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The Supermarket Sector in China and Hong Kong: A Tale of Two Systems

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The supermarket sectors in China and Hong Kong have different histories, structures and competition-related problems. In China, after 1949, all large-scale retail operations were nationalised. Local government control of supply chains and retailing meant there were no nationally organised chain stores. The retail sector was highly fragmented and faced little, if any, competitive pressure. Only in the 1980's did the system change with an abandonment of the formal state plan, the liberalisation of agriculture, and acceptance of small private retailers. By the mid 1990s, various local governments across China encouraged international grocery firms to establish retail chains and grocery hypermarkets. The massive investment by foreign retailers has had a dramatic effect on the sector in major cities and has caused alarm and despondency amongst local retailers who have agitated for protection against the alleged 'monopolistic' practices of the foreign giants. The national government has commissioned reports and new regulations are slated to address these issues. In Hong Kong, the traditional laissez-faire economic policy of the former colonial government has been continued by the post-1997 administration. This has allowed the creation, by market forces, of a supermarket duopoly that has in excess of 80 per cent of the local supermarket trade. The incumbents are both subsidiaries of local property conglomerates and given local conditions the ability of newcomers to enter the market is restricted by high barriers to entry. As Hong Kong has no general competition law complaints have not resulted in any government intervention in the sector. This complacent attitude is likely to change given the recent publication of a government-sponsored Competition Policy Review Committee report that recommended the enactment of a general competition statute which would include powers to investigate and sanction abuses of dominance.

INTRODUCTION

This paper will explore the history, development and regulation, both current and prospective, of the supermarket sector in China and Hong Kong. In order to undertake that analysis, it is necessary to understand the history and structure of grocery retailing in both jurisdictions, the respective roles of domestic and foreign-owned operators and certain demographic, geographic and cultural factors that distinguish grocery shopping behaviour in China and Hong Kong from those observed in Western countries.

The paper will first consider the position in mainland China, then proceed to explain the special features of the Hong Kong market, and conclude with some observations concerning the salient common features of both markets.

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SUPERMARKETS IN CHINA

History and Market Structure

Supermarket-type retailing in mainland China is a recent phenomenon and only started to develop in the early 1990s but has now captured about 30 per cent of grocery sales in the first tier developed eastern cities. China is a large country of 9.5 million square kilometers and a population of 1.3 billion. Economic inequality is very marked as between the urban elite and the ordinary urban residents and rural inhabitants. Despite these income inequalities average incomes have increased substantially over the last 25 years and now average US$1,100 per annum in the main urban areas but decline to only US$700 in rural areas. The continuing high economic growth rate of the last decade, which is expected to continue, means that the overall Chinese retail market is expected to double in size from US$628 billion in 2004 to US$1,209 billion in 2010.[1] The retail market is fragmented with no nationally organized dominant players. The top 10 retailers hold only 2 per cent of the national market, and the top 100 retailers have between them less than 6.4 per cent of the total market.[2] The supermarket sector is similarly atomized nationally but in local sub-markets, greater concentration is apparent, though at a level that is considerably less than in mature Western grocery markets.

As regards cultural habits and demographic factors, the vast majority of China's 1.3 billion consumers still purchase groceries from small local single store outlets and buy fresh meat, fish, fruit and vegetables from traditional street markets on a daily basis. Most rural residents do not have access to supermarkets at all. The percentage of car ownership is miniscule at about 2 per cent of Chinese households and so, of necessity, most grocery shopping is carried out within walking or cycling distance of home on a daily basis in urban areas, whilst in the countryside the local village grocery shop is likely to be the only retail outlet.

Traditionally, retailing in China has been very fragmented with few national distribution networks, save for strategic commodities such as rice and flour. Retailing was previously carried out via small single unit outlets or state-owned department stores on the Soviet model. Wholesale and logistic systems were antiquated, owned by local governments and geared to the needs of the local government catchment area or possibly that of the province, but rarely to the needs of a national market. Each locality produced and consumed their own foodstuffs and household essentials, partly as a result of weak infrastructure (poor road and rail networks) and the lack of national distribution channels, but also for political reasons, namely the Mao-inspired self-contained, cellular, economic structure, devised to ensure that in the event of war, every region of China could remain self sufficient. However, by the 1990s the authorities began to realise that existing arrangements were inadequate for the creation of a unified national market for goods and services, which was seen from foreign examples, to be a

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1 World Bank, IMF World Economic Database, Access ASIA, Chinese Statistics Bureau and A T Kearney analysis to be found in 2005 Global Retail Development Index: China, A T Kearney. See www.atkearney.com

2 Ibid.

necessity to promote balanced and wide-spread wealth creation, as well as to achieve greater economic efficiency by exploiting the benefits of economies of scale.

In the 1990s, local governments in the developed southern and eastern cities of Shenzhen, Shanghai, Guangzhou began to promote greater market integration and the consolidation of retail outlets. Consequently, local chains developed rapidly. The main domestic grocery retailers – Lianhua, Hualian and Wumart – were all originally local government operated department stores. They were encouraged by their official sponsors to develop into chain stores in the 1990s, partly as a result of the need to modernise the retail sector and partly to compete with the impending arrival of foreign multinationals. In order to acquire modern management techniques - logistical systems, marketing, accounting, sourcing, operations management, stock control, computerisation, store location and layout, product mix - new foreign entrants were initially required to partner with domestic firms in joint venture arrangements. Not all these joint ventures have fared well. For example, a joint venture between Lianhua and Carrefour – Dai Lianhua – formed in 2003 with a registered capital of RMB90 million contributed as to 55 per cent by Lianhua and 45 per cent by Carrefour and operating a chain of 120 stores, has made an accumulated deficit over the last three years of over RMB50million; Lianhua is now likely to sell its stake to its joint venture partner.[3] Intense competition in the grocery market in first tier cities has also led to casualties. In May 2006 Hualian, a Shanghai based multiple, which had expanded to the capital city, announced it was withdrawing from the Beijing market due to mounting losses.[4] Local consolidation has also been a feature of the market in Beijing. Wumart's acquisition of MerryMart is one example as is its purchase of Xinhua in the southwest of China. However, over 40 local chain store operations remain in Beijing and it would seem that further consolidation is inevitable as many of the players are very weak financially.[5] However, not all amalgamations are sound business propositions and the grim reaper of market forces is thinning out the ranks of merged market operators. In early 2005, Shanghai Meiya Investments closed the 500 21st Century convenience stores it had purchased only 18 months previously. In July 2005, Yindu Supermarket Group in Hebei province collapsed. PriceMart, previously a leading chain store operator with 40 hypermarkets in 2003 and sales of US$741 million also failed in 2005.[6]

As regards the vast rural, second tier city and small town market far away from first tier cities, the national Ministry of Commerce announced, in 2004, a five year plan to develop a network chain of 250,000 'supermarkets' to service part of the two thirds of China's population that still rely on agriculture for their livelihood. Most of these stores will be very small, perhaps only 100 square metres.[7] Whilst farming families' incomes

[3] Lianhua may pull out of venture with Carrefour, South China Morning Post, 17 August 2006.

[4] Hualian woes highlight tough market, South China Morning Post, 18 May 2006.

[5] Wumart set its sights ongrowth, China Daily, 11 August 2006 and Retail giant swallows rival, China Daily, 3 February 2006.

[6] Supermarket sweep, China Daily, 12 December 2005.

[7] 70,000 supermarkets set up in rural areas in 2005, China Daily, 4 January 2006.

are often much lower than urban ones, consumption spending is problematic due to lack of retail outlets in rural communities and journeys to the nearest town being difficult. On the macro economic level, the national government is anxious to attempt to divert gross domestic product expansion away from over reliance on capital expenditure and to rebalance it more toward consumption. Expanding the opportunities for consumption spending in rural areas is part of that overall strategy. This market is likely only to be serviced by domestic retailers, backed by local governments, rather than by international operators, who will prefer to cherry-pick wealthier urban dwellers in the major cities that may be a more profitable segment of the consumer market.[8]

Foreign Investment in the Supermarket Sector

The development of foreign owned supermarket chains has been explosive, especially in the last five years, since China joined the World Trade Organisation (WTO) in December 2001. The nature and format of foreign direct investment (FDI) in the retail sector had been severely restricted by the national government prior to this date because of concerns about 'excessive competition'.[9] In the 1990s, Carrefour evaded national prohibitory rules that prevented sole ownership, or high equity stakes in ventures, by obtaining business approvals from various local governments, including the Beijing municipal government, that coveted the prestige of having a well-known foreign investor in their locality and who had delegated approval authority for *prima facie* smaller foreign investment projects. Carrefour's strategy was to lay the foundation of a national network by stealth. When the scale of the investment became too big to ignore, and as a result of domestic retailers complaints, the national authorities threatened sanctions and imposed a six month freeze on new investment in 2001. Carrefour was also required to reduce its per centage ownership of various outlets across the country to conform with FDI regulations but once China had joined the WTO it reaped considerable first-mover advantage and had stolen a march on its greatest global rival – Wal-Mart – that had played by the rules and only began investing in a national network in China after WTO accession.

As part of the WTO accession protocol, China agreed firstly to relax restrictions on foreign participation in the retail sector and then, by late 2004, to open the retail sector fully by removing all geographical and quantitative restrictions on FDI.[10] The result has been an avalanche of foreign capital investment in the sector with Carrefour, Wal-Mart, Makro, Metro, Tesco and Emart (South Korea) leading the charge and up to 35 other foreign retailers all becoming involved in one of the largest potential retail markets in the world.

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8 China spurring consumption in rural areas, Xinhua, 28 December 2005.

9 Carrefour revamps business to follow local rule, Business Weekly, 18 June 2002.

10 To read the documents relating to China's accession see the WT web site at http://www.wto.org/english/thewto_e/acc_e/completeacc_e.htm. The services schedule contains China's detailed commitments on opening the retail sector, see document WT/ACC/CHN/49/Add.2.

At present, the share of grocery market held by the largest 100 retailers appears to be split as to 80 per cent to domestic operators and 20 per cent to foreign chains, according to the Chinese Chain Store Management Association. However, increasing foreign expansion in the domestic market is expected in the future with Carrefour intending to expand its current 70 hypermarkets by 20 per year and Wal-Mart increasing its 56 stores by a similar number. Tesco has 50 stores and plans an additional 15 more per year too.[11]

The large volume of FDI that has entered the Chinese market in the last decade, and will continue to pour in, appears to be reaching saturation point in several honey-pot destinations, especially Shanghai. This city of approximately 16 million inhabitants had 126 hypermarkets over 5,000 square metres in 2005, of which 36 were within 1 kilometre of each other with plans afoot for another one hundred similar size stores before 2010. AT Kearney, a major international management consultancy, recently opined that the Chinese retail market may soon suffer from over investment, given that average disposable incomes in most parts of China could not support profitable operations for international investors and that other developing markets might have better prospects.[12] Establishment in second tier cities is also a strategy being actively pursued by some foreign entrants. Initial partnering with local incumbents with a prospect of complete buyout, once the local market is better understood, is the strategy often pursued. This acquisition issue is discussed in more detail below in light of new regulatory controls.

A strategy of geographical expansion is not without difficulty. Infrastructure deteriorates as one ventures further into the central and western regions of China's vast hinterland. Average incomes decline from US$1,100 per annum in the main urban cities to only US$700 in rural areas. In food distribution, only 15 per cent of products that should be temperature controlled are carried by refrigerated transport, compared with 85 per cent in developed nations. Competent managerial talent is often in short supply in secondary or rural areas. All these factors complicate nationwide expansion plans of foreign investors.[13]

Additional market risks include widespread corruption amongst employees who accept or demand bribes from suppliers to place orders with them, and the pervasive presence of pirated products that can enter the supply chain by nefarious means and end up being offered for sale by the unsuspecting retailer. Substandard beer bottles that have a tendency to explode causing personal injury and fake brands of paint containing toxic chemicals that can prove lethal to unsuspecting consumers are relatively common. China has a surprisingly well developed consumer protection law system and such defective products can give rise to substantial liability claims. Domestic courts are willing to impose liability on foreign operators who do not have the same level of

[11] Hualian woes highlight tough market, South China Morning Post, 18 May 2006.

[12] The 2005 Global Retail Development Index: China, AT Kearney. See www.atkearney.com

[13] Ibid.

political protection as their better connected domestic counterparts, who may be owned by the same local government that controls the lower level court system.[14]

Despite these problems, foreign market players continue with expansion plans to open substantial numbers of new outlets in the coming years and also to buy-out existing domestic joint venture partners or local rivals to consolidate ownership, and increase market share, improve efficiency and maximize economies of scale. This strategy is now possible as a result of the implementation of China's WTO services commitments that allow *inter alia* 100 per cent foreign ownership of retail firms. For example, Carrefour has bought out its local partners in Kunming, Wenzhou, Haikou, Shenzhen and Beijing; Tesco has bought out its joint venturers in Beijing, Shanghai, Jiangsu and Guangdong; and Metro has acquired sole control of its joint venture with Jinjiang International for US$949 million.

The Effect of New Regulations on Future Foreign Investment and the Rise of 'Economic Patriotism'

Economic 'nationalism' or 'patriotism' is not a new phenomenon, nor one that is peculiar to China. In recent times, the United States, France, Germany, Spain and Italy have all exhibited this species of xenophobic paranoia. The Chinese state oil company (CNOOC's) bid for a US oil company (Unocal) caused a political storm in the US.[15] The possible take-over of a number of French firms, including casinos and a dairy products manufacturer, by a range of foreign bidders brought out French politicians innate repugnance of foreign ownership.[16] The acquisition of a German mobile telephone operator (Mannesmann) by the British operator (Vodaphone) caused the German government to attempt to block the deal.[17] A foreign bid for a Spanish electricity utility (Endessa)[18] and a Spanish firm's bid for an Italian motorway operator (Autostrada) similarly caused intra European controversy very recently.[19]

In China, such nationalist protectionism is often near to the surface of official pronouncements. For example, in May 2004 the State Administration of Industry and Commerce produced a report demonizing 'foreign domination' of various markets including retailing.[20] Xie Fuzhan of the State Council Development Commission urged government to take action to detect the early warning signals of foreign multi-national

14 For a discussion of consumer liability claims in China see Mark Williams, 'Foreign Business and Consumer Rights: A Survey of Consumer Protection Law in China' (2001) UCLA Pacific Basin Law Journal, Spring Vol 18, No 2, pp 252-272.

15 China's Unocal Bid Raises Political Red Flags, 27 June 2005. http://www.foxnews.com/story/0,2933,160656,00.html

16 Economic Brief: French Protectionism, PINR, 15 September 2005. http://www.pinr.com/index.php

17 Vodafone seals Mannesmann deal, BBC News, 11 February 2000. http://news.bbc.co.uk/2/hi/business/630293.stm

18 Antitrust and mistrust, Financial Times, 7 August 2006.

19 Italy halts Autostrade merger, Financial Times, 7 August 2006.

20 Laws necessary to counter monopoly by foreign giants, China Daily, 15 November 2005.

companies (MNC) attempts to corner markets in China.[21] One of the most strident voices on this topic has been the head of the National Bureau of Statistics, Li Deshui, who warned at the March 2006 meeting of the National People's Congress, that Chinese companies were in great danger from foreign capital's takeover of Chinese firms and that 'more than 80 per cent of large scale supermarkets have been purchased by MNCs by 2005'.[22]

This trio of high level interventions now appear to part of a co-ordinated campaign, rather than isolated, independent siren calls for a more protectionist stance. It has been suggested that several factors have contributed to the deteriorating climate for foreign-backed mergers including 'national pride, lingering resentment over Chinese oil giant CNOOC's failed US$18 billion bid for UNOCAL, and a nationalist resurgence, partly in response to growing protectionist sentiments in the United States and Europe against low-cost Chinese exports'.[23]

Prospective Regulatory Controls

By the summer of 2006, matters appeared to be coming to a head. Three new sets of regulations were either promulgated or were close to finalization.

On 6 June 2006, it was announced by the State Council that the enactment of China's long debated general 'anti-monopoly' law would be speeded up given the pressing need to deal with competition issues.[24] The draft law has now been submitted to China's highest legislative organ – the Standing Committee of the National People's Congress – for final scrutiny, amendment and enactment. This was debated in the session held between 24-29 June 2006.[25] Passage of the law and its detailed provisions remain controversial. A hint of the continuing difficulty that China has with a competition law in terms of its ambit and appropriate enforcement can be gleaned from official comments in the press. Early enactment seems unlikely and the view of the knowledgeable interlocutors appears to be that '[the draft law] will surely attract more attention in the following months, or even longer, before law makers can reach consensus on some of its more controversial articles and pass it'. In the same report, a member of the Committee was quoted as saying that 'there was no timetable for passing the law due to its complexity'. Some law-makers see the law as primarily a defence against 'aggressive foreign take-overs', although other officials have been at pains to point out that 'the draft law does not target any type of foreign-funded companies, so there is no discrimination at all'.[26] Doubts as to the veracity of this protestation exist, as will be seen when two other new regulations are considered later.

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21 Foreign firms' monopolies in China cause Concern, China Daily, 8 December 2005.

22 Foreign Companies M&A more aggressive, China Daily, 15 March 2006.

23 Takeover hostility, China Daily, 12 April 2006.

24 China okays draft anti-monopoly law, China Daily, 8 June 2006.

25 China deliberates new law, Xinhua, 25 June 2006.

26 State strives to boost market competition, China Daily, 21 July 2006.

The draft 'anti-monopoly' law contains provisions in relation to abuse of dominance, collusive agreements and a merger control regime, none of which, superficially, discriminate against foreign investors. The law also has provisions to attempt to more effectively deal with a particular Chinese mischief – 'administrative monopoly' – this may be defined as:

- the abuse of national or local government power to protect producers from competition (whether from other domestic products or imports) by differential taxes or administrative charges;
- the misuse of administrative powers to compel procurement from favoured local suppliers;
- the erection of physical and non-financial barriers to domestic trade or the abuse of administrative power to procure economically unjustified advantages such as soft bank loans for favoured local or national champions; and
- the abuse of licensing or administrative approval powers for the same purposes.

Tackling the decisive influence of governmental power over the internal market is essential if China is to be becoming a functioning market economy but, because of existing political arrangements, this is one of the most intractable issues to deal with.

As for foreign investors, many remain nervous that whilst the draft law is not overtly discriminatory, the implementation of its provisions might be skewed against their interests, especially given the chorus of official shroud-waving that preceded the submission of the draft law to the Standing Committee.

Probably the greatest obstacle to the swift passage of the law is the continuing bureaucratic turf war over which of three competing agencies should take the lead role in the administration and enforcement of this potentially potent economic management tool. The infighting between the Ministry of Commerce, the State Administration of Industry and Commerce and the National Development Reform Commission has been ongoing for at least four years and resolution has clearly not yet been achieved. As a result, the final enactment of the law could be impeded for a considerable time but the Chinese government also appreciates that as the five year transition phase of WTO accession expired in December 2006, enacting a new regulatory regime for the internal market is an urgent necessity. China's accession commitments regarding foreign access to its domestic markets became fully operational at the end of 2006 and there is a perceived need to have a competition law in place to discipline unacceptable market behaviour and to prevent new positions of dominance being achieved in markets that will become more open to foreign capital. The dilemma of how to manage FDI in such a way as to assuage domestic xenophobic fears but at the same time ensure continuing inflows of foreign capital to fuel economic growth and development, is an acute one to which there is no easy solution for the authorities.

There are two other legislative initiatives that will directly affect the retail sector. One is a new merger regime, in advance of the new general 'antimonopoly law', that exclusively regulates foreign take-overs of domestic firms. The other is specifically aimed at new administrative arrangements to inhibit over provision of large format retail chains.

On 8 August 2006, the Ministry of Commerce issued the 'Provisions for Foreign Investors to Acquire Domestic Enterprises (2006)'. These regulations take effect on 8 September 2006 and supersede the Interim Provisions promulgated in 2003. These rules are discriminatory as they only apply to foreign related transactions; domestic-domestic mergers are not regulated. The triggers for administrative approval are contradictory and do not necessarily relate to the creation of market power. As such, they are not similar to most international systems that seek to control mergers only when there is the risk of a substantial lessening of competition created by the merged entity. These new rules clearly make foreign-related mergers more problematic by increasing regulatory risk. On the other hand, the new rules specifically permit the use of shares as consideration for the take-over transaction, so making foreign-related mergers easier to finance. The result is a curious type of compromise, on the one hand tightening the potential controls whilst on the other making merger transactions easier to fund. These new rules may be an attempt to reign in those mergers deemed 'unacceptable' in official eyes, rather than exhibiting a genuine concern over any potentially anticompetitive consequences that would result from a particular merger. Interestingly, the 2003 Interim Provisions were not actually implemented in practice but the new rules might be, especially given the official grandstanding that has taken place over the last few months about the dangers of foreign expansion and domination of markets. These new rules and the political climate could adversely impact foreign supermarket expansion and consolidation in China.

The third new set of regulations that might affect the supermarket sector directly are ones proposed to 'regulate large-scale shopping outlets, which could impede the expansion of foreign retailers such as Wal-Mart and Carrefour'.[27] They include provisions for an additional administrative approval before new large-scale stores and shopping malls could be constructed. They provide for the submission of detailed plans and impact assessments of any proposed store with a floor area in excess of 10,000 square metres and thereafter, public hearings as to the desirability and effect of the opening of the proposed store on the locality in which it would be situated. If adverse effects were found, the new store could be blocked. Alternatively the development might be allowed, subject to conditions such as better road or pedestrian access. The costs of the development would then inevitably rise. Superficially the rules would not discriminate between domestic and foreign firms but the suspicion remains that these proposed rules have been created as a result of lobbying by domestic firms. Local companies have alleged bias by local governments in favour of foreign firms due to the perceived greater prestige of having a foreign brand-name store in their locality. Domestic retailers see the proposed rules as favouring them as was candidly admitted by a representative of Lianhua who said, 'Foreign retailers are always enjoying special

[27] Chinese rules could tie up foreign retailers, China Daily, 17 July 2006.

favours and treatment from local governments. But the [central] government should protect the national companies if they want us to grow strong'.[28]

Exactly how these new rules will affect the development and structure of the supermarket sector in China is unclear but the government will be anxious to balance protectionist sentiment, for domestic political reasons, with the continuing need to advertise China as being a friendly destination for foreign investment, which has provided much of the impetus for the country's stellar economic growth over the last 25 years. Damaging the growth in GDP would have not only profound economic, but also political, consequences and might imperil the legitimacy of the ruling Communist Party of China.

SUPERMARKETS IN HONG KONG

Ideology and Market Regulation in Hong Kong

Hong Kong was founded as a British Crown Colony in 1842. A free port was established in the expectation of creating an entrepôt based on the China trade in tea, silk and porcelain. The prevailing economic philosophy was one of classical laissez faire and this has remained official government dogma ever since, even after the retrocession of Hong Kong to the People's Republic of China in 1997. The government's dogged adherence to a 'free market' economic policy has won it plaudits as the 'freest economy' in the world from various bodies[29] but pole position in terms of 'economic freedom' does not necessarily equate to economy-wide competitiveness; here Hong Kong's ranking is much more average in terms of the OECD economies.[30]

Hong Kong's government has maintained for decades that market forces provide optimal solutions to problems of economic management and that intervention in the form of a competition law is both unnecessary, given (allegedly) few competition problems, and that such a law would be potentially harmful to the unfettered operation of the market. The implicit government assumption has been that Hong Kong must *a priori* be subject to keen competitive forces in the domestic non-traded sector but, in reality, this is untrue for many domestic markets. As we will see in the supermarket sector, unregulated competition has in fact, as one might have predicted given rational profit-maximizing commercial behaviour, produced a highly concentrated market with an effective duopoly. Theoretical notions that competitive pressure can be exerted from unrestricted imports does not apply in service-related sectors such as retail. Whilst the establishment of new players in the Hong Kong grocery sector is a theoretical possibility, given that there is no regulatory impediment to foreign direct investment,

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[28] Ibid.

[29] The Heritage Foundation of the USA and the Fraser Institute of Canada have both lauded Hong Kong as the freest economy in the world for over a decade. See http://www.brandhk.gov.hk/brandhk/e_pdf/efact3.pdf and http://www.hketo.ca/news/pages/September-8-2005_free.html

[30] The World Economic Forum concluded that Hong Kong was ranked No 28th in the world with regards to over all economic competitiveness in 2004/05. http://www.weforum.org/en/events/eastasia/EastAsiaCompetitiveness/index.htm

formidable barriers to entry do exist and when coupled with the market power of the two incumbents, entry into the grocery sector is very difficult, if not impossible.

History, Market Structure and Shopping Behaviour

Supermarkets were first established in Hong Kong in the 1950s. Until the 1970s the development of self-service stores was very slow with only about 30 stores in operation by the early 1970s. From the mid 1970s the development of the sector accelerated markedly, so that by 1980 there were over 200 outlets and by 1990 over 500 such stores. Market concentration intensified from the mid 1980s and through the 1990s with the elimination of small operators so that the market is now dominated by two chains – Wellcome and Park N'Shop.

A striking fact about supermarkets in Hong Kong is that they are, generally speaking, very small in size when compared to those found in Europe, North America and Australasia or indeed to other Asian jurisdictions such as Thailand, mainland China or even Singapore. Few stores in Hong Kong would reach the minimum efficient size suggested by the UK Competition Commission of 1,400 square metres.[31] They also supply a relatively limited range of grocery brands and do not sell (as a general rule) clothing, shoes, household or kitchen equipment or electrical goods as might be found in European or American outlets. They certainly do not sell insurance or financial products, branded credit cards, savings plans or internet services, as may be found in say, UK supermarkets. Neither do they retail petroleum. This is mainly due to small site sizes, high land prices and site scarcity, though there is a suspicion that the lack of diversity of products for sale may also be due to lethargy on the part of the incumbent duopolists given that they dominate perhaps 80 per cent of the local supermarket market with around 250 stores each; this is a very high number of outlets, given Hong Kong's small geographical size of 1104 square kilometers with a developed urban area of only 262 square kilometers[32] and a population density of 26,335 people per square kilometer[33] in urban areas but this phenomenon can be explained by specific local characteristics as explained below.

Cultural preferences and other particular, local conditions play a part in this proliferation of relatively small outlets. Firstly, ethnically Chinese people, who make up over 95 per cent[34] of the population, tend to prefer to purchase fruit, vegetables, meat, fish and seafood from traditional covered markets, known locally as 'wet markets', on a daily basis as traditionally food is bought, cooked and consumed on the same day. The retention of cooked food for later consumption or for freezing is little practiced as a result of cultural preference for fresh food and, in any case, the lack of space in most

31 Competition Commission, 'Supermarkets: A report on the supply of groceries from multiple stores in the UK' (2000), p 78, para 6.16, http://www.competition-commission.org.uk/rep_pub/reports/2000/446super.htm

32 Hong Kong Social and Economic Trends (2005).

33 Ibid.

34 2001 Population Census, Hong Kong Census and Statistics Department.

kitchens precludes the accommodation of large refrigerators or freezers. Secondly, the vast majority of the population does not own a car[35] as most people live in flats with no, or scarce, car parking spaces, which are often sold separately to residential apartments and can be prohibitively expensive. Thus, groceries have to be carried home, so limiting individual purchases substantially. Thirdly, very little storage space exists in kitchens, due to their tiny dimensions, when compared to those typically found in other places. This combination of factors mean that a weekly shopping expedition to the supermarket to buy groceries, transport them home by car and then store them in bulk is impossible. As a result, 'supermarkets' in Hong Kong are not close comparators to those in other jurisdictions.

In his 1992 Policy Address, Hong Kong's last Colonial governor, Chris Patten, announced that:

> Hong Kong is proud of its free and competitive markets. But a more sophisticated and prosperous community has become increasingly unwilling to accept unfair and discriminatory business practices. The public has already begun to voice alarm at the use of market power by suppliers in areas of special importance to the ordinary family's wellbeing … I shall ask my Business Council to put at the top of its agenda the development of a comprehensive competition policy for Hong Kong.[36]

As a result of this policy initiative the government commissioned the Hong Kong Consumer Council to undertake several sectoral investigations including banking, supermarkets, gas supply, broadcasting, telecommunications and private residential property between 1993 and 1996. These reports were conducted without any legal power to demand evidence or to require the production of documents but most business operators did co-operate with the enquiries, to some extent at least.

The Consumer Council 'Report on the Supermarket Industry in Hong Kong'[37] was conducted in 1994 and adopted a government definition, used for the collection of statistics, of supermarkets as, 'establishments that engage in retail sales of general provisions including foodstuffs as one of the major items that use the self-service method'. Convenience stores and traditional wet-markets were therefore excluded from the market definition on the basis that they were not close enough substitute suppliers. It is a moot point as to whether this definition had a distorting effect on the Report's findings to the extent of invalidating them. As regards barriers to entry, there were at that time, and remain at present, no formal legal rules regulating entry into the supermarket sector, by either local or non-Hong Kong firms. But many observers

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35 There were 351,000 private cars registered in Hong Kong in 2005. Given a population of 6.9 million, there is one private car for approximately 20 people or approximately only 5% of the population own a car but up to 20% of households have access to a car. By way of contrast, in the UK in 2003 over 75% of households had access to a car. For Hong Kong, see http://www.censtatd.gov.hk/FileManager/EN/Content_807/transport.pdf For UK, see Department for Transport http://www.dft.gov.uk/stellent/groups/dft_transstats/documents/page/dft_transstats_026282.hcsp.

36 Hong Kong Legislative Council Official Record of Proceedings, 7 October 1992 at p 16.

37 'Report on the Supermarket Industry in Hong Kong', Hong Kong Consumer Council, November 1994.

suggest that non-legal, economic barriers to entry do exist and they help to maintain the dominance of the two incumbents. These alleged barriers will be considered later.

Given the somewhat narrow market definition utilized by the Consumer Council, the two operators – Wellcome and Park'N Shop – had, at the time, some 70 per cent of the market. But if a wider definition was adopted – Hong Kong government subsequently alleged that the supermarket sector accounts for only 35 per cent of foodstuff sales – their market share drops considerably. The government's methodology in undertaking market definition is, however, opaque and has not been explained, so leading to the conclusion that a proper economic assessment of the relevant market remains to be undertaken.

The two market leaders also grew significantly during the Report's study period 1985 to 1993, squeezing the market share of other operators. Access to prime store sites, most of which were situated within the development envelope of new residential housing estates, so giving an almost captive customer base of residents, was seen as a key advantage. Park N'Shop, with around 250 stores in Hong Kong, is part of the Hutchinson Whampoa/Cheung Kong[38] conglomerate controlled by the Li Ka-shing family and Wellcome, with 247 stores in the Territory, is controlled by Dairy Farm International Holdings, part of Jardine Matheson[39] group of companies, that is ultimately controlled by the British based Keswick family.

Hutchinson Whampoa is a diversified conglomerate that also controls the largest electrical retailer in Hong Kong – Fortress with over 60 stores – and a large retail drug-store operation – Watsons – some of whose products overlap with cosmetics, personal care and toiletry goods sold by Park N'Shop.

Similarly, the Jardine Matheson Group, through Dairy Farm International Holdings, also has other substantial retail interests in Hong Kong including over 700 7-Eleven convenience stores, and over 220 Manning drug stores that compete directly with Watsons and also partially with Wellcome in relation to personal care products. Interestingly, Jardines also operate in the supermarket/hypermarket sector in several other Asian countries – namely in Malaysia, Indonesia and Singapore. Hutchinson has expanded the Park N'Shop brand into mainland China where it has 37 stores in the southern region of the country and has ambitious expansion plans to have a total of over 100 stores by 2008.[40] Jardine Matheson also control Hong Kong Land, one of Hong Kong's largest property development companies, which owns much of the central district of Hong Kong and also builds high-end residential developments. Cheung Kong/Hutchinson is fundamentally a property development entity, though it has diversified into the ports, telecommunications and energy sectors. Cheung Kong

38 See 2005 Annual Report Hutchinson Whampoa Limited http://202.66.146.82/listco/hk/hutchison/annual/2005/retail.pdf

39 See 2005 Annual Report Jardine Matheson Group Limited http://202.66.146.82/listco/sg/jm/annual/2005/ar2005.pdf

40 Park N'shop plans mainland stores, China Daily, 27 April 2005.

remains one of Hong Kong's largest commercial and residential developers and this fact may well have a direct impact on the structure of the supermarket sector and distribution and location of stores.

The understandable commercial desire to prefer group companies was highlighted in a competition-related telecommunications case where a large residential development – Banyan Gardens – was constructed by Cheung Kong. The developer awarded the post-completion management of the estate to another group company which in turn gave an exclusive contract to supply telecommunication services and internet broad band services to two other group companies. Residents were obliged, by the terms of the lease, to pay a fixed fee for management services provided by the agent that included the cost of the bundled telecommunication and broadband services, from which residents could not opt out. They could continue to use other providers so long as they paid the full management fee. Complaint was made to the Hong Kong Telecommunication Authority (OFTA) about a potential breach of the sector-specific competition rules but OFTA ruled that as the relevant anti-competitive conduct had been action of the estate management company in offering the exclusive contract to the telecommunication company, and as the law only regulated telecommunication licencees, there was a lack of jurisdiction.[41] This example tends to suggest that close commercial co-ordination between members of group companies is normal business practice amongst Cheung Kong subsidiaries and so, by extension, the fact that most residential estates developed by the group also include an incumbent Park N'shop within the estate complex is unsurprising.

In the 1994 Consumer Council Report, it was discovered that all new residential housing developments at that time, owned by Cheung Kong and many properties developed by Jardines, included of a supermarket operated by their respective grocery subsidiary. The Consumer Council saw this close relationship as a significant barrier to entry.

The Report also thought that dominant position of the two incumbents gave them significant bargaining power over suppliers, including demands for exclusivity agreements. Choice of products within stores was relatively restricted, thus preventing inter brand competition. Further, the prices of many similar or identical items were very similar, if not identical, in the stores of either firm that were in close geographical proximity to each other but varied noticeably across the Hong Kong territory. As a result, the Report noted that price competition was minimal during the period of study, but whether this was due to intense competition, covert collusion or an oligopolistic market structure could not be determined due to lack of information; the Consumer Council had no power to require disclosure or to scrutinize internal documents. The 1994 Report recommended monitoring of the supermarket sector, adoption of effective powers giving the ability to investigate anti-competitive complaints against incumbents and the open tendering by developers of new supermarket sites to prevent the 'tying'.

[41] OFTA Concluded Investigation into Complaints on the Provision of Telecommunications Services at Banyan Garden Estate http://www.ofta.gov.hk/en/press_rel/2004/Aug_2004_r1.html

However, the government has not acted upon any of the recommendations in the decade since the Report was published.

In the last 12 years the industry has become even more concentrated. Two new entrants have entered, and then exited, the market and a competing chain has collapsed. As a result between 1993 and 2003, the two groups grew by 29 per cent.

The French Carrefour hypermarket retailer entered the Hong Kong market in 1996 and operated four large supermarkets in Hong Kong until September 2000 when it closed down citing an inability to access large enough sites to accommodate its 'hypermarket' style of operation. The failure of a new entrant in a novel market is not unknown but for one of the largest and most sophisticated international grocery retailers to make such a drastic miscalculation is odd, especially as it had been expanding at breakneck speed in mainland China at the same time. After it left the Hong Kong market, Carrefour supplied the Consumer Council with the names of 22 companies it claimed had applied pressure to it not to discount retail prices. Of these, seven admitted that they would take action to enforce resale price maintenance. Carrefour had used a low price strategy to build market share but this had upset suppliers. The Council concluded that pressure had been applied by suppliers to maintain price levels, failing which supplies of goods would have been withheld. Clearly, such a pricing system also benefited the two dominant incumbents, who would have every reason to support the suppliers' action.

In June 1999, a new entrant to the food retail market, adMart, operated a no-store, telephone and internet purchasing service with free home delivery. The two dominant firms responded offering competing free delivery services and by reducing prices on selected goods. The new entrant failed within 18 months. The two incumbents then reduced the scale of the home delivery service and subsequently started to charge for the service. Allegations of abuse of dominance and predatory practices were made at the time but no hard evidence emerged and, in any event, even if they could be substantiated, such practices would not have been unlawful. Allegations of refusal to supply were also made against grocery producers but nothing was substantiated.

To further concentrate the market, in June 2001 the 34 branch GD Supermarket chain collapsed, probably as a result of management incompetence and employee fraud. As a result of these structural changes, the combined market shares of the two principal incumbents has increased to approximately 80 per cent of supermarket sales up from 70 per cent a decade earlier.[42]

In 2003, the Economist Intelligence Unit (EIU) conducted a survey[43] of the supermarket sector to investigate claims that the market was an effective duopoly, that the incumbents attempted to increase their dominance by abusing their position by below-cost selling and used intimidatory tactics to pressurize suppliers not to deal with

[42] Supermarket giants 'will continue unchallenged', South China Morning Post, 21 June 2001.

[43] *Closed Shop?* Business Asia, Economist Intelligence Unit, 19 May 2003 Vol. XXXV, No.10.

competitors, such as the now defunct adMart. The EIU concluded that, whether or not the allegations were true was a matter for a competent competition authority to judge and that Hong Kong lacked the means to assess competition problems optimally.

In August 2003, the Consumer Council published another report into the supermarket sector as claims were made that despite over five years of deflation in the consumer price index, the standard sample of foodstuffs from supermarkets had increased substantially in price during the same period.[44] The two chains attempted to discredit the survey, saying its methodology was flawed. Needless to say, Hong Kong consumers were unimpressed by the firms' protestations but the operators claimed there was no foul play and maintained that there was vigorous competition in the sector between the two of them and with other foodstuff suppliers. They denied that their profit margins were excessive but declined to produce any evidence to support this contention; there is no publicly available data to ascertain profit margins as neither Wellcome nor Park N'Shop are listed entities and their financial results are consolidated with other subsidiaries into the published results of their respective parents. Thus, their true profitability is opaque and there exists no legal means to compel disclosure of internal financial information.

The Hong Kong government has not taken any steps to implement the 1994 Consumer Council recommendations concerning this sector, nor has it taken any action to ascertain the true facts concerning the business practices or profitability of these two chains. The sector is highly concentrated and, at present, there are no merger control rules that would prevent the sale of one of the chains to the other, thereby creating a super-dominant grocery retailer which would all but eliminate competition from this sector in Hong Kong.

The Potential Impact of the Proposed General Competition Law

In November 1996, the Consumer Council recommended the swift enactment of a general competition law for Hong Kong.[45] The government issued a response to the Final Report a year later entitled Competition Policy for Hong Kong.[46] In this document the government rejected the principle recommendations of the Consumer Council but did set up an interdepartmental committee to oversee competition policy, know by the acronym COMPAG. This body produced a Statement on Competition Policy in May 1998 which did not have the force of law, did not clearly identify anti-competitive conduct and provided no dedicated mechanism of implementation or any powers of investigation or enforcement. This has remained the position until recently. However, soon after the assumption of office as Chief Executive of Hong Kong by Donald Tsang Yam-kuen in March 2005, the establishment of a new committee was

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[44] 'Report on Competition in the Foodstuffs and Household Necessities Retail Sector', Hong Kong Consumer Council, 11 August 2003.

[45] Competition Policy: The Key to Hong Kong's Future Economic Success, Hong Kong Consumer Council, November 1996.

[46] Competition Policy for Hong Kong, Trade and Industry Bureau, November 1997.

announced to look again at competition policy and law. In June 2006, the committee produced a report that, surprisingly, recommended the enactment of a general competition law for Hong Kong save that only anticompetitive behaviour – abuse of dominance and overly restrictive agreements – would be subject to penalty but 'natural' monopolies, mergers and existing market structures would not be regulated.[47] The government issued a consultation document in October 2006 and hopes to legislate before the end of the current term of the Legislative Council that expires in August 2008. It is therefore likely that Hong Kong will have a new general competition statute and an enforcement agency in the foreseeable future. The interesting question then arises as to what effect the new law will have on the supermarket sector, assuming that mergers are not subject to control and structural remedies are not available. From the above description of market conditions in Hong Kong, it would seem that, at minimum, the new law would be able to attack any collusive activity between market operators and may even be able to deal with non-collusive parallelism. Abuse of market power would also be regulated, so that new market entrants might have a somewhat easier ride than their predecessors. But the spectre of a merger between the two incumbents would remain a real threat with the creation of a single super-dominant firm with an unassailable market share. Further, one might speculate that market structure is at the root of the of the competition problems in the supermarket sector in Hong Kong and the absence of structural divestiture powers is a grievous weakness in any attempt to create a more open market structure. At present the legislation has not been drafted nor has the public consultation been conducted, so there remains the possibility that these two issues may be satisfactorily attended to in the final legislative package.

CONCLUSION

The supermarket sectors in China and Hong Kong exhibit profound differences, in terms of scale, concentration, barriers to entry and foreign participation, thus it is difficult to make precise comparisons. Hong Kong is, effectively (though not legally or politically), a small city state, the equivalent of an island or an isolated market economy, that has excellent external trade facilitation characteristics but a fortress-like and concentrated internal market, whereas China is an entity of continental proportions, with a huge population and an economy that is expanding rapidly. Paradoxically, it is communist China, not capitalist, free market, Hong Kong that has the more open domestic market. Hong Kong's mature, saturated grocery market is characterised by high, almost impregnable, invisible barriers to entry that ensure the continued joint dominance of the two local incumbents. China's huge, and surprisingly open, grocery sector is fragmented and ripe for consolidation that would benefit from economies of scale with the establishment national distribution systems.

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[47] Report on the review of Hong Kong's competition policy, Competition Policy Review Committee, June 2006.

Observations by economists[48] that larger markets tend to have a less concentrated structure as higher profits will attract more market entrants, so reducing concentration ratios, might not apply in the supermarket sector in China even though entry barriers are not significant, at least at the moment. A study by Sutton showed that this is only correct in industries in which advertising and R&D does not play a significant role. [49] Thus, Sutton's hypothesis would postulate's that as the supermarket sector relies heavily on R&D in developing logistic systems and on mass advertising, one would expect to find that in a large market, such as China, supermarket ownership would over the long run tend to become highly concentrated. However, given the special factors discussed here – administrative monopoly, increasing protectionism, and significant state ownership – the market might not consolidate as much as it might in a mature open market economy.

As far as regulatory barriers are concerned, Hong Kong has none but China may be about to erect new ones, though the rigour with which they will be enforced is debatable, given China's overriding need not to scare away foreign investors, notwithstanding occasional outbursts of nationalistic fervour. The incipient introduction of new competition law regimes in both jurisdictions will have interesting but potentially divergent and unpredictable consequences. The only observation that can be made with any certainty is that the current markets for groceries, in both China and Hong Kong, will not be the same in five years time as they are now.

48 Philips, *Effects of Industrial Concentration: A Cross-Section Analysis for the Common Market*, Amsterdam North Holland Press, 1971; Kenneth George & TS Ward, *The Structure of Industry in the EEC,* Cambridge, Cambridge University Press, 1975; Richard Schmalensee, 'Inter-Industry Differences of Structure and Performance' in Richard Schmalensee & Robert Willig (eds), *Handbook of Industrial Organisation*, Amsterdam, North Holland Press, 1989.

49 John Sutton, *Sunk Costs and Market Structure: Price Competition, Advertising, and the Evolution of Concentration*, Cambridge, Mass, Massachusetts Institute of Technology Press, 1991.