Changing Lanes in China

Foreign Direct Investment, Local Governments, and Auto Sector Development

This book addresses two of the most important trends in political economy during the last two decades – globalization and decentralization – in the context of the world's most rapidly growing economic power. The development of the Chinese auto industry is a classic example of China's efforts to re-make inefficient and technologically backward Chinese firms into powerful national champions, and it is an industry on which many of the world's most powerful multinationals have staked their future.

The intent of the book is to provide a better understanding of how local political and economic institutions affect the ability of Chinese state-owned firms to effectively utilize foreign direct investment, and how these institutions shape the prospects for development. In a global economy, the author argues, local governments are increasingly the agents of industrial transformation at the level of the firm. Local institutions are durable over time, and they have important economic consequences. Through an analysis of five Chinese regions, the book seeks to specify the opportunities and constraints that alternative institutional structures create, how they change over time, and ultimately, how they prepare Chinese firms for the challenge of global competition.

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For my parents

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List of Abbreviations

BAIC:	Beijing Automobile Industry Corporation
BJ:	Beijing
BJC:	Beijing Jeep Company
CAD:	computer assisted design
CCP:	Chinese Communist Party
CKD:	Complete-knocked down (kit)
CNAIC:	China National Automotive Industry Corporation
DCAC:	Dongfeng Citroen Automobile Company
FAW:	First Auto Works (Changchun)
FAW-VW:	First Auto Works-Volkswagen
FDI:	foreign direct investment
GM:	General Motors
GPAC:	Guangzhou Peugeot Automobile Company
GZ:	Guangzhou
HK:	Hong Kong
JV:	joint venture
MIT:	Massachusetts Institute of Technology
MMI:	Ministry of Machinery Industry
MNC:	multinational corporation
MOFTEC:	Ministry of Foreign Trade and Economic Cooperation
MOU:	memorandum of understanding
R&D:	research and design
RMB:	renminbi (Chinese currency)
SAIC:	Shanghai Automobile Industry Corporation
SAW:	Second Auto Works (Wuhan)
SEC:	Shanghai Economic Commission

SGM:	Shanghai General Motors
SLC:	Santana Localization Community
SOE:	state-owned enterprise
SPC:	State Planning Commission
SVW:	Shanghai Volkswagen
VW:	Volkswagen
WTO:	World Trade Organization

Preface

As my taxi made its way through the streets of Guangzhou, a city in southern China, the evidence of two decades of unprecedented economic growth flashed by the window. The darkened windows of a Mercedes-Benz sped by on the left; a family of four on a motorbike puttered along on the right; kamikaze taxi drivers veered in and out; a minibus trolled for passengers. My driver, at the wheel of a Chinese-made Volkswagen Jetta, was oblivious to the surrounding chaos, and as he maneuvered for position, I asked him how his car stacked up against the competition. "Better than most Chinese cars," he replied. "It's made in China, but under the hood it's almost all foreign." He proceeded to rank the quality of the cars on the road based on their percentage of foreign content: imports at the top, joint venture cars in the middle, pure local at the bottom. Although hardly a charitable assessment – the quality of domestically manufactured cars was improving rapidly – it was nevertheless truthful. It was 1997, my first year of field research for this project, and although China had come a long way from the lumbering two-ton "Liberation" truck in the breakdown lane, it was still a long way from the sleek Mercedes in the passing lane. The gap has been narrowing quickly.

In the eight years since I began the research for this book, the Chinese auto industry has gone from being something of a curiosity to being one of the most important automotive markets in the world. In the fall of 1996, when I arrived in China to begin field research, there were four multinational auto firms with major assembly joint ventures (and two more that were in the final stages of negotiations) and there was the usual talk about the future potential of the Chinese market. Most of this was just talk. Sales of passenger vehicles for China as a whole hovered around a half million

cars, and more than three-quarters of these were institutional purchases (the government, state-owned firms, and state-owned taxi companies). Technology in the industry was decades behind global levels, but given the protection of high tariff barriers, firms had little incentive to introduce new technology or cut costs. A joint venture between Volkswagen and the Shanghai Auto Industry Corporation (SAIC) controlled more than half of the domestic market for sedans with a model that was based on technology from the 1970s.

In the span of eight years the Chinese auto industry has been transformed. A combination of massive investment on the part of both foreign and domestic firms, a rapidly growing private market, and accession to the WTO have created an intensely competitive market and rapidly increasing capabilities. Both the opportunities and the risks have been abundantly clear in recent years. In 2002 and 2003, annual growth rates were well in excess of 50%, and the primary concern among multinational auto firms was not being able to increase capacity fast enough to meet demand – not even the most optimistic of auto executives would have dared predict such astronomical growth rates. Only a year later, however, the domestic market cooled quickly, after the government began to tighten access to financing, and executives who had worried about missing the boat in China were suddenly concerned about overcapacity and an industry shake-out. Optimism about the long-term potential of the market remained, but it was becoming clear that the near-term survival of individual firms could not be taken for granted. In the spring of 2005, Volkswagen and General Motors were fighting for market share with more recently created Korean and Japanese joint ventures, and independent Chinese firms were rapidly increasing the production of models that often looked suspiciously similar to the models of their foreign competitors.

The road forward will certainly not be smooth – the fragilities of the Chinese economic system, continued dependence on foreign technology, and looming overcapacity in the auto sector insure this – but there can be little doubt as to whether China will have a large and powerful auto industry. Even at relatively modest annual growth rates of 10%, the Chinese market continues to provide far greater prospects for growth than the stagnant markets of the developed world. Chinese firms are also rapidly becoming major exporters of automotive components, and the export of cars has only just begun. What remains to be seen is whether the Chinese auto industry will be one that is controlled by the large multinationals – under the hood all foreign, as the taxi driver described it – or whether it

will eventually lead to the development of large and powerful Chinese firms.

This book uses the dramatic context of the Chinese auto industry as a means of understanding the rise of China as an industrial power and its integration with the global economy. The book is first and foremost a work of comparative political economy. It seeks to understand how local institutional structures, and in particular local governments and business groups, shape and influence the process of industrial development and the prospects for Chinese firms. Although the framework is academic, the story of the Chinese auto sector is of interest to more general readers as well, and to an extent, it can be read independently. The theoretical context and argument are presented in general terms in Chapter 1, and a roadmap for the book as a whole is provided at the close of this chapter. Readers who are less interested in the theoretical argument of the book, but are interested in the rise and development of the Chinese auto industry, might prefer to skim through this first chapter, begin reading Chapter 2, which provides the context and background on auto sector development efforts, and then proceed to the case studies. The early development efforts of each region (prior to WTO accession) are the subject of Chapters 4, 5, and 6. Chapters 7 and 8 analyze the more recent challenges of technical upgrading and governance in the post-WTO era.

As might be expected, I was helped by many while researching and writing this book, although I alone remain responsible for the final product. Ironically, the people who were most critical to this process are those that I cannot thank – the factory managers and government officials in China who graciously took the time to explain to me the inner workings of the Chinese auto sector, but wished to remain anonymous due to the subject of the information they shared with me. It was always humbling to realize the extent to which the success of my research depended on the kindness and patience of others.

There are many, of course, whom I can thank. The book began its life as a dissertation in the Government Department of Harvard University, where I was fortunate to be under the guidance of Roderick MacFarquhar, Iain Johnston, and Dwight Perkins. Their comments, suggestions, and encouragement were invaluable at every stage of the project. While at Harvard I benefited from the advice and encouragement of many, but in addition to my advisors, I would particularly like to thank Lawrence Broz, Peter Hall, Yuen Foong Khong, Jean Oi, Elizabeth Perry, Ezra Vogel, and Yasheng Huang. At every step of the graduate school

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Although my tenure as postdoctoral Fellow at the Industrial Performance Center (IPC) at M.I.T. was relatively brief, the members of the IPC research teach had a profound influence on the way I viewed the process of globalization. The IPC also introduced me to the pleasure of interdisciplinary team-based research. I am particularly indebted to Suzanne Berger for her advice and comments on the manuscript.

The final stage of this project was done at Princeton University, where I was blessed with another set of wonderful friends and colleagues. For reading and commenting on different parts of the manuscript, I would particularly like to thank Nancy Bermeo, Eun Kyong Choi, Kent Eaton, Jeff Herbst, Bevan Jones, Atul Kohli, Evan Lieberman, Illan Nam, Kate McNamara, Lynn White, and Robert Willig. Rita Alpaugh provided assistance of every sort, and invariably did so with good humor and efficiency. I am also grateful to the Center of International Studies (now the Princeton Institute for International and Regional Studies), the Woodrow Wilson School, and the Class of 1934 Preceptorship for financial support during the final rounds of research and revisions.

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Finally, I would like to thank my family for their love and support during what surely must have seemed to be an endless process. I was fortunate to have my brother, Chris, living close by at several different stages of the project; my sister, Kirsten, and the entire Dunn family provided a welcome refuge in Vermont on many occasions. My wife, Jennie, has endured my lengthy absences, while I was in both Princeton and China, with little complaint and with unfailing support, and I could not be more grateful for all the happiness that she has brought to my life.

I dedicate this book to my parents. At every stage of my education they provided encouragement and support (even when there was good reason to be skeptical), and from very early on, they demonstrated the importance of asking questions and seeking answers.

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