

Chapter One

Building National Champions

Insofar as the international division of labor is a hierarchy, worrying about development means worrying about your place in the hierarchy.

—Peter B. Evans, *Embedded Autonomy:
States and Industrial Transformation*

China's passenger car industry has received very little share of the benefit in the international division of labor in processing and manufacturing.

—Chen Xiaohong, ed., *中国企业国际化战略*
[China enterprise internationalization strategy]*
(Beijing: Renmin Chubanshe, 146.
Development Research Council,
State Council of the PRC, 2006)

*All translations appearing in this book are by the author except where indicated otherwise.

Perhaps the first Chinese automaker that many business-minded people in the developed world ever heard of was Chery. The company's name surfaced in Western publications in early 2005 when Malcolm Bricklin, the auto entrepreneur known for having imported the Yugo to America in the 1980s, announced that cars made by Chery would be the first Chinese-made automobiles sold in the United States beginning in 2007. But the agreement between Bricklin and the Anhui Province-based Chery Automobile collapsed in 2006, and as of this writing, Chinese automakers have yet successfully to export a passenger car to the United States.¹

The story of how Chery came to exist is not well known outside of China, yet it is an interesting tale illustrating the evolution of business-government relations in China during the reform era. The story is interesting because it contains many of the elements that describe not only how China's auto industry has developed, but how China's central and local governments have both cooperated and competed to develop the national champions of China's most important industries.

The typical large industrial Chinese company is, like Chery, a local state-owned enterprise (or LSOE, as distinguished from a *central* state-owned enterprise or CSOE). It is wholly or majority-owned by a local government which appoints senior management and provides free or low-cost land and utilities, tax breaks, and, where possible, guarantees that locally made products will be favored by local government, consumers, and other businesses. In return, the enterprise provides the local state with a source of jobs for local workers, tax revenue, and dividends. Very often, the LSOE is also a source of local prestige and, depending on the product the LSOE makes, a source of free or inexpensive goods for local officials and bureaucrats.

But as this brief story about Chery will illustrate, the local government is but one player among several that have shaped and influenced the growth and development of China's industrial giants. While China's economy has become increasingly subject to market forces over the past three decades, these forces have been, and continue to be, directed by the wishes of the state. Throughout the reform era, China's five-year plans, developed by the central government with input from various central ministries, industries, and local governments, have become increasingly sophisticated in terms of their demands on

China's most important industries. And despite the increasingly influential role of local governments over the past three decades, the central government still manages to get most of what it wants. At the same time, the central government has demonstrated a pragmatic flexibility in that it is willing to bend its own rules when it sees fit.

Chery: A State-Owned Startup

The idea for starting Chery was first promoted in 1992 by Zhan Xialai, an assistant to the mayor of Wuhu City in Anhui Province.² Zhan was among those state officials known as a *hongding shangren* (红顶商人, literally, a “red-hat businessman”), a term originating from the Qing dynasty and originally used to describe state officials who also engage in commerce. Contrary to commonly held beliefs, not only among some in the Western media, but also among many Chinese citizens, Chery is not, nor has it ever been, a private company. From its founding, Chery's controlling shareholder has been the city of Wuhu, and its second largest shareholder is the Anhui Provincial Government.³ When asked why this point on Chery's ownership is so confusing to so many, the typically knowledgeable Chinese auto industry insider answers that “Chery is entrepreneurial. It acts like a private company.”⁴

Zhan Xialai, who ultimately became the Communist Party secretary of Wuhu, was also Chery's first chairman, but he was ultimately forced to choose between running the company and running the city.⁵ He chose to keep his Party title where, presumably, he could have an even greater influence over, not only the business, but the local environment in which it operates. Many of those interviewed for this project believe it was Zhan's role in the founding of Chery that has influenced the entrepreneurial behavior of the company. Granted, all local governments wish to see their local companies succeed, but in the case of Chery, in which the local Party Secretary is also the company's founder, there exists a personal connection between the business and the local state. In the opinion of one interviewee, “Zhan still thinks of Chery as his company.”

The involvement of the local government, however, did not mean that Chery's founding went smoothly. At the time Chery was founded in the mid-1990s, the central government, concerned with an

increasingly fragmented auto industry, had called for a moratorium on the establishment of new passenger car manufacturers. This meant that Chery had to get its start—with the help of local government—under the radar.

Zhan recruited Chery's first chief engineer, Yin Tongyao, away from Volkswagen's joint venture with a major state-owned enterprise (SOE), First Auto Works (FAW). Yin is now Chery's chairman. The venture started out with a very low profile, making only engines on a used assembly line purchased from Ford in the United Kingdom. Eventually Chery's engineers "designed" a complete car based on the Volkswagen Jetta from plans Yin Tongyao had obtained from a Spanish subsidiary of VW.⁶ With the help of a Taiwan-based molding company, Chery's first car came off the line in 1999, but these cars could only be sold and driven locally as Chery had still not obtained permission from Beijing to manufacture cars.⁷ Without this permission (which required being listed in an official government catalogue), Chery cars could not be issued license plates. Chery's cars could be given a pass by local authorities in Anhui, but without official plates, they could not be legally sold in other provinces.

Eventually, the central government became aware of what was going on in Wuhu and issued an order for Chery to stop manufacturing cars. But rather than punishing Chery's leaders and dismantling the factory, the State Economic and Trade Commission (SETC) advised Chery to negotiate with one of China's largest automakers, Shanghai Automotive Industry Corporation (SAIC). This connection between Chery and a reluctant SAIC was facilitated by Wu Bangguo, who was at the time a vice premier.⁸ Wu, who is originally from Chery's home province of Anhui, had also previously served as Party secretary in Shanghai. His connections with both Anhui and Shanghai placed him in a position to bring Chery and SAIC together.

The two companies negotiated a 20 percent ownership stake in Chery by SAIC, which would eventually allow Chery to manufacture vehicles under the "Shanghai-Chery" brand name. Chery was able to resume assembly of autos, which, due to Chery's new affiliation with SAIC, were legitimately listed in the official catalogue. During its time as part of SAIC, Chery was never under the direct management of SAIC and never paid dividends to SAIC.⁹ It only received the "investment" of

SAIC, which, according to a veteran Chinese auto industry journalist, amounted to Chery simply *giving* SAIC shares in itself valued at 300 million yuan.

Within a few years, Chery's arrangement with SAIC began to unravel after Chery was accused by General Motors (GM), a joint venture partner of SAIC, of having copied its Chevrolet Spark. The Spark had been based on the Matiz made by GM's South Korean partner Daewoo. It was due to be sold in China toward the end of 2003, but Chery beat GM to the punch, releasing its QQ earlier in the year. How closely had the QQ been based on the Chevrolet Spark? GM's general counsel in Shanghai revealed to author and journalist Peter Hessler photos demonstrating that the doors of the Chevy Spark and the Chery QQ were completely interchangeable.¹⁰ According to China auto consultant Michael Dunne, when GM asked its partner SAIC for advice in addressing Chery's apparent violation of GM's intellectual property, GM had not even been aware that SAIC was a 20 percent owner of Chery.¹¹ GM attempted three times to sue Chery for its apparent violation, twice in China and once in Korea (from whence the plans for the Spark had originated), but in no case was it demonstrated that Chery had *illegally* obtained the plans for its QQ.¹²

Surprisingly (or probably not surprisingly to veteran China watchers), the episode ended up working in Chery's favor anyway. Though Chery's violation of intellectual property rights was never proved in court, there existed the suspicion that Chery had used its relationship with SAIC to access illegally the blueprints of SAIC's partner, GM. Following this episode, SAIC washed its hands of Chery, leaving it as an independent, stand-alone company. By this time, Chery, having become one of China's largest exporters of automobiles, had no difficulties getting its vehicles properly listed in the central government's catalogue. SAIC had (albeit reluctantly) helped Chery to become a legal automaker in China, giving it the time it needed to demonstrate its importance to the central government.

Not only was Chery attracting notice because of its exports, but the company had also begun to catch the eye of the central government for another important reason. Because Chery did not have a foreign partner, the company had demonstrated its commitment (intellectual property issues notwithstanding) to developing its own, domestically branded cars.¹³

After China's entry into the World Trade Organization (WTO) at the end of 2001, the development of domestic Chinese brands (or 自主品牌, *zizhu pinpai*) had become a top priority of the central government for the auto industry. China's independent automakers, with Chery at the forefront, were leagues ahead of China's lumbering SOEs in carrying out this directive.

By the end of the 2000s, China's central government, having in the 1990s and early 2000s been practically antagonistic toward the independent automakers, had changed its tune—somewhat. These companies, particularly Chery, Geely, BYD, and Great Wall (the latter three of which are nominally private), began to receive encouragement from the central government, not only in the form of state leader visits, but also through access to state-owned bank funding.¹⁴ Without a foreign partner whose brands it could sell, Chery has no choice but to rely on development of its own brands—something the central government has been demanding of its automakers for years. But research and development (R&D) does not come cheaply: the development of a new car model can cost upward of a billion dollars.¹⁵ And herein lies the attractiveness of partnering with a foreign automaker: the foreign partner does all of the R&D heavy lifting.

What Chery Reveals About Chinese Industry

The story of Chery presents the recent development of Chinese industry in microcosm. Through this case we can see the important role that local governments play in the startup phase of industry—particularly when an enterprise must be formed out of the view of the central government. However, we can also see a central government that, despite its desire to see an auto industry shaped in a certain way, was nevertheless flexible enough to find a way to allow a job-creating, tax-generating enterprise to continue to operate within the rules. Furthermore, we see a central government that was able to learn and adapt, a central government that began to see the value that a smaller, independent automaker brought to the industry.

In Chery, we see a company that, like many Chinese businesses, got its start by “borrowing” foreign designs, but that has thus far had

difficulty moving beyond this stage into one of real innovation. This raises the important question of whether China's industrial giants will be able to move beyond cost competition to compete head-on with the foreign multinationals (MNCs) in advanced technology. And Chery's difficulties in coming to an agreement with Malcolm Bricklin and subsequent lawsuit with GM are also illustrative of a Chinese auto industry (and a central government) with an ambivalent attitude toward foreigners. On the one hand, we see an industry still heavily reliant on foreign know-how, yet on the other hand, Chinese sources continue to lament what they see as a foreign "monopoly" over China's auto industry.¹⁶

What this case, and this book as a whole, do not illustrate are the infallibility or invincibility of the Chinese government. Indeed, mistakes have been made, and most certainly will continue to be made. What this book does illustrate is a government that is still largely "crossing the river while groping for stepping stones"* as it tries to balance the competing priorities of economic growth, social stability, and the continued rule of the Communist Party. What it also illustrates is that China's central government has a firm intention of dominating, not only its domestic markets, but as many of the world's markets as it possibly can. The words and actions of China's central government demonstrate its commitment to this goal, and this study of China's automobile industry demonstrates just how determined China's central government is to win.

While I offer no prognostication of China's ultimate success in dominating the global auto industry, I do offer the reader a clear picture of how China has become the world's largest auto market, and how it will very likely continue to pursue the growth of, and eventual dominance by, Chinese businesses throughout the world. But China's dominance is still not a given; whether China ultimately wins also depends very much upon the innovative visions and strategic behavior of the world's other automakers. Even if China's automakers were never to develop the design capabilities of the foreign multinationals, the multinationals would in any case find staying ahead of China to be

*The phrase "crossing the river while groping for stepping stones" (摸着石头过河) was used to describe the experimental nature of Deng Xiaoping's reforms. See Richard Baum, *Burying Mao: Chinese Politics in the Age of Deng Xiaoping*, (Princeton, NJ: Princeton University Press, 1994), 17.

increasingly difficult: the Chinese are good at copying, and they're getting better.

This story is, however, much larger than that of a single industry. It is a story about politics, a story about nationalism, and a story that seeks to answer some very important questions about business–government relations—questions that many economists thought they had already addressed, but that the Great Recession of the late 2000s has once again brought to the forefront.

Why China?

Writing over a year after China surpassed Japan to become the world's second-largest economy, behind the United States, it may seem almost absurd to ask, "Why China?" This is a country that, since its opening in 1978, has turned in double-digit economic growth for over three decades while allowing only selective expansion of the personal freedoms of its citizens. China has opened up opportunities for its private sector to grow and develop while maintaining state control over the country's largest and most important industries. The opportunities made available to Chinese citizens have led to an unprecedented generation of wealth, yet, while the industrial economy has grown, the country as a whole is still relatively poor in terms of its gross domestic product (GDP) per capita. And while there have been opportunities for some, there have not been opportunities for all. As some Chinese grow wealthier, the gap between rich and poor has grown wider.

Throughout the latter half of the twentieth century, many economists and political scientists studied the phenomenon of late development, asking why some late developers have chosen their respective paths of development, why some have succeeded, and why some have failed.¹⁷ As an even *later* developer, China poses another set of questions, not only about the paths it has chosen, but about what it may have learned from other late developers that came before it. And while China seems to exhibit traits similar to other late-developing countries, notably, China's East Asian neighbors Japan, Korea, and Taiwan, the sheer magnitude of what China has accomplished, and is trying to accomplish, seems to place the country in a category all by itself in many respects.

Some scholars have even proposed a term to describe the uniqueness of China's approach to development. *Beijing Consensus* describes a prescription for economic development that includes heavy state involvement in economic development through both allocation of resources and commitment to innovation and experimentation. It also includes authoritarian government and limited personal freedoms for citizens.¹⁸ It is contrasted with the *Washington Consensus*, a set of solutions many Western economists have recommended to late developers, which includes fiscal discipline, interest rate liberalization, privatization, deregulation, and free trade—accompanied by a democratic form of government.¹⁹

There are, of course, problems with both consensuses, and not all China watchers agree on how China has been able to achieve its success. According to Yasheng Huang, China's best performance, in terms of raising the living standards of average Chinese, came during times of its more liberal, less state-centric period in the 1980s, not in the 1990s and 2000s as is commonly assumed.²⁰ Furthermore, John Williamson, credited with coining the term *Washington Consensus*, points out that *Beijing Consensus* is not even used by the Chinese to describe their own system.²¹ And the *Washington Consensus*, as it turns out, was not actually followed in Washington as the United States developed prior to World War II. The U.S. development model looked, in some respects, similar to that of today's China: heavy trade protectionism, fixed exchange rates, and government-controlled interest rates.²² Nevertheless, the so-called *Beijing Consensus*—or however one might label China's model of state-led capitalism—may have a certain appeal for the leaders of other developing countries who have grown weary of Western lecturing about democracy, human rights and minimal state intervention in the economy in exchange for economic assistance. Aside from recognition of China's interests with respect to its territorial integrity, China's assistance tends to come with fewer strings attached.

Regardless of whether the term *Beijing Consensus* is taken seriously by economists or political scientists, it seems to touch upon a feeling common among Westerners that China's approach of capitalism *without* democracy may somehow give that country an advantage.²³ It raises the question of whether America's formula of capitalism *plus* democracy,

long thought to be the *sine qua non* of progress, is as durable—or as effective—as once believed.

Ian Bremmer, president of the Eurasia Group, uses a broader term, *state capitalism*, to describe the political economy of China and other countries with similar systems.²⁴ State capitalism describes a “strategic long-term policy choice” that embraces markets as a tool of ruling elites to serve a country’s national interest.²⁵ The rulers of a country that follows a form of state capitalism are typically motivated by a “fear of chaos” and, therefore, approach governance as an exercise in risk management. This engenders a type of micro-management in which the state attempts to use all of the tools at its disposal to minimize the inherent risks to power that arise from openness to market forces. Among the tools state capitalist countries use are state-owned corporations, sovereign wealth funds that invest abroad, “resource nationalism” (attempts to control stockpiles of, and access to, commodities and national resources), and development of state-backed “national champion” enterprises that can compete globally and that are not limited by concerns for democracy or human rights.

Bremmer quotes Chinese Premier Wen Jiabao, who gave a definition of China’s brand of state capitalism in an interview on CNN television in 2008:

The complete formulation of our economic policy is to give full play to the basic role of market forces in allocating resources under the macroeconomic guidance and regulation of the government. We have one important piece of experience of the past thirty years, that is to ensure that both the visible hand and invisible hand are given full play in regulating the market forces.²⁶

What Wen Jiabao’s definition fails to capture, however, is the fact that, through its five-year economic plans, China’s government, not the markets, decides which industries will grow, which will receive resources, and which will be promoted. The market does have a role in state capitalism, but its role is limited primarily to acting on resources that have been allocated largely according to the state’s wishes.

Bremmer makes the case that the financial crisis of the late 2000s cemented in the minds of many of China’s leaders the determination to

maintain a firm state hand in management of the economy. While they understand the vital role China's private sector has played in growth, they have made a conscious decision to concentrate resources in state hands so as to protect China from the "natural excesses of free-market capitalism" that they believe to have caused the Great Recession among the developed economies.²⁷

A Challenge to the West

In the West—particularly among countries following the more traditionally *laissez-faire* Anglo-American model—it is accepted, almost as a matter of faith, that government involvement in business is not a good thing. Americans need look no further than Amtrak and the U.S. Postal Service as examples of perpetually money-losing, state-owned enterprises that constantly return to Congress with their hands out for subsidies. When GM faced bankruptcy and possible liquidation in early 2009, many Americans were astounded that part of the solution included the U.S. government taking an initial 61 percent ownership stake in the ailing automaker. A Gallup poll indicated that 55 percent of Americans disapproved of the government takeover.²⁸ Many Americans believed GM had failed for years to produce cars comparable in quality to those produced by their Japanese and German counterparts. If GM were unable to stand on its own, it should have been allowed to die. This is, in the minds of many Americans, how capitalism is supposed to work: those who cannot compete exit the market.

Regardless of how a majority of Americans may have arrived at their conclusions that state involvement in business is a bad thing, there also exists a body of economic literature that supports this position, both theoretically and empirically.²⁹ Over the two decades prior to the Great Recession that began to surface in 2008, a consensus had developed among economists that private ownership of firms is, in general, superior to that of public ownership. In theory, the managers of state-owned enterprises (SOEs) are not subject to many of the disciplinary measures that lead to the superior efficiency, productivity, and profitability achieved by private enterprises. Hard budget constraints (i.e., the threat of bankruptcy), oversight by creditors, greater exposure to competition,

the threat of hostile takeover, and pressures from owners whose interests are not conflicted by political and social objectives are but a few of the disciplinary measures to which private sector managers are subject. On these and other points, economic theory is supported by dozens of empirical studies and (until recently) challenged by very few (non-Marxist) dissenting voices.

As long as governments around the world continued during the 1990s to move toward privatization of their economies, and as long as those governments that did not privatize were punished with poor economic outcomes, then countries that adhered to these beliefs of minimal government involvement were comfortable in their chosen paths. But there were two major changes in the latter 2000s that challenged this logic and set Western minds to worrying. The first change was a gradual trend throughout the course of the 2000s toward increased state involvement in China's economy—or, to be more precise, an apparent *reversal* of China's late-1990s trend toward *increased* private sector involvement. The second change was the onset of the Great Recession during 2008, which called into question the viability of the Western economic model.

The first change was highlighted by increased usage of the term *guo jin min tui* (国进民退; “the state advances, the private sector retreats”) during the late 2000s. This was a clever reversal of a term with the exact opposite meaning, *guo tui min jin* (国退民进; “the state retreats, the private sector advances”), that emerged in the early 2000s to describe the trend of increased private sector involvement in the economy begun during the Premiership of Zhu Rongji. The reversal of private sector advancement began with the rollback of reforms in China's financial sector in 2005 chronicled by Walter and Howie in *Red Capitalism* (2011).³⁰ It became apparent in China's industrial sector during 2008 and into 2009 as Chinese newspapers began reporting on an increased pace of nationalization and favoritism toward SOEs. One of the most commonly reported stories was of the forced nationalization of dozens of privately owned coal mines in Shanxi Province.³¹ There was also a vigorous debate about this phenomenon in the Chinese press among academics, economists, and government officials.³² Many observers credited the strengthening of the state-owned sector at the private sector's expense with largesse heaped upon SOEs in the form of loans

from local government financing vehicles as a result of the central government's stimulus program in late 2008.³³

The second change was that the developed world, the United States in particular, fell into a major economic recession largely of its own making. Though the recession had temporary repercussions for emerging markets as well, by the middle of 2009, it was clear that the extent of the damage had been limited primarily to the developed markets. Developing countries such as China took steps to stimulate their economies, but otherwise continued their trends of world-beating economic growth. As a result, economic observers the world over began to question the viability of the Western model—particularly the notion that governments should generally remain aloof from business, allowing the market and the private sector to make all of the decisions. Former U.S. trade representative Charlene Barshefsky put the change in thinking into perspective: “Our competition has gotten tougher during a period for the United States of profound economic weakness that magnifies any perceived threat . . . There is a significant and profound—almost theological—question about the rules as they exist.”³⁴

Among the questions observers are asking are, what if a government not only refuses to relinquish control over important sectors of its economy, but also manages to achieve impressive economic outcomes? And what if those outcomes are superior to those achieved by any developed country in nearly half a century? Would that country's processes, institutions, and outcomes not be worthy of further scrutiny? More specifically, what are the trade-offs that China has accepted in order to maintain heavy state involvement in the country's most important businesses, and are any of these trade-offs possible, or even desirable, in free and democratic societies?

Why Autos?

In an attempt to answer some of these questions, I have chosen to conduct an in-depth analysis of China's automobile industry. The reason for this choice is that the automobile sector serves as a nice microcosm of China's industrial economy as a whole. Within this single industry, state-owned enterprises, private enterprises and Chinese-foreign joint

ventures (JVs) compete for market share. The top three automakers, which together command nearly a 50 percent domestic market share, are all state-owned enterprises (SOEs) whose production comes primarily from joint ventures with foreign manufacturers. Among the top 12 automakers in China, three are privately held. The recent median five-year compound annual growth rate (CAGR) in unit sales among China's top 12 manufacturers was 30 percent.³⁵ The three private firms, BYD, Geely, and Great Wall, had five-year CAGRs of 116, 24, and 44 percent, respectively.³⁶ The point here is that, while China's auto industry is dominated by state-owned enterprises, there is room for private players to compete and grow—an empirical phenomenon that already calls into question economic theories that state-owned investment in an industry drives out private investment.³⁷

It is not difficult for the impartial observer to view the recent success of China's auto industry with a measure of admiration. Within the space of 30 years, China has gone from having practically no passenger car production to building more cars than any other country in the world. But how does China's early growth stack up against that of other major players? Figure 1.1 charts the growth of auto production in four

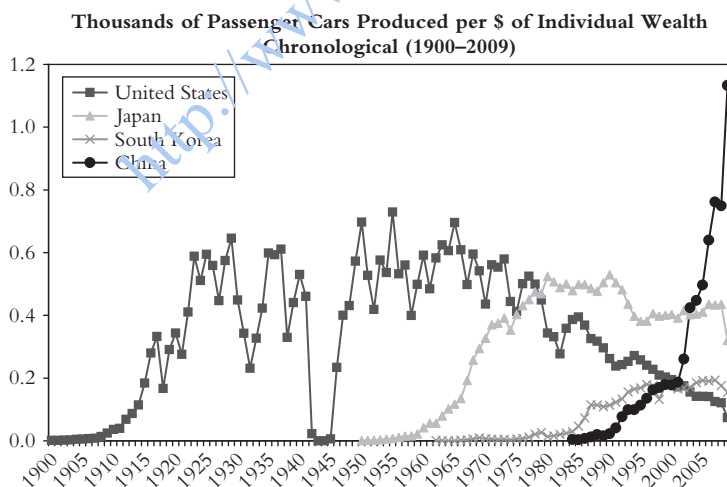


Figure 1.1 Relative Importance of Auto Industry in Selected Markets

Data Sources: Angus Maddison, *China Automotive Industry Yearbooks*, Japan Automobile Manufacturers Association, International Organization of Motor Vehicle Manufacturers.

countries from 1900 until 2009. The statistic measured, thousands of passenger cars produced per dollar of individual wealth, is simply the number of passenger cars produced in each given year in thousands (both for domestic consumption and export) divided by GDP per capita.³⁸ Using a common denominator, this measure describes how important each country's respective auto industry is as a part of its national economy.

The countries selected are the United States, Japan, South Korea, and China. As Figure 1.1 demonstrates, U.S. production, with the notable exceptions of some key interruptions such as the two world wars and the Great Depression, has experienced a clear rise and fall as the global leader, reaching its peak as Japan began production in the 1950s. Japan then also experienced a steep rise, which began to level off in the 1980s, around the time the United States forced it to accept "voluntary" export restraints of its cars. (The Japanese countered this resistance by building factories in the United States, but cars produced in these "transplant" factories show up in the U.S. figures.) Japan's auto production then began to stagnate as its real estate and investment bubbles burst in the early 1990s. Like Japan, Korea also experienced a fairly steep initial rise which also leveled off quickly as its smaller land mass and population quickly reached saturation with automobiles.

Though China began to produce passenger cars as early as 1958, for the purposes of comparison, I am using 1984 as the beginning date for the rise of China's auto industry. Until the late 1970s, China produced fewer than 3,000 passenger cars in any given year. Nineteen eighty-four was the first year that China began its focus on passenger cars in earnest as this was the year that negotiations with American Motors Corporation (AMC) and Volkswagen for China's first auto joint ventures were completed. As Figure 1.1 illustrates, China experienced growth somewhat comparable to that of the other three countries in its early years, only to level off slightly toward the end of the 1990s. Then, once China joined the WTO in 2001, production skyrocketed. The slight dip between 2007 and 2008 is the drop in China's growth rate due to a tightening of the money supply in 2007 and the global financial crisis that emerged in 2008. Subsequent to that time, China once again experienced outsized growth (48 percent growth in passenger car production in 2009 and 32 percent in 2010) due to stimulus measures

enacted by the central government and a rebound in confidence as it became evident to Chinese consumers that their economy would be less affected by the global downturn than that of many other countries.

Each of the three countries that began production before China appears to have started strongly and then leveled off at some point. Though this point is not essential to this analysis, it seems plausible that the leveling-off point for each of these three represents a level of saturation of cars given each country's population and land mass. If that is the case, then the fact that China's line is still headed into the stratosphere should not come as a surprise: with a population approaching 1.4 billion and a burgeoning middle class, China's auto market still appears to hold potential.

A more important question that this picture raises is how well China has performed in its early years as compared to these other three markets. Is China's early growth rate any better or worse than that of the others? Figure 1.2 takes the first 30 years of each country from Figure 1.1 and starts them all in Year 1.

The first observation is that China's line is steeper than that of the others, which confirms that the growth of China's auto industry is

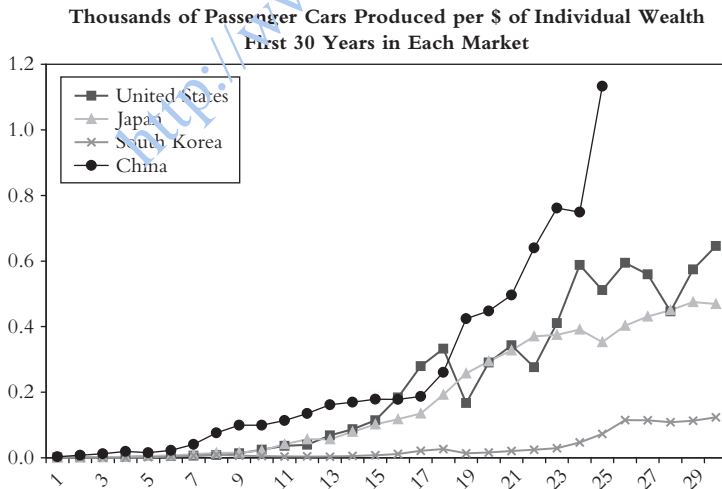


Figure 1.2 Relative Importance of Auto Industries—30-Year Comparison
Data Sources: *China Automotive Industry Yearbooks*.

indeed worthy of investigation. Second, this picture also highlights the fact that each successive entrant into the auto industry has experienced less volatility than the one before. Japan, Korea, and China have each benefited from a less volatile, U.S.-dominated world into which they could launch their auto industries.

While China also subjected imported autos to extremely high tariffs prior to 2006 (year 22 in Figure 1.2),³⁹ one major difference is that China invited foreign auto companies to build factories on its own soil, something Japan and Korea have never done.⁴⁰ Perhaps this is one of the primary reasons that China's curve turned initially steeper than those of the others. Another factor that may have also favored China is the "advantage of backwardness"—the fact that China was in a position, not only to copy what the United States and others had done, but to observe the successes and failures of two fellow latecomers, Japan and Korea.⁴¹ China's authoritarian government may have been in a position to provide the country with the coordination it needed to launch a competitive auto industry where none had existed before.

Figure 1.2 shows that China is selling a lot of cars relative to individual wealth—more than the United States, Japan, or Korea ever did—but selling a lot of cars is not a sustainable activity if it cannot be done profitably. If China's automakers are losing money in the process, then we may conclude that the industry is on an unsustainable footing. However, that does not appear to be the case. Figure 1.3 shows combined industry profitability from 1993 through 2008. This represents only the profit on sale of vehicles, and does not include ancillary businesses.⁴² With the exception of declines in 2004 and 2005, the trend is one of generally increasing profitability.⁴³

Conclusion, and a Roadmap

My primary task in this book is to explain the figures shown in Figure 1.2—to explain how China was able to build a competitive industry from scratch while transitioning from a planned economy to one that is more market oriented; to explain how a formerly communist country (though still Communist in name) can both maintain an authoritarian political system and at the same time build a potentially globally

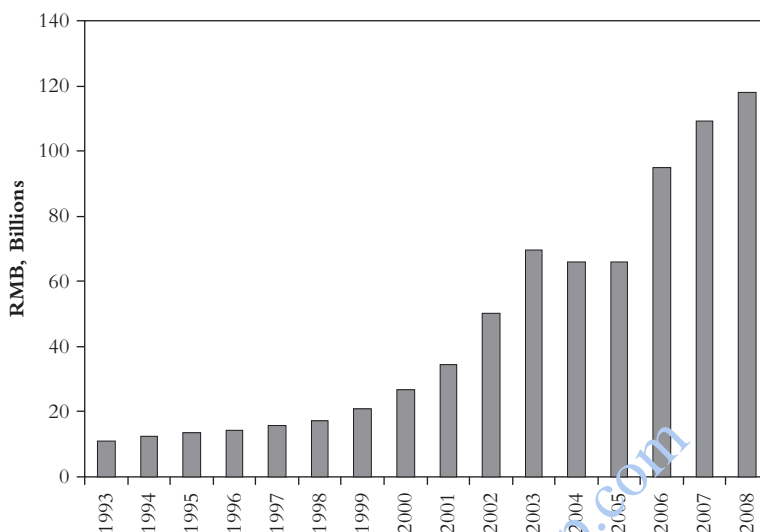


Figure 1.3 Auto Industry Profit, 1993 to 2008

Sources: Angus Maddison, *China Automotive Industry Yearbooks, 1994–2009*, Japan Automobile Manufacturers Association, International Organization of Motor Vehicle Manufacturers.

competitive industry—something that has, until now, proven elusive under authoritarian systems. This book aims to answer the questions: What is unique about China that has allowed it to succeed where many others have failed? Is China breaking the rules of capitalism or rewriting them? And finally, what are the weaknesses and limitations of China's model? Will the line on China's graph continue to shoot ever upward, or is China subject to the same laws of gravity as everyone else?

The arguments of this book are as follows:

- First, while China's state-led capitalism has achieved impressive results, China's one-party rule introduces contradictory objectives that have prevented the central government from achieving its economic objectives.
- Second, China's central government has nevertheless exhibited an ability to learn and adapt to achieve many of its desired outcomes.
- Third, while local governments have a certain amount of power to act outside the will of the center, the center will ultimately have its way.

- Fourth, China's insistence on state control over pillar industries is detrimental to innovation.
- This insistence on state control may not be as harmful to China's continued development prospects as we might think because, fifth, China has created an environment in which the unavoidable price of entry for foreign multinational firms is relinquishment of intellectual property. Innovation becomes less important when you can get your competitors voluntarily to hand over their technology.

This chapter began with the story of Chery, a story that illustrates many of the essential points describing the evolution of China's auto industry over the past several decades. Chapter Two contains the story that illustrates the main arguments of this book. Here we can see the major determinants of success and failure in China's industrial planning model. In this chapter I describe the auto industry's players and their objectives. From this description emerges a picture of how these elements result in an industry with clear strengths, but that is nevertheless beset by some key weaknesses.

Chapter Three contains the back-story, essentially, a moving picture that describes how China's auto industry developed over the past three decades. I cover three stages of auto development in the People's Republic of China (PRC)—state-centric (1949–1978), global partnering (1978–2001) and indigenous innovation (2001–present)—spending most of my time on the latter two. This chapter demonstrates how policy has developed and changed over time.

Chapters Four through Six contain the case studies that provide details to support the main arguments of this book. Chapter Four focuses on the backbone of China's auto industry, the Chinese-foreign joint ventures. This is the most unique aspect of China's auto industry, as no other country has relied so heavily on foreign partners to help build its domestic industry. To this day, the foreign brands continue to account for nearly 70 percent of all passenger cars (sedans) sold in China.⁴⁴ Chapter Five then looks at the case studies of the "independents," a group of Chinese automakers that lack foreign partners, and that must, by definition, rely on development of their own independent brands. The independents include one large local state-owned enterprise (Chery, a case study of which began this chapter), several prominent

private enterprises, an SOE whose chief executive at one time believed the enterprise to be his own private company and one audacious automaker wannabe that captured attention briefly in 2009.

Chapter Six includes in-depth reviews of three of the most prominent mergers to have taken place in China's auto industry within the past decade. These stories are important because they illustrate two seemingly conflicting aspects of the role of China's central government in the auto industry. Depending on how evidence is presented, the central government can be made to look either impotent or all-powerful. These case studies show how the central government, despite its decades-long desire to see consolidation in the auto industry, has patiently waited for the market to encourage some of these mergers. Yet at the same time, when the timing was right, the central government was able to apply leverage in order to correct strategic mistakes or ensure policy adherence. Toward the end of this chapter, I also analyze data on the fragmentation of China's auto industry relative to that of the United States and highlight the interesting finding that China actually has *two* auto industries: one that the central government intends to be competitive, and another that serves as a sort of welfare system in local regions.

Chapter Seven then takes what we have learned about China's auto industry in Chapters Two through Six and compares this with the auto industries in Japan and Korea during their own start-up periods. For Japan, the time was roughly 1950 to 1980; for Korea it was roughly 1960 to 1990; and for China, we compare the reform era, from roughly 1980 until the present. The key aspects I compare are degree of state ownership versus private, the key institutions that each country appointed to manage development of its auto industry, each country's methods of technology acquisition, the degree of foreign involvement, the amount and types of industry support, and the structure of each auto industry. Many readers will not be surprised to learn that Japan and Korea experimented early with state ownership but quickly allowed the private sector to take over their auto industries. The state then "guided" the private sector during its early development. In China, most auto industry assets remain in state hands.

Chapter Eight, the conclusion, summarizes the evidence emerging from the policy analysis and case studies. This chapter then closes with a

look forward and asks, among other questions, about the future promise of China's private sector, the ability of China to spur innovation, and whether foreign multinationals will always be welcomed.

Notes

1. Bricklin's negotiations with Chery were the subject of a documentary film released in 2009. Jonathan Bricklin, *The Entrepreneur*, Documentary, 2009, www.hulu.com/watch/85122/the-entrepreneur.
2. Gordon Fairclough, "In China, Chery Automobile Drives an Industry Shift," *wsj.com*, December 4, 2007, <http://online.wsj.com/article/SB119671314593812115.html>.
3. This fact was confirmed to me in no uncertain terms by a member of Chery's senior management team.
4. Surprisingly, even a few supposed auto industry experts whom I interviewed seemed confused as to whether Chery's status was public or private.
5. "8,000 Chinese officials quit business posts," *People's Daily Online*, December 29, 2004, http://english.people.com.cn/200412/29/eng20041229_168987.html.
6. Michael J. Dunne, *American Wheels, Chinese Roads: The Story of General Motors in China* (Hoboken, NJ: John Wiley & Sons, 2011), Ch. 14; Peter Hessler, *Country Driving: A Journey through China from Farm to Factory*, 1st ed. (New York: Harper, 2010), 65.
7. Lu Feng, "中国汽车工业的自主开发道路行得通吗?" [Is the Chinese auto industry's path toward self-development achievable?], *Unirule*, 2007, www.unirule.org.cn/symposium/c258.htm.
8. As of this writing, Wu serves as chairman of the National People's Congress (NPC).
9. Lu Feng, "中国汽车工业的自主开发道路行得通吗?" [Is the Chinese auto industry's path toward self-development achievable?].
10. Peter Hessler, "Letter from China: Car Town," *The New Yorker*, September 26, 2005, www.newyorker.com/archive/2005/09/26/050926fa_fact_hessler. The three-dimensional spaces into which the doors of a car fit are, according to automotive experts, as unique as fingerprints.
11. Dunne, *American Wheels, Chinese Roads*, 134.
12. *Ibid.*, 135.
13. In addition to the failed negotiations with Malcolm Bricklin, Chery also negotiated separately with both Chrysler and Fiat in 2007, but failed to establish a venture with either company.
14. In 2008, Chery received 10 billion yuan in funding from China's (state-owned) Export-Import Bank, and in 2009 Chery received another 2 billion yuan from a private equity arm of the Bank of China. Then, in the spring of

- 2011, Chery was granted a 43 billion yuan (US\$6.6 billion) credit line by the China Development Bank to use for research and development (R&D) over the course of the 12th Five-Year Plan (2011–2015).
15. Dunne, *American Wheels, Chinese Roads*, 131.
 16. The following Chinese sources contain passages accusing foreign multi-nationals of “垄断” or monopoly over China’s auto industry. The first source is an influential former bureaucrat in the auto industry, the second is from China’s Ministry of Science and Technology, and the third is from the Development Research Council, a think tank attached to the State Council. Wu Facheng, *汽车强国之梦* [Dream of an automobile super-power], (Beijing: Xinhua Chubanshe, 2009), 151; Tang Jie, Yang Yanping, and Zhou Wenjie, *中国汽车产业自主创新战略* [China auto industry indigenous innovation strategy], (Beijing: Kexue Chubanshe, 2009), 84; Chen Xiaohong, *中国企业国际化战略* [China enterprise internationalization strategy], 149.
 17. The following are but a portion of the literature that deals with this topic: Alice H. Amsden, *Asia’s Next Giant: South Korea and Late industrialization* (New York: Oxford University Press, 1989); Kent E. Calder, *Strategic Capitalism: Private Business and Public Purpose in Japanese Industrial Finance* (Princeton, NJ: Princeton University Press, 1993); *The Political Economy of the New Asian Industrialism*, Cornell Studies in Political Economy (Ithaca, N.Y.: Cornell University Press, 1987); Richard F. Doner, “Limits of State Strength: Toward an Institutionalist View of Economic Development,” *World Politics* 44, no. 3 (April 1992): 398–431; Evans, *Embedded Autonomy*; Alexander Gerschenkron, *Economic Backwardness in Historical Perspective: A Book of Essays* (Cambridge: Belknap Press of Harvard University Press, 1966); Chalmers Johnson, *MITI and the Japanese Miracle: The Growth of Industrial Policy, 1925–1975* (Stanford Calif.: Stanford University Press, 1982); Dani Rodrik, *One Economics, Many Recipes: Globalization, Institutions, and Economic Growth* (Princeton, NJ: Princeton University Press, 2007); Robert Wade, *Governing the Market: Economic Theory and the Role of Government in East Asian Industrialization* (Princeton, NJ: Princeton University Press, 1990); Meredith Woo-Cumings, *The Developmental State*, Cornell Studies in Political Economy (Ithaca, NY: Cornell University Press, 1999).
 18. Joshua Cooper Ramo, *The Beijing Consensus: Notes on the New Physics of Chinese Power* (London: Foreign Policy Centre, 2004); Stefan A. Halper, *The Beijing Consensus: How China’s Authoritarian Model Will Dominate the Twenty-First Century* (New York: Basic Books, 2010).
 19. John Williamson, “Democracy and the ‘Washington Consensus,’” *World Development* 21, no. 8 (1993): 1329–1336. The “Washington Consensus” is so named, not necessarily because its prescriptions have been promoted by the U.S. government, but because the group of economists who devised this “consensus” just happened to have been meeting in Washington, D.C.

20. Yasheng Huang, "Rethinking the Beijing Consensus," *Asia Policy* 11 (January 2011): 1–26.
21. John Williamson, "Beijing Consensus versus Washington Consensus?," November 2, 2010, www.piie.com/publications/interviews/pp20101102/williamson.pdf.
22. Wade, *Governing the Market*, xv, no. 5.; Barry J. Eichengreen, *Exorbitant Privilege: The Rise and Fall of the Dollar and the Future of the International Monetary System* (New York: Oxford University Press, 2011).
23. Kellee S. Tsai finds that entrepreneurs in China, far from agitating for democracy, seem to be content to work within the existing system. See *Capitalism without Democracy: The Private Sector in Contemporary China* (Ithaca, NY: Cornell University Press, 2007).
24. Ian Bremmer, *The End of the Free Market: Who Wins the War between States and Corporations?* (New York: Portfolio, 2010). Among countries that have adopted a form of state capitalism, Bremmer also lists Saudi Arabia, the United Arab Emirates, Egypt, Algeria, Ukraine, Russia, India, Mexico, Brazil, and Venezuela, among others.
25. *Ibid.*, 51–52.
26. *Ibid.*, 129.
27. *Ibid.*, 144–145.
28. Gallup Poll results from: www.gallup.com/poll/120842/disapprove-majority-government-ownership.aspx.
29. William L Megginson, *The Financial Economics of Privatization* (New York: Oxford University Press, 2005); Armen Albert Alchian, *Economic Forces at Work* (Indianapolis: Liberty Press, 1977); Avinash Dixit, "Power of Incentives in Private versus Public Organizations," *The American Economic Review* 87, no. 2 (May 1997): 378–382; John Vickers and George Yarrow, "Economic Perspectives on Privatization," *The Journal of Economic Perspectives* 5, no. 2 (Spring 1991): 111–132; Eytan Sheshinski and Luis F. Lopez-Calva, "Privatization and Its Benefits: Theory and Evidence," *CESifo Economic Studies* 49, no. 3 (January 1, 2003): 429–459; Maxim Boycko, Andrei Shleifer, and Robert W. Vishny, "A Theory of Privatisation," *The Economic Journal* 106, no. 435 (March 1996): 309–319; Andrei Shleifer, "State versus Private Ownership," *The Journal of Economic Perspectives* 12, no. 4 (Autumn 1998): 133–150; János Kornai, *The Socialist System: The Political Economy of Communism* (Princeton, NJ: Princeton University Press, 1992).
30. Carl Walter and Fraser Howie, *Red capitalism: The fragile financial foundation of China's extraordinary rise* (Hoboken, NJ: Wiley, 2011), 14–21.
31. Yang Guang, "消失的利益链" [Disappearance of the chain of interests], *Economic Observer*, October 23, 2009, <http://eeo.com.cn/eeo/jjgcb/2009/10/26/153709.shtml>.
32. In a series of four posts on my blog, *ChinaBizGov*, in the spring of 2010, I analyzed this phenomenon along with several Chinese sources which are

- linked in the accompanying posts. <http://chinabizgov.blogspot.com/2010/03/is-china-really-re-nationalizing.html>.
33. “China’s state-owned enterprises: Nationalisation rides again,” *The Economist*, November 12, 2009, www.economist.com/node/14859337; “Guojin mintui,” *Caixin Online*, December 24, 2009, <http://english.caing.com/2009-12-24/100102800.html>.
 34. Jason Dean, Andrew Browne, and Shai Oster, “China’s ‘State Capitalism’ Sparks a Global Backlash,” *Wall Street Journal*, November 16, 2010, <http://online.wsj.com/article/SB10001424052748703514904575602731006315198.html>.
 35. Figures from *China Auto*, Tianjin, 2005, 2006, 2007. *China Auto Bluebooks*, 2008, 2009. China Association of Automobile Manufacturers.
 36. The two highest growth rates among the top dozen were achieved by Great Wall and BYD.
 37. Sheshinski and Lopez-Calva, “Privatization and Its Benefits.”
 38. GDP per capita figures are all expressed in 1990 Geary-Khamis dollars as compiled by Angus Maddison. Maddison’s data are available at www.ggdc.net/MADDISON/oriindex.htm.
 39. As a condition of WTO entry, China’s auto import tariffs were gradually lowered from 80–100 percent in 2001 to 25 percent in 2006.
 40. Though foreign automakers have subsequently invested in existing Japanese and Korean companies.
 41. Gerschenkron, *Economic Backwardness in Historical Perspective*.
 42. As two different China representatives of the American “Big 4” auditing firms acknowledged to me, there exists the probability that the profitability of at least some state-owned automakers may be overstated due to losses being absorbed by state-owned parts manufacturers whose losses are in turn being absorbed by the state. (In accounting parlance, this is a “transfer pricing” issue.) The concept of the “complete listing” (整体上市), by which all subsidiaries of exchange-listed enterprises are supposed to be consolidated on the balance sheet of the listed entity, was intended to alleviate this problem, but thus far only a handful of automakers have done a “complete listing”—and this still does not address the probability that unrelated state-owned entities could be selling parts to the listed automakers at a loss. Of course, the private automakers, which are listed on overseas markets (primarily Hong Kong), are less likely to benefit from such state generosity, and are, therefore, more likely to be genuinely profitable.
 43. Profitability in 2004 and 2005 was affected by an overall tightening of credit in China as well as selling price decreases that had got ahead of related cost reductions in response to increasingly lower import tariffs required under WTO membership.
 44. Xinhua News Agency, China Economic Information Service, “Profile of China’s Passenger Vehicle Industry in 2010,” January 14, 2011. Accessed through ISI Emerging Markets.