4

Market competition

This chapter analyses market competition faced by the sample firms with special emphases on the barriers to market entry, business competitors and partners, the role of networks, and reactions to market irregularities. Before discussing these issues, a brief description of China's general macroeconomic conditions in recent years is provided.

Macroeconomic conditions

The year 1992 marked the beginning of a new round of exceptional expansion of the Chinese economy. As inflationary pressure gradually built up in the economy, the government began in late 1993 to implement deflationary measures. These measures were effective. In 1994 the inflation rate was 21.7 per cent;[1] by 1996, it had been lowered to 6.1 per cent. By July 1997 when the East Asian financial crisis broke, China had already begun its deflationary path.

In the meantime, the economy kept growing, albeit at a slower rate (GDP grew by 13.5 per cent in 1993 and 8.8 per cent in 1997). Consequently, China's deflationary measures were hailed as an economic soft landing. However, these measures, together with the Asian financial crisis, began to take a toll on the economy in 1998–99. The growth of aggregate demand had been lowered considerably.

China was not directly hit by the East Asian financial crisis largely because of its strong macroeconomic conditions after onset of crisis and the restrictions on the free convertibility of its currency and the insulation of its financial sector from the outside world (Song 1998). In the wave of currency depreciation that spread in East Asia, China stood the test and has won the applause of the international community by not devaluing its currency. However, China was affected by the crisis as its exports began to decrease in late 1998, mainly as a result of appreciation of the effective exchange rate, and because the purchasing power of the Southeast Asian countries decreased as a result of the crisis. As these countries began to recover, China's export growth also increased. China's export growth accelerated from late 1999.

However, problems of structural imbalances in the Chinese economy characterised by over-capacity and over-supply in manufactured goods (both producer and consumer goods) markets, were persistent and became one of the fundamental causes for ongoing deflation.[2] Such imbalances and the resulting price deflation are putting severe pressure on both state-owned and non state-owned including private firms.

At the macroeconomic level, one contractionary effect of deflation is to raise real interest rates for any given nominal rate, thereby reducing investment and other interest-sensitive expenditures.[3] Reduced investment implies slow growth. This is devastating since China's economy needs to grow at a high speed to create jobs for workers laid off from the restructuring of state-owned enterprises.

Deflation also has the negative effect of delaying consumption. Many Chinese people expect lower prices in goods and services and therefore wait to make a purchase. This can create a dangerous deflationary spiral: weak demand may lead to more downward pressure on average prices, resulting in further spending delays (Schlevogt 1999).

At the micro level, firms have long begun to feel the effects of the deflationary measures. Liquidity began to be a problem for many firms as soon as these measures were put into effect in the mid 1990s. Private firms were hit hardest because they are in a disadvantageous position in terms of getting loans. Some firms in the coastal areas turned to foreign loans through their subsidiaries in Hong Kong. As Chapter 3 showed with data from the sample firms, firm profitability and employment in some cities were lowered considerably in the period of contraction.

A fundamental cause for the steady decline in growth rate and persistent deflation from mid 1997 to mid 1999 was that growth has been driven mainly by large-scale government investment (fiscal expansion), which was not matched by the increases in domestic non-state investment including private investment. Faced with satiated product markets due to over-supply, and low profit margins due to increasing competition and in reaction to weak market demand, investments from the non-state sector slowed down considerably.

A practical way of reviving non-state investment in the circumstances of deflation was to open more sectors for investments from the non-state sector, by relaxing market entry barriers which had limited participation in certain sectors by non-state including private firms. In so doing, the economy as a whole benefitted, since the non-state sector in general performs more efficiently than the state sector. The further relaxation of market entry barriers to the non-state sector also increased pressure for faster reform in SOEs, banking and financial areas.

Market entry: openness and requirements

Although private firms have been officially allowed to exist for more than 10 years, there are still various government restrictions on market entry by private firms.

The central government stipulates that fifteen types of businesses should exclude the entry of private firms.[4] Furthermore, localities have the discretion to impose only part of the restrictions under a general guideline which rules that private firms' entry to the following industries should be restricted. They are (1) industries using very scarce resources; (2) industries that are vital to the national economy; and (3) industries whose products have certain public hazards. Since there are not precise criteria, there is room for officials' personal judgments.

Various forms of market barriers such as industrial monopoly structures and market size were regarded by some of the sample firms as adverse influences on their business operations. For example, the survey results indicate that entry barriers to major products are encountered by between 26–28 per cent of firms. The survey results also indicated the presence of small regional differences in entry barriers for private firms. For example, for the first major product, the highest percentage was in Wenzhou, 33 per cent, and lowest was in Deyang, 22 per cent.

Table 4.1 shows the distribution of the types of entry barriers. Five entry barriers, namely licenses, general policy restrictions, local protection, industrial monopoly, and market size, were mentioned by the firms. The first three are related to central and regional government regulations and policies, whilst the last two are related to market structure. It is noteworthy, though, that the last two might be based on firms' perception of the market rather than objective realities. Among the 69 answers, 75 per cent were directed to the first three kinds of barriers. Beijing had the highest number of answers (35 firms) with business licenses ranked the highest (31.4 per cent), followed by policy restriction, industry monopoly and local protection.

In the course of the study, the research team learned that there were several kinds of licenses that prohibited private firms entering into certain industries. For example, private firms could not engage in recycling, the taxi business, and the production of products considered a public hazard. Box 4.1 provides an example of how a taxi business in Beijing worked around government restrictions by establishing a *guakao* unit for itself. In Shunde, the local BICM provided an example of the effects of government licensing for high-pressure containers. A collective firm produced such containers before it was privatised. However, after it was privatised, it could no longer continue its production, because the government does not issue licenses to private firms to produce this kind of product.

Private firms were restricted in establishing medicine distribution or direct export businesses. The restricted entry to medicine distribution has done damage to the economy. One consequence of this restriction is the existence of regional monopolies. Licensing restrictive and the medicine market is divided into small fragmented pieces based on administrative jurisdiction. For example,

Table 4.1 Types of entry barriers (% of firms with 'yes' answer)

City	Licenses	Policy restriction	Local protection	Industry monopoly	Market size	No. of firms
Beijing	31.4	25.7	11.4	25.7	5.7	35
Shunde	33.3	55.6	11.1	–	–	9
Chengdu	50.0	–	33.3	16.7	–	6
Wenzhou	50.0	33.3	–	–	16.7	12
Mianyang	50.0	50.0	–	–	–	2
Deyang	–	20.0	20.0	40.0	20.0	5
Total	34.8	29.0	11.6	17.4	7.2	69

Source: CEO survey.

a medicine distributing company in Shunde cannot undertake business in Guangzhou, a place with a much higher demand.

A direct consequence of such restrictions is that consumers have to pay higher prices for medicines. In an interview with a manager of a medicine distributing company in Shunde, it was interesting to find that the manager said he welcomed competition. His company enjoyed a high profit but he was quite conscious of the social cost of the license restriction and regional monopoly, and fully prepared for more competition. He was confident that his company would win a share of large cities' medicine markets.

In the case of direct access to export, private firms have been in a disadvantageous position. Before 1998, private firms were not allowed to export directly although this right had been granted to select state firms for several years. Starting in 1998, the government began to grant direct export licenses to selected private firms. Currently, about 150 private firms have the licenses. Besides the advantages associated with the direct business link with foreign companies, having license also enables a firm to hold foreign currencies and by-pass trading companies. This gives them access to value-added from exporting, as well as to the tax rebates associated with exports.

The effects of entry barriers may differ across firms of different sizes (see Table 4.2). It is clear that firms of all sizes had complaints about government licensing and restrictions. Larger firms were more concerned than others with local protection. This might be because larger firms sold their products outside their own provinces while smaller firms tended to sell locally. In addition, larger firms enjoyed larger markets and had larger shares in these markets. This was why larger firms with more than 100 people were less concerned with industrial monopoly and market size than smaller firms.

Box 4.1 W Arts Co. Limited

W Arts Co. Limited, located in Beijing, was established to avoid government restrictions on private taxi companies. Before the company was established, the manager ran a taxi company that was registered as a subsidiary of a collective firm. This arrangement is known as *guakao*, literally meaning 'get backed', the private firm is called a *guakao* firm, or a 'red hat' firm, and the unit, a state firm, collective firm, or a government agency, providing the backup is called a *guakao* unit. In 1996, the manager's *guakao* unit, i.e., the collective firm, was transformed into a shareholding company, but the taxi business was excluded from this arrangement. As a result, the company became a private company and lost the privilege of continuing the taxi business because the government policy states that only companies owned by a bureau level unit can operate in the taxi business. To meet this requirement, the manager approached the district government for assistance. Since the taxi business provides considerable local tax revenues, the district government decided to set up a new company called W Arts Co. Limited, a trade company specialising in jewellery and arts articles. This new company was partly owned by the district government and qualified as a collective firm, or *guakao* unit, for the taxi business.

The manager also owned another trading firm with a state firm as its *guakao* unit. Now, she could operate on three fronts: a taxi business, a collective firm, and a state firm. This arrangement was made to avoid political risks and to get around government restrictions. Although the Fifteenth Congress of CCP gave the private sector the same status as the state sector, the manager did not change this arrangement immediately, preferring to wait for restrictions on private firms to be lifted.

Competitors, partners, and the role of network

Amid the slowing of the economy and shift from a seller's market to a buyer's market due to over-supply of many manufactured products in the late 1990s, market competition has been fierce. This is shown by the answers provided by the sample firms to the question of the competitiveness of the market of their major product. Among the 501 firms providing an answer, 56 per cent said the market competition was very intense, 41 per cent saidt it was intense, and only 3 per cent said that their major products did not have competition.

It is interesting to find that the competitors of the sample firms were overwhelmingly private firms. In the answer to the question: 'who were your competitors?' some 46 per cent of the 338 CEOs interviewed said they were small domestic private firms, and 35 per cent said they were large domestic private firms. In contrast, only 12 per cent thought state firms were their competitors. The per centages for illegal imports and smuggled goods as competitors were 9 per cent and 13 per cent, respectively (the percentages may not add to 100 per cent because the question allowed for multiple answers).

The high degree of competition among private firms themselves can be a result of the increasing number of private firms in the economy, which include

Table 4.2 **Types of entry barriers by firm size (% of firms with 'yes' answer)**

Size of employment	Licenses	Policy restriction	Local protection	Industry monopoly	Market size	No. of answers	% of answers*
<51	22.6	29.0	6.5	29.0	12.9	31	10.3
51–100	50.0	12.5	12.5	25.0	–	8	9.6
101–500	37.5	37.5	18.8	–	6.3	16	17.8
>500	80.0	–	20.0	–	–	5	16.1

Note: * Percentage of firms providing an answer in the total number of firms in a size category.
Source: CEO survey. Gregory et al., 2000. *IFC Report*, Table 4.1, p.38.

newly established, privatised SOEs, *gaizhi* firms and 'red hat' firms. The high degree of competition among private firms can also be a result of the concentration of private firms in several industries. This can be particularly true in rural areas where many small private firms are producing similar low-grade products and competing with each other and with other TVEs. This second explanation is supported by the current study that found that private firms tended to form clusters in terms of both location and industry. Such clusters tend to deepen degrees of industrial specialisation, increase economies of scale, enhance efficiency and widen the scope for development of private enterprises. Local governments' policy of developing hi-tech areas such as in Beijing and Chengdu help foster the formation of industrial clusters.

The low degree of competition between private firms and SOEs may indicate that private firms are deterred from entering sectors, which have been dominated by SOEs. It can also be said that private firms may not have strong incentives to enter SOE-dominant sectors since many of these sectors have been characterised by over-capacity and low profitability, except in those areas where market potential can be realised by changing the ways of business operation, namely having private participation.

What are the forms of competition? In the CEO survey, 49 per cent of the CEOs believed that the major form of competition that their competitors used was price cuts. This high percentage is contrasted with the proportion of 23 per cent of CEOs who regarded technology as their competitors' main means of competition. It is also noteworthy that 21 per cent of the CEOs thought that government support played a role in helping their competitors.

The economic slowdown and over-supply of products have intensified price competition among firms. Many small firms cannot survive squeezed profit margins and go bankrupt. Low price levels also put heavy pressure on larger firms. Few firms can stand the pressure. Led by consumer electronics and motor industries, the economy has experienced several rounds of price cuts.[5] Government's call for self-enforced higher prices has never been respected for long.

To accommodate the price cut, many firms, especially smaller firms, have lowered the quality of their products. This trend is reinforced by the existence of numerous unregistered small firms. These firms neither pay taxes nor care about long-term reputations. As a result, they have more room and more incentives to cut their prices. Many CEOs expressed their dissatisfaction with the government's inability to close unregistered firms. Smaller firms felt more of the damage because they had smaller markets that also had lower entry barriers in terms of both capital and technology.

Another acute problem is the piracy of new technologies. Box 4.2 shows the torment of a technological leader of the paint industry in dealing with piracy. The research team found in the interviews with CEOs that large firms feared smaller firms' piracy, and smaller firms feared unregistered firms' piracy. Competition increases the efficiency of the economy, but only when effective legal and administrative systems provide firms with an equal starting basis and necessary protection. In a business environment that lacks such effective legal and administrative infrastructure, excessive competition only leads to inefficiency and market disorder.

Turning to business partners, we begin by looking at the types of partners the sample firms had. In this regard, the CEO survey provides useful information. From the supply side, 29 per cent of the 338 firms had the state sector as at least suppliers, 41 per cent had the domestic non-state sector, and 9 per cent had foreign firms. From the demand side, 42 per cent, 44 per cent and 10 per cent had the state sector, domestic non-state sector and foreign firms as at least customers, respectively.

Specifically, the average percentage of sales to the state sector of all the firms was 46. These figures show that the non-state sector was slightly more

Box 4.2 Firm J's conquest of the market

Firm J is a private firm in Shunde and a large paint company. It has been the market leader because of constant technological innovations. Because of this, it has also been the target of piracy from some of the 100 smaller paint firms in Shunde. Small firms can get a new formula either by luring workers in Firm J to work for them or simply by paying Firm J's current employees for information. Firm J attempted to drive the imitators out of the market by lowering prices. The owner was confident that the company's large profit margin would allow it the flexibility to cut prices and drive out smaller imitators. However, as soon as Firm J lowered its prices, smaller firms set their prices even lower, simultaneously lowering their quality. Firm J's concern for its reputation prevented it from lowering its quality. In the end, the owner had to abort his move to conquer the market.

important than the state sector as a market. Nevertheless, the state sector still played a major role. Compared with finding that the sample firms competed overwhelmingly with private firms, this finding is especially interesting. The contrast seems to suggest that the state sector and the non-state sector constitute two different markets between which competition is low, but the demand and supply linkages are strong.

However, there are also remarkable regional diversities. For example, on average, firms in Beijing sold 59 per cent of their output to SOEs, but firms in Shunde only 25 per cent. The percentages of the other four cities spread between 38 and 50. Most of the private firms selling to SOEs produce parts for large firms that dominate the end product market. Shunde was unique in that it had large private firms producing end products.

The CEO survey also provides information on a firm's stable customers and suppliers. Specifically, 85 and 84 per cent of the CEOs said they had stable customers and stable suppliers, respectively. As for types of stable buyers, 26 per cent of the CEOs indicated they were government agencies, 46 per cent state-owned firms, 50 per cent non-state firms, and 42 per cent foreign companies. For stable suppliers, the corresponding percentages are 0 per cent, 45 per cent, 58 per cent, and 39 per cent. These figures show that the sample firms' business partners covered a wide range.

How did they establish their business ties with their partners? Among the 338 interviewed CEOs, 64 per cent said they established the ties with their customers gradually through their own marketing efforts; 21 per cent said that their partners were introduced by friends or family members; 19 per cent said their partners were friends, and 3 per cent family members. As for stable suppliers, 48 per cent of the firms found them by their own efforts; 37 per cent found them by the latter's marketing efforts; 24 per cent said the partners were introduced by friends and family members; 10 per cent said the partners were their friends, and none said that the partners were family members.

These figures provide interesting insights into the role of networks in a private firm's market operations. Family members are seldom business partners of a private entrepreneur, but quite a few of them do business with friends, and a lot of them do business with people introduced by friends or family members. Therefore, networks play a significant role in a private firm's market operations. When asked about the role of family and friends in material supply and product sales, the percentage of CEOs who said the role was important was 30 per cent and 46 per cent, respectively. However, private firms also rely heavily on the 'faceless' market to find customers and suppliers. Private firms like to have the combination of the intimacy of a network and the opportunities of the market.

Firms' reaction to the market conditions

Facing the economic slowdown and wide spread enterprise arrears in the late 1990s, firms were becoming more cautious in selecting their customers.[6] Because firms were operating under a tight liquidity constraint, losing one payment may have meant bankruptcy to them. Many of the sample firms reduced their business volumes in order to avoid deferred or dead payments. 'If you do not have a deal, you are not going to die immediately; but if you have done a deal without payment, you are going to die quickly.' The research team heard this saying quite often in the Survey. To get the information on the payment ability of a customer, a private firm relies on contacts with firms that have done businesses with that customer. Only if the customer has a good record of payment will the firm lock in a deal with it.

Another way of avoiding deferred or dead payment is to reduce business in other provinces. Due to local protectionism, it is difficult to win a lawsuit in another province. People are more likely to get a fair verdict and better enforcement in their own province. Smaller firms prefer to do business with larger firms as debts are not as likely to be deferred.

In addition to becoming cautious in choosing customers, firms also become conservative in choosing the methods of payment. Many sample firms asked for a deposit from their customers when products were sent out; others asked for cash payment. Those two measures definitely reduced their sales volumes, but reduced the risk of running at a loss.

Facing intense competition, small firms without a technological edge feel helpless. The only way for them to survive is to cut their prices as well as the quality of their products. However, there are also firms that maintain quality and do not join the wave of price cuts. For example, a small firm in Shunde specialising in high quality faucets never lowered its prices. In Beijing, a large garment company lowered its total output and concentrated on its higher-end products in order to sustain its profit. It was found in the survey that two types of firms fared the best in the market. One engaged in active technological innovations and possesed unique technical advantages. The other had unique market or supply channels. For example, a firm in Chengdu had a large share of the seafoods consumed in the star restaurants in the city. It did so by having a good supply channel from the coastal areas.

To minimise the loss created by piracy, firms sought to speed up their technological innovations. This was especially important for firms above a certain size. Such firms could not join the ranks of smaller firms and merely survive by price competition. Speeding up technological innovations helped a firm in two ways. One was for it to occupy a unique technological niche and maintain its market share. The other was to make imitation less profitable because the market demand shifted to new products.

An alternative to technological innovations as a means of avoiding piracy was for firms to police their products themselves. The common practice was to ask salespeople to identify pirated products and report to headquarters. The headquarters then contacted the local government of the city where the pirated products were found. In coastal areas, local government usually responded and took measures to stop the production and sales of the pirated products. For example, a Beijing shirt firm found that one of its patented shirts was imitated by a Shanghai firm and sold in one of the local department stores. The firm informed the store and the store did not sell the shirt any more. In another example, a Shunde bed manufacturer found that there was a Shanghai factory using its brand. The firm informed the Shanghai government, and the latter closed the factory.

However, not all local governments were willing to close factories operating in their jurisdictions. In this circumstance, some firms resorted to illegal methods to close the pirate factories. For example, a white wine company in Shunde found that a small factory in a nearby city was using its brand when it produced white wines. It then brought a truckload of employees to destroy the factory. Realising that its production was illegal, the owner of the small factory did not report to the local government. Obviously, the action of the wine company violated the law; but with the lack of legal protection provided by the government, this kind of action was an effective substitute. However, it is dangerous if this kind of unlawful self-protection spreads because it will destroy people's confidence in the country's legal system. Ultimately, government action to enforce laws which define property rights is the only solution to the problem.

Notes

1. If not specified, figures in this subsection come from Yi and Zhao (1998).
2. Another key cause for deflation is weak domestic demand. A partially reformed economic system and new reform measures aimed at deepening the reform bring about uncertainties among residents. With uncertainties associated with various reform programs such as housing, pension, health and education, residents continue to increase savings at the expense of consumption. To the extent that the changes in consumption reduce demand for domestic products, domestic prices will tend to fall.
3. Fernald and Babson (1999).
4. See Appendix to this chapter.
5. Cutting prices to secure market shares is common among enterprises and retailers given the situation of over-supply of goods. A typical example is the so-called 'price war' for colour TV among the big TV producers.
6. Issues of enterprise arrears will be discussed in detail in Chapter 5.

Appendix 4.1: Businesses with restricted entry for private firms

In the following list of the 15 types of businesses, those with * are imposed in Beijing.

1. Production and selling of gold and silver products.
2. Taxis.*
3. Primary real estate market (in Beijing, private firms can engage in the primary real estate market by obtaining a license from the government).
4. Radio and audio products.*
5. Safety products, rubber products.
6. Pressure containers.
7. Inflammable products.*
8. Radio transmission equipment.*
9. Anaesthetic, psychiatric and radiate medicines.
10. Recycling production.
11. Air guns and hunting riffles.
12. Antiques designated by the government.
13. Important raw materials.
14. Copper, steel, iron, and platinum.
15. Polyethylene products.

Source: Information provided by Beijing BICM. *IFC Report,* 2000, Box 4.1, p.37.