Foreign Investment in
Chinese Automobile Industry

How American FDI shaped the development of Chinese automobile industry

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Szakszeminárium-vezető:
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„Én, Patócs Dániel teljes felelősségem tudatában kijelentem, hogy a jelen szakdolgozatban szereplő minden szövegrész, ábra és táblázat - az előírt szabályoknak megfelelően hivatkozott részek kivételével - eredeti és kizárólag a saját munkám eredménye, más dokumentumra vagy közreműködőre nem támaszkodik.”
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1. Introduction

“When the wind of change blows, some build walls while others build windmills.”

(Li Keqiang -Premier of the People's Republic of China)

When I was meditating on what should be the topic of my thesis I had several ideas. I wanted to choose a topic where I have the chance to observe the real-life implementations of what I have learned in lectures. Nevertheless, I also wanted to choose a topic which is not too popular among students. A topic where I really have to do a deep research to understand the context, and get a comprehensive picture. Last year I had the Foundation of Political Economics seminar with Balázs Sárvári, where I had the opportunity to have a basic overview of the Chinese history of the last one hundred years. I found it fascinating, and very different from our European world. I also saw that it is not a popular topic among students despite its significance.

The fact that the enormous China undergone such a large-scale, rapid economic and political transformation only in about 20-30 years, and became a pivotal power on the map, clearly worth the research.

In my thesis I focus on an industry which was at the center of the transformation. I would like to take a closer look on the development, and transformation of China’s automobile industry, because this is one of the sectors where industrialization and economic development had the most impact. It also functioned as a catalyzer for the improvement of many linked sectors. Since Henry Ford revolutionizing assembly and manufacturing, the automobile industry was always a driver of the development of industrial economies. It did not happen otherwise in China.

This industry is a good example of how a manufacturing industry became globalized with a few multinational corporations (MNCs) dominating. It is also a good
example to examine how the nation states are trying to influence the development with policies, as it is a crucial segment of the industry.

Many nations put effort to establish their own, strong, domestically owned automobile industry however, most of them failed. After the World War Two there were only two success stories: Japan, and South Korea. The MNCs from these countries were the driving force of reshaping the industry in the second half of the 20th century. Some countries have lost their domestic industry; others could maintain only with the overwhelming influence of foreign MNCs. (Liu - Yeung, 2008)

It is not an easy job to compete with the already established and developed industries like the USA. However, in automobile industry the size of the country matters a lot. A big country with good capabilities may have the power by bargaining good deals with MNCs and develop a domestically owned production, to step on the global market with own automobile MNCs. The two countries with these opportunities were China and India. As a consequence of the huge potential of its automobile market China could control how the MNCs entered and operated in its industry. With policies it actively defined the form and amount of foreign investments.

In my thesis I examine the development of the automobile industry in China, especially focusing on the effect of foreign investment. First, I do a short historical background, to provide the necessary information on the economic and political scene. Then I present an overview of foreign direct investment and multinational corporations in general, and how they appeared in China. Thirdly, I examine the appearance of joint ventures with foreign investment in the Chinese automobile manufacturing and the government’s regulating policies.

I focus on the years between 1970 and 2008. I decided to limit the scope this way because this is the period when the first joint ventures appeared (from the late 1970’s), and the government started to figure out a development strategy for the industry.
The first round of joint ventures were established with more or less success, and then by learning from the mistakes by 2008 the first period of experimentation closed, and a more secure and stable period followed. Sometimes I give an outlook on what happened since 2008, to put the events in context, but my focus is the 1970-2008 timeframe.

With my thesis I hope to give a comprehensive overview of the nature of FDI, how it was used by investors to enter into the Chinese automobile manufacturing industry, and how the Chinese government tried to keep it under control, and use it for their own goals to develop the industry.
2. China’s Economy and the Appearance of Foreign Capital

If we take a closer look on the Chinese economy, we see that after a long time of isolation, China became the fastest growing economy since the 1980’s. In 2017 China’s GDP has almost reached 12000 billion USD. (Statista, 2018) With that, it is the second biggest economy after the USA. Despite its decreasing birthrate China is the most populous country in the world, with its 1,379 billion people in 2016. It is also the third biggest county after Russia and Canada with its 9,596,961 km². (Bank, 2018)

Figure 1. GDP, current prices (Billions of U.S. dollars)

China could maintain a rapid 9.7 percent annual growth rate between 1978 and 2016. This is more than what any other country could achieve over this period.¹ For comparison, the USA was growing with an annual 2.7 percent. (Jingli, 2018) In my thesis I will focus on the economy after 1970, but first I go back a little further, to give a bit

¹ I am aware of the allegations, that these numbers may not be true, and were distorted by Chinese officials. In spite of these allegations, in my thesis I accept the officially published datas.
more background information, so the development processes will be more understandable.

2.1 Big Push Industrialization and Policy Instability (1949–1978)

The Chinese economy took a rapid change in the year 1949. Since that year China is growing rapidly with a couple of setbacks. (There is another theory which argues that China was already successful before this date, and that it shouldn’t be viewed as a divider, but in this essay, I will accept the traditional view.)

The turning point at 1949 was the result of a social and economic revolution. After years of war between The Nationalist Party and the communists, on October 1949, the People’s Republic of China (PRC) was established, while The Nationalists retreated, and declared Taipei as the capital of China with the hope of returning back to the mainland in the future. (Kissinger, 2012) The communists reoriented the economics of the country with abandoning the traditional framework. Traditionally, China was a household-based economy, but the socialist leaders violently transformed it to a government controlled industrial economy. For 30 years pursuing the idea of socialism, China invested in heavy industry. This is called the “Big Push industrialization”. It is also called “command economy” because government planners steered, and directed the economy instead of the market forces. The mandatory production quotas were allocated by officials.

From an economy perspective, during the socialist period all the systemic settings were set to maximize the potential to “leap”. “But every time the system really began to accelerate, it ran into fundamental problems. The economy would overshoot and hit its head on the ceiling.” (Naughton, 2006, p. 79) This ceiling was the incompetent agriculture which was not able to produce enough food.²

² For more information, I would recommend China’s Political Economy: The Quest for Development since 1949. (Riskin, 1991)
2.2 “Crossing the river by groping for stones”

After Mao’s death (in 1976) the communist ideology was overthought, a new era started which brought openness to new ideas in the fields of economics too. (Gewirtz, 2017) From the ‘90s China defined its market as “socialist market economy”.

From the 1980s Deng Xiaoping was leading the cultural, and economical transformation from what was left behind after Mao: poverty and isolation. His new agenda can be summarized with two words: “reform and opening”. Deng came out as a winner from the fight for the power, with Hua Guofeng on the one side, who was the designated successor of Mao, and the “Gang of Four” on the other side.

With the transition that started in the late 70’s, they successfully moved away from the command economy with waves of reforms and experimenting which occasionally ended up in failure. In contrast to Russia and Eastern European countries where the goal was to move to a successful market economy as fast as feasible, China went on a different path. The post-communist Easter European countries had examples in western Europe which they tried to follow, and catch up to. They were willing to smash the old even if it caused temporary backlash, in the hope of a successful and quick transition. But China was different. (McMillan, 2004)

First, some individuals were granted with the opportunity to satisfy market demands (which were ignored by commands) for their own profit. They also allowed foreign businesses to operate is some special economic zones. “Such policies were seen as contributing to growth while not initially threatening the overall ability of the government to manage and direct the economy.” (Naughton, 2006, p. 87) It was a time of experimenting, and importing ideas from all across the world, as Deng Xiaoping phased: “crossing the river by groping for stones.”

2.2.1 Incremental reforms – 1978-1993

The 1978-1998 timeframe can be split into two stages. The first one between the years 1978 and 1993. The incremental reforms of these years meant that the central command framework stayed, “the reform was carried out incrementally to improve
incentives and to expand the scope of the market for resource allocation”. (Qian & Wu, 2000)

China was able to avoid shortages which is what most of the times happened in history. In this era the GDP grew at an average annual rate of about 9 percent. (Qian & Wu, 2000) Its incremental transformation resulted an economically working reform, something that Eastern Europe was not able to do until the total collapse of the Soviet Union. Before that Hungary for example in the 1980s failed to implement working reforms, and its economy was stagnating. (Kornai, 1986)

These years are associated with Deng Xiaoping who was leading the economic development with Zhao Ziyang (However it is hard to research Zhao’s influence because after the Tiananmen crackdown he was written out of the history. (Gewirtz, 2017) Even now he is not rehabilitated despite of his unimpeachable achievements during the reforms.) Henry Kissinger wrote that “Only those who experienced Mao Zedong’s China can fully appreciate the transformation wrought by Deng Xiaoping” (Kissinger, 2012, p. 321)

The first successful experiment was the restructuring of agricultural system, which basically meant giving motivation for more production for the farmers, by leaving more for them. This was pattern that characterized this era. The government still demanded its part from the production, but it left some for the people. It boosted up local trading and consumption. This system was called “shuangguizhi” or the dual-track system. (“The Chinese term shuangguizhi refers to the coexistence of a traditional plan and a market channel for the allocation of a given good.” (Naughton, 2006, p. 91))

3 Zbignew Brzezinski also had a remarkable relationship with this exceptional leader. In his book, Strategic Vision he shares how they became friends. Once Deng invited Zbignew to a private dinner: “I quizzed him about the evolution of his own political views, he began to reminisce about his youth. Our talk turned to his expedition, as a very young student, from central China (...) to the then-so-remote Paris of the 1920s. (...) He told me how gripped he became by the awareness of China’s relative social retardation compared to France and how his sense of national humiliation made him turn for historical guidance to Marxist teachings about social revolution as a shortcut to national redemption.” (Brzezinski, 2012) He really wanted to improve the living conditions, and social improvement of China.
2.2.2 Radical reforms –1993-1998

In November 1993 the decision was made to abolish the planning system, and start to move in the direction of a modern market system. This decision resulted many radical reforms like the unification of exchange rates and recognition of central bank. Privatization was also started first, with the small-scale state-owned enterprises. The ideological breakthrough happened at the Fourteenth Party Congress in 1992, where the party declared for the first time, that a "socialist market economy" is the ultimate goal.

From January 1994, the reforms started in five main areas. (i) foreign exchange and external sector reform; (ii) tax and fiscal reform; (iii) financial reform; (iv) SOE (state owned enterprise) reform; and (v) establishment of a social safety net (Qian & Wu, 2000, p. 12)

The most important figure of this time was Zhu Rongji, who became an important actor in 1993, and became the premier in 1998. He took steps in three directions: “ending the dual-track system, recentralization of fiscal resources, and macroeconomic austerity. (…) The outcomes of this policy regime were a shift from inflation to price stability, a dramatic downsizing of the state-enterprise sector, the acceptance of a moderate amount of privatization, and the emergence of a reform with losers.” (Naughton, 2006, p. 100)

The “reform with losers” expression is often used to describe this era. It means that many privileged became more vulnerable from competition, as the government restructured and downsized state-owned-enterprises. In other words, the reforms were not
beneficial for all. Many privileged lost their earlier status. The employment of public enterprises dropped with more than 40 percent. The local government officials gained almost free hand in that process, as these SOEs were mostly in their possession. Albeit Chinese government never really used the term privatization, it often happened as “restructuring”. (Naughton, 2006)

With the economic development, the poverty also declined. While in 1990, more than 700 million people was below the international poverty line ($1.90), it declined to less than 10 million in 2005. (figure 2.)

Figure 2. People Living on Less Than International Poverty Line in China

![Figure 2. People Living on Less Than International Poverty Line in China](source: own chart based on Worldbank’s poverty data)

In the early 2000’s China needed new reforms for two reasons. Albeit the earlier reforms, the growth started to slow down in 1998 and 1999, as a consequence of the Asian financial crisis in 1997. It gripped much of East Asia including China. It wanted to react with implementing a more productive economic development. The slowdown emphasized the need for finishing the ongoing reforms. Secondly, China wanted to be part of WTO, and the domestic economy had to be ready for the opening up.
3. Foreign Investment in China

Now that I have an overview of China’s history and economic development of the last century, I investigate how their approach to foreign capital shifted over time. It is impossible to understand what happened in the Chinese automobile sector, without understanding the nature of FDI, so first in this section I describe what FDI is, how and why it became popular, and what other institutions are attached to it. (Riskin, 1991)

3.1 Foreign Direct Investment

In the early 1990’s foreign capital inflow to emerging markets started to increase sharply. The form of these inflows was mostly FDI. (figure 3.) Unlike with portfolio investment, where the investor purchases equities of a foreign company without a controlling stake, FDI means that the investor gets the control over a company or establishes own foreign business operations. The International Monetary Fund’s Balance of Payments Manual defines FDI as “an investment that is made to acquire a lasting interest in an enterprise operating in an economy other than that of the investor, the investor’s purpose being to have an effective voice in the management of the enterprise”. (Moosa, 2002, p. 1) There are many different definitions, but all of them contains the term: control. This is the most conspicuous difference between FDI and portfolio investment.

Figure 3. FDI inflows, 1990-2017
(Millions of dollars)

(source: own chart based on UNCTAD data)
Under control we usually mean that the investor is present in the management and strategy decisions. Decisions like electing members of the board. However, control can be exercised via non-equity (or contractual) arrangements. Some of non-equity forms are franchising, licensing or product sharing. (Moosa, 2002) With this method, not only capital comes but knowledge, new type of methods, new people with new ideas and know-how also arrives to the country. Therefore, FDI can have much stronger and pervasive effect on the whole sector it touches. It has influence on the economy on both macro and micro size.

On macro size, foreign direct investment can result in faster development of the given sector, or even in opening new sectors. It can bring technological breakthroughs, and it can diversify export. Secondly “On the micro side, through knowledge spillovers and linkages between foreign and domestic firms FDI could foster technology transfer, improve managerial and employee skills, and boost investment incentives and productivity in upstream and downstream sectors.” (Alfaro - Chauvin 2018, p. 2)

There are numerous theories and models on how FDI effects the host economy. The literature mostly claims that FDI cannot be unambiguously associated with GDP growth, but it usually results higher wages and domestic export. (Lipsey, 2004) Another effect of FDI can be the lowering the volatility when a crisis happens in the host country, “as foreign owned firms are buffered from negative local shocks by their access to the parent and its global networks. (Alfaro - Chauvin 2018, p. 12)

The interest around FDI started to ascend after its first rapid growth in the 1980s. Since than with the rising amount of FDI, there were changes in its patterns also. It is worth noting, that FDI flows are not affected significantly by the slowing down of world trade, probably because when trade barriers slow down the international capital flow, FDI increase as an attempt to bypass those barriers. When as a result of crisis, the portfolio investments decreased significantly in Asian countries during the 1990s, FDI was intact. (Moosa, 2002)

Because of these effects of FDI considered as an effective tool for transforming former Communist countries. Albeit the uncertainty of many researches and theories on what benefits FDI has on the host economy, we can state that FDI is dominantly present
in emerging markets, resulting capital inflows, macroeconomic benefits (growing productivity, exports, financial stability) and microeconomic benefits (reallocation, development of technology and production, higher wages), with the risk of vulnerability.

3.2 Types of FDI

The economic literature identifies three types of FDI: horizontal, vertical and complex. Horizontal FDI happens, when producing at home and shipping to the target country would be more expensive than producing there. Here the motivation is to supply the target country’s market, and save costs. In this case they produce the same or similar goods, the only difference is the place of the production.

Vertical FDI is when the foreign affiliate will produce input (parts) for the final product. Motivation can be production costs, or the availability of special materials. Finally, complex, or combined FDI is the combination of the previous two. A complex system of global production and distribution chains. (Alfaro, 2018)

From the host country perspective FDI can be import-substituting, export-increasing or government-initiated. Import substituting FDI attempts to produce goods which were imported earlier. The amount of this type of FDI is specified by transportation costs, trade barriers, and by the size of the host country. Export-increasing FDI wants access to new source of materials, intermediate products which it can export from the host country. In case of government-initiated FDI government is involved to attract foreign investors. (Moosa, 2002)

<table>
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<tr>
<th>Type of FDI:</th>
<th>Description:</th>
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<tr>
<td>Horizontal</td>
<td>Establishing the same business in the host country for reducing producing and shipping costs.</td>
</tr>
<tr>
<td>Vertical</td>
<td>Establishing different, but related activity, for example part manufacturing or acquiring raw materials for the main product.</td>
</tr>
<tr>
<td>Combined</td>
<td>The combination of the previous two.</td>
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3.3 Multinational Corporations

Most of the times IDF manifest itself in multinational corporations (MNCs). The literature does not have agreement on what should be the definition for these firms, however all of them uses labels which are referring to the international nature of these companies. On this list we can mention for example Toyota, GM, Daimler-Benz, Coca-Cola, McDonald’s, Apple or Nestle.

MNCs are not equal with international business operations. Under international business firm the literature means that the company has cross-border activity (export, import). MNCs emerge when the firms feel that “it is desirable, if possible, to expand in such a way as to be closer to foreign consumers. Production will then be carried out both at home and abroad. Thus, a multinational firm carries out some of its production activity abroad by establishing a presence in foreign countries via subsidiaries, affiliates and joint ventures.” (Moosa, 2002, p. 6) With some simplification we can say that the firms that indulge in FDI are multinational corporations (MNCs).

According to Lall and Streeten (Sanjaya - Paul, 1977) MNCs generally predominant in industries which are characterized by the importance of marketing and technology. Their products are new, attractive for high income consumers who are responsive to marketing. Their expansion tends to reproduce the oligopolistic conditions of their domestic market. MNCs tend to enter big and growing economies with relatively stable political plight. They usually start to centralize functions like finance, marketing or research (just think about the popular SSCs (shared service centers in Budapest). They tend to gain majority or full ownership of subsidiaries. And their international role can have impact on the socio-political power in developed and developing countries.

MNCs appear with three types of FDI: greenfield investment, cross-border mergers and acquisitions and joint ventures. Greenfield investment happens when the investing firm establishes new production or distribution facilities with no background, or previous activity. It can have the effect of creating many new jobs. The second one, mergers or acquisitions (mostly acquisitions) means that the investing firm acquire an already established firm in the host country. The advantages of this method that it is cheaper (especially if the acquired firm was making loss) and it can be implemented faster than
greenfield investment. On the other hand, large number of M&As will never be profitable, so with the potential, it also carries significant risk.

It is usually said that from the host country perspective M&As are less beneficial, as they are politically sensitive, and most countries likes to keep control over the firms. They do not add new producing capacity, only the ownership structure changes (however with synergetic gains both sides could benefit from it). In case of sensitive markets like media M&As can even impact national culture.

The third type is joint ventures: In this case “one side normally provides the technical expertise and its ability to raise finance, while the other side provides valuable input through its local knowledge of the bureaucracy as well as of local laws and regulations.” (Moosa, 2002, p. 16) As we will see in case of China joint ventures have an important role.

Researches shows that MNCs tend to be more productive and better managed than their domestic peers. After firms are acquired by foreign, they usually increase import and export, make organizational changes and have increased innovation. Having better access to finance results healthier operating as they are less exposed to external short-term debt. (Wang - Wang, 2015)

3.4 Foreign Direct Investment in China

In the spring of 1992, Deng Xiaoping’s “Southern Tour” brought policy changes. Before that only selected companies could gain foreign investments, but then they started to open up more domestic marketplace like real estate. After 1992 China slowly became the number one target for foreign direct investment (FDI) with overtaking the USA (in 2003). (Prasad - Wei, 2005) It is an even more astonishing performance if we consider that in the 70’ and 80’ the amount of FDI was minimal. FDI inflows in 2004 and 2005 were at 63 billion dollars. The world started to realize the opportunities that China’s enormous industry and market held. (see Figure 4.)

Before 2007 China received about one-third of all FDI flowing to emerging markets, and about 60 percent flowing to Asian emerging markets. It is interesting
however, that the United States and the European Union was responsible only for the 15 percent of total inflows in 2003, and it declined from about than 20 percent in 2000. “Asian economies account for a substantial fraction of China’s FDI inflows. For instance, over the period 2001-2004, five Asian economies—Hong Kong SAR, Japan, Korea, Taiwan Province of China, and Singapore—together account for about 60 percent of FDI inflows. “ (Prasad – Wei, 2005, p. 6)

Figure 4. Gross Capital Flows by Component

(Prasad - Wei, 2005, p. 52)

The majority of the FDI inflow came to manufacturing, more exactly to electronics and communication equipment. Real estate, the second biggest was responsible for about 10%. The increasing share of manufacturing can be explained with China’s increasing access to world trade. Manufacturing gained share against non-tradable goods like transport or construction.

Figure 5. shows that while FDI was only 1 percent of the GDP in 1991, it reached 6 percent in 1994. Than is started to decline as the GDP grew even faster than the inflowing FDI. In this regard China is different from other East Asian countries like Japan or Taiwan, where FDI have never exceeded 2 percent of the GDP.
After 1993, the FDI still continued to grow, but not as much as the GDP. We can also see on figure 6, that the 2008 global crisis did not have a significant effect on the FDI inflow.

Figure 5. Foreign direct investment as a share of GDP

![Graph showing FDI as a share of GDP](image)

( source: own chart based on OECD data)

Figure 6. FDI flow to China

![Graph showing FDI flow to China](image)

(Millions of dollars)

( source: own chart based on OECD data)

To summarize in three points, it can be said, that first, FDI was the predominant form of investment in China, portfolio investments and bank loans were not so dominant. Second, the majority of FDI flow into manufacturing. Third, most of the investment came from other East Asian countries, mostly Hong Kong and Taiwan. (Naughton, 2006)
4. FDI in China’s Automobile industry

4.1 Foundation of Automobile Industry in China

In the late 1970’s China was still lagging behind in modernization. The streets were still populated with unreliable and ugly cars from the early 60’s or even older. So it is no surprise that the reform of the automobile industry had to happened with the modernization. (Harwit, 1995)

The automobile industry was established in the 1950’s, however until the 1980’s (when Deng Xiaoping started economic and trade liberalization), it was not developing considerably. In 1953 the Soviets helped to start the First Auto Works (FAW) in Changchun. At these times China was dependent on Soviet technology. FAW started to produce the first passenger car in 1958. It was based on Daimler Benz’s 200. With this black sedan limousine, the target audience was the government elite. (Gallagher, 2003)

After the so-called Sino-Soviet split in 1960, all foreign technology transfer was halted, resulting a two-decade long stagnation.

Neither the Great Leap Forward campaign helped the industry’s prospects. It sponsored small-scale rural industries instead of creating big companies capable of mass production like the American and European auto makers. In 1963 only eleven cars were produced in the whole country. In these decades Japan and Korea could develop, leaving China behind. In 1969 the 33 automobile factory produced only 150 cars, and during the Cultural Revolution between 1966 and 1971 there were no investments in the automobile industry. First, in the 1970’s they turned to Japan, to solve the need for vehicles. Japan exported large amount of trucks, and granted some technological support, but as it feared of helping a potential competitor, it could not be the long-time solution. (Harwit, 1995)

In the 1980’s the domestic demand for passenger cars started to rise quickly (mostly by the government sector), and as the domestic production was still not sufficient, the import was rising also. In 1985-1986 the import (150,000 cars) was nearly nine times bigger than domestic production. (Liu – Yeung, 2008)
In China they knew that if they want to improve their automobile industry they will need help from outside, from more advanced countries. Chinese decision makers had to find a way to get technological development from foreign automakers without losing the control over the industry.

4.2 Appearance of FDI

After the 1980’s the industry was improving by partnerships with foreign automakers. The policy makers cleverly permitted foreign investments only with joint ventures with local partners. This way the involvement of the Chinese part manufacturers, or other companies was unavoidable, and they had the opportunity to improve with the foreign knowledge and technology.

From the Chinese side the partner usually was a local manufacturer or a state-owned company (SOE), and only 50% or less than 50% was allowed to be owned by the foreign carmaker. This type of joint venture was established for example by Volkswagen, GM, Toyota, Honda, Peugeot. From the other side Shanghai Automotive Industry Corp. (SAIC) and First Automotive Works Corp. (FAW) were some of the main actors. (Riskin, 1991)

“The stated goal of the Chinese government then was to create a market dominated by a limited number of internationally competitive joint venture assemblers, supplied by local parts manufacturers, and producing to world standards.” (Tang, 2012, p. 2)

The output increased from 2 million in the late 1990’s to more than 18 million in 2011. With overtaking Germany in 2006 China became the third biggest vehicle manufacturer. Than during the global economic crisis in 2008 for the first
time China with 9.5 million vehicles overtook the USA, and became the second biggest vehicle manufacturer after Japan. Only one year later, in 2009 with 13.6 million vehicles China occupied the first place as the world largest producer, and it continued the growth (however, it seems to have flattened). (Tang, 2012)

The years of recession after the crisis became beneficial for China. While the vehicle production stagnated, or declined in other countries, China was able to maintain the growth, and overtook them. On figure 8. we can see how it left the other emerging countries behind.

Figure 8. BRIC Countries Motor Vehicle Production

![BRIC Countries Motor Vehicle Production](image)

(Tang, 2012, p. 6)

The composition of production also changed over the years. In the mid-1990’s only 25% of the vehicles were passenger cars. Buses and trucks were the majority output. The vehicle ownership started to grow after 2000, mostly in big cities and coastal urban areas. The growth slowed in 2008, but with incentives the government successfully prevented major setbacks. This fiscal stimulus package worth Rmb 4 trillion yuan including cutting sales tax on vehicles.

Because of the increased demand for passenger cars, production also grow. From 2004 every year China produced more passenger cars than commercial vehicles. (see figure 9.) This change could happen because in 2000 China granted these joint ventures
with the right to produce affordable vehicles (“people’s cars”) for domestic market. Before that, their production was assigned by the politicians.\footnote{But with the boom of passenger cars on the road other critical problems occurred. In August 2010 China had the worst traffic jam in history. It lasted for more than 10 years, and was longer than 100 kilometers. In big cities traffic jams, and limited parking spaces became part of everyday struggle. For that, the government started to limit the registration of new vehicles. In Shanghai during the rush hour only vehicles with Shanghai plates are allowed. This caused a huge increase in demand for license plates, which resulted auctions where the price of one plate could reach more than 9000 USD. (Lingfei, 2012)}

Figure 9. Chinese Motor Vehicle Production

4.3 Joint Ventures

The Chinese auto manufacturing landscape can be divided into three areas. First, the traditional state-owned automobile firms (FAW or SAIC), secondly, the international JVs (e.g. FAW GM, FAW VW, Shanghai GM, or Shanghai VW) and thirdly the indigenous firms with self-owned brands (e.g. Chery, Geely). In this section I examine how joint ventures (with foreign investment) appeared, what government policies shaped them and what effects they had on the Chinese automobile manufacturing industry.
The first series of joint ventures were not success stories; the results were mixed. The first major joint ventures were Beijing Jeep, Volkswagen SAIC and Guangzhou Peugeot, in the second half of the 1980’s.

4.3.1 The First Round

After negotiations, in 1983 American Motors Corporation (AMC) and China’s Beijing Automotive Works signed a joint venture (JV) agreement creating Beijing Jeep Corporation (BJC). This was the first of its kind, and the goal of the agreement was to produce Jeep Cherokees. (Tang, 2012)

It was established with the help of Premier Zhao Ziyang. He wanted to make this joint venture an “example of cooperation between Western business and Chinese socialism”, (Babcock, 1990) however back then the parts produced by the Chinese were poorly-made, and the workforce was unreliable. As this was the first attempt to for an American and a Chinese automobile manufacturer to work together, neither side knew what they should do to achieve a successful cooperation.

Jim Mann uses the metaphor “tong chuang yi meng” (same bed, different dreams) in his book, the Beijing Jeep, to describe the nature of this joint venture. (Mann, 1977) The two partners were not able to attune their different goals. The economic knowledge from the Chinese side was also insufficient. For example, they did not understand during the negotiations why should they took inflation in to consideration with auto parts.

The lack of faith also undermined the cooperation. Many AMC executives considered the Chinese market risky, while from the Chinese side, many could not understand why they have to work together with such a different capitalist country. After AMC and BJC lost money and market share in 1997 Chrysler acquired AMC. AMC’s Jeep brand was one of the main reasons of the acquisition, as it was well known, and had a good reputation. It caused concerns on the Chinese side, as they were not used to acquisitions, and they never experienced anything like that before. In 1998 Daimler Benz merged with Chrysler Corporation, creating the world third largest automobile company,
however the differences between the American and German management styles caused troubles.\(^5\) (Tan, 2013)

Shortly after AMC, VW established the second joint venture with Shanghai Automotive Industry Corporation (SAIC) in 1984. It was a 25-year agreement with 50 percent foreign ownership. By 1993 they produced more than 100,000 vehicles. (Gallagher, 2003)

In 1985 PSA Peugeot Citroen and Guangzhou Automotive Manufacturing (GAM) established a joint venture with a $52 million investment. Peugeot held only 22 percent and GAM 46 percent. In the first phase the goal was to produce 15,000 Peugeot 504s, then in the second phase in 1989 the investment reached $300 million, and production was up to 45,000. With their 504 and 505 models they targeted taxis and government cadres, but were not selling well. The engines had high fuel consumption, and the design was not resonating with the Chinese taste. (Volkswagen’s joint venture, based in Shanghai designed popular model called the Santana, targeting the same audience as Peugeot.) (Tan, 2013) They also lacked good distribution channels. Those who wanted to buy their car from Beijing, had to travel to Northern China and drive back all the way. The production grew from 2700 in 1987 to 22 500 in 1992 nevertheless the executives of Peugeot were not satisfied with the results. In the next two years the JV started to lose money, and accounted a $12-24 million loss in 1994 and $39 million in 1995. Therefore, the investors decided to dissolve the joint venture. (Gallagher, 2003)

As we saw, the first attempts were far form success stories. It was a new situation for China and for foreign investors also, and they needed time to adjust to this new situation, figure out how implement a strategy that can work for both sides. In this era foreign companies were exposed to the good will of the government officials. If they supported them they had a chance to be successful, if not, they had no options. This was

\(^5\) After declaring bankruptcy in 2009 with help from the US government, Fiat took control over Chrysler. (Tang, 2012) Fiat Chrysler Automobile (FCA) currently has a 50-50 joint venture with Guangzhou Automobile Group. They produce four Jeep models in Changsha and Guangzhou, and also import two other. The production of Fiat sedans stopped last year, and they have no intension to start it again. They will be present with their three core brands: Jeep, Maserati and Alfa Romeo. (Malan, 2018)
one of the main reasons why Volkswagen was successful, and grasped the small but rapidly growing Chinese car market while Peugeot failed. While Volkswagen had great connections with the Shanghai government where their plant was located, Peugeot was not high on the priority list for the decision makers responsible for the Guangzhou area. (Gallagher, 2003)

In these years China followed the “crossing the river by groping for stones” idea, which resulted in an experimental policy and strategy making. Foreign vehicle manufacturers came, but there were no standardized methods for transferring technology, which was one of the main reasons of establishing these JVs on the first place. JVs started production, but the Chinese side could not internalize the technologies.

4.3.2 Automobile industrial policy of 1994

In 1994 the government declared some industries so-called “pillar industries”. Some of them were the automobile, transportation, electronics, construction, machinery and petroleum industry. (Eun & Lee, 2002) Automobile industry became a strategic sector, as it was growing rapidly, and was connected to many other industries like glass, plastic, textile, chemistry and many others.

After years of inadequate regulation, in 1994 China’s government issued the first industrial policy for automobile industry. The aim of it was to “promote rational competition, reap economies of scale and exploit coordinative specialization”. (Lu-Tang, 1997, p. 78) The merits of this policy can be split in to two main areas.

Firstly, consolidation. Learning from the American model of “Big Three” (where a small amount of big companies dominates the sector), China wanted to consolidate the many existing companies into a few “powerhouse firms”, and support mostly them. Secondly, they started to protect manufacturers located in China, (including joint ventures). They introduced import quotas and high tariffs on cars and parts. It also put more emphasis in part manufacturers, as they started to see that they have great importance on the overall quantity and quality of output.
Foreign capital was still allowed only through joint ventures. They were limited to have only 50 percent foreign ownership with more knowledge transfers and trainings for Chinese workers. Each foreign firm could establish maximum 2 joint ventures, producing a different model. (Chin, 2010) This way the foreign manufacturer could reduce risk by having two partners, but China could prevent them from having too big ownership, and could maintain the consolidation. On the other hand, it also had the downside that the Chinese partners had no motivation for improving performance, as the foreign partner was “locked” to them.

It also limited the amount of private capital invested in auto manufacturing, creating place for the foreign and state-owned joint ventures. Albeit the stricter policies, in the forthcoming years many multinationals initiated establishing new joint ventures. General Motors was made the biggest investment in that time.

In 1991, 81,055 cars were manufactured, in 1992 two times that. During the 1990s, the average annual growth rate of passenger car production was 27 percent. It is a huge growth, but we should also consider that in 2000, 17.2 million new cars were registered in the United States, and China still produced only 612,000. Even in 2002, there were only 8.5 million passenger cars in China compared with 179 million in the United States. (Gallagher, 2003)

In the automobile manufacturing, the economies of scale is exaltedly true. Therefore, it is crucial for the manufacturers to achieve large output amount. The Chinese industry lacked the centralization in the 1980’s and 1990’s as a result of the government decentralization. The role of the provincial governments was too strong without a central strategy. Many small manufacturers appeared, but they were not big enough to step on in the international market. The fate of the firms was highly depended on the regional decision makers. As a result of the 1994 policy the central government elevated a couple of state-owned firms by approving their JVs and annexing smaller ones. (Tan, Z. 2013)

4.3.3 WTO entry

After years of negotiation, in 2001 China was admitted to the World Trade Organization (WTO). It clearly signaled that China wanted to became part of the global
economy. With that, the previous import limits and high tariffs were abandoned. From 2001 the import was unlimited with a much friendlier 25 percent tariff. (Tan, 2013)

As a result, of the previously detailed actions, the incoming FDI flow grew even faster. Between 1992 and 1997, the total FDI inflow was $196.8 billion, which is more than $32.8 billion annually. Between 1997 and 2002 it grew to about $45 billion per year. (Cassidy, 2002) The Overall production also increased by 38.8 percent in 2002. (Luo, 2005)

4.3.4 The Second Round

From the second round of investments I highlight the two most important: General Motors and Ford. General Motors (GM) opened its Chinese office in 1994, and after years of negotiations, in 1997 GM established a joint venture with the Shanghai Automotive Industry Corporation Group (SAIC) and with Wuling Automotive Company. (SAIC was chosen by the Chinese government to be its main passenger car manufacturer.)

The 50-50 joint venture with SAIC achieved the most success in the Chinese auto market. GM invested $350 million in what is said the biggest single FDI of those years.6 (Faison, 1998) (Gallagher, 2003) (It even sold more cars in China than in the US in 2010 and 2011. GM manufactured GM Buick, Chevrolet, Opel, Cadillac and Wuling.)

6 In 2017 GM has 10 joint ventures in China6 and still sell more cars there than in the USA, where the passenger car sales plummeted in the recent years. “In China, Buick is still the fourth largest auto brand with a market share of just under 5% so far this year, behind Volkswagen, Honda, and Toyota.” (Richter, 2017) But as GM owns only 44% of Buick many says that the part of the agreement that means transfer technology to SAIC can be risky: In 2017 GM sold more than 4 million cars in China which accounts for the 14% of the total market. (Fernholz, 2018) GM has big plans for the future in China. In 2018 it plans to introduce 15 new and refreshed models. “China is expected to play an important role in the company’s global move toward a future of zero emissions, zero crashes and zero congestion. A substantial share of GM’s 20 new zero-emission vehicles to be introduced by 2023 globally will be sold in China.” (Anon., 2018) For GM growth in China is vital because they exited other large markets like Europe Russia and India.
GM was one of the first to fulfill the requirements of the 1994 automobile policy, to share technological knowledge. They established a separate joint venture between GM and SAIC called the Pan Asia Technical Center (PATAC) for $50 million. It was a testing center, with 400 engineers who were provided technological support. Their first product in 1998 was the Buick Xin Shi Ji (New Century). It was a luxury sedan just like Peugeots first car in China. When they started the production the localization was 47 percent, and it was considered as a modern and good quality sedan. By 2000 They could lower the part import by achieving a 60 percent localization. (Gallagher, 2003)

Two years later, their more affordable sedan which was manufactured by involving the PATAC engineers could achieved a 70 percent localization. GM could perform better than those who previously attempted to conquer the Chinese market, because it put emphasis on product development, while others usually brought one of their older models, and manufactured it for many years without any changes. “Shanghai GM introduced a more modern product than that being produced by Shanghai VW and other competitors, provoking them to either upgrade their product or introduce an entirely new model” (Gallagher, 2003, p. 13) It is also worth noting, that despite the expansion of sales volume in China, the profits still a lot lower than in the USA as a consequence of the joint venture structure, as you can see on figure 10.

Figure 10. Profit Gap

![GM profits and GM volume graphs showing the growth in profits and sales volume for North America and China from 2010 to 2016.](Moss – Colias, 2018)
The next big American company that I would like to highlight is Ford. It entered relatively late. Ford started to sell trucks and vans in the late 1990’s through joint venture with Jiangling Motors. Than it started to produce passenger cars only in 2003 in a three-way joint venture with Chongqing Changan and Mazda. It was a $98 million joint venture deal where Ford contributed with $49 million worth of cash and assets. (Gallagher, 2003) However, Ford could not achieve as big success as GM. In 2011 the total sales were only 519,390 units, nearly one-fifth of GM’s.7

4.3.5 Automobile industrial policy of 2004

After 1994, in 2004 a new policy was put in place dealing with the regulation of the automobile industry. The main difference between the 1994 and the 2004 is that the later was much more focused on providing strategic direction and encouragement than regulation. “The 2004 policy also ended the requirement for local content and export, simplified administrative procedures, encouraged energy saving and environmental protection etc. However, government maintained its role as a guide for industrial structure mainly through its tool of granting an entry approval but also through guiding mergers and restructuring.” (McCaleb, 2015, p. 166)

The automobile firms are not located everywhere in the country. There are grouped in some bigger regional industrial centers. The most important clusters are Changchun, Chongqing, Beijing, Guangzhou, Shanghai, and Wuhan. This six cluster can be accounted about 70 percent of total automobile output in China. (see figure 11.) Each of these clusters has a big anchor firm like BAIC in Beijing, SAIC in Shanghai, SAW in Wuhan, Chang’an in Guangzhou. These big firms are then surrounded smaller part manufacturers and suppliers.

7 Ford plans to expand its presence in china with a third joint venture with Zotye, creating Zotye Ford Automobile Co. Ltd with 50-50. Its goal will be to “offer a range of stylish and affordable electric vehicles for consumers in China (…) Pending regulatory approval, the new JV will develop and manufacture all-electric vehicles under a new Chinese brand. Service offerings provided by the JV will include all-electric vehicle leasing, data-driven fleet management solutions, in-vehicle digital services, connectivity and vehicle customization.” (Ford, 2017)
These clusters were not formed by market forces; the influence of the government was dominant. Both SAW and FAW were established by the government. SAW was built to the northern part of the country in the hope of getting technological support from the soviets, and FAW was placed to a remote place because of military considerations. (Tan, 2013)

Figure 11. Growth of automobile production at major locations in China, 2000–2007

(Liu-Yeung, 2008, p. 540)

4.4 FDI and Technological Cooperation

As I mentioned, in the first period, one of the most important objectives was to build up technological knowledge. China had to internalize the knowledge that was brought from abroad.

The process of building up technological capabilities happened through 4 different ways. The first strategy is “learning by doing”. This method was used by “newly established indigenous firms such as Chery and Geely, which have started from reverse engineered components and are gradually expanding their R&D activities”. (Tan, 2013,
The drawback of it was that it could end in intellectual property issues with foreign firms.

Secondly, the big Chinese firms, beside JVs usually had their own operations also. For example, FAW manufactured Audi A4 in JV, but also produced Red Flag HQ3 independently. Chang’an had Ford Focus in JV, and CX30 independently. These self-owned vehicles were developed with the technical knowledge from the JVs. It created competition for their own cars, and resulted in some sort of cannibalization in the automobile market place.

Thirdly collaboratively established research and development centers could also help gaining technological knowledge. The best example is probably the Pan-Asia Technical Automotive Centre, or PATAC which I already mentioned. Albeit it was established to provide design and engineering support for all domestic firms, it soon became tied closely only to SAIC, which prevented it from exposing impact on the whole industry. (Tan, 2013)

Lastly, as the domestic Chinese manufacturers started to become stronger, and had more and more capital, they started to buy stake, or acquire foreign companies. In 2005 Nanjing Automobile Corporation (NAC) bought MG Rover for £53 million, and Geely acquired Volvo in 2010 just to mention some of the biggest deals. (Nicholson, 2010)

China could improve technologically, but it was not easy and successful from the beginning. The American companies controlled the important areas of operating like finance and management. They were also focusing on keeping the new development secret. They shared the older, basic, technologies with the Chinese partners, but kept the cutting-edge technology. (Tan, 2013)

It also has to be noted, that JVs had effect on corporate structure and behavior. Before the economic reforms, the soviet style management was dominant in the state-owned firms. With the appearance of JVs and privatization, a new corporate company system emerged.
5. Conclusion

From my researches it became clear that the appearance of foreign capital had influential effect on the development of the Chinese automobile industry. After the first automobile firm was established in 1956, for a long time no significant development happened. It took more than 30 years to reach the production of 1 million units per year. From there 10 million was only 17 years. After decades of slower development, rapid growth came between 1994 and 2002.

While until the 1980’s the production was mostly trucks and other heavy vehicles, after the economic reform in the late 1970’s, a new wealthier class emerged in the densely populated areas, with a growing appetite for passenger cars. However, China was not possessing the technological know-how for satisfying the ever-growing demand.

In these years, we can see three phenomena happening at the same time. We can see an industrial revolution happening in China, with a huge market opening up as a consequence of policy changes. There are the advanced foreign companies, with an appetite for the emerging Chinese market. And there is also the Chinese government, which on the one hand want the Chinese economy to improve and catch up to its foreign rivals technologically and by output, but on the other hand, it also has to be careful not to let the whole industry become foreign owned.

As the economy became more and more opened, the government had to keep up with the changing market situation. It did first with restricting foreign capital, allowing only a very limited number of investments, and even those could happen only in the form of joint ventures. This prevented the formation of a fully foreign automobile sector, but also limited the potential for development a lot.

In 1994 they issued the first automobile industrial policy which was dealing with this industry separately. It tried to trigger consolidation with lifting up a couple manufacturers, so they can be big enough for achieving significant development, and step out on the international market. And besides all this, with issuing high tariffs on import, and restricting the amount of foreign ownership in JVs at 50 percent they started to work on establishing a domestic auto manufacturing industry. They could join the WTO in
2001, and in 2004 they issued a new automobile industrial policy which reflecting on the WTO join, and set further guidelines for the development of the industry.

The automobile companies can be classified in three different types: The traditional stated-owned automobile firms like SAIC or FAW, the international JVs like FAW VW, Shanghai GM or Shanghai VW), and the Indigenous firms with self-owned brands (e.g. Chery, Geely). Between the 1980’s and 2000’s, the international JVs had an outstanding role in the development of the sector. After some unsuccessful early attempts, many successful JVs were established. The biggest and most successful was between GM and SAIC in 1997.

The most important effect of foreign direct investments arriving to China in the form of joint ventures was providing manufacturing, design and research capabilities. From the government’s perspective it was successful to certain extend. The whole industry was based on these technologies and cooperation. The government policies could achieve the establishment of research centers like PATAC. However, until China relies on the technology given from JVs, it will always fall behind. The interest of the foreign MNCs is to share only the older technologies, and keep the most advanced to themselves. From the multinational automobile manufacturers perspective, they had the chance to have a piece from the rapidly growing Chinese automobile marker, and while some of the early JVs failed, in general it became a good deal for them also.
6. Abbreviations

AMC - American Motors Corporation
BJC – Beijing Jeep Corporation
FAW - First Auto Works
FDI – Foreign direct investment
GM – General Motors
JV – Joint venture
MNC – Multinational corporation
NAC - Nanjing Automobile Corporation
PATA C - Pan Asia Technical Center
R&D – Research and Development
SAIC - Shanghai Automotive Industry Corporation
SOE – State owned enterprise
SSC – Shared service center
WTO – World Trade Organization
7. Bibliography


