, launched its own car model, Luxgen, in China, jointly with China's Dongfeng Motor (東風). With low domestic demand, Taiwan has had no domestic automakers. Yulong's project is the first of its kind. China's huge and rapidly expanding domestic market has allowed the Taiwanese company to venture out into a field that was unimaginable for the company in the past. Another Taiwanese company Master Kong (康师傅) has emerged as the world's largest instant noodle maker after it conquered China's huge market. As these cases show, many companies from Hong Kong and Taiwan are targeting the Chinese market. Foreign companies are following suit.

Strategies for entering China's domestic market and coping with market changes have become a crucial factor that determines the fate of many companies around the world. Let us take a look at the offensive and defensive plays of Chinese and foreign companies competing in China's domestic market, in the sectors that the Chinese government pledged to support through consumption stimulus policies in May of 2012.

Home appliances: a market of unlimited competition, led by local firms

In China's domestic market, local firms have always held the largest market shares in the home appliance sector. There are more than 150 home appliance makers in China. Some of the best known are Haier, which has the largest market share in China's washing machine and refrigerator markets and is also well known in Korea; Hisense, the leader of the television market; and Gree and Midea, the largest and second largest companies in the air-conditioner market.

It is clear that the Chinese market has become a global standard market where global companies compete to introduce world-class goods and services.

Most global home appliance makers are doing business in China, though their market shares are smaller than those of Chinese companies. German companies include Siemens, which is famous for front-loading washing machines, and Bosch, which sells refrigerators. There are many Japanese companies in China. After buying Sanyo, Panasonic is performing well in the washing machine, television, and air-conditioner markets. Sony and Sharp are also making a lot of efforts in the television market. Though their market share is insignificant, America's Whirlpool and Sweden's Electrolux have a presence in China. Korean companies are doing well in China, too. Samsung is gaining a footing in the television and refrigerator markets, while LG is gaining ground in the front-loading washing machine and refrigerator markets. With competitive LED technologies, Korean companies will lead the high value-added and energy-saving product markets.

China's indigenous companies have been able to grow rapidly since the country's reform and opening-up policies, given that it takes a relatively short time for companies to become competitive in technology and products in the home appliance sector. China's home appliance market is characterized by unlimited competition among 200 foreign and local companies. There is no case of joint venture or partnership in the industry.

Global firms' strategies seem to vary in this industry. However, they have one thing in common: their competitiveness in the Chinese market comes from tailored strategies that are based on strengths acquired through years of competition in the global market. German companies' strategy is to provide Chinese consumers with strong and trustworthy products made with verified technologies. Japanese companies' competitive edge is precise and simple design and functions.

Chinese firms are already going beyond the local market. Haier, the front runner of the home appliance market, went global a long time ago. It already knocked on the door of the Korean market many years ago. Other Chinese companies are in the early stages of going global, focusing mostly on Southeast Asia.

As it announced last May, the Chinese government considers the home appliance sector a major target of its consumption stimulus policy, with plans to strengthen its control over energy saving and environmental protection. In China's home appliance industry today, the Chinazation of global companies is intersecting with the globalization of Chinese companies in a competition landscape that allows only for sole competition, with no room for horizontal or vertical alliances. There are pressures for energy saving and environmental protection, and demand for high-end goods and demand for low-end goods coexist.

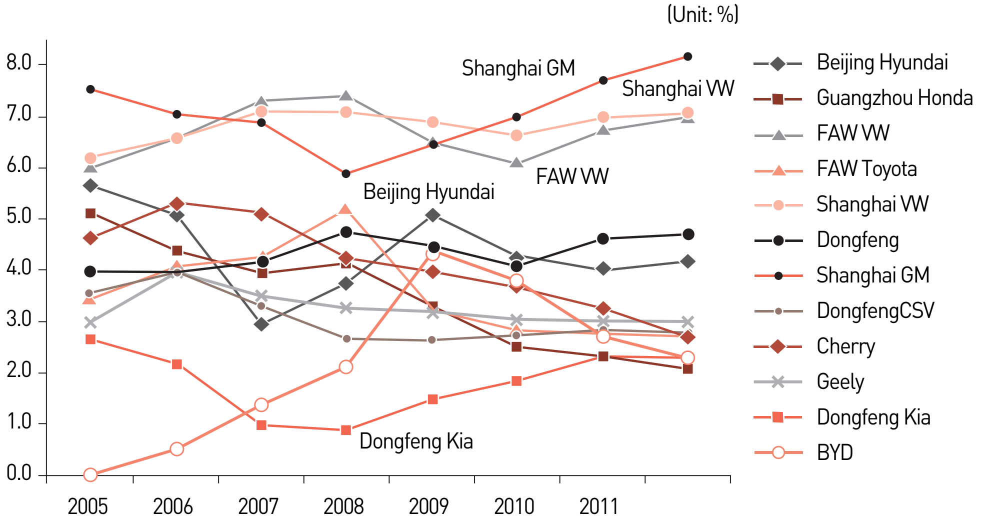
The automotive sector: alliances, competition, and government policies

In China, private local carmakers are chasing one another, while most global carmakers have partnered with China to produce and sell cars through joint ventures. The Chinese government is pursuing strong policies for development and arbitration within the automotive industry, such as policies supporting the development of independent technology and brand promotion, and policies to nurture energy-saving and new energy vehicles. The competition between Sino-foreign joint ventures and private local carmakers, together with the Chinese government's ambitious policies, has resulted in wildly varying degrees of success for all involved.

Such mixed results are well reflected in the changing landscape of the automotive market. China's "Big Three" carmakers—Shanghai GM (Shanghai Motors + GM), Shanghai VW (Shanghai Motors + Volkswagen), and FAW VW (First Automobile Works + Volkswagen)—have led the rapid expansion of the market, but they faltered slightly in the early 2000s, when they were challenged by late movers, such as Korean companies Hyundai and Kia, and local carmakers. With their product and brand competitiveness and extensive lineups, however, China's "Big Three" carmakers have shown their latent power by boosting their market share since the mid-2000s. Korean carmakers Hyundai and Kia, which achieved great success for three to four years after their first production in China in 2002, but took a hard blow between 2006 and 2007, have shown this same kind of power.

One should not overlook the fact that the success of China's "Big Three" carmakers, and of Hyundai and Kia, in China, is the result of the successful application of their global competitiveness to the Chinese market. With their product and brand competitiveness, which has been proven over a long time, and their competitiveness in full lineups, these companies are targeting the Chinese market. Volkswagen, the first global carmaker in China, established joint ventures with FAW and Shanghai Motors many years ago.

Market share of Chinese carmakers



Source: CEIC

Volkswagen is dominating China's market by rolling out various car models through these two joint ventures, without overlap. Volkswagen excels in the selection of partners and in localization, and holds the largest market share. It is fair to say that China has sustained Volkswagen since the 1980s.

Of course, some global companies are struggling in China. They are mostly Japanese companies. Despite endless efforts, Toyota, Honda, and Nissan have failed to recover their diminishing market shares. This is a result of many factors working in conjunction: decision-making methods, timing, relations with the Chinese government, and national brand image. Comparisons between German and Japanese carmakers offer meaningful insight into China's automotive market.

Challenges by China's indigenous carmakers in the mid-2000s made global companies nervous. However, Chinese carmakers suffered inexplicably from declining market share from the late 2000s. Chinese carmakers, including Geely, Cherry, and BYD, enjoyed fairly high market shares between 2007 and 2008, bolstered by government policies to nurture

The competition environment for consumption stimulus sectors

Sector	Characteristics of management and competition	Foreign & Chinese companies' corporate strategy	Government policy
Home appliances	Sole competition among Sino-foreign and Chinese firms - Chinese firms have a competitive edge in the market	(F) Independent market entry (D) Independent market entry	- Subsidies for buying energy efficient products - Selective preferential treatment for foreign-invested companies
Automotive	Led by joint ventures chased by Chinese firms	(F) Market expansion by collaboration (D) Competition through independent companies or joint ventures	- Chinese firms going global - Subsidies and tax cuts for buying energy-efficient small cars - Selective preferential treatment for foreign-invested companies
Machinery & Equipment	Sole competition among foreign and Chinese firms - Foreign companies have a competitive edge in technology	(F) Market exploration with technology competitiveness (D) Chasing foreign companies	- Subsidies for buying energy-efficient products - Selective preferential treatment for foreign-invested companies
IT & Electronics	Sole competition among foreign and Chinese firms	(F) Leading the market with technology competitiveness (D) Targeting the low-end market - Cooperation & collaboration between Chinese and Taiwanese companies	- Selective preferential treatment for foreign-invested companies - Preferential treatment for advanced technology

Note: Selective preferential treatment means the promotion of investment with restrictions on investment methods, and shareholding limits.
Taken from various sources

Chinese car brands and save energy. Their market shares have recently been falling, and their products have been labeled knockoffs with substandard technology and design. Time will tell whether this is a temporary setback or fundamental limitation. However, it is clear that Chinese carmakers need more time to show significant competitive prowess.

There are some key points determining the present and future of China's automotive market: rapid market expansion, various levels of demand and the sophistication of consumers, the Chinese government's determination to develop its own technology and to nurture brands, and energy saving and environmental protection. Based on the effects of these key points, some 100 carmakers will continue to write stories of success and failure, through sole competition or through horizontal and vertical alliances.

IT and electronics: global brands chased by allied Chinese firms

The front runners of the IT and electronics market, represented by mobile phones, are Samsung with the Galaxy series and Apple with the iPhone. They are chased by Nokia, which once dominated China's market, and by Chinese companies. Entry strategies into the Chinese market are various, as are the results and their implications. The reason for this variation is the characteristics of the Chinese market: rapid market expansion, the huge size of the market, and diverse demand.

China is one of the largest battle fields for Samsung and Apple. Samsung, the number one company in China's smart phone market, is building and operating an independent development and production system based on its advanced production technologies. Samsung has almost completed the relocation of its global production bases to China. For Samsung, China is a global manufacturing base and an export destination.

While utilizing China as an outsourced production base, Apple is making efforts to increase sales in the Chinese market. Even though Apple started doing business in China in earnest as late as 2009, it surpassed Nokia and became China's second largest smart phone maker in 2011. Apple is making strenuous efforts in the Chinese market, as shown by recent moves: promotion of iOS localization, acceptance of App Store payments in yuan, and addition of the Baidu search engine to Chinese iPhones. On the other hand, Nokia, which used to be the front runner in the mobile phone market, fell to third place by market share in 2011.

Taiwanese companies are playing a unique role in China's IT market, and solidifying their foothold in the IT industry, earning the name "China's allied force." With their manufacturing technology, their management capability, and their workforce within China, Taiwanese companies have strengthened their position as original equipment manufacturers (OEM) for global companies. A good example is Hon Hai's Foxconn, the largest OEM for Apple and HP.

Another strategy of Taiwanese companies is to provide Chinese low-end mobile phone makers with technology platforms. Thanks to Taiwanese IT firms, Chinese companies were able to increase their market shares with cheap mobile phones, including knockoffs. In 2010, Media Tek, the leader in low-cost mobile phones, expanded its facilities for producing mobile phone SIM cards. In addition to Foxconn, other Taiwanese IT sourcing companies include Inventek (laptops), Quanta (laptops), and Innolux (LCD panels). These companies, which have formed "China's allied force" with their own technologies, and production and sales networks within China, have recently been seeking cooperation with Korean companies.

Machinery and equipment: competition and partnerships based on technology and price

Companies are competing independently with one another in the machinery and equipment industry. Global companies have a competitive edge in technology. Global companies with abundant technology, such as

Germany's Siemens and Japan's Hitachi, are leading the equipment and production facilities market, excluding the general machinery market. Korean and Taiwanese companies that have a competitive advantage due to high quality relative to price, are close behind, followed by Chinese companies with inferior technology and quality, but with good price competitiveness and networks in China.

This industry is domestic consumption-oriented, with a high proportion of B2B transactions. It takes a long time to gain enough experience in the industry to be competitive in technology. For this reason, cooperation and collaboration between global and local companies is prevalent in this industry. The Chinese government has prioritized the nurturing and protection of the industry, facilitating increased cooperation between global and local companies. Kawasaki Plant System (plant construction), Toray (water treatment facilities), and Nordex (environmental facilities) have increased investment in China through cooperation and collaboration with Chinese firms. On the other hand, Chinese companies are not partners, but strictly competitors of Korean and Taiwanese companies.

It is not easy to sum up the competitions and collaborations among the many companies striving to secure their places in China's domestic market. They can only be explained through a comprehensive analysis of demand by sector, the competition landscape, industrial and technological characteristics, market growth potential, government policies, and corporate case studies. However, it is clear that the Chinese market has become a global standard market where global companies compete to introduce world-class goods and services. In addition, the Chinese government's unique industrial policies make it all the more difficult for foreign companies to secure positions in the Chinese market. That is why it is important to pursue a balance between corporate-level efforts and government cooperation in trade.