

# The Impact of WTO Membership on the Automobile Industry in China\*

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Many areas of China's economy stand to see change from WTO accession, from agriculture to insurance and banking to telecommunications. Among the sectors affected, the automobile industry, as an old-line heavy industry, seems one of the most open to a global challenge. Since its reorganization in the post-Mao Zedong reform era, China's auto industry has been nurtured in a protectionist environment. Joint venture companies have satisfied domestic passenger car vehicle needs, but price and quality problems have left the industry open to some challenge in a free market post-WTO world.

This article assesses the ways China has built a significant yet vulnerable vehicle production system. It then examines various provisions of the WTO and their potential effect on the country's auto industry. It concludes with a discussion of possible future developmental paths in the vehicle sector under the new international trade rules.

## *Post-Mao Growth of the Auto Sector and Protectionist Measures*

As China began to open itself to world trade and economic reform in the late 1970s, change in the vehicle sector emerged as an important part of the country's modernization drive. Both the infant passenger car industry and the relatively well-developed truck manufacturing sector faced new policies as a result of Deng Xiaoping's economic revitalization plans.

The passenger car industry was a minor part of vehicle production during the first three decades of China's socialist economy.<sup>1</sup> As late as 1985, the country produced a total of only 5,200 cars.<sup>2</sup> During the pre-reform era, government officials were discouraged from using private vehicles. The dearth of tourism and lack of disposable income among Chinese citizens also meant there was a low demand for taxis and other passenger cars as means of local transportation. With an opening to international tourism and foreign business in the early 1980s, and relaxation of rules on perquisites for government offices, the need for passenger cars rose quickly. As domestic production could not meet demand, import totals rose dramatically (see Table 1), despite a 260 per cent import duty on foreign vehicles. The country spent some \$3 billion to

\*The author thanks the University of California at Davis's Institute of Transportation Studies for funding support during research in summer 2000.

1. For more information on the early development of China's vehicle industry, see Eric Harwit, *China's Automobile Industry: Policies, Problems, and Prospects* (Armonk, NY: M.E. Sharpe, 1994), ch. 2.

2. *1996 Automotive Industry of China* (Beijing: Beijing Institute of Technology Press, 1996), p. 12.

Table 1: China's Vehicle Imports, 1981–1990

<i>Year</i>	<i>Cars</i>	<i>Trucks</i>	<i>Total</i>
1981	1,401	20,770	41,575
1982	1,101	7,730	16,077
1983	5,806	8,445	25,156
1984	21,651	28,047	88,743
1985	105,775	111,492	353,992
1986	48,276	64,570	150,052
1987	30,536	17,554	67,182
1988	57,433	14,201	99,233
1989	45,000	12,587	85,554
1990	34,063	18,395	65,430

*Note:*

Total vehicle column does not add up, as it includes buses, disassembled vehicle parts kits, off-road vehicles and other categories of automobiles.

*Source:*

*Zhongguo qiche gongye nianjian (China Automotive Industry Yearbook)* (Tianjin: CATARC Press, 1999), p. 188.

import more than 350,000 vehicles (including 106,000 cars and 111,000 trucks) in 1985 alone.<sup>3</sup> Taxi companies in particular thirsted for Japanese cars, such as Toyota Crowns and Nissan Bluebirds.

China's answer to the import binge was to sign a series of joint-venture passenger car production agreements. In 1983, American Motors Corporation (AMC, later acquired by Chrysler Corporation) signed a 20-year contract to produce their Jeep-model vehicles in Beijing. The following year, Germany's Volkswagen signed a 25-year contract to make passenger cars in Shanghai, and France's Peugeot agreed to another passenger car project to make vehicles in the prosperous southern city of Guangzhou.

Though joint venture agreements provided a window for foreign manufacturers to tap the China market, there were limits on their participation. Vehicle manufacturers could not own a majority stake in a manufacturing plant – Volkswagen's venture took the limit of 50 per cent foreign ownership.<sup>4</sup> Manufacturers also had incentives and pressures to source parts from Chinese suppliers, with a 40 per cent local-content rate bestowing reduced parts import duties of some 30 per cent on the foreign partner.<sup>5</sup> The Chinese also kept control of distribution networks for the jointly-produced automobiles.

The various incentives, combined with maintenance of import tariff

3. Harwit, *China's Automobile Industry*, p. 29.

4. Wholly-foreign owned enterprises, ones meant to export vehicles, however, were allowed, and the Panda Motor Corporation was approved at local and national levels. The rise and fall of that venture are outlined in Harwit, *China's Automobile Industry*, ch. 7.

5. At 60% local content, the import duty fell to 24%, and 80% local content meant only a 16% import tax. From summer 2000 interview in Shanghai.

duties, helped achieve success for at least some of the new joint venture companies. Volkswagen's Shanghai plant was by the far the winner under the regime, as it produced cars that could function as taxis, vehicles for government officials and transport for the newly emerging business elite. As car imports fell to some 34,000 in 1990, Shanghai-Volkswagen's (SVW's) production of its Santana models reached nearly 19,000 vehicles that year. By 1993, SVW's output had reached 100,000 vehicles.

Volkswagen was aided by some Shanghai municipal efforts. Various restrictions on engine size, as well as incentives to city taxi companies, helped ensure a safe market in the company's relatively wealthy home arena. Volkswagen also encouraged its foreign parts suppliers to create joint ventures in China, and their resulting product helped SVW achieve an 85 per cent local content rate by 1993.

VW's competitors did not fare as well. AMC's Beijing Jeep venture never found a mass market for its high-platform vehicles, and the company struggled into the 1990s to produce more than 15,000–20,000 vehicles. Peugeot did even worse, as it found little heavy industry in southern China to support its manufacturing operations. The low quality of its product also alienated southern Chinese, many of whom benefited from large-scale car smuggling operations over the region's porous borders. Peugeot withdrew from its joint venture in 1997, though the facility soon reached a new agreement with Japan's Honda Motors to continue manufacturing small cars.

The market for both cars and trucks grew in the mid-1990s, as Deng Xiaoping's invocations to speed economic expansion and spur private enterprise led to high-speed growth. As GDP rose at annual rates of 10 to 14 per cent from 1992 to 1995, both car production and imports rose dramatically. Total passenger car production reached 325,000 in 1995, and totalled 508,000 in 1998.<sup>6</sup> As Table 2 shows, Shanghai Volkswagen's factory production topped 200,000 cars in 1996, and a new VW factory in Changchun, Jilin province made some 64,000 Jetta and Audi vehicles in 1998. A Tianjin manufacturer that licensed technology from Japan's Daihatsu corporation made some 100,000 "Charade" model cars in 1998.

As the economy surged and domestic production rose, lower import tariffs contributed to a rise in cars crossing China's borders. In early 1994, duties fell from 150 to 110 per cent for small cars, and from 220 to 180 per cent for large cars.<sup>7</sup> Rates fell further in the next two years, averaging some 80 to 100 per cent in 1996,<sup>8</sup> though there were no further cuts over the following four years. In January 2001, duties fell to between 70 and 80 per cent.<sup>9</sup> Table 3 indicates that the country faced a second wave of imports in the middle of the decade.

6. *Zhongguo qiche gongye nianjian (China Automotive Industry Yearbook)* (Tianjin: CATARC Press, 1999), p. 5.

7. Harwit, *China's Automobile Industry*, p. 171.

8. Xu Zhonglun, "A briefing of Chinese auto import and export trade," in *China Auto*, Vol. 8, No. 1 (1998), p. 20.

9. *South China Morning Post*, 4 January 2001, Business section of web site <http://china.scmp.com/business/ZZZRVLMPGC.html>.

Table 2: Production at Major Passenger Car Assembly Plants, 1990-mid-2000

Manufacturer	Vehicle production										
	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	First half 2000
Shanghai	18,537	35,005	65,000	100,001	115,326	160,070	200,222	230,443	235,000	230,946	99,723
Volkswagen	—	—	8,062	12,117	8,219	20,001	26,864	46,404	63,922	75,566	50,932
First Auto	—	—	—	—	—	—	—	—	—	(Jettas only)	(including Jettas and Audis)
Works-VW (Changchun)	—	—	—	—	—	—	—	—	—	—	—
Beijing Jeep	7,500	12,700	20,001	13,809	14,703	25,127	26,051	19,377	8,344	9,294	3,659
Guangzhou	3,415	9,094	15,666	16,075	4,805	6,936	2,522	1,557	2,246	N.A.	N.A.
Peugeot	—	—	—	—	—	—	—	—	—	—	—
Shenlong	—	—	—	—	—	1,314	9,158	30,035	36,240	40,200	23,839
Citroën (Hubei)	—	—	—	—	—	—	—	—	—	—	—
Tianjin	2,920	11,261	30,150	47,850	58,500	65,000	88,000	95,155	100,021	111,500	45,700
Daihatsu	—	—	—	—	—	—	—	—	—	—	—
Changan	—	245	5,565	10,463	10,020	13,180	13,383	28,861	35,555	51,170	26,703
Suzuki (Chongqing)	—	—	—	—	—	—	—	—	—	—	—
Guangzhou	—	—	—	—	—	—	—	—	344	10,008	12,287
Honda	—	—	—	—	—	—	—	—	—	—	—
Shanghai General Motors	—	—	—	—	—	—	—	—	—	23,290	14,439

## Notes:

Statistics from each source are compatible for comparative purposes. N.A. = not available

## Sources:

China Automotive Industry Yearbook, p. 7, for 1990–98; Asia Pulse, 29 February 2000, “Profile – China’s automotive industry,” for 1999 figures, and Zhongguo qiche gongye (Automotive Industry of China 2000) (Tianjin: CATARC Press, 2000), p. 20 for Guangzhou Honda and Shanghai General Motors, 1999 figures only; Wen wei bao, 19 July 2000, for first half 2000 numbers.

Table 3: **China's Vehicle Imports, 1991–first half 2001**

<i>Year</i>	<i>Cars</i>	<i>Trucks</i>	<i>Buses</i>	<i>Total</i>
1991	71,557	23,402	3,490	98,449
1992	158,294	46,685	5,227	210,206
1993	222,336	83,099	6,283	311,718
1994	184,421	74,656	19,956	279,033
1995	126,933	16,862	1,244	145,039
1996	63,857	10,611	1,395	75,863
1997	35,345	9,907	3,787	49,039
1998	27,455	8,002	4,761	40,218
1999	27,205	5,238	2,749	35,192
2000	NA	NA	NA	37,200
First half 2001	NA	NA	NA	39,000

*Notes:*

Though the sources of these numbers differ from those in Table 1, the totals are compatible with the numbers from the previous decade. From 1991, the import numbers were categorized to include imports of buses, and car-kit imports and other categories of imports are subsumed into the most appropriate of the three vehicle categories. NA = not available.

*Sources:*

For 1991 to 1998: *Automotive Industry of China*, p. 15; for 1999: e-mail correspondence with Chinese automotive industry official, March 2001; for 2000 and 2001: *China Daily*, 4-5 August 2001, p. 3.

As Tables 2 and 3 show, imports began falling and domestic production slowed in the late 1990s. The major causes of these trends were a decelerating economy (GDP growth rates fell below 9 per cent after 1996) and new limits on vehicle purchases by government offices and state-owned enterprises. For imports, China continued to have quotas on the number of cars that could enter the country, with import licences needed to purchase a foreign-made vehicle legally. The country's 1994 industrial policy statement on the vehicle sector suggested that by the year 2000, domestic production should meet 90 per cent of demand,<sup>10</sup> so falling import numbers helped conform to the state's long-term plans.

Other factors, including regional protection measures such as those noted earlier from the Shanghai municipal government for Shanghai Volkswagen, also limited the market for imported cars. In addition, foreign auto companies were prohibited from acting as vehicle importers, distributors and retailers, and could not directly provide financing for vehicle purchase or offer after-sales service. Higher domestic vehicle quality, in particular from Shanghai Volkswagen and VW's Jetta facilities in north-east China, as well as from new French entrant Citroën, and, later, America's General Motors in Shanghai and Honda in Guangzhou, also made imported vehicles less attractive for current or prospective future purchase.

A further factor in reducing official import numbers was a flow of "grey market" vehicles. Cars crossed borders with such countries as Russia and even North Korea, with many given import licences under

10. Xu Zhonglun, "A briefing," p. 19.

bilateral agreements. Cars that came in through North-East Asia were often made in South Korea.<sup>11</sup> The January 2001 fall in duties, however, led to a near doubling of total vehicle imports in the first half of the year.

As for trucks, import surges also tended to follow economic strength. A rise in fortunes, particularly in coastal rural areas, in the mid-1980s led to an import binge that paralleled that of passenger cars (see Table 1). In a similar way, growth in the early 1990s contributed to an import mini-boom for trucks from 1992 to 1994 (see Table 3). Import tariffs for trucks varied by type of vehicle, but some duties were as low as 9 per cent.<sup>12</sup>

China also has a few truck manufacturers that license foreign technology and use limited amounts of foreign management and capital. Nissan's pick-up factory in Zhengzhou, Henan province, the Ford-invested Jiangling truck company in Nanchang, Jiangxi, and Isuzu's Qingling truck facility in Chongqing are among the largest co-operative projects. The major automotive joint venture facilities, however, are mainly found in the passenger car sector. Furthermore, the majority of China's trucks, produced by major manufacturers such as First Auto Works in Changchun and Second Auto Works in Shiyan, Hubei, are made with virtually no foreign capital or management input.

#### *WTO Membership and the Auto Industry's Concerns*

China's quest for WTO (formerly the General Agreement on Tariffs and Trade) membership began in 1986, and talks proceeded slowly. Critical problems in reaching an accord lay not only with auto-related issues: other sectors such as telecommunications, tourism, banking and entertainment also complicated the path towards an agreement. Resistance from industries still not ready to face foreign competition, such as insurance, telephone and film production companies, made progress in talks difficult.

Some Chinese leaders agreed with those who resisted WTO membership. Opening to foreign competition could result in unemployment for Chinese farmers in the countryside as well as urban workers from factories unable to compete with imported goods. Some sectors – such as telecommunications and banking – were potential security risk targets should foreign firms wrest control from state agencies. China could lose its sovereign control over key parts of its economy.

Proponents of WTO membership argued that competition with foreign firms would sharpen the quality of Chinese production and service provision. Furthermore, the country stood to gain from enhanced access to foreign markets and new avenues for appeal should China's export targets levy unfair tariffs on PRC goods.

For the auto industry, some of the conservative concerns were relevant.

11. From summer 2000 interview with automotive official in Beijing. This official lacked precise numbers on how many "grey market" vehicles flowed across China's borders, but asserted they numbers in the "tens of thousands."

12. From summer 1999 interview in Beijing.

According to one estimate, sales in the auto sector in 1999 totalled about \$38 billion, or nearly 4 per cent of the country's GDP, and an increase of 19 per cent over the previous year.<sup>13</sup> Furthermore, some 7 million people, or about 3.3 per cent of the total Chinese urban workforce, were employed in 1998 in occupations related to automobile production.<sup>14</sup> Of these, some 2 million were vehicle manufacturer and parts supplier employees, and 2.4 million worked in sales and service and repair centres. Another 2.1 million were part of raw materials production units (including steel, lubrication and other facilities), and some 300,000 worked in related areas such as auto insurance and administrative offices.<sup>15</sup> The threat of unemployment with a diminished auto sector extended beyond simple vehicle assembly plants, although it is true that many of these workers, such as repair centre workers and administrators, would still be needed to service imported vehicles. Raw materials suppliers could also shift production to other manufacturing segments, such as construction or perhaps export. The most directly affected would be the domestic vehicle manufacturer employees. Among the 2 million production workers in 1998, some 650,000 assembled cars and trucks, 780,000 worked in the parts industry, 200,000 made motorcycles, and the rest were employed in specialized sectors such as engine production.<sup>16</sup>

One area of particular worry in the assembly sector was brought by a proliferation of small, economically inefficient vehicle producers in nearly every province of the PRC. The number of manufacturers rose from about 20 in the 1960s to 60 in the 1970s, and peaked at about 125 in the early 1990s.<sup>17</sup> Nearly all of these companies, which made products ranging from minivans and postal vehicles to garbage trucks, had limited annual runs of a few thousand or even a few hundred units. Should the country open to foreign competition, officials feared these manufacturers and their supplying companies would face tremendous pressure to close. During the late 1990s, however, only nine of the factories actually were shut, as local pressures to maintain employment levels worked against market forces.<sup>18</sup>

Other potential problems existed even for the established factories. The level of domestic vehicle quality was hampered by the drive for quick localization and utilization of Chinese parts. Honda Motors had taken ten years, from 1982 to 1992, to reach 75 per cent local American parts content for its production in the United States, but VW had reached that level of Chinese domestic content at its Shanghai factory in only seven years.<sup>19</sup> SVW's Chinese managing director said in 1992 that "at the

13. Anita Narayan, "China's auto sector to clear road for foreign participation, report says," from China Online (Chinaonline.com), 9 February 2001.

14. *Zhongguo qiche gongye (Automotive Industry of China)* (China Automotive Technology and Research Centre Press, 1999), p. 1.

15. *Ibid.* p. 1

16. *Ibid.* p. 6

17. Harwit, *China's Automobile Industry*, p. 24.

18. One foreign automotive official estimated that only 25 to 30 of the 125 or so companies were viable, and that the rest would eventually fail. From summer 2000 interview in Shanghai.

19. Harwit, *China's Automobile Industry*, pp. 99–100.

moment, we are not competitive. If they were to open the market, we could not compete.”<sup>20</sup> In mid-1998, a Chinese official in a national automotive research institute estimated China needed at least nine years for the auto industry to be competitive under WTO rules.<sup>21</sup>

As the actual 1999 agreement to allow China into the WTO was being negotiated, Changchun’s First Auto Works (FAW) was among the most vocal of the large companies to express its worries. FAW has joint ventures with both Volkswagen and General Motors, but still fears competition from imports. “We need another two or three years” said one FAW official in early November, before the new deal was announced. He continued: “It’s not just our company: the restructuring of the whole auto industry needs it.”<sup>22</sup>

One of the few public Chinese reports that focused on the auto industry and WTO membership found a mixed picture on the country’s readiness to join the trade organization.<sup>23</sup> The essay considered five factors seen as vital to the future success of the industry: manpower, knowledge base, raw materials, basic equipment and per capita financial strength. It found China compared favourably to both Japan and South Korea on all points except for financial ability. The study also pointed out that Chinese producers had advantages, including domestic market knowledge, and that they had long been making cars for Chinese, rather than foreign, consumers.

Other domestic proponents of free trade found liberal economic virtue in an agreement. One Chinese auto official suggested that WTO membership would provide the market forces needed to close the most inefficient of the small and medium-sized producers.<sup>24</sup> Price competition would force the established joint ventures to become more competitive with imports, and prices to Chinese consumers might fall. Other benefits could come with the introduction of more fuel efficient and cleaner running imported vehicles, with the resultant energy and environmental benefits.

### *Implications of the 1999 WTO Agreement*

As Tables 4 and 5 point out, the latest pact includes provisions for transforming many of the protectionist features of the auto industry over the next six years. Taken as a whole, they stand to present a significant challenge to the domestic manufacturers in a relatively short time.

The greatest challenge to the industry may come with tariff reductions. By 2006, import duties will be cut to a maximum of 25 per cent for passenger cars, and, including trucks, buses and other vehicles, should average about 10 per cent by the conclusion of the trade pact’s provi-

20. *Ibid.*, p. 171.

21. From summer 1998 interview in Beijing.

22. “China: WTO or bust?” in *Businessweek Online*, 22 November 1999.

23. Hu Yazhuang, “Zhongguo jiaru shimao zuzhi qiche gongye zhunbei hao le ma?” (“is the auto industry prepared for China to join the WTO?”), in *Gongye jingji (Industrial Economics)*, May 1999, pp. 20–23.

24. From summer 1998 interview in Beijing.

Table 4: Key Issues for the Auto Industry Under the WTO Agreement

<i>Issue</i>	<i>Current status</i>	<i>Agreement proposals</i>
Import tariffs	80–100% on passenger cars; as low as 9% on some other vehicles	Reduced to 25% for passenger cars by July 2006 (see Table 5). Overall average cut to 10% by 2006.
Import licensing requirements	Quotas vary by year on number and value of imported vehicles; 27,000 vehicle import licences issued in 1999	Raised limit to \$6 billion worth of imports on accession, 15% annual growth until elimination in 2005
Local content requirements	Various incentives to speed use of domestic parts suppliers	Elimination of local content requirements on accession*
Import arrangement rights	Foreign enterprise cannot directly import vehicles	Import rights granted within 3 years of accession
Distribution, retail, after sales service	Car manufacturers must use Chinese distributors to sell their vehicles, and domestic firms to service them	Distribution, sales and service rights for foreign firms phased in over three years
Finance	Chinese consumers have difficulty financing vehicle purchase using domestic bank loans	Non-bank foreign firms can provide unrestricted auto financing on accession

*Note:*

\*An official at Shanghai Volkswagen maintained that elimination of local content requirements had not yet been officially decided, and one Chinese auto official agreed with this assessment.

*Sources:*

Interviews in Beijing in 1999 and 2000; Tim Stratford, general council and vice-chairman, General Motors (China) Investment Co., presentation at American Chamber of Commerce, Beijing, 19 June 2000.

Table 5: Proposed WTO Changes for Auto Import Tariffs (%)

Category	Accession	1/2001	1/2002	1/2003	1/2004	1/2005	1/2006	7/2006
100% tariff cars	77.5	61.7	50.7	43.0	37.6	30.0	28.0	25.0
80% tariff cars	63.5	51.9	43.8	38.2	34.2	30.0	28.0	25.0
Trucks	-	-	-	-	-	15-30	-	-
Buses	-	-	-	-	-	25.0	-	-

Source:

Tim Stratford, general council and vice-chairman, General Motors (China) Investment Co., presentation at American Chamber of Commerce, Beijing, 19 June 2000.

sions. The phasing out of import licence requirements and easing of restrictions on import and distribution practices will also widen the door for foreign vehicle makers.

A Chinese auto policy official familiar with trade negotiations says import numbers will definitely rise as the tariff rates fall.<sup>25</sup> "If the import tax falls, people will want dependable cars," said the official. However, she believed that domestic makers would still be strongly price-competitive players even in a post-WTO auto regime. For example, she asserts that domestic parts sourcing and low labour costs would keep prices low for producers such as Shanghai Volkswagen and new entrant Shanghai General Motors.

In the short term, other provisions of the trade pact will have mixed results, according to the Chinese official. Loan financing may have little impact in the next few years, as China's credit rating system remains very undeveloped. Prospective purchasers often lack the collateral needed to secure a large loan, and, even under WTO provisions, lenders are not allowed to register to put a lien on the vehicle if payment is not received.

Several joint venture company leaders expressed guarded optimism that their companies would do well under the new WTO rules.<sup>26</sup> Officials from General Motors, for example, maintained that their new plant in Shanghai, built at a cost of \$1.55 billion, would produce high-quality vehicles that would be competitive against any kind of import. The company would benefit, moreover, from new rules on distribution, ones that would allow it greater flexibility to sell its domestically-made Buick Regal sedans throughout the nation.

Company representatives maintained the car would be very competitively priced. For example, with a price of \$25,000 for a Buick vehicle made in the United States, added costs of transport (10 per cent), reduced custom duty (25 per cent after all the WTO cuts), value-added tax (17 per cent) and consumption tax (8 per cent) would bring the price to \$40,000, or about *renminbi* 330,000. The cost of a Buick sold in Shanghai, as of mid-2000, was approximately *renminbi* 369,000<sup>27</sup> (about \$45,000), so the company would only need to cut costs by some 11 per cent to be competitive once tariff rates fall to 25 per cent in 2006. GM officials noted in mid-2000 they had no plans to export vehicles comparable to the Buick to China as the import tariff rates fell. They were, however, considering sending some high-end luxury vehicles, such as Cadillacs, to the PRC in the coming years.

Officials at Volkswagen in Shanghai shared GM's optimism, and predicted that the government's industrial policy goal of 90 per cent

25. From summer 2000 interview in Beijing.

26. The author conducted interviews with the following companies in Beijing and Shanghai in the summer of 2000: Asimco, Beijing Jeep, Shanghai Volkswagen, Shanghai General Motors and Toyota. The following discussion, unless otherwise noted, is based on these interviews.

27. This figure does not include high vehicle registration fees, which varied by region. In Shanghai in mid-2000, the fee was about *renminbi* 80,000 (some \$9,700). From summer 2000 interview in Shanghai.

domestic market share (limiting imports to 10 per cent of consumption) would stay in place. SVW itself was modernizing its production line, and introduced its Passat model vehicle to its assembly lines in March 2000. For this vehicle, SVW officials maintained the technical standard was the same as that used in Europe, and processes such as laser welding had been introduced at the Shanghai facility. "With good quality, we will have no disadvantages against imports," according to one manager. In 2002, the company planned to produce their Polo model car in Shanghai.

Still, SVW officials admitted their prices had to come down over the next few years to be cost competitive. The current price of the Santana model car is *renminbi* 183,000 (about \$22,000) but VW's goal was to cut the price by 25 to 30 per cent over the next five to six years. In particular, supplier factories would have to cut their prices and raise their quality. To ensure these developments, VW offered training programmes to members of their 250-company Chinese supplier network.

Other car companies, such as Beijing Jeep Corporation (BJC), face a less certain future after WTO accession. As Table 2 indicates, production stagnated in the late 1990s as the company's products failed to meet market needs and quality problems dogged production and sales. Internal problems, such as inability to control social benefits and reduce excess employment rolls, hurt the company's profitability. BJC's domestic joint venture partner, Beijing Automotive Industrial Corporation, has been slow to push for reform, and the Chinese company's role as a parts supplier to the joint corporation further complicates modernization efforts.

In late September 2000, BJC's current American partner, DaimlerChrysler, announced it would invest an additional \$50 million into the venture, with the Chinese partner adding some \$68 million.<sup>28</sup> With the company's 20-year joint venture contract due to expire in 2003, there was a theoretical chance for the venture to reinvent itself to produce a different type of vehicle, or to perhaps modernize its facility to make a higher quality product with greater efficiency. Without major revision, this automotive project would probably face even greater challenges under the new WTO regime.

Two new Japanese entrants to China's domestic production field, Honda and Toyota, stood to change the face of the auto production landscape in the first decade of the new century. As noted above, Honda began producing its Accord model cars in Peugeot's former Guangzhou facility in 1998, and made some 12,000 vehicles in the first half of 2000. As with GM and VW efforts, the newer model car and more efficient production facilities gave Honda some instant market appeal. Furthermore, according to a Chinese automotive official, Japanese cars (like German ones) enjoyed a higher reputation for overall quality than did American vehicles.

Toyota announced plans to build cars in Tianjin (alongside its Japanese

28. Calum MacLeod, "DaimlerChrysler to jump-start Beijing Jeep," from China Online (Chinaonline.com), 27 September 2000.

partner firm, Daihatsu) in May 2000. Its goal was to make 30,000 cars in 2002, and later reach annual production of 120,000. The facility would make small cars, similar to their Echo and Yaris models.<sup>29</sup> Toyota's production plan places it alongside Volkswagen, Citroën, Suzuki and Honda as companies targeting China's compact market segment (Daihatsu may curb its production of Charades with the arrival of Toyota). This target of the vehicle sector is probably the one with greatest growth potential, so General Motors' Buick facility, even if price competitive with vehicles in its category, may face a static market for its larger, luxury-type cars.<sup>30</sup>

In 1998, Toyota exported some 25,000 vehicles (both cars and trucks) to China, making it one of the leading foreign companies selling to the PRC.<sup>31</sup> Following China's entry to the WTO Toyota was one of the few companies that faced a dilemma: should it push to increase domestic production, or try to use the new trade rules to increase exports? According to a Toyota official, in 2003, the company could expect to produce some 30,000 cars in China, and perhaps also export 30,000 vehicles. The official could not predict how a future mix would be constituted, though, noting that this would depend on market conditions as the Chinese economy grew. However, Toyota did plan to set up a consumer finance plan for potential purchasers to stimulate demand.

In short, Toyota seemed to be hedging its bets: if it could make cars at a competitive price in Japan, and WTO rules actually lowered import barriers, it would continue to seek a market for exports. It was also willing, however, to test domestic production facilities and see how well it could compete with cars made within China's borders.

As a late entrant to domestic production, Toyota stood to benefit from other WTO concessions. Though it was not clear at the time of writing how local content rules for parts suppliers would change under the new agreement, companies would presumably no longer face pressure to use Chinese parts for their vehicles. In essence, the companies could source parts from their home factories, or even from facilities in South-East Asia or Latin America.

All of the vehicle ventures interviewed in summer 2000, however, maintained they would continue to build parts from supply networks in China. Toyota noted that the advantage of low cost was a main factor, but that the company would have to pay careful attention to quality. Even

29. *International Herald Tribune*, 31 May 2000.

30. For the very low end of the market, vehicles in the \$3,000 price range and below, so-called "agricultural vehicles" seemed to be taking a major market share. These truck-like vehicles had engines too small to be classified as trucks, but many were of a size similar to small pick-up vehicles. For some citizens, they could even substitute for small cars, and there were some 3 million vehicles produced in 1999. (From summer 2000 interview with Asimco in Beijing.) They had high rates of pollution and low quality of performance, however, and the Chinese government in mid-2000 considered measures to curb their production. They were generally not allowed to run on the street of major Chinese urban areas. A more comprehensive discussion of this market sector goes beyond the scope of this essay.

31. This and following information are derived from a June 2000 transcript of an e-mail interview between a Toyota official and Professor Lee Branstetter, University of California at Davis, Economics Department.

after WTO entry, according to one company official, foreign parts would still carry an import duty of 10 per cent in 2006, though this was significantly below the highest rate of 50 per cent in 2000 and a new top rate of 40 per cent announced in January 2001.<sup>32</sup> Shipping costs and other duties would add to the price. Shanghai GM officials noted that they had no plans to “de-localize” (to cut the percentage of Chinese parts used for their vehicles).

For the parts industry, then, WTO entry probably will have little impact, though foreign parts manufacturing companies might find a friendly environment for creating new facilities in China if domestic production increased. As assembler ventures could be more selective on which parts manufacturers to use, parts quality could be a key factor in keeping the industry viable. Assembler ventures would presumably be free to import parts (though at a greater cost) if domestic quality did not measure up to required standards.<sup>33</sup>

Of course, all the proceeding discussion assumes the Chinese will move without hesitation towards a more liberal trade regime. However, there is evidence that various trade barriers outside WTO rules could remain. A Chinese auto official interviewed in summer 2000, for example, was quick to point out that countries such as Japan and South Korea, both WTO members, were quite skilled at protecting their vehicle markets. In those countries laws on environmental protection, safety and other areas effectively prevented large numbers of vehicles from clearing customs offices. The official also noted that South Korea in particular used nationalistic sentiment to encourage its citizens to “buy Korean.” Though she did not make the assertion explicit, the implication was that the Chinese government could use non-tariff barriers to prevent a surge of foreign-made cars and trucks across the country’s borders.<sup>34</sup>

In fact, it was not only the Chinese side that expressed the possibility of continued trade barriers after WTO entry. Officials at General Motors, Volkswagen and Beijing Jeep all acknowledged that various forms of protectionism would probably develop in the wake of WTO entry. Though their companies stood to profit from this kind of protection, all argued that they fully supported the move towards trade liberalization, and, as outlined above, saw their continued viability after the trade rules were in place.

Still, several cases indicate that regional protectionism in particular may remain a problem into the foreseeable future. The various ways the city of Shanghai tried, and largely succeeded, to have its citizens purchase mainly SVW (and now General Motors) products has already been noted. A glance at the city streets, choked with almost nothing but SVW Santanas and occasional Buicks, indicates the strong municipal will to encourage local purchasing. Another example comes from Hubei, where

32. *South China Morning Post*, 4 January 2001, Business section of web site <http://china.scmp.com/business/ZZZRVLMUPGC.html>.

33. One Chinese auto official noted that complex parts, such as electrical control systems, might be more appropriately imported than made in China.

34. These ideas were also reflected in parts of the earlier cited essay by Hu Yazhuang.

the city of Wuhan, in late 1999, gave special tax relief to purchasers of the provincially-made Citroën-Fukang cars. Moreover, those who bought non-Fukang cars, in some parts of the city, had to pay a special fee of up to *renminbi* 70,000 (about \$8,400).<sup>35</sup>

### *The Auto Industry Under the WTO Regime*

Under the new WTO rules, what can be expected on the automobile industry's landscape? At one extreme, there may be severely negative effects on the domestic industry, with both state-owned enterprise manufacturers and joint venture companies swamped by imports, and a series of bankruptcies among the weakest players. In a more optimistic outcome for the PRC, domestic manufacturers would rise to the challenge of WTO membership, and producers would make world-class vehicles competitive in most ways with imported cars and trucks. A middle ground course would see the industry muddling along with characteristics similar to the status quo.

The first outcome is possible if foreign companies with relatively little production presence in China, such as Daimler Chrysler, Ford Motors, Nissan, Hyundai and others become very aggressive about exporting passenger cars and other vehicles to the PRC. The attractiveness of world-standard cars selling at competitive prices could prove to be overwhelmingly attractive to Chinese citizens accustomed to the often-dated technology offered by the joint venture and domestic vehicle manufacturers. Even major producers such as Toyota (with its plan to produce cars in Tianjin) and Honda (with a relatively small plant in Guangzhou) may forego major domestic production to ship cars from Japan.

In fact, early signs from consumer reaction to the WTO announcement in late November 1999, indicated the eagerness for foreign cars. Domestic vehicle sales temporarily fell, as some potential customers were apparently delaying a purchase in anticipation of buying an imported car in the years ahead. Tables 1 and 3 indicate that, given a strong economy, low import tariffs and the favourable circumstances that existed in the early 1990s, imports would find a warm welcome in the Chinese market. With imports crowding out the domestic products, economies of scale could be lost, and China's own vehicle industry could see many or most of the major producers disappear.

A more optimistic outcome, however, could develop if companies such as GM continue to assure high product quality and update their vehicles to world standards. In December 1999, GM announced it was adding a minivan to its product mix. Should companies like Honda, Toyota, Volkswagen and some of the other major producers expand plans for their low-wage domestic vehicle production, the foreign challenge could fail to materialize. Gradually, China could absorb more advanced technology, and emerge as a legitimate world-class producer, as South Korea

35. *China Daily*. 13 December 1999.

did in the 1970s with its Hyundai and Kia brand vehicles, though a large domestic Chinese market, fierce international competition and some lingering quality concerns would probably preclude Korean-style large-scale exports. Tariff rates allowed even under WTO rules would provide some continued price protection, and a sense of nationalism might also persuade Chinese consumers to support the domestic producers.

However, little real change could come if the WTO rules fail to have an active impact. For example, even if import tariffs fall, China, as noted above, might try to use national and local non-tariff barriers to continue subtle protection of the domestic industry. Domestic distribution of vehicles is particularly susceptible to manipulation by local and national officials. And disguised subsidies to other, smaller domestic producers could keep workers from facing the unemployment lines in several coastal and inland provinces. Both established domestic firms, as well as old and new joint venture producers, would probably have some sympathy for this course of action.

It is difficult to forecast which path is most likely. Based on the PRC's general caution in opening key market segments, however, one might expect a course similar to the last two developmental patterns, with domestic industry continuing to survive under various protective measures and some kind of improved quality levels, as the one China will follow. After some 20 years of fostering domestic vehicle production, the central government would be loath to see it crumble in the face of foreign import competition. Local governments would share this protectionist sentiment. And the loss of billions of dollars in auto sales and 2 million or more jobs in key parts of the country's heavy industrial manufacturing sector would be hard for even the most liberal of Chinese leaders to tolerate.

At the time of writing, the country has still not been definitively accepted into the world trade body. Assuming China does join sometime in the year 2001, the auto industry faces important challenges. Domestic manufacturers must improve their product to face a higher degree of foreign competition. Foreign producers, if they can quickly learn to navigate new rules for China's auto market, may find a fertile market for sales. And the Chinese government will have to balance a new openness with sentiment to protect the auto industry's revenue production and employment value. The future course of the auto sector will depend on an interplay of forces among these major actors.