Supermarkets in China: Entry Limitations and Strategic Dilemmas

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Abstract

Since their 1992 introduction supermarkets have already established a visible presence in Shanghai, with 700 stores and 21 supermarket chains. The role supermarkets play in food retail modernization, the problems encountered at the entry stage and the strategic dilemmas faced by the supermarket sector as it moves to the next development phase are discussed and evaluated. It is concluded that while entry was surprisingly fast and smooth the supermarket sector is still small and highly fragmented. The key for take-off is the appearance of large supermarket chains but supermarket companies face major obstacles in increasing volume and expanding their operations. Consequently progress in the second phase can be expected to be more difficult.
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SUPERMARKETS IN CHINA: ENTRY LIMITATIONS
AND STRATEGIC DILEMMAS

INTRODUCTION

China is at the early stage of the modernization of its food retail system. The origin of
the process can be found in the reforms of the early and late 1980's (Holton 1985; Luk
1995; Kingdon and Zhang 1995; Ho and Leignt 1994; Hong Kong Development
Council 1994A; Qiang and Harris 1990; Sternquist and Qiao 1995; Taubman and
Widmar 1987; Vernon-Wortzel and Wortzel 1987; Yip 1995) that abolished the state
monopolý, relaxed price controls, allowed varied forms of distribution enterprise
ownership. A large amount of decision making and performance responsibility was
shifted to the enterprises. The rigid, administratively determined supply arrangements,
assortment definition and distribution function responsibilities of manufacturers,
wholesalers and retailers were dismantled. In 1992 China’s retail sector was opened to
foreign companies. The central government, selected cities and special economic
zones where allowed to grant approval for joint venture retail projects. Government’s
aim is to reform and modernize China’s commercial sector. The emphasis is on the use
of foreign capital, modern management techniques and chain store operations. Both
joint ventures (J.V.s) and domestic companies were to participate in the modernization
push. (Hong Kong Development Council 1994A).

Since 1992 a large number of foreign retail companies have started operations in the
major cities. Foreign supermarket companies, foreign invested commercial buildings
and shopping centers, counters in department stores, department stores and speciality
stores are visible in all the major cities. It is estimated that Shanghai alone authorized
till 1994, 440 foreign funded retail projects (Levy 1996). However, the process of
modernization is only at its early stages and has a long way to go.

A number of articles and reports have already given an overall view of the emerging
new retailing landscape (Business China 1996; China Economic Review 1995; Cho
Kong-Wing and Tsang Wing Kwong 1994; Euromonitor 1996A; Euromonitor 1996B;
Greaves and Baldwin 1994; Kingdom and Zhang 1995; Levy 1996) but we lack an indepth analysis of the modernization process. This paper focuses on the food retailing sector and provides a detailed discussion of the introduction of supermarkets and food retail modernization.

China is a very big and highly heterogeneous. There are major differences in incomes, living standards, spending, shopping and consumption patterns, involvement in modernization of local governments, competitive situation and distribution and supply systems among urban and rural, North, East, South and Western parts of China and also within regions, urban areas and among cities. (China statistical publishing House 1995; Levy 1995; Euromonitor 1996A; Euromonitor 1996B; Hong 1990: Hong Kong Development Council 1994B; The Economist 1995) Consequently, it is better for an in-depth look at a specific retail sector to focus on one place. Shanghai has clearly been the pioneer and leader in modernizing its retail system in general and food retailing in particular. The food retail modernization process in Shanghai is much more advanced than in other cities and thus issues and dilemmas that are first encountered there are likely to appear later in other parts of China. (SRG 1995; Greaves and Baldwin 1994; Hong Kong Development Council 1994A, 1994B).

The issue of supermarket introduction and food retail modernization should be of interest to retail, consumer goods and marketing services companies already operating in China or in the process of entering this market and to the Chinese modernization agencies. It is of interest also to a variety of other audiences: Global supermarket, consumer goods and marketing services companies and international and government organizations entrusted with fostering economic development. Since the repertoire of cases of food retail modernization lacks in-depth analyses of Asian examples this case should also be of interest to researchers of retail modernization, marketing role in economic development and international retailing.

A brief overview of the food retail modernization literature is first presented. The Shanghai food retail system and the state of supermarket penetration are next described. The problems encountered at the entry stage and the central dilemmas
faced as the sector is about to move to the next development phase are identified and analysed. The paper concludes with a discussion of the lessons learned and the implications for the participants in the process and for researchers.

Food Retail Modernization Research Tradition

The food retail modernization literature originated in the 1960’s. The research was grounded in the "modernization" tradition dominating the thinking of development economists and sociologists at that period. The central issue was how to foster economic and social growth in the non-western, less developed countries (LDCs). Followers of the modernization ideology believed in replacing the "traditional" structures and practices characterizing these countries with "modern" ones. Since the developed Western systems were considered the most advanced, modernization was simply viewed as the process of acquiring the institutions, technology, and modes of conduct of these systems. (Dholakia and Sherry 1987; Joy and Ross 1989; Wood and Vittel 1986).

Marketing was regarded as having an important role to play in this process. Various subareas have been discussed but most attention focused on the role of the food distribution sector. Agricultural economists dealt with distribution, mostly with physical distribution infrastructures, and marketing scholars concentrated on food retailing. The justification for this focus was that LDC consumers devote a large proportion of their income to food purchases, but the food retailing system is visibly costly and inefficient consisting of small, family operated stores, and layers of middlemen. Consumers have few product choices, shop in an unpleasant environment, in many stores, encounter low quality products and pay high prices. Introducing modern retail institutions and methods was expected to lead to greater economic efficiencies, improved outputs to consumers, lower prices and to have a positive impact on the economic and social systems. (Galbraith and Holton 1965; Slater 1969, 1970). The supermarket format dominating Western food retailing was viewed as a superior retail technology and was advanced as the main modernization vehicle. (F.A.O. 1973A, 1973B; Goldman 1974; Slater 1969, 1970.). A large number of food retail modernization programs sponsored by international agencies and financed by international
organizations were undertaken. In all cases the introduction of supermarkets constituted the central element of these efforts.

A related research tradition has looked at the historical evolution of food retailing. Issues analysed include the development of food retailing in North America and Western Europe, supermarket evolution and diffusion (Appel 1972; Bucklin 1972; Goldman 1975/6; Dawson 1984; Markin 1963; Zimmerman 1955), and the historical development of the U.S. and Western European retail systems (Bucklin 1972; Hall et al 1961; Messinger and Narasimhai 1995).

The issue of food retail modernization and the role of supermarkets continued to attract attention in the ensuing decades but, as reflected in recent review articles, the number of new empirical studies have dwindled and no new insights have emerged. (Findlay et al 1990; Samiee 1993; Savitt 1988).

Food retail modernization problems are coming to the front again. A large group of countries is now entering the first steps of the food retail modernization process. Supermarkets have started to appear in Russia, the former republics of the Soviet Union, in Central and Eastern Europe, in China and in the other rapidly developing Asian economies such as India, Indonesia and Malaysia. The food retail modernization processes in these countries takes place in a different environment. The South American, Middle East and African countries involved in the 1960's were very poor and in the very early stages of economic development. This is not the case with the new group of countries. Furthermore, in the past modernization efforts were mostly carried by governments and international organizations. Whereas at present international and local retail companies are heavily involved.

Methods

The study is based on a series of personal interviews conducted during 1995/1996 with participants in the Shanghai food retail and distribution systems. These included (1)
the senior management of J.V. and local supermarket chains. In many cases interviews were also conducted with managers of the buying, operations and logistics departments and with store managers. (2) managers and owners of independent supermarkets. (3) traditional retailers both state owned and private. These included all retail formats operating in the city ranging from large wet markets, open market sellers, to convenience stores and to managers of large provision stores. (4) discussions with store personnel on numerous visits to supermarkets and traditional stores. (5) management of wholesale companies mainly in the fresh foods area. (6) management and sellers in wholesale markets for fresh foods. (7) packaged goods private wholesalers. (8) government officials involved in the food retailing modernization process at the municipal and district levels. (9) manufacturers, both J.V. and state owned companies. (10) research centers and experts. (11) Analysis of articles, reports, statistics and research materials from various sources. In all, some 150 formal interviews and many informal ones were conducted.

**BACKGROUND: SHANGHAI FOOD RETAILING SYSTEM**

Shanghai metropolitan region consists of 12 districts and 10 counties. It has an official population of 13.1 million but the migrants and floating population residing in the city swell the number to an estimated 15 million. Out of these 7-8 million reside in the city itself and the others in the outer counties consisting of thousands of villages and small towns. The central urban area is around 280 square km with additional very large industrial-residential development areas around the city. The inner city districts have population densities of 50-70 thousand people to a square km, the districts further from the center densities of around 15 thousand people per square km and the outlying districts are much larger in size with of 1-2 thousand people per square km. Shanghai is the largest city in China and a leading financial, industrial and commercial center.

Official Chinese statistics (China Statistical Yearbook, 1995) put the total number of food and daily use goods stores in China in 1994 at 7.7 million stores employing 17.3 million people. This sector constituted 63 percent of the total stores in China. According to official statistics the total number of retail outlets in Shanghai in 1994
was 108,000 which, assuming the same proportions, means some 70,000 food and daily necessities stores. The SRG China Retail Census (SRG 1995) estimates the total number of FMCG (fast moving consumer goods) stores in Shanghai at 16,8700. Of these, 73 percent are under 20 square meters and only 2 percent are above 100 square meters. However this retail census does not cover the estimated 70,000 fresh foods street stalls and 300 wet markets in the city. In general, the food retail situation is very fluid with a large number of stores opening, changing from one retail function to another, and closing. Consequently, the above numbers should be taken only as indicators.

The Traditional Food Retail System: Formats

**Wet Markets:** (Non-Staple Food Markets) are enclosed state owned facilities ranging from few hundred to 1500 square meters. Some have few branches in the same district. They sell vegetables, aquatic products, meat, poultry, eggs, and bean products. Most are owned and managed by district owned non-staple food companies. Space is divided among large counters each specializing in one product line. Each market has a general manager, counter managers and up to few hundred employees. Meat is carved on the spot from large animal parts and chicken and fish are killed and cleaned. The environment resembles that found in wet markets throughout Asia -- slippery, dirty floors, noise, crowding, crude facilities and no climate control.

The wet markets are in decline. Modernization and rebuilding efforts aided by government subsidies (loans, low rents and lower tax rates) have not stopped the process. The heavy burden of employee costs, low service levels (many close between 10:00 to 14:00) and a thriving competition from the individual street market sellers are to blame. Many have converted into supermarkets or leased space for other retail functions.

**Street markets:** are the most important source of fresh foods in the city. They sell the same products as the wet markets. All street market retailers are private, some are
farmers from around the city, but migrants dominate. The stalls are small, sometime a cart or few boxes, and are operated by one or two sellers. Markets are located near wet markets and all around the city. In some cases, street markets have more permanent enclosed facilities along market streets. These markets continue to flourish and are responsible for about 80 percent of fresh food sales in the city versus 20 percent by the wet markets.

**Grocery Stores:** Packaged foods, snacks, drinks, dairy products, basic non-foods, fruits, and other daily necessities are sold in grocery (provision) stores. Some are very big with areas of few hundred square meters but most are around 100 square meters. These stores belong to state companies mostly owned by municipality or district departments. There is no self service, store space is divided into departments, employees serve consumers behind counters and payment is made separately at each counter. Scores of these stores are present in every district. In some cases these stores converted parts of their space into self service or even became a supermarket and some provision store companies have converted into supermarkets but most still operate as they did before.

**Staple Stores:** Rice, noodles, oil and sugar are still sold in small rice and oil stores but many changed into individual or chain convenience stores.

**Kiosks:** selling mostly drinks, beer, cigarettes and snacks serve as neighbourhood convenience stores. They locate in each housing complex and within every neighbourhood. All Kiosk retailers are private.

**Modern Food Retail Formats**

**Supermarkets:** Few supermarkets operated in the big cities including Shanghai in the 1980’s (Blois 1989; Ho and Lo 1987) but all have failed. A major push by the Shanghai government and the entry of the early foreign supermarket retailers has resulted in the opening of the first supermarkets in the early 1990’s. It is now
estimated that Shanghai has some 700 supermarkets\(^1\), (4000 supermarkets are estimated to operate in China) and 100 new ones are expected at the end of 1996. About half of the stores belong the 21 supermarket chains while the others are independents. A small number of the chains are Joint Ventures (J.V.) between a foreign supermarket company and a local partner. The local partner is typically a state company that contributes store sites and connections with authorities. In all cases the J.V. is managed by the foreign company. The large majority of the chains are local, among them the two largest with 50 stores each. Most local chains originated from wet market, department store, district provision stores, and wholesale companies. Some chains are owned by companies in different lines of business such as hotels and restaurants and some belong to large diversified retail groups operating in the city.

Local supermarket chains are collective owned companies. They are managed professionally and management is being judged on economic performance but state officials do exert influence informally and through positions on the board of directors. Private entrepreneurship in food retailing is still confined to small kiosks, stalls in street markets and small independent supermarkets.

Unlike the early supermarkets in LDCs who targeted expatriates and high income consumers, all but few of Shanghai supermarkets cater to the mass market.

The dominant supermarket format is the small "conventional" one. Among the chain companies, the average store size is 500 square meters and the range is between 300 to 1,000 square meters. The typical number of Skus is 4,000-5,000 with 70-75 percent foods and 25-30 percent non-foods. The early supermarkets were located in the inner parts of the ring road. Recently, more stores have been opening on the outside of the inner ring road zone and some of these are of superstore size: 2,500 square meters. In addition, a 4000 square meter Carrefour hypermarket has opened recently. Another French hypermarket company and European warehouse club companies are expected to enter Shanghai shortly, joining the two existing large warehouse clubs.

\(^1\) Strictly speaking in the Chinese context a "supermarket" is a self service store. Among these 700 supermarkets an unknown number are too small to qualify as supermarkets in west. Thus, the number should be taken only as a general indicator.
Independent supermarkets are very small, many less than 200 square meters. Department store and shopping center supermarkets are also included in the independents' category and some of these supermarkets are considered to be among the best managed in the city. The large number of independents reflects the low entry barriers to supermarket retailing. Many of the independents were opened by factories, wholesale, district or municipal companies with no experience in retailing, simply because they happen to control space in good locations and saw opportunities in this sector. Naturally, the failure rate among these is high.

Supermarkets are officially (Shanghai Finance and Trade office, 1995) estimated to have captured some 2.5 percent of the city's consumer goods sales, to cover 210,000 square meters of retail space and to have sales of some 300 million dollars. Recalculation official statistics, supplemented by data collected for this study on individual supermarket sales, transaction sizes and customers' store visits seems to indicate supermarkets' share of food and daily necessities may already have reached 7 percent market share.²

Convenience Stores: There are a number of local chains with an hundreds self service convenience stores among them. Many have evolved from state companies running the oil and rice stores. The sector in ripe for foreign participation and a major Japanese convenience store retailer has recently entered into a J.V. with one of the large retail conglomerates.

² Taking as a base the 1994 data in the China Statistical Yearbook on per capita food and daily-use item expenditures in Shanghai, adjusted to 1996 minus the amount spent on eating out, leads to an estimate of total consumer retail expenditures on food and other daily necessities of 5.5 billion U.S. dollars. The average yearly sales of a supermarket store belonging to a chain is around 0.9 million U.S. dollars and of the independent supermarket, 250,000 U.S. dollars. Thus the total estimated yearly sales of the supermarket sector is around 400 million U.S. dollars which is about 7% market share.
Modernization Agency

The Shanghai municipal government plays a central role in the food retail modernization process and a special department in the Finance and Trade Office is entrusted with the task. Its functions include matching foreign supermarket companies with local J.V. partners, developing overall strategy and long term plans for the sector, identifying problems in the modernization process and help resolve them, act as a diffusion center for new ideas, concepts and models from abroad and evaluate their effectiveness. The agency carries influence with the management of the local supermarket chains, arranges for loans, subsidizes activities and projects, and is involved in infrastructure developments (distribution centers, supply arrangements for fresh items, bar codes) aimed at enhancing supermarket efficiency. The agency organizes symposia, visits abroad, and inspects supermarket prices, services and the quality of products sold there.

The modernization of the food retail system is expected to result in a more efficient, technologically advanced retail system and raise consumers’ standard of living (choice, shopping environment, quality products, and service). Consumer goods manufactures will be getting better access to the mass market and pressures will be put on state companies to reduce costs, improve product quality and presentation, and be more tuned to consumer demands. Positive effects are also expected on the distribution sector and on the agricultural sector. Supermarket chains will provide farmers with outlets for high yield, value added products leading to increased profitability and lessening of the move away from the farms into the city. Foreign retailers participation is encouraged. They are assumed to provide investments, technology, and experience.

Evaluation

In a relatively short period of time supermarkets have been able to establish themselves and become an integral part of the retail system. Many indicators attest to this. Consumer surveys find that a large proportion of consumers are familiar with
supermarkets and use them. For example a 1996 survey (Frank Small and Associates China Omnibus Retailing Index) found that 61 percent of consumers said they have visited a supermarket in the past week up from 48 percent in 1995. Similarly, a report by Xinhua, the official Chinese news agency, cites a Chinese consumer behavior study in Shanghai which found that 40 percent of daily necessities were purchased in supermarkets (China Economic Review, 1995). J.V. companies reported (Levy 1996) that 12 percent of their sales already go through chain stores, supermarkets and warehouse stores. Inspite of this, it is too early to talk about a revolution in food retailing. The supermarket sector is still small and faces problems. Many issues are being dealt with successfully but others have not been resolved.

Shanghai supermarkets face two types of issues. The first are associated with the entry stage and concern the limitations on supermarket ability to function efficiently in the Chinese environment. The underlying problem is that of the adaptability of the western supermarket technology. These limitations were encountered by supermarkets in the LDCs and extensively discussed in the modernization literature. The second relate to the question of how best to proceed in the next development phase and reach the take-off point of the supermarket sector.

In this part of the paper these two types of issues are discussed. We start by focusing on the supermarket entry stage. First, the lessons learned from supermarkets' experiences in the LDCs are reviewed and serve as a background for evaluating entry limitations on Shanghai's supermarkets. Then the question of how to move to the next phase of development is discussed. The alternative directions supermarkets can follow to increase sales volume and expand their operations are identified and evaluated.

ENTRY LIMITATIONS: THE LESSONS FROM THE LDCS

The LDC food retail modernization studies have identified four factors limiting supermarket acceptability and success: consumer behavior, supply, the traditional food retail system and government's attitudes. (Goldman 1981)
Consumers Behavior

Supermarkets may become available but consumers may decide not to purchases there. This has been explained in cost-benefit terms. Supermarkets, being larger than traditional retail stores are located further away from consumers, thus shopping there results in extra transportation and carrying home costs. In addition consumers may lose some benefits from shopping in traditional stores such as credit and social interaction. The advantages supermarkets are assumed to offer consumers include prices, quality products, pleasant shopping environment, self service, hygienic conditions, selection and one-stop shopping. The price and quality savings gained at each shopping trip depend on the quantity purchased whereas transportation costs are independent of the amount purchased. Supermarkets will therefore be adopted by consumers who purchase in larger quantities and less frequently. In a situation where consumers shop very frequently and buy small amounts, travel and carrying home costs involved in switching to the distant supermarket outweigh the benefits of shopping in the near by traditional outlets. Furthermore, the qualitative advantages may either not be considered important (e.g. selection) or are not very relevant (e.g. one stop shopping when the opportunity costs of time are low). These shopping patterns appear in situations where homes are small, consumers lack storage facilities, do not own cars, public transportation is not developed, and where unsteady incomes lead to inability to plan purchases and consumption.

Supply Side Limitations

Product Availability: Supermarkets emphasize prepackaged products and consistency in product standards. They also require consistency in supply. In an LDC environment the availability of a large enough assortment from local manufacturers to fill the space is often a problem. Furthermore, many of the available products do not fit supermarket requirements. Products are sold in bulk since packaging is costly and packaging when available is of low quality. The same products vary in size, weight, quality and ingredients from shipment to shipment. Information and labels on packages is often inaccurate. Production is fragmented among small producers thus
consistency in quality and in supply is a problem. Fresh produce presents special difficulties since products are often not graded, production technology and distribution system are inadequate leading to low quality, short shelf life, highly perishable products that are not compatible with the self service nature of supermarkets.

**Infrastructures:** Supermarkets, rely on the existence of infrastructures to operate efficiently. Infrastructures relate to activities that are essential to supermarket performance but in developed countries environment are established and maintained by others. Examples include a bar-code system, inventory and space management programs, employee training, grading and processing of fresh produce, packaging, labelling and price tagging, refrigerated trucks and warehouses, and store fixtures such as shelves, refrigerated cabinets and check-out systems. In an LDC environment these are often lacking.

**Cost of Operations:** Supermarkets in LDCs often incur higher operational costs than the competing traditional retailers. Their payments for rent, labor, energy, store fixtures, equipment and taxes are higher.

**Leveraging Scale Advantages:** Western supermarkets derive major cost advantages through special payment and delivery terms. In addition rebates, incentives and allowances for various activities are frequently granted. These are provided because of large scale purchases, and cooperation in promoting manufacturers’ products. In an LDC environment manufacturers are small, production is erratic and shortages often occur. Under these conditions manufacturers are unable and unwilling to commit themselves to long term supply arrangements involving large amounts. They prefer to exploit market opportunities and emphasize short term gains.

**Traditional Retail System**

The LDC retail system is weak consisting of many small, family owned businesses. Retailers’ power is based on numbers. They often wield political influence pressuring
local or central government to put restrictions on the modern retailers. They boycott manufacturers and wholesalers serving supermarkets and appeal to the community residents to support local retailers against the outsiders.

**Government**

LDC governments behave in an ambivalent manner. Most promote modernization but they are influenced by pressures of traditional retailers and are worried about finding employment solutions for the multitude of store owners and employees driven out of business. In cases where foreign retailers or large corporations were prominent in the modernization effort, patriotic considerations and anti capitalistic sentiments contributed to negative attitudes by governments.

**ENTRY LIMITATIONS: THE CASE OF SHANGHAI**

Of the four types of limitations found to negatively impact supermarket's success in the LDCs, only the supply and cost related factors are relevant in the Shanghai case.

Shanghai consumers have adopted supermarket shopping almost immediately. True, Chinese consumers display the shopping patterns typical of LDC consumers. They buy foods daily, buy small amounts in each shopping trip (the typical supermarket transaction is less than $4), reside in small apartments (average per capita space is 8 square meters), do not own cars and public transportation is inconvenient. However, the key difference is the close proximity of supermarkets to consumers depriving the traditional stores of the distance advantage that figured heavily in supermarket failures in LDCs. Supermarkets' small sizes and location in high density neighbourhoods enables them to be viable even in relatively small trade areas.

Because of cost and supply related reasons, to be discussed later, supermarkets are not able to offer consumers meaningful price advantages. Also, their fresh foods offering
is weak. However, they were able to attract consumers by having visible advantages over the state owned grocery stores in assortment, product quality, shopping environment and the convenience of self service shopping. In addition to functional advantages, research conducted by supermarkets highlights the importance of the foreign atmosphere, modern looking stores, exposure to new products and frequent promotions.

Traditional retailers have not objected to supermarket entrance and many retail state companies have transformed themselves into supermarkets.

Government’s support has already been discussed. Supermarket are viewed as a major tool in raising consumers’ living standards, modernizing the production and distribution systems and as a major element in the new market economy.

The key limitations faced by Shanghai supermarkets relate to costs and supply. We turn now to a discussion of these issues.

**Cost Issues**

At present supermarket chains are caught in a situation where their operational costs are high but their ability to compensate by high margins, increased turnover and better supply terms is constrained.

Rents in Shanghai for commercial space are very high. Traditional state owned retailers often do not pay rent since they own the space or, in the case of wet markets, rent is subsidized by government. Labor costs are also high since supermarkets pay not only for employees’ pensions and social welfare but they continue to employ the staff of the state companies from whom space is rented or of the J.V. partner. Supermarkets even pay the pensions of retirees of these companies. Some chains were able to negotiate taking on responsibility for only small number of these employees, but
all chains are grossly over staffed. The costs of expatriates in J.V. chains and salaries for management in local chains further add to labor costs.

High store operation costs, losses from theft and shrinkage, investments in stores, renovations, store fixtures and in distribution centers further add to costs. Finally, lack of infrastructures leads supermarkets to perform themselves essential functions such as sorting, cleaning and packaging of fresh foods, putting their own bar codes on products and conducting training, marketing research and promotions.

**Supply Issues**

There are many manufacturers in each product line and abundant supplies. Many state owned manufacturers, however, are small, unreliable and produce variable quality products. Markets are flooded with fake and imitation products using low quality ingredients. Another consideration is the continuity and reliability of supply. Many state manufacturers behave opportunistically and are unwilling or unable to guarantee continued supply. Consequently, Shanghai chains took a lot of time and care to sort out and screen the many state owned suppliers, agents and wholesalers and ended with a group of selected suppliers. This group typically consists of hundreds of suppliers, a much larger number than is common in the West. Lack of general wholesalers and smallness of suppliers is partly to blame.

State companies dominate in the staples and usually cover the popular lower price range in the various lines. Joint venture products cover the branded, higher value, part of the assortment responsible for around half the volume. Imports play a more important role in J.V. supermarkets but even there they are used only when no suitable local alternative exists.

Even after the screening major supply difficulties remain. They involve mostly the state companies. Packaging is old fashion, low quality materials are used, information printed is inaccurate, frequent changes occur in package sizes and materials and even
when bar-codes exist they are unreliable. Other concerns relate to reliability and nature of relationships. Supermarkets are not viewed as important customers. Supplier agreements are signed but implementation is deficient. Promised goods do not arrive on time, inaccuracies in order filling occur, and resolution of problems is slow. Chinese distribution infrastructure problems and the difficulties of working with state owned wholesalers, are well known and widely reported (Greaves and Baldwin 1994; Levy 1996). While they affect all suppliers, state companies have been slower than JVs to find ways to work around these problems. Because of the frequent stockouts supermarkets are forced to build safety stocks and establish distribution centers where stocks are kept, products repackaged and bar-codes attached. Given the small number of stores in the typical chain, these costs may not be justifiable but supermarkets prefer not to use wholesalers to perform these functions. Most are state owned, are not client oriented and cannot be relied on to provide supermarkets with these services.

State owned manufacturing companies are not marketing oriented. They are not concerned with building up their market share, do not provide promotion allowances and are inflexible towards special payment arrangements, (rebates, incentives and warehouse allowances). In contrast, J.V. suppliers follow western marketing and supply methods and are more service oriented. Supermarkets have already become major clients and are treated accordingly. They are interested in market shares, develop long term plans, encourage special arrangements (e.g. exclusivity), provide rebates, incentives, allowances and initiate frequent in-store promotions. The practice of consignment were goods are considered as the responsibility of the manufacturer until sold exists among local supermarket chains. The arrangement involves only state owned manufacturers, not J.V.s. They shift the risk to themselves to help sales of products of uncertain demand. Popular products expected to sell easily are not part of this arrangement. Supermarkets see consignment as an easy way to finance inventory and avoid risks of unsold products. However, this practice has a far reaching negative impact. It lessens supermarket management control over assortments, increases the proportion of slow moving items, and reduces the pressure on buyers. The practice reflects more basic issues: state owned chains do not realize
the importance of product turnover and focus only on margins. Also, it reflects the belief that supermarket space is abundant and there is no need to manage it carefully.

**STRATEGIC DILEMMAS: HOW TO MOVE TO THE NEXT DEVELOPMENT PHASE?**

Supermarkets face a new set of issues relating to the next phase in their development. Their market share is small. In addition the sector is highly fragmented consisting of a large number of small companies. Volumes are too small to motivate suppliers to adjust their operations to better fit supermarkets' needs, to enable supermarkets to get special deals and to justify investments in supply and distribution infrastructures. Also, supermarket companies lack the resources needed to finance investments in new technologies, in facilities, personnel training and in expansion. An increase in the number of supermarket stores that is not accompanied by a restructuring of the supermarket sector is not enough. The key for take-off of the supermarket sector is the appearance of large supermarket companies. A large but fragmented supermarket sector consisting of many independents and where chains continue to be small and weak will not trigger the process leading to the reshaping of the supply and distribution systems and the resolution of the entry problems discussed above.

The possibilities available for supermarket companies to gain major increases in volume are identified and evaluated in this section. These are strategic dilemmas because they require both companies and government to make decisions that will shape the nature of this sector in the future.

Analytically a supermarket company can increase its sales volume as follows:

1. Increasing sales volume of individual stores
   - Selling more to existing customer base
   - Increasing its penetration within existing trade area boundaries
   - Pushing the boundaries of the trade area
(2) Increasing the number of stores in the chain
   - Opening new stores
   - Taking over independents
   - Merging with other chains
Which of these expansion directions are relevant in the Shanghai context? Which are more likely to yield the best results? What are the difficulties in pursuing each?

**Increasing Sales Volume of Individual Stores**

Increasing sales to the existing customer base can result from consumers trading up from staples to higher value products or supermarkets expanding their assortment to include important product categories not offered or not covered well. Trading up is income related and is unlikely in the short term. In the Shanghai context the assortment expansion option is much more relevant. At present supermarkets do not cover well fresh foods. Also, the apparent success of the hypermarket format points out to the possibility of drastically increasing the proportion of non-foods in the assortment.

We lack data on penetration levels of supermarkets within their trade areas but research by some supermarket companies indicates that about 40% of consumers in their trade area buy there. Excelling in fresh foods and more emphasis on the elements that do draw consumers to supermarkets will increase this proportion somewhat.

Supermarket ability to draw consumers from larger distances is constrained by the prevailing patterns of frequent shopping and small purchases. Given the small homes, the importance of fresh goods and no change in transportation mode these are not likely to change. Increasing supermarkets appeal by including fresh foods and more emphasis on other drawing elements (spacious stores, modern appearance) may push trade area borders somewhat but no major changes can be expected. Large hypermarket and warehouse club formats in Shanghai do draw consumers from large distances. Their extensive selection in non-foods have made them destination stores.
However, this is not a relevant solution for neighbourhood supermarkets that will continue to be the backbone of the supermarket sector in Shanghai.

To further evaluate the viability of these expansion alternatives the issue of fresh foods in supermarkets and the nature of supermarket format need to be discussed.

The Fresh Food Dilemma

Fresh foods constitute a central category of Chinese consumers’ food purchases. The 1994 household expenditure survey (China Statistical Publishing House, 1995) reports that 57.4 percent of per capita food retail purchases of Shanghai consumers were devoted to fresh products (meat and poultry 23.3 percent, fish 16.6 percent, vegetables 10.4 percent and fruits 7.1 percent). Dining out was only 11.2 percent of consumers food expenditures and most meals are prepared at home from fresh ingredients. (Anderson, 1988)

Fresh foods play a central role in government policies towards supermarkets and the Shanghai government has been pushing supermarket chains to offer a full assortment of fresh foods. Officials feel uneasy about the situation where the retailing of these products is shifting from the wet market channel they control to the difficult to control street markets and hope supermarket will become an alternative. Also, they aim to help the large Shanghai agricultural sector supplying most of the city’s fresh foods by providing mass outlets for higher quality, higher value products.

Chains too are interested in fresh foods. They view these categories as a central mechanism for increasing volume, bringing new consumers into the stores and for increasing the frequency of store visits.

In spite of the realization of the importance of these categories Shanghai supermarkets were not successful in this area. Most chains do carry fresh foods but assortment is limited, presentation is poor, quality low and prices are high. Consumers who adopted
supermarket shopping split their food purchases. They buy frozen foods, snacks, drinks confectionery and branded packaged foods in supermarkets but most continue to purchase fresh foods in the traditional retail formats. The end result is that supermarkets hardly made a dent in the sales of these items. For example, it is estimated that total vegetable sales by supermarkets amounted to less than a quarter of a percent of the city’s vegetable retail sales.

The difficulties supermarkets encounter in selling fresh foods are not unique to Shanghai. The early supermarkets in the U.S. and in Europe offered mostly packaged and processed food items and only a limited selection in fresh foods. (Appel 1972, Goldman 1974/5, Zimmerman 1995, Markin 1963). Studies of the modernization process of food retailing in other countries show that consumers react to the weakness of supermarkets in fresh foods by using supermarkets “selectively”. (Goldman, 1982). Fresh foods are regularly purchased in traditional outlets, while packaged processed and staple foods are bought in supermarkets. Supermarket’s market share, in these situations, is limited by its inability to compete with traditional outlets in fresh foods.

In the West these categories are viewed as central to supermarket success. Consumers select supermarkets on the basis of the quality of their fresh departments. Also these are high margin categories, providing opportunities for high profits for those who learn how to effectively handle them. In Western supermarkets these categories have become major contributors to profitability, responsible for a much higher proportion of supermarket profit than their share of in store sales.

Western supermarket successes in fresh foods resulted from a strategic commitment to the area and major investments in personnel (expert buyers and store level people), in training, in development of physical infrastructures (processing and distribution center facilities, storage areas, cold chain distribution systems), in operational procedures (quality standards and quality assurance systems), in store facilities and in research (consumer preferences, food technology, product quality, shelf life). By far the single most important factor was supermarkets’ success in bypassing wholesale markets and establishing closer relationships
(directly, through agents, or through dedicated wholesalers) with suppliers (growers, co-operatives, packing houses, and processing facilities).

Can Shanghai’s supermarkets use the same methods to gain a competitive advantage over the traditional market system? Three factors constrain Shanghai’s supermarket chains ability to effectively handle fresh foods: Supply and distribution, costs and profitability and space limitations.

**Fresh Foods Supply and Distribution:** Shanghai retailers are supplied with the main fresh food lines such as vegetables through scores of wholesale markets to where farmers directly ship their produce. Supermarket companies buy in the wholesale markets but find products to be of variable quality and not sorted. Thus a large amount of further processing needs to be done. To help supermarkets overcome these difficulties the municipal government directed the state owned Vegetable Wholesale company managing the state wholesale markets to established processing facilities for supermarkets. These currently supply most of the chains with sorted, cleaned and prepacked vegetables. This operation is heavily subsidized by government. A number of chains have been going directly to the farm level and buying from big farms and collectives. The most ambitious attempts involve long term arrangements with selected farmers. Heavy time and money investments are involved but given the small volumes involved and the instability on the production side the long term viability of such an approach is not clear. Fresh food wholesalers specializing in serving supermarkets are missing in Shanghai. These were instrumental in helping Western supermarkets bypass wholesale markets.

The efforts being made in Shanghai in the fresh products area, even if successful, are likely at most to help supermarkets overcome some of their disadvantages, not become superior to traditional retailers. The few supermarkets who do buy directly are not able to get price advantages. Furthermore, supermarkets are often regarded as less desirable clients than the private wholesale companies or street market retailers who pay in cash and do not require invoices. Supermarkets find it especially difficult to deal with live fish and chicken and freshly slaughtered animals. Supermarkets may
easily access the large state slaughtering and processing facilities but lack the storage and distribution infrastructures and the expertise needed to handle these products. Consequently, while supermarkets do offer meat and fish, it is often prepacked, chilled or frozen and the offering is far from covering the whole spectrum of consumer needs.

**Costs and Profitability of fresh foods:** Large spaces are required for presentation and for processing of fresh foods but supermarkets' cost of space is high. Additional costs are incurred in preparing the fresh products for sale and supermarkets report high levels of shrinkage and loss (5.8%). Success in assuring adequate supply depends on the quality of the fresh food buyers but the function of a buyer as it is known in Western supermarkets did not exist in China. Those J.V. supermarkets that had some successes in fresh foods employ highly paid expatriates as buyers. In contrast to the West where fresh foods contribute disproportionately more to store profitability in Shanghai their margins are lower than those of packaged and processed groceries. The reason is government's control of prices and the need to match prices in traditional markets. Given the higher costs it is not surprising that all supermarket chains claim they do not make money on fresh foods. Those who make special efforts, do so to generate store traffic, build up future demand and build an expertise in this area.

**Space Limitations:** Most Shanghai supermarkets do not have enough space to present a broad and deep assortment in the various fresh lines. Furthermore supermarkets lack the space for on premise processing and service that is typical in the traditional markets. Some supermarkets have recently devoted, in their larger stores, more space to the fresh lines in an attempt to duplicate the presentation and feel of the traditional markets. However, it is not yet clear how the economics of the situation will shape out.

It is clear from the above that fresh foods are highly important in the Chinese context but the difficulties supermarkets face in effectively handling these lines are major. The problems are complex and will take years to solve. It does not look like dramatic growth in supermarket volumes will come from this direction any time soon.

**Supermarket Format Dilemmas: Size and Assortment**
Most supermarkets in the city are small. To a large extent this was initially dictated by space availability as most supermarkets are located inside the city in converted retail facilities. Most independents can be expected to continue operating small stores but as both local and J.V. supermarket companies continue to expand to areas further from the center and to revamp existing stores, they face the question of the appropriate size. A related issue is that of the assortment. Supermarkets are mostly of the "conventional" format, but other formats with different assortment combinations already operate including warehouse club and hypermarket.

In North America, Western Europe and in other countries passing now through the modernization process (e.g. Brazil, Mexico) large formats such as superstores, wholesale clubs, hypermarkets and supercenters play an increasingly important role. They attract consumers because they carry a large selection, are more pleasant to shop in, offer consumers shopping excitement and devote more area to display, promotions and service departments (Retail Monitor International, 1996). Furthermore, while the supermarket format still dominates most western food retail systems the typical supermarket is far larger, than the 500-1000 square meter prevalent in Shanghai. Formats differ also in their coverage of product lines. The "conventional" supermarket format and the limited-line discounters in Germany provide a limited coverage in the perishables area. Similarly, all supermarkets carry non-foods but the hypermarket and supercenter formats emphasize these to the extent that they compete in some departments with department stores and speciality retailers.

At present, Shanghai cannot, support large scale Western style stores. First, much of what has been written about the Chinese consumers and changes in consumption patterns, is exaggerated. (Hong Kong Development Council 1994B; Levy 1996; Euromonitor 1996A, B). Consumers have little use for many processed food categories that are basic in the West and can do with fewer brands, package sizes and tastes variations. Consumers still buy mostly the basic ingredients for meal preparation at home not the high value processed items western consumers buy. On the other
hand, those companies that have already opened the large sized superstores face difficulties in filling the shelves with appropriate items.

Another issue is that of trade area size. Most consumers walk or bicycle to supermarkets, buy very frequently, shop in a number of store types in each shopping trip and purchase small amounts. This shopping behavior leads to small supermarket trade areas. While density is high, there are not enough people and purchasing power in a trade areas to support larger size stores with significantly more SKUs.

It is clear from the above discussion that limitations on large scale supermarket formats exist. True, at present most supermarkets carry a limited assortment in fresh foods. If supermarkets will eventually be able to effectively handle fresh foods they will need to increase their size to better accommodate these products, but store sizes of 1,200-1,500 square meters should be enough.

The Carrefour example is often viewed as supporting the notion of bigger stores. However a closer look shows that this is not the case. The store is 4,000 square meters with a 2,000 square meter supermarket floor, but it carries there only 2,000 food Sku’s, and these already include a large assortment in fresh foods. Its assortment size in processed and packaged foods is actually smaller than the 3,000 food Skus typically carried in other much smaller supermarkets. The more focused assortment and less choice does not deter consumers but makes it possible for the company to devote half the space to fresh foods, bakery, deli, chicken roasting facility and a service butcher shop. In addition the store emphasizes modern store environment and a pleasant atmosphere. These are in sharp contrast to many other Shanghai supermarkets where a large number of items are crammed into a small space, boxes and large size packs of staples block passages, staff uniforms are dirty, shelves are often not stocked, and the atmosphere is that of an old store rather than a shining modern place. The focus on few popular items in each category means higher turnover, more bargaining power with suppliers and lower prices to consumers.

The Carrefour example raises another format related issue that of the combination of foods and non-foods. Carrefour Shanghai assortment includes white goods, kitchen
utensils, stationary, home electronics, books, CD’s, paper products, men women and children clothing, toys, games, shoes, sport department etc. The hypermarket competes in these categories with department stores and speciality retailers. The success of the hypermarket format in Thailand and Taiwan attests to the strength of the format in Asia. The viability of this combination format in the Shanghai context depends mostly on the strength of the traditional retail system in these non-food product areas. This issue is beyond the scope of this paper but it is worth noting that the department store sector is well established with scores of big department stores operate in Shanghai. This means that at best Shanghai can support only few of these stores and it is not a general solution to the volume expansion issue faced by supermarket chains.

The Chain Store Dilemma: How Best to Increase Chain Size

Encouragement of chain stores has become one of the main themes of the Chinese retail modernization program, emphasized both in the central and Shanghai government pronouncements. The concept of retail chains is new in China. Retail stores owned by the same state company operate independently even when located in the same district. In the Chinese context the issue of “chain stores” primarily relates to efficiencies to be gained from size related economies and elimination of duplications.

The more important issue, however, is that of the development of large supermarket companies through the expansion in the number of stores in the chain. Supermarkets have already exhausted most of the expansion possibilities in the inner city districts.

It is not uncommon to find supermarkets located within 15 minutes from each other and management complain about intense intra-type competition. As chains focus on the same areas, shortage of sites and high rents constrain growth. Possibilities for opening new stores exist at the new suburban residential complexes housing the people moved from the inner city areas but the potential there is unclear since more lower income consumers reside there. Similarly, venturing out to the suburban counties is constrained by the lower densities and incomes. While Shanghai is big and in the long
term will most likely support many more supermarkets the potential for a rapid expansion in the number of supermarkets is limited.

Another expansion possibility is that of taking over existing independents. Some Supermarket companies already entered management agreements with independents taking over management for a fee. To accelerate the process the Shanghai’s modernization agency policy is to freeze the number of new chain licenses. The experience in China (East Asian Executive Reports 1994) shows that such franchise arrangements are difficult to implement. It is likely to be even more problematic in the Shanghai context. Supermarket companies are themselves small and lack strong management systems and the independents involved are a mixed bag originating from very diverse sources (provision store companies, factories, department stores). Thus, this route is problematic diverting management attention and resources from the main tasks.

In the West, the breakthrough in the supermarket industry towards accelerated growth of supermarket chains began when weak chains merged with strong ones, first on a local level and then on a regional one. It is thus, clear that consolidation among the existing chains in Shanghai should be encouraged leading to the appearance of few strong local chains. At present there are political, legal and economic barriers preventing expansion across provincial borders. (The Economist 1996; Holton 1991; Lam 1995). There are reports some foreign retail companies are about to get central government permission to operate a national chain and examples exist of Chinese retail companies operating as chains in more than one province but the practice is not widespread. Typically all foreign supermarkets operating in different parts of China are forced to manage their operations as separate entities. If the appearance of large strong supermarket companies is to be encouraged and supported, there is no alternative to the development of cross province, regional supermarket chains.
CONCLUSIONS

Supermarkets in Shanghai have successfully completed the entry stage. In a span of only few years they were able to establish a firm and visible presence, have become accepted, built a supply base and adjusted to local conditions. Given the well known difficulties supermarkets faced when introduced into the LDCs and into other Asian countries, one would not have expected such a smooth and rapid entry. Of the various factors negatively impacting supermarkets in the LDC’s only supply and cost issues pose a real problem in the Shanghai environment. Especially interesting is the fast acceptance of supermarkets by Chinese consumers. The location of supermarkets in close proximity to consumers, the fact that consumers were used to buying in large stores (department stores), the weakness of the traditional grocery stores, government support and the ideology of modernization all had a positive impact.

While many of the entry limitations are in the process of being solved, the long term outlook for food retail modernization and the supermarket sector is still clouded. The real issue is not whether China will have supermarkets. It is that of how to accelerate the retail modernization process replacing traditional retail formats with supermarkets and substantially increa the sector’s market share. At present the sector is highly fragmented. Half the stores in Shanghai are small independents and the others are owned by many small and weak chains. The key for take-off is the appearance of few large chains with large enough volume to make an impact on the supply and distribution systems and having the resources needed to reverse the cost disadvantages. Thus, the next phase in the development of the supermarket sector in Shanghai is of critical importance and involves more than merely increasing the number of supermarkets in the city.

Options for increasing volume and market share of individual chains were identified and evaluated. Many were discarded because they are still irrelevant in the Chinese environment or are likely to yield only marginal sales volume improvements. Only two were judged to have the potential for major volume increases and for bringing about a strategic shift in the position of the sector -- fresh foods and increasing the number of stores in a chain.
The issue of fresh foods was discussed in detail because it is a universal supermarket problem but especially prevalent among Asian supermarkets. The strategy of "fresh foods first" pursued by the Shanghai modernization agency and by supermarket chains there, is a sharp departure from the universal supermarket development pattern. In all other cases supermarkets focused first on packaged foods and started dealing with the fresh food problem only when they became well established and strong. This is one of the reasons the Shanghai case is of special interest. Each of the various approaches explored in Shanghai to deal with fresh food supply problem suffers from serious limitations and is likely to yield only sporadic advancements. Short of a major comprehensive effort led by government, involving also the agricultural sector, conducted at a regional level, with the participation of foreign global agribusiness companies, (China Trade Report 1996A, 1996B) no dramatic change in the situation can be expected.

Another issue is that of increasing the size of chains. The key for accelerated modernization is having a strong supermarket sector consisting of few large and strong chains with hundreds of stores each and volumes in the hundreds of millions of dollars. Given the limited potential for increasing the number of stores in the Shanghai area, drastic moves are required. These include encouragement of a major consolidation among the existing chains and more importantly expansion across provincial borders. The development of chain stores is one of the goals of the Chinese and Shanghai retail modernization program but the full meaning and the implications of this concept seem not to have been thought through. Major legal, political, economic and ideological barriers preventing the development of western style large scale regional or national chains exist and little has been done to start dismantling them.

The Chinese case already provides some lessons to students of retail modernization and international retailing and highlights issues that need to be further researched. First, supply and cost issues are critical at the entry stage because supermarkets operate in an environment not compatible with their requirements, but are not as yet able to generate the efficiencies this technology enjoys in western environments. Second, the food retail modernization and development literatures focused mostly on
entry and diffusion. We know little about the more important issue that of take-off. At some point supermarkets pass from simply being another retail format functioning alongside the traditional retailers to a force that dominates food retailing, reshapes supply and distribution arrangements and influences consumer shopping and consumption patterns. Continued research on Chinese food retail modernization is likely to yield insights about this process. Thirdly, the Chinese modernization process involves both local and foreign supermarket companies. It provides an opportunity to observe the interactions among these two groups and to assess the foreign contribution. Fourth, government takes a leading position in the process. The contributions government can make, the complex set of considerations, and the limitations need to be assessed (Business Beijing 1996). Finally, the question of appropriate supermarket format underlies many of the issue discussed in this paper (Bucklin 1976). In a Western environment with diversity of segments and needs, different supermarket formats operate. In a developing country one format is likely to be the main modernization vehicle in the early stages of retail modernization. In the Chinese context, where modernization starts in urban areas, consumers mostly walk or bicycle to stores and the emphasis is on prices and not on variety, a small scale, focused assortment, discount oriented supermarket format seems most appropriate. However, since one of the main attraction of the supermarket concept is the modern look and atmosphere, discounting must be generated through efficient operations rather than a cheap store environment.
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