

China



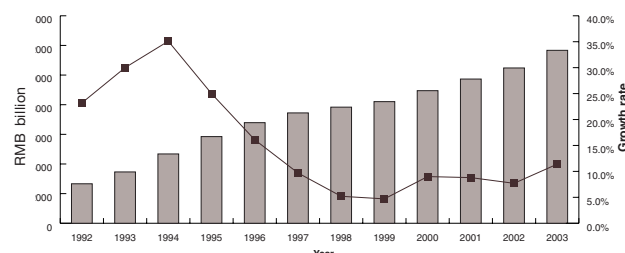
ECONOMIC OVERVIEW

After two decades of market reform first instigated by Deng Xiaoping 20 years ago, China has become the world's second-largest economy by purchasing power parity. Since joining the World Trade Organization (WTO) in 2001, China has been gradually liberalizing and expanding its market, creating tremendous opportunities for both domestic and foreign investors.

GDP AND CPI

Notwithstanding the outbreak of Severe Acute Respiratory Syndrome (SARS), China achieved real GDP growth of 9.1% in 2003. From 1992 to 2003, China's GDP has grown at an average annual rate of 15.5%, increasing fivefold since 1992.

China's GDP evolution (1992-2003)



Source: China Statistical Yearbook 2003

The CPI increased by an annual average rate of 1.2% in 2003, after a marginal decrease in 2002 of 0.8%, mainly due to price rises in food, services items, housing, fuels and utilities. Official estimates put inflation for 2004 at an average of 3.2% as the government acts to cool investment levels to prevent the economy from overheating.



Area ('000 sq km): 9,600

(US 9,600 – EMU 2,500 – World 133,700)

Capital: Beijing

Population (million): 1,280

(US 288.4 – EMU 305.5 – World 6,200)

GDP (USD billion): 1,300

(US 10,400 – EMU 6,600 – World 32,300)

GNI per capita (USD): 960

(US 35,400 – EMU 20,320 – World 5,120)

Currency: Chinese Yuan Renminbi (CNY or RMB)

Languages:

Standard Chinese or Mandarin, Yue (Cantonese), Wu (Shanghaiese), Minbei (Fuzhou), Minnan (Hokkien-Taiwanese), Xiang, Gan, Hakka dialects, minority languages (see Ethnic groups entry)

Main religions: Daoist (Taoist), Buddhist

Government type: Communist state

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UNEMPLOYMENT

China's official urban unemployment rate was 4.2% in September 2003. However, this figure does not include displaced rural migrants, laid-off workers who have labor contracts with their former state-owned employers, or new graduate and young people entering the work force. Overall urban and rural unemployment could therefore be much higher. At the same time, more laborers are withdrawing from the work force due to dismal prospects in the job market – most of the jobless are low-skilled workers engaged in traditional sectors. Moreover, private enterprises also face greater pressure to rationalize their operations to be more efficient to fend off increasing foreign competition. Urban unemployment is targeted to stay below 5% in the tenth Five-year Plan period. In 2004, the government is planning to create nine million new jobs as a means to defuse the potential threat to social stability posed by rising unemployment.

ECONOMIC FORECASTS

Fixed asset investment, particularly the State sector, is one of the driving forces of economic growth in China. However, recognizing that rampant investment is threatening the economy, the central government has been taking measures to moderate investment flows and to maintain a stable growth. At the same time, the government is focusing efforts on stimulating domestic consumption as the key driver for sustained economic growth. Some economists estimate that the Chinese economy will grow at an annual rate of 7-8 % from 2004 to 2008. The robust performance in export in 2003 is set to continue as the outlook for the world economy becomes more positive. Growth in private consumption will lag behind overall economic growth, but it is likely to pick up and contribute steadily to continued growth in the future as disposable incomes rise.

REGULATORY ENVIRONMENT

FOREIGN DIRECT INVESTMENT

In 2003, China overtook the US as the largest recipient of foreign direct investment (FDI). FDI in 2003 amounted to USD53.5 billion, a 1.4% increase from 2002. 39% of FDI was attributed to investments from Hong Kong and Taiwan, while investments from the US, Japan and Korea amounted to 26%. A major part of the total FDI was channeled into manufacturing with a focus on labor-intensive, low-tech export manufacturing projects. With the substantial liberalization of China's service sector by December 2004, it is expected that more FDI will go to the service sector.

Regulations governing the retail and consumer sector and its relaxation

In accordance with the World Trade Organisation ("WTO") market access timetable, foreign enterprises are allowed to set up wholly foreign-owned enterprises ("WFOE") to engage in retail and wholesale activities by 11 December 2004. Most restrictions on equity, geography, number of service suppliers will be eliminated by then.

On 16 April 2004, the Ministry of Commerce issued the MOFCOM Notice (2004) No.8 "*Administration Measures for Foreign Investment in Commercial Sector*" providing further relaxation for foreign participation in retail and wholesale industries. Major relaxations brought about by the Notice are:

- Lower registered capital requirement: The requirements are set to align with those stipulated in the Chinese Company Law, which are substantially lower than the WTO commitment. The minimum registered capital for setting up a wholesale enterprise is RMB500,000 and RMB300,000 for a retail enterprise.
- Elimination of prerequisites for foreign investors: There will no longer be any requirements on annual sales and asset value on foreign investors (except for selected goods like motor vehicles) in order to enter China's retail & consumer sector.
- Granting of import and export right: The WFOE set up under the Notice will have full import and export rights.

- Removal of geographical restrictions: All restrictions on the locations for operating wholesaling and retailing activities will be removed at the end of 2004.
- Expansion of business scope: The business scope has been expanded so that a single WFOE can engage in different distribution activities including wholesaling, retailing, franchising and commission agency services upon approval.

Major hurdles of investing in retail and wholesale industries for foreign investors will therefore be removed.

Closer economic partnership arrangement

On 29 June 2003, the China government signed the Closer Economic Partnership Arrangement (CEPA) with the government of the Hong Kong Special Administrative Region. CEPA permits earlier access for Hong Kong companies and service providers to the mainland market, ahead of China's WTO timetable by way of lifting customs tariff for Hong Kong exports, liberalizing market access and lowering investment thresholds for Hong Kong companies. For some industry sectors, CEPA offers concessions extending beyond China's WTO commitments.

Companies in Hong Kong can start to set up WFOE engaged in retailing and wholesaling on 1 June 2004 provided that they have obtained the CEPA Hong Kong Service Supplier certification in accordance with the requirements of CEPA from the Hong Kong Trade and Industry Department.

Free Trade Zone trading companies

Largely due to the heavy restrictions imposed in this sector before the full liberalization by 11 December 2004, foreign investors use different ways to carry out their distribution businesses in China. One of the most common distribution models in China is setting up wholly owned trading companies in some of the 15 free trade zones (FTZs), including Shanghai Waigaoqiao and Shenzhen Futian FTZs. It is expected that with China's full market liberalization by the end of 2004, the attractiveness of FTZs as the only trading platforms may minimize because foreign companies can set up trading and distribution companies without geographical restrictions. In response to the challenge of the market opening, some of the zones, such as the

Shanghai Waigaoqiao FTZs, have set up logistics parks and repositioned themselves as logistics and distribution hubs in order to attract foreign investments.

PROPERTY / REAL ESTATE REGULATIONS

In China, all land is owned by the State, but individuals, including foreigners, can hold long-term leases for the right to use land and property. Real estate transactions take place in the form of transfer of the right to use land. One can acquire the right to use land from the government for a fixed term and must use the land for the purpose specified in the land-grant contract. Granted rights have approximate true title, i.e. the rights can be leased, mortgaged or transferred in the open market. The rules governing real estate business conducted by foreign investors consist of two levels, the central government and local authorities. The most notable rules regulating land administration are the Law of Land Administration, the Interim Rules on Sale and Transfer of State Land's Use Rights in Cities and Towns and the Regulations on Development and Administration of Tracts of Land by Foreign Investors.

OTHER REGULATIONS

With its accession to WTO, China has been reviewing laws related to foreign trade to make its legal system consistent with its WTO commitments. In many areas regulated by WTO rules, such as service, telecommunications and market monopoly, China has to promulgate the necessary laws and regulations. In other areas such as foreign investment, customs, intellectual property protection, foreign trade, China has been modifying existing laws, regulations and rules to ensure conformity with WTO requirements. In addition to the necessary changes in its body of laws and regulations, China is also making efforts to ensure that all laws and regulations are applied and administered in a uniform and fair manner.

A major legal step has been taken in the recent amendment to the Foreign Trade Law, which has come into force on 1 July 2004. Among other amendments, the revised law removes the restrictive qualifications for foreign trade operators and provides a level playing-field in foreign trade. Moreover, the revised law adds three chapters about investigation into unfair practices, trade dispute remedies and protection of intellectual property rights in trade, thus aligning this trade law with business law in many countries.

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DEMOGRAPHICS AND CONSUMER BEHAVIOR

POPULATION

With a population of 1.28 billion and an annual growth rate of 1%, China represents a huge consumer market with enormous potential by its sheer size alone.

The current population of China is characterized by its uneven geographic distribution and irregular age structure. Despite its recent economic drive, China is still predominantly a peasant and working class society. Approximately 61% of its population remains rural. Nearly half of China's population lives in the central and northwest provinces.

As China's southeast coastal provinces become more economically developed, per capita income and consumer spending have been rising, particularly prosperous cities. However, rapid urbanization in recent years has raised the size of the urban population, which is projected to grow by 64% within a decade.

While a majority of the population is within the age group of 20 to 39, the proportion of senior citizens is growing. The impact of the one-child policy implemented in the 1970s has led to a decrease in the proportion of infants and youths. Moreover, households are becoming smaller as a direct result of the aging population and lower birth rate. These demographic changes have clear implications for the consumer market. With high expectations on the only

child in the family, parents are very generous when it comes to spending on education and education-related products such as computers.

INCOME / BUYING POWER

Not surprisingly, wealth and consumption are concentrated in large urban areas. In 2002, the ten largest cities in China accounted for 9% of the country's population, but together they comprised around 19% of total domestic retail sales. In 2003, the average annual disposable income per head in urban areas was RMB8,472 which is three times the figure in rural areas. While urban household income has been rising, the income distribution pattern among households is also changing. For example, in Shanghai, middle-income households represent a higher proportion of the population. Moreover, the average consumption of an urban household in Shanghai amounted to approximately RMB16,500, which is almost three times the national average of RMB6,000.

Accounting for some 48% of the population, women constitute an important driving force in the consumer market, generating substantial consumption in cosmetics, personal care and beauty products. Seventy percent of FMCG in China are purchased by women. However, the demographic shifts in the next few years will see a larger proportion of the male population generating different consumption demands.

Economic indicators by the 10 most prosperous provinces/municipalities, 2002
(Based on urban household consumption)

Province / Municipality ⁽¹⁾	Major cities	Population (million)	GDP per capita (Rmb'000)	Household consumption	
				Urban (Rmb'000)	Rural (Rmb'000)
				Shanghai	N/A
Guangdong	Guangzhou	78.6	15.0	10.9	3.0
Beijing	N/A	14.2	28.4	11.4	4.4
Zhejiang	Hangzhou, Ningbo	46.5	16.8	10.5	4.0
Tianjin	N/A	10.1	22.4	9.4	4.0
Liaoning	Shengyang, Dalian	42.0	13.0	7.9	2.6

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Province / Municipality ⁽¹⁾	Major cities	Population (million)	GDP per capita (Rmb'000)	Household consumption	
				Urban	Rural
				(Rmb'000)	(Rmb'000)
Fujian	Fuzhou, Xiamen	34.7	13.5	7.8	4.1
Jiangsu	Nanjing	73.8	14.4	7.7	3.1
Shandong	Jinan, Qingdao	90.8	11.6	7.1	2.7
Chongqing	N/A	31.1	6.3	7.3	1.5
Total in the 10 major provinces/municipalities		438.1			
Total in Mainland China		1,284.5			

(1)- A municipality is a city which reports directly to the central government
 Source: China Statistical Yearbook 2003

CONSUMER BEHAVIOR

It would be a misconception to see China as one single, nearly homogeneous, economy. Different regions within China are developing at their own pace due to vast differences among cities and regions in terms of geography, population, regulations, economic systems, business culture and ethics. As a result, income distribution within China is as diverse as consumer behavior and preferences.

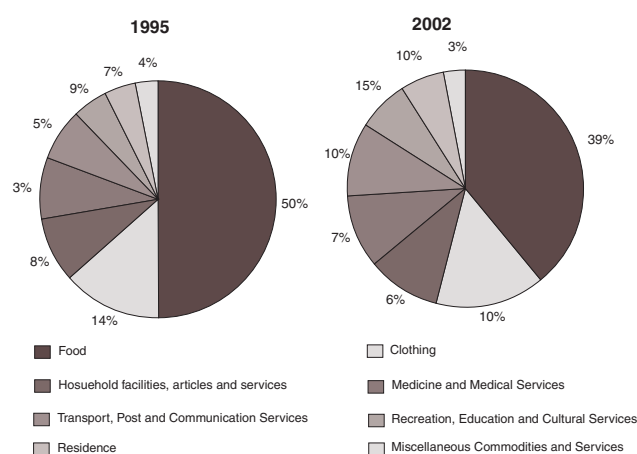
On average, the Chinese spent approximately 37% of their living expenses on food in 2003. The increase in income and living standards had perpetuated a notable increase in processed and convenience food, accounting for approximately a quarter of the spending on food. The next major spending areas were on clothing, household appliances and articles. In total, these accounted for approximately 16% of spending.

With rising disposable income, consumption patterns are maturing in urban households. The more affluent consumers are moving from conventional demand of daily necessity to a quest for higher quality of life. The emerging middle-class consumers, are sophisticated and yet rational spenders. Hi-tech products will be the major consumption drivers in 2004 and sales of mobile phones and digital cameras are expected to soar, particularly in the run-up to the 2008 Beijing Olympics and 2010 Shanghai World Expo. The quest for personal development and enjoyment will see higher

consumption on educational and child-oriented products, recreation and holidays abroad. Moreover, rising household income has spurred Chinese consumers to increase spending on apartments and motor vehicles.

The cultural tradition of gift giving has great influence on the consumption patterns of Chinese households. During the three "Golden Week" national holidays of Spring Festive, Labor Day and National Day, surges in consumer spending have a significant impact on retail sales.

Composition of average household consumption: 1995 vs 2002



Source: China Statistical Yearbook 2003

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RETAIL & CONSUMER SECTOR PERFORMANCE

MAJOR CONSUMER GOODS PLAYERS

Since China opened up its economy to the outside world in the 1980s, its consumer market has been growing at astounding speed. As local consumer goods players grow in number, rapid and strong competition means survival of the fittest. However the survivors still have to contend with their foreign counterparts. Notwithstanding this, several Chinese companies have emerged as powerful rivals to foreign players, including Haier in home appliances, Huawei in

telecommunication products and Tsingtao in the beer industry. Indeed these local players are not only standing up to foreign entrants in the domestic market, but they are also beginning to make inroads on the global market. With the emergence of modern retail formats and the increase in retail outlets, the fast moving consumer goods market has been growing at a staggering pace. Since 1999, consumption value in 43 major FMCG categories has risen by 36% in China's 10 largest cities.

Major CPG players

Company name	Category of product	% Volume		
		Market share 2001	Market share 2002	2001-2002 Evolution
Tsingtao Brewery Co. Ltd	Beer	10.8	12.1	12
China Resources Enterprises Co. Ltd		6.3	8.7	37
Beijing Yanjing Beer Group		7.4	8.5	14
		24.5	29.3	19
Total sector sales in USD million :		9,344	9,984	7
Procter & Gamble Co,	Cosmetics and toiletries	13.7	13.5	-1
The Unilever Group		8.6	8.6	0
Colgate-Palmolive Co.		4.0	3.9	-2
		26.3	26.0	-1
Total sector sales in USD million :		5,036	5,455	8
Haier Group	Large kitchen appliances	14.7	16.4	11
Wuxi Little Swan Co. Ltd		7.8	9.6	23
Zhejiang Shuaikang Co. Ltd		6.9	7.4	8
		29.4	33.4	14
Total sector sales in USD million :		6,110	6,264	3
Zhejiang Nice Daily Use Chemical Co. Ltd	Household care products	12.8	13.9	8
Shanghai WhiteCat Co. Ltd		7.1	7.3	2
Unilever Group		7.1	6.8	-3
		27.0	28.0	4
Total sector sales in USD million:		3,541	3,681	4
Coca-Cola Co, The	Soft drinks	12.4	11.7	-6
Danone, Group		9.7	9.8	1
PepsiCo Inc		7.9	7.7	-2
		30.0	29.2	-3
Total sector sales in USD million:		12,230	13,390	9

Source: Consumer China 2004

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MAJOR RETAIL PLAYERS

Retail sales

Although the market was depressed in 2003 due to the impact of SARS, retail consumption bounced back later in the year. Retail sales of consumer goods in China saw year-on-year growth of 9.1%, as a direct result of rising personal income and the change in attitude towards shopping; consumers are increasingly seeing shopping as a leisure activity.

Greater home ownership levels in recent years have also generated higher spending on home decorations and household appliances. At market level, emphasis has shifted to improving purchasing levels per household and selling to consumers wishing to upgrade their products at home.

Retail sales from 2000 to 2003

Year	2000	2001	2002	2003
Retail sales (RMB billion)	3,415	3,760	4,203	4,584
Growth (%)	9.7	10.1	11.8	9.1

Source: National Bureau of Statistics of China

Major local retailers in China

Ranking	Company name	Main format	Number of stores	2003 Sales (Rmb billion)	2002-2003 Growth (%)
1	Shanghai Bailian Group (a merge of Shanghai Lianhua and Shanghai Hualian)	Supermarkets, hypermarkets, convenience stores	4,357	48.5	21.9
2	Dashang Group	Department stores, shopping malls	96	18.2	42.2
3	Beijing Gome Home Appliance	Specialty stores (Home appliances)	139	17.8	63.3
4	Beijing Hualian Supermarkets	Supermarkets	62	13.6	32.0
5	Shanghai Nong Gong Shang Supermarkets Company Limited	Supermarkets, hypermarkets, convenience stores	1,213	12.4	41.8

Major local retailers

Retail sales of consumer goods in China quadrupled within a span of 10 years. The total value of China's retail sales reached RMB4,584 billion in 2003, a rise of 9.1% over 2002.

The retail boom has brought along a massive influx of new retail outlets, leading to rapid and intense competition. Most of the major local players are located in eastern China and over half of them are in 10 ten of China's largest cities. Lianhua, the largest local food retailer entered achieved its rapid expansion through a merger deal with three other State-owned retailers in 2003 and has become a heavyweight in the sector.

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Ranking	Company name	Main format	Number of stores	2003 Sales (Rmb billion)	2002-2003 Growth (%)
6	Suning Appliance Chains	Specialty stores (Home appliances)	148	12.1	43.7
7	Shandong Sanlian Commercial Corporation	Supermarkets, chain stores, franchising stores	202	10.7	26.6
8	Huarun Wanjia	Supermarkets, hypermarkets	467	10.3	20.2
9	Jiangsu Suguo Supermarkets	Supermarkets	1,162	9.6	35.8
10	Shanghai Yongle Household Electrical Appliance Co Ltd	Specialty stores (Home appliances)	55	8.8	80.2

Source: Ministry of Commerce of the PRC

Apart from these major retailers, the Chinese retail market remains fragmented comprised mainly of small, individually owned stores and large state-owned stores. Modern retail formats such as large chain stores, super and hyper stores have emerged in recent years and are increasing in popularity.

Major international retailers

At present, more than 70% of the world's top 50 retailers have operations in China.

Company name	Home country	Main format	Number of stores	Geographic location	2002-2003 Sales (Rmb billion)
Aeon (Jusco)	Japan	General merchandise superstores	3	Guangdong	0.7
Auchan	France	Hypermarkets	7	Shanghai, Beijing, Tianjin, Nanjing, Ningbo, Chengdu	0.8
Carrefour	France	Hypermarkets Discount stores (Dia)	41 55	20 cities	13.4 (2003)
Ito-Yokado	Japan	General merchandise superstores	3	Beijing, Chengdu	1.7
Kingfisher (B&Q)	United Kingdom	DIY	15	Shanghai, Beijing, Wuhan, Shenzhen, Guangzhou, Hangzhou, Qingdao, Suzhou, Kunming	1.6

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Company name	Home country	Main format	Number of stores	Geographic location	2002-2003 Sales (Rmb billion)
Metro	Germany	Cash & Carry	18	Fuzhou, Nanjing, Ningbo, Qingdao, Shanghai, Tianjin, Wuhan, Changsha, Wuxi, Xian, Xiamen, Chongqing, Hangzhou, Chengdu	5.6 (2003)
Tengelmann (OBI)	Germany	DIY	8	Shanghai, Wuxi, Nanjing, Qingdao, Shenyang, Tianjin	0.7
The Daiei	Japan	General merchandise store	1	Dalian	n/a
Wal-Mart Stores	USA	Discount stores	33	Changchun, Dalian, Dongguan, Fuzhou, Harbin, Kunming, Shantou, Shenzhen, Shenyang, Xiamen, Changsha, Qingdao, Tianjin, Beijing, Jinan, Nanjing, Nanchang	5.8 (2003)

Sources: Company's annual reports, Ministry of Commerce of the PRC and China Retail Market 2003

Non food retail channels

Department stores

In the development of new distribution channels, department stores are the most significantly impacted. Their market share is gradually eroded by other retail formats. Major local player is still Shanghai No. 1 Department Store which is expected to make strategic restructuring and expansion in business operation under its new ownership, the Bailian Group. Among foreign players, department stores with Asian connections, such as Malaysia's Parkson and Taiwan's Pacific, are making market gains and have plans to expand further in China.

Specialty stores

In recent years, specialty stores have sprung up across major cities in China. Typically these stores focus on one product category such as household appliances, mobile phones, clothing, building materials or pharmaceuticals. As a burgeoning channel for

household appliances, specialty chain stores are thriving and have enormous development potential. For example, Gome Home Appliance, a leading retailer in China, is in the process of expanding to around 200 stores and is venturing into the northeastern city of Dalian. The rapid development of specialty stores is closely related to the emergence of shopping malls where a diverse range of specialty stores are located to offer choices and variety to the consumers.

DIY home goods and furniture stores

The boom in home ownership has led to demands for home goods and furniture. The huge market potential has attracted a number of foreign retail players, including B&Q of the U.K., the biggest DIY chain in China, Obi of Germany and Leroy Merlin of France. These DIY stores have adapted their products and services to local condition and consumer behaviour to make DIY more appealing to consumers. Major local contenders in this sectors include Home Way DIY, the first to introduce warehouse home improvement format in China in 1996, and Home Mart, the second biggest

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DIY chain in China after B&Q. Both retailers have made the successful switch from traditional retailing and have big expansion plans in store.

E-commerce

The number of people with access to the Internet in China grew by 34.5% in 2003 to reach 79.5 million, of which 22% enjoyed broadband access. Moreover, the Internet community has continued to grow at a fast pace this year; by the end of June 2004, the number had reached nearly 87 million, up 28% on the level recorded on June 30, 2003. At the same time, the number of subscribers to broadband services is increasing at an even faster pace - this service has notched up growth of 78.7%, or 31.1 million new subscribers, in one year.

With China being a WTO member and its commitment to liberalize telecommunication and financial services sector, it is forecast that this will give further impetus to e-commerce development. In July 2004, China's first e-commerce portal, www.ChinaEC.com, becomes fully operational, linking some 30 businesses to consumers. These businesses include home appliances, home decoration, software and book sales, gift and flowers, and telecommunications. Gome Home Appliance, China's domestic giant in the home appliances market, is one of the businesses that has embarked on online shopping. The current limitations such as lack of a credit card system and lack of e-commerce specific law are expected to be resolved gradually. China's first law on electronic signature and first series of e-commerce policies are expected to be enacted in the latter half of 2004. The retail landscape is set to be changed with e-commerce.

RETAIL & CONSUMER CHALLENGES, OPPORTUNITIES AND EMERGING TRENDS

CHALLENGES AND OPPORTUNITIES

China – a vast and diverse market

The vast consumer market of China is characterized by its regional diversity and differences. Consumer behavior in the various regions is as diverse as the traditional local culture and tastes. This is amply illustrated in the case of beer where the leading brand in most of the regions is invariably the local brand. Understanding the market is both essential and challenging. Foreign companies interested in tapping China's rapidly expanding consumer market need to study carefully in advance to identify the location that would best suit the company's merchandise and retail format.

Fierce competition among retailers

With an increasing number of retail outlets, competition for market share has become the order of the day. While local players have to fend off their foreign counterparts, existing regional retailers are wary of new entrants, whether local or foreign. Although Chinese consumers generally prefer foreign brand names that stand for good product quality and social status, they are not particularly renowned for

being loyal shoppers. Price and range are key deciding factors in their purchasing routines. At the same time, local brand names are emerging, particularly for household appliances. This in turn creates greater choice and competition into an already highly competitive environment. Thus Foreign companies need to adopt a range of different strategies and business models if they are to succeed in the hyper competitive Chinese retail market.

Efficient logistics and supply chain essential

With the market in the coastal regions reaching saturation, foreign companies already ensconced in the market are extending their operations to second-tier cities. Local tastes and preferences aside, the inefficient logistics and supply chain is a challenge as well. As a solution, some existing foreign players have started to source locally and take ownership of the supply chain. For example, Wal-Mart has established its own purchasing centers in Shenzhen and Dalian to streamline its supply chain, and set up distribution centers in four major cities to provide logistics support. At the same time, centralized logistics and quality standards are being introduced. The opening up of the logistics service industry under CEPA is expected to alleviate distribution problems. Meanwhile distribution

channels are set to become more structurally streamlined through industry consolidation and the introduction of more professional service providers.

Transfer pricing for cross-border transactions

With China's market liberalization, it is anticipated that more WFOE will be set up in China to perform the wholesaling and retailing functions for their overseas-related companies. In that regard, cross-border related party transactions will inevitably increase.

Owing to the stringent transfer pricing enforcement in China, it is important to formulate reasonable transfer pricing policies to be adopted by WFOE for their related party transactions. Furthermore, it is suggested that WFOE should maintain proper transfer pricing documentation including inter-company agreements, which would serve as a defence tool in case the tax authorities raise queries on their transfer pricing policies in the future.

Finding suitable middle management remains an issue

Foreign companies are confronted with the problem of a shortage of experienced local professionals and managers. With expanding business operations, finding and retaining suitable local middle managers with the required experience and knowledge of the local market is a challenge.

EMERGING TRENDS AND OUTLOOK

Attractive consumer market and global sourcing hub

The Chinese market is expected to record massive growth over the next few years. With a middle-class group swelling in size and household income increasing, consumer spending is projected to rise to 65% by 2010 and 71% by 2020. Retailers are eager to target their middle-class products at this emerging market. Leveraging on their retail operations in China, foreign retailers are increasingly seeing China as a major sourcing hub for local as well as global markets.

Modernization of China's retailing

With the rapid expansion of China's retail sector and the influx of foreign players, chain operation of modern retail formats such as supermarkets, hypermarkets, convenience stores and specialty stores is becoming the dominant model in China's main cities. At the same

time, chain operations of in other segments such as household appliances, home improvements, pharmaceuticals and clothing are evidently on the increase. Shopping malls, offering a "one-stop shop" for entertainment, restaurant, services and leisure shopping, are increasingly popular. Over the next coming years, more shopping malls and commercial streets, incorporating a diversity of retail formats and operations, are expected to spring up in cities of various levels.

Diversity of retail formats

Modern retail concepts in a wide range of formats, including supermarkets, hypermarkets, convenience stores and warehouse stores, have seen phenomenal growth in recent years. Retail outlets of different sizes and with varying product offerings to cater for different segments have been introduced. For example, Carrefour has expanded its hypermarket chain to include two more formats: the discount store "Dia" and the supermarket "Champion". Furthermore, foreign retailers are restructuring their retail format to align more closely with local consumer lifestyles. Membership warehouse stores have been transformed into supermarkets or are waiving membership requirements to attract consumers.

Continuous expansion from Tier 1 to Tier 2 cities

In general, cities in China can be classified into three tiers. Tier 1 cities are the provincial capitals and municipalities whereas Tier 2 cities are the inner provincial capitals and coastal cities. Tier 3 cities are those other than the Tiers 1 and 2. Coastal cities in the southeastern region and the Special Economic Zones are more open and receptive to foreign merchandise. Foreign players find market entry less of a hurdle in these cities, but competition is equally strong. Challenged by global retail giants, local retailers have moved to refine their networks in big cities and at the same time are striving to develop strategic positions in Tier 2 cities. Geographic expansion into interior markets is also on the agenda for established foreign players as they accelerate store openings in other main urban areas.

Increasing alliances and mergers & acquisitions

As foreign giants step up their bids to tap the Chinese consumer market, local retailers have begun to realize with a sense of urgency that they must sharpen up

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their acts to retain their competitive edge. The market is gradually consolidating through mergers, engendering local behemoths large enough to stand up to foreign competition. The Shanghai Bailian Corporation, the largest commercial group in China, was created through the merger of four state-owned enterprises.

Foreign companies seeking entry to China's retail & consumer market are increasingly buying their way in through acquiring existing local companies. For example, Anheuser Busch gained access to the beer market through the acquisition of Harbin Brewery, and Tesco entered the hypermarket sector through a partnership with Hymall Commercial Retail Group which owned 25 hypermarkets in the country.

ADDITIONAL INFORMATION FOR HONG KONG

Hong Kong is a Special Administrative Region of China and offers an ideal springboard for both foreign companies to enter China and Chinese companies to invest overseas.

Area ('000 sq km): 1

(US 9,364 - EMU 2,436 - World 133,432)

Population (million): 7

(US 285 - EMU 307 - World 6,130)

GDP per capita (USD): 25,330

(US 34,280- EMU 20,670- World 5,120)

Currency: Hong-Kong Dollar (HKD)

Languages: Chinese (Cantonese), English

Main religions:

Eclectic mixture of local religions (90%), Christian

Government type:

Special administrative region of China

ECONOMIC OVERVIEW

In 2004, the economy of Hong Kong has exhibited a strong, broad-based upturn. Real GDP growth in the first quarter of 2004 grew by 6.8% from a year earlier. Boosted by brisk global and intra-regional demands, export of trade and services showed marked increase. Growth momentum in the export of services has been

further underpinned by robust inbound tourism and buoyant offshore trade. The official forecast of GDP growth is 6% for 2004.

Consumer spending has gradually recovered from the setback of SARS. Retail sales volume has increased substantially since August 2003, partly due to the strong increase in visitors from China. Unemployment rate has fallen from the historical high of 8.7% in 2003 to 7% in May 2004 as labor market conditions improved. The Composite Consumer Price Index fell by 2.3% in 2003. Overall prices remain depressed, but the recent increases in asset prices should lead deflation to subside. The official forecast of CPI change is -1% for 2004.

ECONOMIC RELATIONS WITH CHINA

Hong Kong occupies a gateway position to China and is the most important entrapoint to the country. Hong Kong handled about 25% of China's foreign trade, consisting of products sourced on and bound for China. Hong Kong is the largest source of foreign direct investment in China, with 48.3% of the country's foreign-funded projects being tied with Hong Kong interests in 2003. On the other hand, China is the largest source of inward investment in Hong Kong. At the end of 2002, China's direct investment in the territory amounted to USD76.2 billion. At the same time, Hong Kong is the key offshore capital-raising center for Chinese enterprises. 258 Chinese companies were listed in Hong Kong with a total market capitalization of USD217 billion, or 31% of Hong Kong's total capitalization as at the end of 2003.

The coming into operation of the Closer Economic Partnership Arrangement (CEPA) in January 2004 marks a new era in trade and investment cooperation and economic links between China and Hong Kong. CEPA liberalizes the trade in goods and services and will further enhance Hong Kong as the leading global platform for Mainland China business.

HONG KONG AND OPPORTUNITIES FOR GLOBAL RETAIL AND CONSUMER COMPANIES

With its strategic location in Asia and gateway position to China, combined with its sophisticated infrastructure, world-class financial, marketing and technical expertise, Hong Kong offers a distinct advantage in obtaining the expertise, information and

facilities needed for global companies to tap the market in China.

Window to China Consumers

Surveys have indicated that Hong Kong is the most popular destination for business and leisure for Mainland Chinese. Chinese visitors are impressed by the merchandise and retail outlets in Hong Kong, seeing them as the leading brands and best formats. For this reason, many international retail and consumer companies are setting up flagship stores in Hong Kong to leverage on this opportunity for building brand awareness and capturing the heart of the swelling legions of consumers in China.

Human Capital

Hong Kong is endowed with a skilled workforce that is well educated, resilient, flexible and entrepreneurial. Geographical proximity and the similarity in language and culture have seen increasing employment in China for Hong Kong's workforce in the past 20 years. The accumulated experience gained in China, plus the international outlook nurtured in Hong Kong, have created a talent pool of expertise that would provide foreign companies a solution to the existing supply and demand mismatch encountered in the workforce in China.