

International business
environment of
chinas automotive
industry economics
essay



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The objective of this report is to analyze various aspects of the international business environment of China's automotive industry, and offer a recommendation on whether a U. S. multinational passenger car producer should engage its business in China and how.

The introduction of the open door policy in 1979 marked a new era in China's automotive industry. By 1985, the number of domestic producers jumped double. In addition, China's entry to the WTO has brought both benefits and costs to the domestic automotive industry. The Chinese officials are fully aware that the local producers are weak and inefficient, and protections are essential to develop the industry.

To do effective business in China, foreign businesses do not only have to overcome disadvantages stemmed from a high level of protection measures against foreign competition, but also to embrace the cultural difference in business practice. In particular, guanxi or network of relationships, are considered to be a critical success factor for businesses to survive in China. Finally, possible yuan revaluation may well suggest that exporting would be a better means to enter the Chinese market, as U. S. export will become more competitive in terms of price.

Introduction

This section gives an overview of the Chinese automotive industry. First, it begins with a brief history of the development of China's auto industry, which serves as background information for China's auto industry analysis conducted later in this report. Second, it examines the current and future state of the passenger car market.

China's automotive industry had been through two important stages of development: the pre-reforms period (1949 -1979), and during the reforms period (1980 and onwards). Before 1949, China heavily relied on import from overseas to fulfill the domestic demand, given the local automotive producers were yet to be developed. Not until the end of the civil war in 1949, China's new government started to develop its large-scale industries, including automotive, with the aid from USSR.

The Pre-reforms Period. The First Automotive Work (FAW), established in 1956, was the first local producer in China. Its establishment was a result of China's modernization and industrialization efforts. In 1958, the Chinese witnessed its first domestic-made passenger car, Red Flag or Hongqi, launched by FAW. However, in that period, the Chinese automotive industry was rather inefficient and confronted severe pressure from importers that possess better technology and managerial proficiency.

In December 1978, China's economic reforms were instituted. The introduction of the open door policy in 1979 had influential effects on the automotive industry. Firstly, the central government loosened the entry regulation to the domestic enterprises. Under this policy, the automotive industry developed rapidly and became less saturated. For instance, within five years, the number of automotive enterprises doubled, as shown in table 1.

Table 1. Number of Automotive Enterprises and Parts and Components Suppliers

Source: China Automotive Industry Yearbook 2003

Secondly, the open door policy actively encouraged foreign multinational car manufacturers to invest and operate in china's automotive market through joint venture. The rationale behind served two purposes: First, joint venturing with local partners would allow foreign manufacturers to obtain market access in exchange for the technological transfer. Second, the joint venture format would shield the infant industry from direct competition against foreign giants. And, in 1983, the first Sino-foreign joint venture in the automotive industry was formed by Beijing Automobile Corporation and the American Motors Corporation.

The Reforms Period. Today, China is one of the world largest automotive producers. As shown in figure 1, China has experienced a sustain growth since 2000. Until recently, China auto production has surpassed the U. S. and become the second largest auto producer, trailing only Japan, which has shown relatively little overall growth in production.

Figure 1. Total Annual Production of Leading Motor Vehicle Producers

In particular, the exponential growth in the passenger car market, generated by the increasing demand among middle-class, is the main driver to today's expansion in China's automobile industry, shown in figure 2. Note that the passenger car market was not substantially developed until in late 2001, when china's entry to WTO sufficiently lowered its tariff barrier to foreign manufacturers.

Current State of China's Auto Industry. Presently, roughly 70% of the China's car market is held by Chinese-foreign joint ventures. The introduction of

foreign competition and joint ventures are important in maintaining the vitality of the market. As indicated in figure 3, the current fragmented passenger car market is dominated by numerous of producers, with which the largest producers, Shanghai-Volkswagen, capturing less than 11% of the total sales or 708, 100 vehicles in the market, indicating the passenger market is very healthy.

Figure 2. Chinese Motor Vehicle Production

Figure 3. 2009 passenger cars sales round up (10, 000 unit)

Source: China association of automobile manufacturers

Another evidence of vigor of china's passenger market is the number of new product development launched into the market. There are in total 175 of new car models introduced, which is equivalent to a 75% growth in compared to that of 2008. However, it may be overoptimistic to expect the passenger car market will continue to grow at a rocket rate. As Li (2004) illustrates, the sharp increase in ratio of car ownership in urban cities to 190 cars per 100 citizens, indicating on average a single Chinese person possesses almost two cars, may exert pressure on the aggregate demand for passenger cars, or at least from those major cities like Beijing and Shanghai.

Analysis of Chinese National Business System and Cultural Conditions

Foreign businesses are influenced in a great extent by the regulations set by the state. One significant difference between the two nations' business system is the role of government, in terms of the activeness of government involvement and the extent in which economic power is decentralized to

private interests. Unlike in the U. S. where the enterprises are liberalized to pursue private interests, the less transparent business system in China is heavily regulated and controlled by the central state. One such example, relevant to the automobile industry, is the entry regulation for foreign direct investment. While it is possible to set up wholly foreign-owned enterprises in China, foreign business are not allowed to sell their products in the domestic market. Alternatively, they can choose to have joint venture with a local partner, to gain access to the Chinese domestic market.

It is well recognized that Chinese local automotive producers are heavily protected from international competition by high tariffs and strict import quotas and regulations. For instance, China has restored the local content rules that it was required to abolish as part of its WTO Accession Agreement in 2001. To be specific, if more than 60% of the value of a vehicle is accounted for by imported parts, the manufacturer must pay duties of 25% on all imported parts in the vehicle. Consequently, this measure does not only put pressure on the financial performance of foreign businesses, but it may also interrupt their production and supply chain.

The impact of the entry restriction and the local content regulation are relatively unimportant for those foreign joint venture enterprises that mainly produce low-middle class vehicles, since the less sophisticated production requirement can be met by using Chinese local produced automobile components. But the impact of local content regulation is costly to companies, such as BMW, Mercedes and Lexus, which are positioned in the up-end market, which heavily depend on quality imported auto parts. Thus, top-class automobile producers should only compete through exporting

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instead of foreign investment, or otherwise they may find themselves at a disadvantage.

However, to further complicate the matter, the joint venture partnership, as an entry regulation, in certain extent can be viewed as a contributor and opportunity for foreign businesses to better integrate the cultural difference instead of an obstacle to be overcome. If the entry regulation were eliminated, it would be relatively difficult for foreign entrants to understand the needs of the Chinese consumers and to adopt the local culture.

In particular, for instance, Guanxi, or relationship backed by reciprocal obligation, are widely accepted to be a critical success factor for businesses to survive in China. Firms that lack sufficient guanxi may find themselves at a disadvantage. As one important lesson that can learn from Wal-Mart's success in China is to embrace unions and parties in order to build up guanxi, which subsequently opened the way for Wal-Mart to gain a strong foothold in the market (Hill, 2009).

National culture critically affects many aspects of international business. Given the cross-cultural difference in the U. S. and China, the buying behavior is significantly different. But to succeed in China, foreign businesses must adapt its merchandising and operations strategy to meshes the Chinese culture and preference.

Summary of Findings Based on Wheel of Consumer Analysis. One method for understanding the car buying behavior between the U. S. and China is referred to as the wheel of consumer analysis, created by Olson & Peter (1994). The framework consists of three attributes: Environment, referring to <https://assignbuster.com/international-business-environment-of-chinas-automotive-industry-economics-essay/>

all physical and social characteristic of the consumers' environment condition; affect, or cognition, concerning the internal and psychological reaction in response to marketing stimuli; and behavior, regarding the physical reaction in response to marketing stimuli. These attributes are useful to explain the reasons for buyer behavior differences between American and Chinese consumers.

An earlier study undertaken by Liu and Bai (2008) indicated that Chinese car buyers are relatively cautious and quality conscious. Relevant to the environmental characteristics, the influence of the presence of reference group seems to differentiate the two groups. Empirically, for instance, about 68% of the Chinese buyers in Beijing use reference group as their primary source of information during the purchasing process, unlike the Americans consumers who are more likely to conduct extensive information research based on internet and brochure as inputs.

Another important aspect, which is unique to the Chinese auto market, is the elasticity on car ownership. From an economic point of view, the level of elasticity is proportionate to the size of purchase relative to the total expenditure. In other words, if the expenditure on purchasing the car takes up a large portion of the consumers' total expenditure, it is more likely that consumers will become price-conscious and negotiate vigorously. In fact, as opposed to this phenomenon, Chinese consumers demonstrate a high degree of sensitivity on price, even if the size of expenditure does not appear to matter (Johnson & Chang, 2000).

Note that, the wheel of consumer analysis is not complex enough to fully reflect the sophisticated national culture between the U. S. and China. Beyond this issue, foreign businesses shall be alarmed the cultural differences and any possible change in the car buying behavior. Some may argue that existing foreign joint ventures are educating the local consumers and gradually changing the purchasing culture in China towards a convergent global culture through globalization (Hipsher, 2007). Whether this would be desirable depends on the current state of development of china's auto industry. To be recalled that, about 70% of the China's car market is held by Chinese-foreign joint ventures. This may able to mix the Chinese culture with modernity, capitalism and values, in a way China is still struggling to find.

U. S.-China automotive trade pattern and Trade protection

U. S.-China Trade Pattern. As shown in table 2, the U. S. has been experiencing a trade surplus with China in motor vehicles. Theoretically, according to Ricardian model, U. S., which has a comparative advantage in producing technological product compared to China, should be exporting sophisticated product, like automobile, to China in exchange for labor-intensive products, in which China has a comparative advantage. Then, what may explain the growing trend of U. S. importing motor vehicles from China?

Table 2. U. S.-China Automotive Trade, \$ millions

While most of the vehicles imported into the United States from China have been largely limited to trucks and vans, China does export minority of domestic-produced passenger cars to U. S. The passenger cars imported from China are mainly produced by foreign manufacturers rather than local

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producers. This phenomenon was a result of several major foreign automobile producers, such as MG Rover and Honda, have been using China as a platform for exporting vehicles to other countries, by taking advantage of the competitive labor cost and the rising skill and quality of labor. Moreover, the favorable entry regulation to the automotive component industry, will be discuss later in this report, have encouraged firms to enter China through FDI and build facilities, to exploit a greater synergy from vertical integration.

On the other hand, what may explain the high growth in U. S. motor export to China given a number of U. S. producers have already gained access to the Chinese market? According to Qiu (2005), one explanation is that the increasing number of middle-class in China have increased the demand for imported luxury cars, such as Mercedes Benz and BMW, which those brands are discouraged to produce in China due to the weak intellectual property rights and the discriminatory tariff on foreign imported auto parts that sufficiently hurt the long term competence of the those up-market brands.

China's Trade Barriers. Despite China has abolished its local content rules as part of its WTO Accession Agreement in 2001, there are still various forms of trade barrier set by China to protect local automobile producers. Today, China imposes a 25% import duties on automobiles to moderate the level of competition from foreign export markets. Another protective measure that required more attention is the duties on auto parts and components.

Originally, China has reduced the auto parts duties from a high level to a unified rate of 10-14% as a commitment to the WTO regulation. However, there is evidence showing that China implicitly by-pass WTO regulation and <https://assignbuster.com/international-business-environment-of-chinas-automotive-industry-economics-essay/>

restore discrimination in favor of local content. Manufacturers are not only required to register their parts, and if more than 60% of the value of a vehicle is accounted for by imported parts, the manufacturer must pay duties of 25% on all imported parts in the vehicle (Tang, 2009). In effect, the import tariff and the automobile parts duties could effectively offset the cost advantages achieved by foreign giants which would otherwise pass on to the customers.

However, the impact of imported parts tariff has been weakening over time. For instance, after China re-established the local content rules, there is a tendency for foreign manufacturers to build and operate its wholly-owned automobile parts subsidiaries in China to avoid duties on auto parts. In addition, substantial cost efficiency can be induced by integrating vertically as well as to reduce reliance on imported car components. Therefore, it is extremely important that foreign businesses possess a strong technological base and assets which could potentially be developed it into a sustainable competitive advantage, or they may confront a two-fold disadvantage.

4. U. S. Concerns Over China's Exchange Rate Policy

U. S.-China Exchange Rate Regime. Before July 2005, China adopted a fixed exchange rate with U. S., pegging at about 8. 28 yuan per dollar. After that, the Chinese central government modified its exchange rate system and pegged its currency to a basket of foreign currencies. The modification induced an appreciation of yuan by 2. 1%, from previous 8. 28 per dollar to 8. 11. The new exchange rate system would allow the Chinese currency to be more adjustable and responsive to market supply and demand, given yuan would be capped by a ceiling of 0. 3% of fluctuation on a daily basis against <https://assignbuster.com/international-business-environment-of-chinas-automotive-industry-economics-essay/>

the basket. As opposed to the currency basket, U. S. adopted a free floating exchange rate system, which the exchange rate of RMB to dollar will adjust accordingly to the trade performance between the two nations.

The undervalued Chinese currency and effect on US auto manufacturers. Despite the Chinese government has allowed its currency to appreciate in certain extent, as shown in figure 4, the sharp growth in China's foreign exchange reserves and China's huge trade surplus over the past few years strongly indicates that the Chinese currency is significantly undervalued, by as much as 40% (Preeg, 2003).

Figure 4. Yuan-Dollar Exchange Rate Before and After the July 2005 Announcement

Source: U. S. Federal Reserve

An undervalued yuan has brought both positive and negative impacts to U. S. producers. From a perspective of a U. S. auto exporter, the impact of the undervalued yuan is two-folded. Not only the U. S. export become more expensive in China, but to those manufactures which rely on foreign auto components will suffer from a high production cost, compared to other producers which adopt Chinese local parts. Although manufacturers which opt to produce in china are somehow immune from the adverse effect, they are posed with another issue. The profit margin of those manufacturers, denominated in yuan, is lower than it would otherwise be if the Chinese currency were allowed to appreciate according to the market force.

On the positive side, the undervalued Chinese currency has contributed to a low global price level. Although China's auto market is restricted to the <https://assignbuster.com/international-business-environment-of-chinas-automotive-industry-economics-essay/>

production of lower-end products, such as tires, wheel hubs and interior material, due to its limited R&D capacity, both foreign and local Chinese auto producers should benefit, directly and indirectly, from a cost advantage induced by the Chinese export parts, as shown in table 2.

In the long run, we may expect China will revalue its currency to counter the appreciation pressure, and the perceived benefit of an undervalued yuan would gradually eliminate. However, what is more important is the extent of the appreciation of the yuan. The one-off revaluation is likely to make China exports more expensive and U. S. imports cheaper. However, foreign businesses should be aware of the deviation between real and nominal exchange rates. It is likely that the inflation in China will be lower than U. S. inflation, after U. S. effort to combat the financial crisis has raised the spectre of inflation. As a result, it is possible that the real exchange rates will be slightly lower than the nominal terms, which partly offset the appreciation pressure after the revaluation.

Description of Recommended Strategy and Risk Assessment

Recommendation will be given, based on the analysis undertaken in the previous sections, regarding whether the firm should undergo FDI or exporting in order to enter the Chinese auto market.

A Joint venture partnership will be a suitable choice if the company highly regards the advantages of ownership, location and internalization, as stated in the Eclectic Theory developed by John Dunning (2000). However, this lead to another question: How should foreign businesses select their joint venture partner, given they are all subject to different background and operation

scale? It is important to note that the perceived benefits induced by JV partnership will largely depend on how well the two companies integrate their managerial and operational practices. Recall that, to be success in China, it does not only required a superior technology level in both production and auto parts, but also to possess guanxi. Foreign businesses, as newcomers to China's auto industry, will be at an incumbency disadvantage compared to the existing competitors that have already developed its brand image and network of relationships. In sum, the best candidate for partnership should possess the desirable organizational attributes, namely a good network of relationships, superior strategic and financial competence as well as a good marketing and distribution channel, to allow the joint venture to quickly develop in China's auto market.

Despite the import tariff barrier, exporting automobile could be an effective way to enter the Chinese market. Fortunately, after the accession to the WTO, China has been somewhat adheres to its WTO commitment. Besides Chinese government allowed its currency to appreciate, tariff on imported motors fell from 180%-220% in 1992 to currently about 25%. In this view, the two biggest threats to U. S. auto exporters, namely the undervalued yuan and the tariff barrier, should gradually disappear over time as China liberalized and modernized its auto industry.

Consequences of China's Political Risk

Foreign businesses, which are engaging in FDI or exporting to the China's auto market, they share a common risk. They all are vulnerable to any potential dispute in international trade and relationship between the two

nations. Political retaliations, consequently leading to a severe tariff war, are <https://assignbuster.com/international-business-environment-of-chinas-automotive-industry-economics-essay/>

a by-product of the dispute. For instance, Obama administration has imposed a 35% tariff on car tires imported from China is one form of protectionist measures. Other than a tariff barrier which could cushion the impact by achieving substantial cost advantage, international issues could induce regulatory changes that sufficiently change the industry structure. The imperfect regulatory system in China's auto market, unveiled by the recent Toyota quality travail, is yet to be revised to implement stricter rules to protect consumers. Foreign business should not only anticipate any regulatory changes but, more importantly, to response actively to the impacts bring to the auto industry.

Concluding Remarks

One major concern among U. S. auto producers over China's automobile industry has been linked to the protective measures against foreign imports and FDI. Meanwhile, many economists argue that the high protection given to the Chinese domestic producers may harm the long term development of the Chinese auto market, as the protective measures will blindly protect those below-efficient firms, undermines the foreign producers, and prevents the most efficient distribution of resources in the automobile industry.

The Chinese officials are fully aware of the concern and stated they plan to further liberalize the automobile industry to foreign competition. But, they strongly emphasis that the reformation and consolidation should be in a gradual manner, to avoid any unnecessary disruptions to the industry.

Nevertheless, the next few years are crucial for since the evolution of the Chinese automobile industry will produce both winners and losers in the U. S. as well as in China.

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