



# Executive Action

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*Underestimating China's Market Advantage...*

## China: Creating An Unlikely Edge In The Global Market Share Battle

by Francisco Dao

The world acknowledges that China has favorable labor costs and a growing, educated workforce. But many experts conclude that more developed nations, particularly the United States, will maintain their advantage through innovation. This assessment, however, is dangerously flawed.

The reality is that China does not need to catch the United States, Europe or Japan in innovation, it only needs to be developed enough to exploit the technology. Basing future market performance strictly on the more developed nations' ability to innovate ignores how markets are won.

### **Down Home: Exploiting Mass Markets**

In the quest for market dominance, the ability to exploit the mass market is much more important than cutting edge innovation. This is where Chinese firms have a distinct advantage. The demands of China's domestic economy create

an innovation and productivity pull on their industries that will eventually drive them to international competitiveness in higher valued goods. Simply being located in the middle of the world's most rapidly growing market gives Chinese companies an immediate advantage in developing strategy to serve mass markets. Furthermore, since China's emerging market more closely resembles the conditions of the worldwide population than the developed markets of the West, the beneficial effects of their domestic market demands become even more substantial. More than any other factor, this corollary gives China an unparalleled edge in the battle for superior global market share.

## Underestimating the Impact of Local Demand on Global Competitiveness

Conventional economic wisdom about what creates a competitive industry: natural resources, abundant labor pool, favorable business environment—consistently ignores or underestimates the effects of local markets in fostering a global competitive advantage. Harvard business professor Michael Porter’s research has shown that factors such as the availability of natural resources and favorable labor costs decline in importance as value-added activities increase. In a modern skill-based economy the single most important element that drives a competitive industry is the existence of a demanding domestic market.

Local market challenges increase competitive pressure on companies in that market, which then puts those companies in a better position to compete globally. Additionally, the particular demands of the home market have a disproportionately large effect on how companies interpret customer requirements and develop strategy.

Consider Germany’s strong global position in high-performance automobiles. Germany has very high labor costs and no obvious advantage in access to natural resources, yet a highly competitive home demand for performance vehicles has driven this segment of the German auto industry to near dominance. This pattern of domestic demand conditions fueling global competitiveness can be seen in industries worldwide. Other clear examples include Japanese electronics, French wine, and American farm equipment.

## Driving Innovation in the Direction of Lower Costs

A frequent mistake in considering the effects of demanding local markets is the tendency to interpret “demanding” as synonymous with “technologically sophisticated.” The common misperception is that Chinese demands are less sophisticated than American or European demands and therefore the location of Chinese firms is not an advantage. This perspective ignores the fact that while the demands of the Chinese market may not be as technologically advanced as Western markets, its unique characteristics create equally challenging conditions. Because its citizens are less affluent, Chinese market requirements drive innovation in the direction of lower costs.

Consider Kelon Electrical Holdings, which developed a patented cooling system to create a line of low-cost refrigerators and air conditioners for poorer Chinese families. The result was a 49 percent increase in sales. Innovating in the direction of reducing price, as opposed to higher content, should not be underestimated as a key determinant in achieving market leadership.

Historical examples abound of innovators who failed to capture the larger market because of high price. For instance Johnson & Johnson pioneered disposable diapers with their Chux brand, but due to their cost was unable to capture a significant segment of the overall diaper market (washable diapers were still the norm). Several years after the introduction of Chux, Procter and Gamble developed a lower cost manufacturing process for disposable diapers and Pampers quickly became the dominant brand. The increasing pace of technological development has actually increased the likelihood of this scenario. In the video recorder market, Ampex lost its lead to Sony and Matsushita who made the VCR affordable for home use. The lead in personal computers

shifted from Apple to IBM, and finally to less expensive fast followers such as Gateway and Dell. In laser printers both Xerox and IBM had introduced models before Hewlett-Packard, but HP came to dominate the market by offering significantly lower cost versions. By adopting new Western technology as a low-cost fast-follower and innovating in the direction of reduced cost, Chinese firms can leverage their rapidly growing demand to positions of worldwide market leadership.

### Emerging Market Technology Achieves Mainstream Acceptance

The second common mistake in considering the importance of local market effects on innovation is the inclination to underestimate the ability of emerging market technologies to achieve mainstream acceptance. China's advancement is remarkably similar to that of Japan's in the 1950's and 60's and Korea's in the 1970's and 80's. While it is still relatively poor, it is rapidly advancing in size and sophistication. These conditions dictate a demand for low-cost products but with a steadily increasing quality component. The dismissal of Chinese products as being poor quality and generally unsuitable for export and global competition is the exact same opinion applied to the early products of Toyota and Sony, and later to Korean brands such as Samsung, LG, and Hyundai, all of which have become major global competitors. In fact, several Chinese firms have already begun making inroads into Western markets. TCL Corp, China's largest television and cellphone producer, merged its television business with Thomson-RCA. Chinese appliance manufacturer Haier recently made a bid for Maytag, and local computer maker Lenovo has taken control of IBM's PC business. The rapid development trend of emerging market technologies would indicate mainstream acceptance of Chinese products is most likely only several years away, and not the decades that many predict.

### China's Manufacturers are Turning the Tables

Further analysis of the effects of market demand shows that once a nation or region begins to develop a strong position in a certain industry, complementary firms such as suppliers and specialized tool makers develop and form a symbiotic cluster that helps drive the entire segment. Examples of this can be seen in Silicon Valley, the Los Angeles entertainment cluster, and the German performance auto industry. Under normal circumstances, a developing country would suffer from weak or non-existent clusters but, as the new hub of worldwide manufacturing, many segments of the Chinese economy enjoy the benefits of pre-existing clusters. The infrastructures and value chains created by foreign investment are now readily available to emerging Chinese industries. Instead of building from scratch or sourcing and recruiting from foreign countries and distant locations, Chinese firms have access to the same component suppliers and specialized contract manufacturers as leading Western companies. That these complementary industries are local to the Chinese firms gives them the added advantage of being able to work more closely with one another.

The proximity of the supporting firms facilitates open communication and the opportunity for technical cooperation on research and development. Much in the same manner that local market competition has a disproportionately large effect on company strategy and development, so too do local suppliers and support networks contribute to the advancement of entire segments of industry. As a result, firms such as networking giant Huawei were able to rapidly ramp up development by capitalizing on their easy access to the expertise and supporting clusters developed by foreign companies.

Proof that China's development cannot be categorized as typical can be found in its trade patterns with the United States. Conventional wisdom postulates that an emerging nation would favor exports in raw materials and low value-added products, while a developed nation would skew toward high-end finished goods. China's trade with the United States directly contradicts this position. As of year-end 2003, China had a \$25 billion dollar annual trade surplus in computer hardware with the United States, while America's largest segment of surplus with China (approximately \$3 billion) was in oil, seeds, and grain. This statistic alone might be considered an anomaly but, when examined against the other unique conditions of China's unparalleled growth, should be considered at least a warning that its rise may not follow other expected patterns.

### The Myth of First Mover's Advantage

First mover's advantage has been grossly exaggerated when considering the battle for market dominance. In the late 19th and early 20th centuries the United States benefited from the world's fastest growing domestic market and leveraged that advantage to global superiority. Many technologies initially developed in Europe, such as the internal combustion engine, automobile, and Bessemer process of mass producing steel, were exploited by U.S. producers who took advantage of unquenchable American demand and economies of scale to undercut their old world rivals. While Europe's economy continued to grow, America's grew faster.

Today these same conditions are aligned in China. Through the effects of challenging domestic conditions and pre-existing cluster development, entire segments of Chinese industry gain a competitive advantage by their direct relationship with their local markets. The pattern of disruptive technologies shows that the most serious threats to established players always evolve from low-cost substitutes. In this respect the low price demands of China's giant emerging market are perfectly aligned to

fuel a wave of disruptive innovation. This is the core of China's competitive advantage. Analyses that assume continued Western dominance without considering this are incomplete at best.

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#### About the author

Francisco Dao is a consultant and speaker in the area of organizational performance and strategy. He is a sales and leadership columnist for Inc.com, and has served as a strategic development consultant to numerous technology start-ups. Mr. Dao was the founder of TDEC Inc., and held senior positions in sales and Asia-Pacific Rim development for several technology firms. He can be reached at [FDao@FranciscoDao.com](mailto:FDao@FranciscoDao.com)

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