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BEYOND THE BUBBLE

China Inc. Looks Homeward as U.S. Shoppers Turn Frugal

By [ANDREW BATSON](#)

SHUNDE, China -- With the longtime engine of global growth, the American consumer, pummeled by recession, some of China's hugely productive exporters are eyeing a new market: the Chinese.

Bicycle manufacturer Tandem Industries has long supplied big overseas retailers such as Wal-Mart Stores Inc. But Tandem's American sales have tumbled 40% since September 2008, the month a U.S. credit squeeze turned into a credit panic. So Tandem is about to offer its bikes to riders in its home province, Guangdong, under its own brand and at its own stores.

"China's ability to consume has now reached a fairly high level. It's at a turning point," says Tandem's general manager, Tom Tseng. Incomes are rising in China and people can afford more high-quality goods, he says, while "in the U.S., people now only want to buy cheap things."

Chinese businesspeople like Mr. Tseng are adapting to what they believe will be a lasting consequence of America's deep recession. Savings by suddenly frugal U.S. households soared to an annualized \$566 billion in the second quarter, more than quadruple the rate at the start of 2008. While that is important to rebuilding U.S. financial health, it is also sucking demand out of the world economy. China's exports, after growing for years at a steady 20%-plus rate, recorded a year-over-year drop last November. They kept falling, and in August were down 23% from a year earlier.

Spending by Chinese consumers, meanwhile, is holding up pretty well, partly because of heavy stimulus spending by a government flush with cash. Urban household spending in China was up 9.2% in the first half of 2009, not far off the country's average overall growth in recent years.

This shifting dynamic shows how the global economic turmoil is pushing China, the world's second-largest exporter after Germany, to become a more inward-focused economy. Even once world growth gets back on track, China is likely to run into limits on how much more it can expand its export market share, economists say. The World Bank expects that slower export gains in the future will shave about two percentage points off China's historical growth rate of 10%.

With the recession, Chinese exporters have been taught the dangers of a narrow business model. "The lesson we learned from the financial crisis is not to put all your eggs in one basket. We relied too much

on the U.S. market," says Mr. Tseng, a 42-year-old native of Taiwan. "If we had started domestic sales earlier, our business wouldn't have declined so much this year."

Chinese domestic demand isn't a panacea for exporters. For one thing, domestic demand itself can suffer to some extent when exports decline, because the jobs of so many Chinese are linked to export industries. In addition, China's consumers simply don't have the money to drive the global economy in the same way as big-spending New Yorkers and Parisians.

The consumers of the U.S. and Europe each pump more than \$9.5 trillion a year into the global economy, even at their current recession-diminished pace. China's much poorer households spent in aggregate just over \$1.5 trillion last year. Per-capita disposable income in the U.S. was \$35,486 in 2008, versus \$2,270 in China. So even such a huge and growing country is in no position to replace the U.S. and Europe as an engine of global growth.

But with prospects for exports remaining weak (although U.S. imports rose in July), and with Chinese incomes continuing to rise, domestic consumer spending is becoming a bigger part of China's own growth story. Among the exporters giving the local market a try are, besides the bike maker, a firm that is seeking to sell Chinese parents a talking doll that knows when it is being spoken to.

There's even a chance the trend could have an effect on the piracy problem. Foreign companies selling in China have long complained that patent violations and copying are rampant, but they have gotten little sympathy in local courts. That attitude could shift if more Chinese manufacturers selling in China start to make the same complaint.

Since American consumers are hesitant to spend at levels they once did, economists have said Asian consumers can help make up the difference and serve as new markets for U.S. companies.

Tandem has been making bicycles since 1992, when much of the area around its home base of Shunde was rural and the local government was eager to attract new businesses. Tandem became one of thousands of small businesses in southern China that learned to thrive on a bare-bones business model: using low-cost labor to assemble products on contract for foreign distributors and retailers. The focus on pure manufacturing let these companies concentrate on keeping costs down and volumes up, without the distractions of design or marketing.

The foundations of that model have weakened in recent years. Empty land is filling up; Tandem's 124-acre operation butts up against other factories and the few tiny farms that remain. In addition, Mr. Tseng says it has been getting harder to find good workers, leading him to install robotic welding arms to assemble frames. Then came the downturn in overseas demand.

Mr. Tseng saw the first signs of that in July 2008, when the orders at local electronics factories started to slip. Tandem didn't feel the full brunt until the credit crisis struck the U.S. hard late last year and frightened consumers. "I went to the U.S. in December and saw that car dealerships in San Francisco were empty," he says.

Some of Tandem's directors opposed trying the domestic market, worried about distributors who wouldn't pay their bills, unscrupulous competitors who would flood the market with knockoffs, and steady downward pressure on prices. But Mr. Tseng, convinced the U.S. consumer downturn wouldn't reverse quickly, argued for giving domestic sales a try.

He says Chinese are becoming more receptive to the alloy-frame racing and mountain bikes Tandem

makes for abroad. "The way people use bicycles is changing," he says. Bicycles were traditionally just a utilitarian form of transport in China, which was called the "kingdom of bicycles" before the recent takeoff of car buying. Today's urban consumers are more likely to see bike riding as a form of leisure or exercise, Mr. Tseng argues: "Their ideas are gradually changing. China's consumers are becoming more like other countries' consumers."

Driving his sport-utility vehicle through downtown Shunde on a recent day, Mr. Tseng saw domestic consumer demand all about. He pointed to vehicles filling the parking lot of a shopping center. "How much does one of those new cars cost? Where is the lack of consumption?" he asked. "Every car company in the world comes here because of the domestic demand."

Tandem's board gave final approval in July to begin domestic as well as export sales. The shift has made the company, which had sales of \$114 million last year, more of a normal business, with goals and problems not so different from the multinationals that sell to the Chinese.

Changing course hasn't been simple. There were bureaucratic barriers. Tandem has been registered as what is called a "processing trade" company. That legal status allows it to import materials duty-free, process them and assemble them into final products -- which must then be exported. But processing-trade firms are essentially cut off from China's domestic economy. To be able to sell locally, Tandem had to register a new "normal trade" company with separate accounts. The legal maneuvering should be completed by November.

Other challenges await, like branding and distribution. A business long focused on making a product to order for other companies needs a change in mind-set and organization. "For us, manufacturing is the easy part. We've been doing this for 17 years," says Vincent Chen, a manager. "Now we are designing the product ourselves, without outsourcing."

Tandem's interest in this market may be new, but competition in many consumer goods is intense in China, with multiple foreign and domestic brands crowding store shelves. Big companies like Giant Manufacturing Co. of Taiwan already have a strong presence in the high end of the domestic bicycle market, where Tandem's products would fall.

So, Tandem is targeting a niche first: children's bikes, where Mr. Tseng thinks local producers are more vulnerable. "They approach kids' bikes like toys. We start off from making bicycles, so our quality and safety will be much better," he says.

There isn't much need to redesign products. Mr. Tseng's showroom is already full of colorful children's designs, from a shocking-pink Barbie brand bike to flame-emblazoned bikes with names like Firestorm and Striker. "Like kids in the U.S., Chinese kids like bikes that are thick and solid looking. And the colors they like are not very different," Mr. Tseng says.

The company won't try to sell in existing Chinese stores, dubious that either distributors or retailers would push its products, and concerned about spending a lot on a marketing effort that might fall flat. Instead, it plans to build its own bicycle stores, starting with one in Shunde.

"To build stores and pay for advertising is a lot of money, and you won't necessarily get a result at first. That's why we're starting small and building up slowly," Mr. Tseng says. "We have to pay our tuition first."

This means domestic sales aren't going to make a big difference for Tandem this year. "We will still do

exports -- I can't give up that business. But we're going to work more on domestic sales. We have to have both," Mr. Tseng says.

The bicycle maker's strategy wouldn't work for every export business, by any means. China's biggest exporters use the country as a base to manufacture for the global market, and most of their exports are electronics and machinery, not consumer goods.

Nonetheless, China's government is increasingly encouraging those exporters that can to look at the domestic market, just as for years it offered financial incentives to ship goods abroad. Domestic subsidies for purchases of cars and home appliances, such as tax breaks and coupons for discounts, have helped boost local sales of those products in recent months.

Economists say a more vibrant domestic consumer market in China will require changes that enable people to benefit more from the country's growth, such as liberalizing the financial sector.

Tandem is steeling itself for the near-certain prospect that its products will be knocked off by local competitors. "We haven't seen pirated goods yet, but expect to once we start selling domestically," Mr. Tseng says.

Worries about copying didn't deter doll-maker Mei Ye Plastic Products Co. from launching last year what it hopes will be a blockbuster: a talking doll with voice-recognition technology so it can respond when a child speaks to it. The company, based in the Guangdong province city of Shantou, says the doll is the result of more than three years of research.

It shipped the first models to Russia in June of last year. But the global downturn dashed its hopes of big export sales.

So, factory boss Chen Guoliang decided to look at the domestic market. He ordered the dolls programmed with English and Chinese -- enabling the company to pitch them to ambitious Chinese parents as a language-learning tool for their children. The first shipments went out to domestic distributors in December.

In the first half of this year, exports at Mei Ye, which makes many other kinds of dolls as well, were down about 40% from a year earlier. Mr. Chen says domestic sales are replacing about three-quarters of the decline.

The company had some initial hiccups. For the domestic market, the designers' first instinct was to make the dolls with yellow-toned skin and black hair, to match their Chinese owners. The response wasn't so good: It turned out many Chinese girls preferred dolls with pink skin and blond hair.

The switch was made, and Mei Ye continues to refine the product. The next generation of talking dolls should hit the Chinese market in October.

—Ellen Zhu contributed to this article.

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