An analysis of shanghai volkswagen

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Shanghai Volkswagen is one of the largest single foreign-invested projects ever conceived in China and has proven to be a successful development. Com- pared with Beijing Jeep's course, the German venture's progress was steady and smooth. In 1997 Shanghai Volkswagen headed the list of the top 500 foreign-funded enterprises operating in China. It is a joint venture between Volkswagen of Germany and Shanghai Automobile Industry Corporation. It posted a 21. 3-percent rise in sales of its Santana model for the first seven months of 1997 in comparison to the same period in 1996 and reported a 10- percent increase in net profits for 1997 to 472. 6 million renminbi. This will further the venture's reputation as the most successful partnership in China's car industry (Woodard 2002, p 39).

Volkswagen has an aim as part of its global competition strategy to build up a business base in the Far East that will limit the dominance of Japanese firms. Its strategy is for China to become a big export base for the whole of Southeast Asia. In the year 2003 Volkswagen wants to be able to go to Japan with German-engineered cars that are produced in China. Officially, the

company plans to produce nearly 700, 000 cars by 2000 (Ball & McCulloch 2005, p 77). However, the vision calls for at least a million cars. Shanghai Volkswagen was built on a more solid mutual foundation than the Jeep venture. In October 1984 a joint-venture agreement was signed between Volkswagen AG (VW AG) and a consortium of Chinese partners led by the Shanghai Automotive Industrial Corporation (SAIC), the Bank of China, and the Chinese National Automotive Industrial Corporation (CNAIC).

Literature Review

The agreement, valued at I billion renminbi, established a twenty-five-year Sino- German partnership with 50-percent equity provided by VW AG, 25 percent by SAIC, 15 percent by the Bank of China, and 10 percent by CNAIC. Initial equity from the partnership was used to finance the renovation of production facilities, to import production lines from Brazil, and to import the Santana completely knocked-down kits (CKDs). The new joint venture was christened Shanghai Volkswagen (Raveed & Renforth 2007, p 49). Over the previous five-year period, the Chinese consortium had negotiated with more than eight international automobile manufactures before opting for a partnership with Shanghai Volkswagen’s German parent. As the second automobile joint venture in China after Beijing Jeep, the joint venture planned to manufacture automobiles and engines and was granted a special tax relief under Chinese guidelines for advanced technology partnerships: a standard two-year tax holiday and a special six-year reduced tax rate exclusive to Shanghai Volkswagen, all in exchange for promised technology transfer (Shanghai Volkswagen Automotive Ltd. 2004, p 23).

West German experiences with Socialist East Germany have contributed to an understanding of command economies and their shortcomings (Raveed & Renforth 2007, p 48). Therefore, Volkswagen representatives already knew what and how to negotiate with the Chinese partners. The contract they negotiated with the Chinese was notable for attention to detail, and for its ability to predict future difficulties. On one part of the contract, the Germans insisted on the assembly of imported CKD kits (The Economist 1990, p 16). Other parts of the contract also demonstrated Volkswagen's foresight. Anticipating the problem of paying for imported kits with Chinese renminbi remittances, the contract allowed Shanghai Volkswagen to convert RMB into German marks at the prevailing official exchange rate until the venture had produced 89, 000 cars (Bates et al. 2008, p 6-7). Such a clause would help protect the company against foreign exchange shortage that could possibly occur within the venture. The contract took into account the need to localize the Santana model. According to the agreement, however, responsibility for providing quality parts made in China rested squarely with the Chinese; Volkswagen had no obligation to hasten the process (Woodard 2002, p 41). To help balance the foreign exchange flowing out of China to pay for kit imports, the contract called for the venture to purchase engines produced in Shanghai to be used in cars manufactured in Europe (Hook 2001, p 10).

The earnings generated from such exports would support the use of foreign currency by Shanghai Volkswagen for importing the kits and later the foreign components used for assembly in China. In addition, the price Volkswagen would pay for each engine was predetermined. The primary concern was the possibility for localization. Localization was planned to start immediately in

order to reduce the foreign exchange expense of importing the Santana kits from Germany. It was planned to reach a local content of 20 percent in 1988, 32 percent in 1989, and 84 percent in 1990 (Frisbie 2003, p 4). The negative factors were poor local supply, the Chinese partner's existing technical capability, and foreign exchange. Volkswagen also worried about the effect poor-quality products would have on the company's reputation.

At this time China was not known for its ability to manufacture complex products with dependable quality. The industrial infrastructure in the auto-mobile industry was poor. Components were imported because local suppliers could not manufacture them to the requisite quality standards. Imported components faced high import tariffs of 25 to 40 percent (The Economist 1990, p 16). The technical standards of Chinese automobile-component suppliers in 1986 were nearly thirty years behind component manufacturers of Europe, Japan, and the United States. Even some simple materials, such as sandpaper for polishing cars and major items such as batteries, had to be imported. Although an automobile industry did exist in China, quality parts were hard to find (Raveed & Renforth 2007, p 47).

The problem was the development of local suppliers who could make components to Western standards. Furthermore, Volkswagen's technical staff found it difficult to communicate Volkswagen's concept of quality to the Chinese autoparts manufacturers. Since Shanghai is the most developed industrial area in China, it was expected that car components could be locally made there in the near future (Hofstede 2006, p 25). Local supply was therefore expected to improve, but it would take time. In fact, the development of local capabilities was incredibly important to their ability to

compete in the market and has proven to be the most troublesome feature of Shanghai Volkswagen’s short history. In order to increase the value of an automobile from China-based factories, and to prove that the Chinese automotive industry could indeed compete with foreign suppliers, Volkswagen worked with their European parts manufacturers to encourage their entry into China. Volkswagen’s technical staff sup- ported them by assisting with the identification of possible Chinese partners for the various parts to be manufactured.

Also, Shanghai Volkswagen encouraged Chinese suppliers to forge cooperative relations with peer parts makers from abroad. From Volkswagen’s supplier group, suitable partners were chosen by Chinese suppliers and formal joint-venture relations between foreign and domestic supplier firms were signed. In order to assure quality improvement, Shanghai Volkswagen rated its suppliers (Woodard 2002, p 43). The joint-venture contract specifically charged the Chinese with responsibility for providing parts of acceptable quality. It categorized its suppliers into A, B, or C classes: A suppliers produced parts of export standard, B suppliers produced parts used for the domestic market that were not yet of export quality, and C suppliers produced parts below even first-rate domestic standards (Shanghai Volkswagen Automotive Ltd. 2004, p 45). Because of Shanghai Volkswagen’s strict quality control and demands, it rewarded its suppliers handsomely. This reward would provide an incentive to the suppliers so that they would maintain their quality standards. Shanghai Volkswagen promised to pay its suppliers a purchase price capped at the price of a similar import, in addition to custom duties (Ball & McCulloch 2005, p 112).

It guaranteed a profit for every manufacturer in its parts-supplier network. Furthermore, Shanghai Volkswagen organized their suppliers into the Santana Localization Community. The community served to forge closer ties between Shanghai Volkswagen and its suppliers, and more important, among the suppliers themselves. The organizing principle behind the localization community was the relentless pursuit of quality (U. S. China Business Council 2008, p 5). Throughout the barrage of Chinese criticism over localization levels, the Germans refrained from making their problems public. Volkswagen officials patiently allowed the Chinese to find a solution to problems. On the Chinese side, the government granted some incentive for the Germans to increase local content. After 40 percent of parts were localized, the imported parts were no longer considered CKD kits and were then taxed at a lower rate. Similar tax reductions were made once the 60- and 80-percent localization barriers were crossed. Although there were some components and tasks that were still impossible to source in China, the progress of localization did quite well (Hofstede 2006, p 8).

Research Questions And Objectives

To prove that German patience paid off in the long run. Local content was 70 percent after the engine and gearbox were localized in 1991. The company reached its goal of 80- percent local content in 1993 (Bates et al. 2008, p 8). By the end of 1995, 90 percent of the components were locally sourced. In the Changchun plant, local content was 40 percent for Audi and 60 percent for Jetta. The company had strong, reliable dealer and supplier networks in place. Shanghai Volkswagen made a profit largely because they were able to provide a substitute for imports from Japan, and because they were assisted

by the high import tariff set by the Chinese government (Hofstede 2006, p 23).

To prove the logistical importance of the Guangdong factory. It initially appeared to be a logical site for the new factory. The province had one of the highest standards of living in the country and had acquired extensive experience with joint-venture projects. Moreover, with Guangdong far from Beijing’s watchful eye, Peugeot officials anticipated a greater degree of managerial autonomy than a plant in northern China might enjoy. Local government support for the joint venture also seemed strong. Yet these apparent advantages could not shield the Sino-French joint venture from its share of difficulties (United Nations Centre on Transnational Corporations 2009, p 11).

During the set-up phase, for example, Peugeot discovered that GPAC workers-formerly employed at the GAM bus and truck factory-had inadequate skills. Consequently, Peugeot had to spend more than anticipated, both on training PRC workers in Europe and sending French managers to the PRC. Commitments to localize parts production posed additional stumbling blocks for GPAC (United Nations Centre on Transnational Corporations 2009, p 6). Though the joint-venture contract called for GPAC vehicles to reach a 90-percent Chinese content level within five years of start-up, the French partner found few suppliers of quality parts in Guangdong and was prohibited by Guangzhou officials from sourcing from other regions in China. Peugeot, for its part, was slow to establish its own joint-venture parts manufacturers, a key to Volkswagen AG’s success in Shanghai (Hook 2001, p 6).

GPAC thus had to assemble automobiles largely from imported parts, which proved costly when the French franc appreciated some 110 percent against the renminbi in the late 1980s. The resulting rise in prices of imported parts, together with PRC localization and consumption taxes totaling more than 45, 000 yuan ($12, 000, based on the 1989 exchange rate) per vehicle, substantially raised the final prices of finished vehicles. In early 1990, for example, the company's model 505 station wagon sold for 200, 000 yuan ($54, 000), while Shanghai Volkswagen Co. Ltd.'s Santana, which was subject to similar taxes, sold for 180, 000 yuan ($49, 000). GPAC's growth slowed as a result (Ball & McCulloch 2005, p 34).

Stiff Competition

GPAC's troubles were aggravated by such stiff competition from Shanghai Volkswagen.

The Santana had achieved 75-percent local content by 1992, and thus was able to keep production costs and sales prices relatively low. Though GPAC had reached similar levels of domestic content by 1994, its least expensive station wagon (in the year 1997) costs 170, 000 yuan ($21, 000, based on the 1997 exchange rate), compared with 135, 000 yuan ($16, 000) for the least expensive Santana model. Moreover, the quality of both GPAC parts and finished vehicles remained poor. Because the local government objected to sourcing from plants outside Guangzhou, GPAC was forced to use local parts that often failed to meet international standards. Some of Peugeot's management decisions also contributed to GPAC's competitive weaknesses. The company reportedly repatriated most of its profits and made relatively

few changes to its 1980s era products, whereas Volkswagen reinvested profits and refined its production, introducing a new Ê» Santana 2000Ê» model in the mid-1990s. The GPAC sedan also had problems finding a market niche, as its large engine's high fuel consumption precluded the car's use as a taxi, and its outdated design failed to attract Chinese buyers. When com- pared with the Audi 100, made in Changchun by a joint venture between Audi AG, a subsidiary of Volkswagen, and China's First Automobile Works (Group) Corp., the GPAC sedan lacked the prestige that status-conscious private or government consumers sought in a vehicle (Hofstede & Bond 2010, p 12). GPAC also was not as high a political priority for Guangzhou officials as the Volkswagen plant was for the Shanghai government (Bates et al. 2008, p 10). While the Shanghai municipality invested 5 to 6 billion yuan ($600-$700 million) to aid Volkswagen's endeavor, Guangzhou officials only contributed about 1 billion yuan ($120 million) to help GPAC (Sender 2007, p 90). Further, because of Guangzhou's laissez-faire approach to production and consumption, city leaders were reluctant to urge government officials or enterprises into purchasing GPAC's vehicles. In Shanghai, by contrast, the city's taxi company was one of the largest purchasers of Volkswagen Santanas. Further, 1996 Shanghai municipal rules on engine size for taxis effectively eliminated Volkswagen's competitor in the city, the Tianjin Charade, from the taxi business (Hofstede 2006, p 23). Ironically, while GPAC's remoteness from Beijing protected it from central-government interference, the southern China venture also did not rank high on Beijing's planning agenda. And the lack of a central-government partner meant PRC leaders did little to forestall the joint venture's decline.

Many MNCs are approaching China as a long-term strategic market, and they are investing large sums of money to help build sustainable long- term positions. This can be a rational strategy. MNCs that do not consider exploring China's vast market with its emerging consumer base could be missing a tremendous growth opportunity. But some MNCs take the long-term argument too far. The traditional belief that a firm has to be around a long time to get results is not necessarily right in all cases. Long-term success is best achieved through measurable short-term results (Sender 2007, p 91). It is true that Shanghai Volkswagen, Matsushita's TV tube factory, Charoen Pokphand's animal-feed ventures, and Otis's elevator plant are all early entrants that are growing at double-digit rates. But Peugeot entered the Chinese market at the same time as Volkswagen, and it has lost tens of millions of dollars each year since 1995. Kraft entered China more than ten years ago, and all of its plants are now reported to be losing money (Shanghai Volkswagen Automotive Ltd. 2004, p 66).

In a volatile market such as China's, sustainable long-term positions are necessarily built on a series of successful short-term moves. Short-term results can help build brand recognition, attract local talent, and secure support from the parent company. They can create a virtuous cycle (Frisbie 2003, p 4). By contrast, when MNCs see no positive short-term results, a vicious cycle could arise. Rather than revise the company's strategy, managers typically justify poor performance with the argument that China is a long-term market. Patience and longevity are not enough. In fact, many MNCs accomplished great short-term success. For instance, Ericsson, the Swedish telecom company, acquired 40 percent of the cellular handset

market, worth $4 billion, in only three years. Kodak gained a 15-percent share of the $500-million film market in less than two years. Tingyi built a $500-million instant-noodle business from nothing in just four years (Daniels & Radebaugh 2004, p 45); its average operating margin over that period was more than 20 percent. Many of these successes can be attributed to recent moves these companies have made, not to how long they have been in China. These examples show how MNCs can plan for success by making smart short-term moves, thereby helping to establish new rules for the game (Karp 2002, p 74).

Their successes are also founded on their continuous learning in the market and their ability to react correctly to changing dynamics. Performance is driven by an adaptive strategy that can be implemented rapidly. In this respect, recent developments in the cellular handset market are particularly instructive. Continuous learning and adaptability is essential to manage the vastness of the market and the rapid rate of change (Hofstede & Bond 2010, p 52). This is difficult in an environment like China, where Western managers face exceptional language and cultural differences, and doubly difficult because consumer demographics and tastes are constantly changing. Kraft's Tang was successful at the start, but carbonated drinks and fruit juices were quickly substituted for it. Motorola was very successful with male consumers, but Ericsson took advantage of the demo- graphic shift in the cellular handset market toward women (Daniels & Radebaugh 2004, p 62). As Ericsson's success dramatically shows, in an emerging market, effective learning is essential. Although Peugeot and Volkswagen entered the Chinese automobile market at roughly the same time, their performances have

differed dramatically. Volkswagen’s revenues have grown at a compounded annual rate of 77 percent since 1985. Sales exceeded $2 billion by 1995. Today Volkswagen has expanded its capacity to 300, 000 cars; the company produces close to 200, 000 cars per year. It enjoys more than a 50-percent share of the passenger car market and earns a double-digit after-tax profit. By contrast, Peugeot built a 90, 000-car capacity and sold only 2, 000 cars in 1996 (Bates et al. 2008, p 9).

Research Plan

Perspective

The factors are labeled as political, legal, cultural, economic, historical and geographic. This paper addresses the six environmental factors as they apply to IJVs in the People’s Republic of China. Examples are drawn from an active IJV in Shanghai. Much of the information on this IJV was gathered during a research visit to the manufacturing facility during spring. Data gathering techniques included an on-site interview in Shanghai and material secured from corporation and government agencies (Shanghai Volkswagen Automotive Ltd. 2004, p 2).

Why have scholars avoided looking closely at the Chinese bureaucracy? First, the Chinese system has, until recently, been quite difficult to penetrate. Chinese citizens were to avoid divulging “ state secrets” to foreigners (Manguno 2003, p 8); even general communication with such outsiders was discouraged. Much of the relevant information, then, was found in statements of the top leaders, published in newspapers or journals or broadcast over the radio. Foreign researchers in the 1960s and 1970s found

that exiles and migrants from southern China to Hong Kong were also good sources, but the scarcity of central government bureaucrats among their numbers made many types of focused, in-depth interview research nearly impossible (Sender 2007, p 90).

Data Collection Methods, Access and Sampling Strategy

Although China remains a relatively secretive society, the amount of personal contact allowed with foreigners has vastly increased. The requirement for efficient functioning of economic transactions forces the Chinese to be more open in publicizing their bureaucratic procedures. In other words, even in the face of the June 1989 crackdown on dissent, it is now easier to gain access to the lower levels of power than in the years preceding the economic opening to the outside world (Frisbie 2003, p 4). Lin’s conclusions included lists of the positive and negative factors Americans faced in choosing to invest in China. He also made some comparison of Chinese and American attitudes toward the joint ventures. He omitted, though, focus on misperceived and misunderstood actions related to divergence in the long-term goals of the two sides (Manguno 2003, p 7).

Ball and McCulloch, (2005) analyzed cultural expectations in conducting business in China. 20 He investigated Chinese feelings toward various nationalities, and used these results to predict the future success of some eighteen different nations and regions in trade relations with China. Although this work was useful for examining the Chinese attitudes toward the outside world, no comparison was made of foreign perceptions of and approaches to the Chinese side. Business journals present a further source of empirical

data. Publications such as The China Business Review and business school magazines feature articles tailored to potential future investors. Availability of space and the general scope of these journals, however, tend to prohibit a fully developed theoretical analysis of Chinese industrial development (Hofstede 2000, p 32).

Earlier studies also failed to employ Jervis’s ideas of misperception. Considering the great differences in culture and past practices of the Chinese and foreign automotive representatives, it would be surprising if misunderstandings did not cloud the stimuli foreigners exerted on the Chinese policy makers. To further utilize Jervis’s work, one should also consider the influence of misperception between higher and lower levels of the Chinese political system. Finally, the motivational elements of “ wishful thinking” may also distort the policy process at many levels of the Chinese bureaucracy (Daniels & Radebaugh 2004, p 12).

My own approach seeks to build on the theoretical framework of Sender and Hook and the analysis of Hofstede on, while adding new empirical data in a different industrial sector, that of the automobile industry. In doing so, this thesis will take into account several variables that shaped both the political and the economic development of the Chinese automotive sector (Hofstede 2000, p 32). Four case studies look at the “ stimuli” of domestic and foreign economic forces, and discuss their effect on the Chinese central government (Hofstede & Bond 2010, p 11). The empirical parts will also examine the bargaining that took place between central and local politicians, and the misperception that affected the policy process. Finally, the studies shall note

the differing policy outcomes for the four automotive ventures, and try to make projections of their future progress based on past experiences.

Ethical Considerations

Peugeot's poor performance appears to have been caused by its repeated inability to learn in, and adapt to, a rapidly changing environment. As Volkswagen's success demonstrates, the Chinese automotive industry is attractive, and Peugeot began its operations in China with plenty of advantages (Mowery 2008, p 3). Its joint venture was set up in the wealthy south, which has a more entrepreneurial culture because of its proximity to Hong Kong and because of the early promotion of the reform policies of the late Deng Xiaoping. By contrast, Volkswagen's joint venture was established in the more conservative Shanghai region. Until the mid-1990s Shanghai's economy was dominated by loss-making state-owned enterprises, and the city was not allowed to implement aggressive reform policies (Hofstede 2006, p 13). Yet Peugeot was not able to exploit its advantageous position in the south and did not learn how to succeed with commercial customers. In the 1980s automobile industry experts predicted that growth would be driven by consumer wealth and consumer demand. But the market in China remained commercial (U. S. China Business Council 2008, p 12). Even now, the vast majority of Chinese consumers cannot afford to own cars: More than 70 percent of cars in China are purchased by commercial companies. Volkswagen was quick to adjust its assumptions and operating paradigms; Peugeot was not. To serve the commercial market, Volkswagen built an aggressive distributor network and sales force (Hook 2001, p 32).

Conclusion

The company recognized that commercial buyers were less price sensitive than other consumers, given that they needed and were willing to pay for high-quality after-sales servicing. Volkswagen was able to push volume through its distributors and achieve critical mass. This growing volume allowed Volkswagen to realize considerable scale economies, thereby allowing it to drive down prices. Because Peugeot never man- aged to develop an effective approach for commercial buyers, it never generated the prices and profits needed to motivate distributors (Woodard 2002, p 2). Without this high-channel profit, it was unable to attract capable and aggressive distributors and could not develop a reasonable service network. Peugeot also failed to learn other important lessons. An understanding of the development of down- stream industries, for example, was crucial in identifying and promoting potential demand. Volkswagen’s partner lobbied the government to support the establishment of taxi companies in Shanghai. Although consumers could not afford to buy private cars, their demand for taxi services supported the growth of taxi companies, which did buy cars from Volkswagen. Peugeot did not follow a similar strategy. The company was unable to secure a dominant position in its home province in China. Hence, it never achieved critical mass and a competitive cost position to grow its operations to a national scale. Losses piled up, and after a twelve-year stay in China, Peugeot exited the market.