

## **CHAPTER 6:**

# **WHY DOES ASIA BECKON SOME EUROPEAN AUTO FIRMS AND NOT OTHERS? AN ASSESSMENT OF MARKET AND NON-MARKET STRATEGIES**

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## **I. INTRODUCTION**

The decade of 1985-1995 was an important watershed in the history of the international automobile industry. World demand for automobiles had stagnated. Declining international competitiveness had thrown North American and European automobile manufacturers into labor turmoil. Overcapacity threatened home markets which had already achieved predictable and mature growth rates, resulting in a glut of excess manufacturing capacity, now estimated at about 40 unneeded assembly plants worldwide. Japanese-U.S. and Japanese-European Union trade relations were increasingly strained, as Japanese automobile manufacturers penetrated western markets, while carefully protecting their home turf.

While these problems festered, the Asian auto market was exploding. With the exception of Japan, the remaining last frontier for market penetration appeared to be Asia: economic growth rates were high throughout the region; a middle class with a significant disposable income was emerging; and few people owned cars. But European and American firms faced formidable Japanese competition; Japanese manufacturers had built an important presence in Asia through decades of market penetration in sales and the location of manufacturing facilities.

Rapid economic development in China in the 1980s, however, provided the promise of large market share to all those who could establish a presence there; Japanese manufacturers had never gained a toehold in the Chinese market. Domestic producers had long manufactured vehicles for government purposes, producing limited models with standard technology. Thus, in the absence of Japanese competition, China's 1.3 billion people and rapidly developing economy appeared to be one of the few great growth plays

left for European producers. By the mid 1980s, the rapid rise in per capita income held the promise of opening new market segments for a wide range of models, including compacts, light trucks, minivans, mid-sized cars, and even luxury vehicles. As income rose rapidly in the 1990s, analysts saw on the horizon an increasing demand for large, chauffeur-driven sedans for government officials and for the expanding number of foreign businesspeople and entrepreneurs beginning to flood China. The market was wide open, and, betting on growing demand, European producers rushed to grab market share. By 1999, Volkswagen, with 55% of all auto sales, dominated the Chinese market; Peugeot and Volvo, however, pulled out early, after initial failures resulted in huge losses.

This paper analyzes the causes of Volkswagen's success and Peugeot's failure in penetrating the Asian market by locating production facilities in China. Despite the persistence of central planning, protected market, and a lack of infrastructure, China displays two factors central to any analysis of market penetration in Asia: First and often ignored by the conventional focus on state planning, China possesses all of the characteristics of a "developmental state" common to many Asian countries.<sup>1</sup> Thus, nonmarket political influences provide important constraints and opportunities for market entry and control. Second, China's growing economy provides even more access points and incentives for market entry than the economies of other Asian developing countries. This growing economy creates the possibility for huge economies of scale for the manufacture and distribution of industrial products for foreign multinational firms. And it provides those firms with an expanding, consumption-oriented middle class. Demand for autos is arguably more pronounced in China than in other parts of developing Asia.

In this context, we provide a comparative case study to investigate the interaction of market and nonmarket strategies in determining the success or failure of market penetration of the automobile sector. The experience of Peugeot and Volkswagen in China suggests that both strategies can be fruitfully investigated. Both companies shared the following motivation and action: 1) they set up production facilities within a year of each other; 2) both attempted to escape high labor costs in Europe by relocating production facilities to areas with low cost labor; 3) both were anxious to expand market share under the pressure of stagnating global demand; 4) both expressed a commitment to establish a production base in China in order to penetrate the rapidly growing Southeast Asian market; and 5) both were among the first auto firms to be allowed access and entrance in the Chinese market. Further, each firm's home government took measures to promote auto exports and investments abroad, and in both cases there was a long-standing tradition of close government-firm collaboration to protect the national auto industry from global competition. Finally, both firms benefited equally from EU efforts to exploit overseas investment opportunities and the increased liberalization of emerging economies, especially China and India. Indeed, the EU managed to avoid any connections between the human rights violations in Thailand and the 1996 EU-ASEAN leaders' meeting which focused on the creation of closer economic and trade ties. Despite these important common incentives and constraints, VW succeeded in gaining a foothold in the Chinese market, and Peugeot failed. By the end of 1999, VW had a fifty-five per cent share in the Chinese market, and Peugeot had sold its production facilities in China to Honda. Why?

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<sup>1</sup> For definitions of the relevant aspects of the Asian "developmental state" see Wade (1994) and Johnson

To address this puzzle, we begin with a description of the regional context and the chief demand factors that shaped the investment strategies of Western auto firms in Asia in the last two decades. We then turn to a more specific description of the market and non-market forces that pose both threats and opportunities, shaping the conditions for the competitive success of European firms. We then present the comparative study, analyzing the factors that contributed to both success and failure.

## **II. POSITIONAL ANALYSIS**

### **A. Geographical Orientation**

One can quickly see why the Chinese market has gained importance: China posted an average annual GDP growth rate of 10.2% in the 1980-1990 period, which were significantly higher than that of India (5.8%), Indonesia (6.1%), Japan (4.0%), Korea (9.5%), and Malaysia (5.2%). This dramatic growth did not decelerate in the early part of the 1990s. Between 1990-1997, China averaged an annual GDP growth rate of 11.9% while India grew by 5.9%, Indonesia by 7.5%, Japan by 1.4%, Korea by 7.2%, and Malaysia by 8.7%.

This rapid economic growth was mirrored in the annual growth of per capita private consumption. Between 1980-1996, China grew by an average annual per capita rate of 4.5%; in comparison India grew by 1.6%, Indonesia by 2.8%, Japan by 2.9% and Malaysia by 1.7%. In this sense, what Asia, and China in particular, offered was a chance for expansion that the most other markets could no longer provide.

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(1985).

Although sectoral statistics rarely speak for themselves, the growth potential of the Asian markets for automobiles could hardly have been lost on any of the interested parties, whether they were international automobile manufacturers, host national governments, or trade unions in the advanced industrial markets. In terms of auto registration, Asia witnessed an average rise of 46.3% between 1981 and 1988, with rates rising by 31.8 % in Japan and 204.6% in Taiwan, 210.8% in South Korea and 343.3% in China. Even if the important Korean and Japanese industries are excluded, Asia's share of global auto production increased from 1% to 3%.<sup>2</sup> The increases in registration and production continued well into the 1988-1991 period, with auto production increasing by a factor of 4 in Korea, a factor of 1.5 in Taiwan and a factor of 2.6 in Thailand. Similarly, auto registration increased by a factor of 4.3 in Korea, a factor of 3.2 in Taiwan and a factor of 3.5 in Thailand.<sup>3</sup> In the 1992-2000 period, the forecasts for annual compound growth rates for new car sales were between 21.9% for China, 10% for Malaysia, and 4.8% for Indonesia, significantly higher than the world average of 2.4%.<sup>4</sup> Although dampened by the Asian financial crisis of 1997, growth rates continue to exceed those of most other developing countries. As Vaughn Koshkarian, the president of Ford China, optimistically stated at the onset of the 1997 financial crisis, "by 2010 China will have four vehicles per 100 people and a market volume of between 5 and 6 million vehicles, the fourth largest market in the world after North America, Europe and Japan. [Additionally,] by 2010, after substantial consolidation, this automotive industry will have a highly educated, skilled and industrious workforce. In essence, China will have

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<sup>2</sup> Karmokolias (1990), p. 4.

<sup>3</sup> Karmokolias (1994), p. 7.

everything necessary to become a primary, manufacturing nation in Asia”.<sup>5</sup> Robert Buscelhofer, a member of the VW’s car management board, underlined this prediction: “in the next five years, the world’s total car market will increase by about five million cars to about 42 million cars. Almost two million of them will originate in the Asia-Pacific market, a third in China and two-thirds in the remaining emerging markets.”<sup>6</sup>

Nonetheless there are two caveats: First, there has been a fall in wholesale prices across Asia, with significant deflation in Japan and China – strong indicators of general overcapacity. Since the crisis, overcapacity has been especially evident in the auto market. Second, the Chinese market in particular is still largely a *potential* one. Demand is still poorly understood and currently small, with sales of about 1.5 million vehicles a year compared to U.S sales of cars and light trucks of about 16 million units a year. Since the 1997 crisis, savings rates have risen and spending has decreased. Analysts suggest that workers fear that they will lose their jobs as industrial restructuring accelerates. Incomes are still relatively low; auto financing does not exist; and distribution continues to be chaotic. Non-market barriers include a wall of tariffs and regulatory protection that will only come down when China enters the WTO. We discuss these factors in greater detail below, beginning with a broad examination of the Asian market in general and a more specific discussion of China.

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<sup>4</sup> Maxton and Wormland (1995), p. 155.

<sup>5</sup> Financial Times, 6/25/1997.

<sup>6</sup> Financial Express, 7/23/1997.

## **B. Market Forces**

In analyzing the market forces at work in the Asian auto sector, we follow Porter's "five forces model": 1) the bargaining power of suppliers, 2) the bargaining power of buyers, 3) the threat of substitutes, 4) the degree of competition, and 5) the degree of globalization in the industry. We rank the relative importance of these forces for European firms in the Asian context and find the last two factors to be most significant in shaping the success of market penetration.

Local suppliers have little bargaining power vis-a-vis the major auto firms, because Asia lacks a network of suppliers capable of bargaining with long established and technically savvy Western firms. In fact, the relative absence of local suppliers provided a barrier to entry into these markets. Because local content requirements were mandated throughout Asia, firms wishing to locate production facilities in the region had to provide years of technical training, certification processes and technology transfer. Nonetheless the relative absence of local suppliers provided a long-term bargaining advantage for western firms. As individual firms provided firm-specific training, certification, and technology to local suppliers, their dependence on those firms was assured.

The growing demand for automobiles in these markets means comparatively weak bargaining power for consumers. In the mature North American and European markets, consumers can choose among hundreds of models, forcing manufacturers to move rapidly through product cycles, thus contributing to the increase in production costs. High demand gave local buyers in Asian markets little say over the level of product differentiation required; Western firms were therefore in a good position to slow product cycles and reduce manufacturing costs.

As noted above, however, the level of actual demand in China should not be overstated. Most automakers that enter the Chinese market can count on a low volume of sales at the outset, with the expectation that demand will eventually increase. They therefore must be willing to produce a number of product types to find a wider initial market. GM Shanghai, for example, produces only 30,000 Buicks a year but plans to add the production of a minivan and small car to achieve economies of scale.

As in other parts of Asia, auto manufacturers in China do not face a “threat of substitutes.” Public transportation is underdeveloped, even in the cities. Four factors are responsible for reducing the threat of public transport as a substitute for automobiles: First, public transport is not efficient in serving areas with low population or employment densities. Low usage means infrequent service, and infrequent service, in turn, deters users. The kind of demographic fragmentation that characterizes most of Asia is an almost insurmountable challenge for public-transport systems.

Second, the rapid growth of Asian economies has changed travel patterns as new growth areas have sprung up. Fixed transport systems, such as rail lines, quickly become obsolete under conditions of rapid growth. The sunk costs that characterize mass transit systems are simply too high in areas where the shift from rural to urban demographics is rapid, and also too high when growth in developing economies is low.

Third, many types of public transport have high opportunity costs. Flashy rail systems can consume resources that could serve far more people if devoted to improving bus travel. And finally, the preference for public transit decreases as income level rises; at the same time, consumers increasingly prefer autos over motorbikes.

The issue of competition in Porter's model has been complicated by transnational mergers and acquisitions. In the 1980s and 1990s, the auto industry was slow to respond to pressures for mergers despite excess capacity. Consolidation, automakers felt, would undermine brand recognition and loyalty, considered in the industry to be a key weapon in the fight for market share. And as the Japanese auto industry grew stronger, international competition among national firms intensified.

While the auto industry as a whole tried to fend off consolidation, Japanese firms came to dominate Asian markets, with significant and growing European market penetration, especially in China and Taiwan. Local Asian manufacturers also increased market share from the 1980s. In Malaysia, for example, Proton and Peruda, both Malaysian firms, increased their market share from 15% of all automobiles sold in 1987 to over 30% by 1996, with Japanese manufacturers still maintaining their hold over 60% of the sales market. The vehicle market in the Philippines was divided between Japanese and Korean manufacturers; Japanese firms had an 80 percent market share, while Korean firms controlled 15 percent. In the Indian market, Suzuki, through its joint venture with the state-owned Maruti holding company, had been able to increase its market share from 33% in 1987 to over 43% by 1996; the remainder was divided between European, Indian and other Japanese manufacturers. More than 90 per cent of the Indonesian market between 1991 and 1996 was controlled by Japanese manufacturers. Japanese and Korean manufacturers each control 95 per cent of their domestic markets, although the import share in the Japanese market increased from 1% in 1980 to over 5% by 1994. The only market that U.S. firms had successfully penetrated was the Taiwanese market where Ford

increased its market share from 19% in 1991 to over 23% in 1996. Nonetheless, the Japanese manufacturers still controlled over 50% of the market.<sup>7</sup>

China was the only market that Japanese firms had not conquered. The Chinese regime had raised a number of barriers to entry for Japanese firms, and by 1985, Japan controlled only 20 percent of the market, with the remainder held by state-owned Chinese firms. Thus, both because of its potential for rapid growth and the small Japanese presence, American and European automakers have considered China to be the last market frontier.

Driven both by continued overcapacity in the 1990s and by intense competition in the Asian market, cross-national consolidation began to eclipse cross-national competition. Indeed, the problem of overcapacity had grown worse: in 1999, the average worldwide plant utilization was only 69%, compared with 80% in 1990. By the end of the decade, most national firms were pushed by lower profit margins to merge. A few examples illustrate the changed structure of the industry at the turn of the century: Ford held a controlling 33 per cent interest in Mazda, and GM had acquired 49 per cent of Isuzu and almost 10 per cent of Suzuki Motors. In 1999, GM bought 20% of the Subaru car business of Fuji Heavy Industries. And DaimlerChrysler's purchase of a one-third interest in Mitsubishi Motors merged German, American, and Japanese firms into the third largest auto company in the world.

Now, the competition is not between national firms but between consolidated firms, often acquired for their competitiveness in specific market niches. It is too soon to

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<sup>7</sup> For more country-specific statistics observe the attached graphs at the end of the paper. They are based on data collected for the World Motor Vehicle Data (various issues). What is important for our analysis, is the fact that the Japanese firms have remained the dominant firms in this regional market.

tell whether these mammoth firms will simply be holding companies for the smaller manufacturers, but it is likely that the mergers will diversify production profiles so that firms can position themselves more competitively worldwide. Daimler, for example, which holds a significant share of the world market for trucks and large cars, needed Mitsubishi's smaller models to fend off growing competitive assaults on its overall market share from Ford, Volkswagen and Opel. And a controlling stake in Mitsubishi with its strong position in Asia would give Daimler an immediate presence in Asian markets. Indeed, Daimler's CEO, Jurgen Schrempp, made it clear that he wanted the surging Asian market to provide a quarter of sales by 2010, compared with 3.2% in 1999. Similarly, when GM acquired Subaru, it held only 1 per cent of the Asian market, anticipating that Subaru would create a wedge that would permit GM more access there.

In addition to this cross-national consolidation, increased globalization of the automobile industry, aided by the internet, further changed the nature of competition. As Asian economies began to liberalize their economies, lowering tariff barriers and phasing out local content requirements, local producers could realize economies of scale by producing parts for a number of companies rather than just one or two. And auto firms could buy parts from the most efficient producers and ship them to their factories worldwide, rather than attempt to acquire all parts for each factory from small suppliers in each country. Indeed, increasing trade liberalization permitted Renault-Nissan and DaimlerChrysler to pursue strategies of volume production across at least two regional markets.

Even more radical strategies have been envisioned. The large manufacturers have begun to sub-contract the design and production of entire sub-assemblies, such as brakes,

steering, and suspension. For example, companies such as Valmet, a Finnish engineering company with roots in paper-making machinery, Magna, a Canadian parts company, and Steyr-Daimler-Puch in Austria are outsiders who have begun to make sub-assemblies for established companies like Porsche and DaimlerChrysler. Some analysts predict that the large consolidated companies might even begin to shed some of their assets to parts suppliers. The process of globalization is still in its infancy.

The apparent globalization trend in the auto industry may conflict with one of the key nonmarket strategies needed for success in the Chinese market: connections with local officials who have access to both political and economic resources that the auto industry may need. The more parts and sub-assembly suppliers in the region, the larger the political constituency supporting the foreign automaker will be. As we shall see below, the success of VW can in large part be attributed to its diverse local suppliers. Below we discuss this and other non-market factors and strategies that shape success in the penetration of China's market.

### **C. Nonmarket Constraints, Opportunities and Firm Competencies**

In China, the strong arm of the authoritarian government and the continued use of five-year plans for industrial production and technology transfer in aid of the creation and growth of a domestic auto industry is the most important factor in any non-market strategy for market penetration. The Chinese government injected \$2 billion over the 1995-2000 period into the auto industry through subsidies, preferential treatment in loans, import duties and overseas funds, etc. in order to increase production consolidation and rationalization and foster technological innovation. This state-led path of automobile

production development, which increased from 222,000 units in 1980 to 510,000 units in 1990 to 1.45 million in 1995, has been explicitly directed under the auspices of an ambitious five-year plan which aims to change the present scattered structure of auto production, and to build large-scale auto enterprise groups with strong competitive powers, so as to realize the economy of scale....to change the backward, passive situation of the development of auto products ; to build up independent, initiative R&D scientific system...and to face the new circumstances of gradually connecting tracks of domestic markets with international markets ; and to promote the export of automobiles and auto parts and components ; so as to meet the overall market situation of competitions, both domestic and overseas (China Auto International Information, 1997).

Having said this, however, the most crucial aspect of the non-market environment is *how* the resources are distributed in order to build the capability to meet the central plan targets. This entails a discussion of the institutional characteristics of the Chinese reform process in foreign direct investment, involving Sino-Foreign joint ventures, center-local governmental relations and informal administrative networks. Although the conventional wisdom stresses the increase of power of the coastal regions over the center during the period economic liberalization, there is a lively scholarly debate about the consequences of this shift of power. Shirk (1993) has argued that the internal CCP power conflicts have allowed the regional party leaders to increase their power base and allocational mechanisms at the expense of the center, thus providing an increasingly robust political base for the continuation of the reforms. Naughton (1995) has argued that the logic of the reforms has been primarily economic, i.e. the central state's need for an increased revenue base as well as the goal of accelerated national economic development.

Montinola, Qian and Weingast (1996) have argued that the increased devolution of power from the center to the regions has produced a market-preserving form of federalism, where the different regions have engaged in jurisdictional competition in order to generate market-friendly policies and outcomes. Because of this, the relationship between foreign firms and local political officials is crucial to the firm's success. Solnick (1996) and White (1993), however, caution that, although the center has seen its power reduced, it still maintains an overwhelming amount of control over high-profile investment projects.

In this changing institutional context, informal *guanxi* networks within the center-region power relationship exercise an important influence on the success of Sino-foreign joint ventures.<sup>8</sup> Although the Chinese central state may have conceded some of its monitoring and enforcement mechanisms to its regional subordinate units, this loss of power has not been symmetrically distributed – *guanxi* networks have mattered more in some regions than others in terms of their ability to procure resources from the center toward facilitating joint ventures and accelerating the process of market-based economic development at the regional level.

Doner (1991) stresses the importance of the role of the host state in developing a coalitional base composed of local and regional governmental officials for automobile production. As we shall see below, Volkswagen's successful management and negotiating strategies at each of these levels in setting up a joint venture in China were honed during the Cold War, when Germany established a number of joint ventures in

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<sup>8</sup> *Guanxi* networks have been defined as both vertical and horizontal networks which operate both in terms of symmetrical and asymmetrical reciprocity. For more on *guanxi* networks see Walder (1986), Oi (1987) and Gold (1985).

Eastern Europe.<sup>9</sup> Studies of West European market penetration of Eastern Europe and the Soviet Union during that period suggest the importance of non-market strategies, particularly strategies in negotiating joint ventures.<sup>10</sup> George Halliday (1979), for example, examined the Volga and Kama River joint automobile ventures with western firms and demonstrated the importance of demanding high quality inputs in contract negotiations with Soviet officials. The contractual stipulations for special plastics and metals and high-octane gasoline and service facilities drew inputs away from traditionally high-priority economic sectors, including the military sector. Success in this venture suggested that auto firms would also be successful if they made similar demands in negotiations with China. Because they have long experience in joint ventures with enterprises in centrally planned economies, European firms can use that experience in penetrating the Chinese market.

European automakers also face constraints and opportunities in their home environment which shape strategic decisions. The tri-partite alliance between labor, business, and government is both a blessing and a curse. Preoccupied about unemployment, European governments and labor unions have traditionally resisted efforts on the part of auto makers to produce abroad; yet when this resistance is overcome, the tight relationship between banks and corporations in both France and Germany has provided the financial backing for international ventures. Indeed the fact that bankers and corporate CEO's sit on each others boards of directors gives European firms a financial edge over their American counterparts.

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<sup>9</sup> See Harwit (1995).

<sup>10</sup> See Crawford (1993).

In the last years of the 1990s, European auto firms have tended to focus their attention on the European Union and its regulatory environment. Indeed, European auto firms are tailoring their mergers and production bases in Asia to meet EU standards and compete within the boundaries of non-market constraints in Europe. For example, Daimler needed more fuel-efficient models in order to meet the European Union's directive to reduce fleet-average fuel consumption to sharply lower levels by 2008. Mitsubishi's range of ultra-efficient GDI (gasoline direct-injection) engines would permit Daimler to conform to the new standard.

In short, firms face non-market constraints and opportunities both at home and in China at the supranational, national and regional levels. A firm could lobby its home state and multilateral bodies. But as Aggarwal argues in the introduction to this volume, what is truly important in the realm of non-market strategies is the fit between the firm's core competencies and its institutional environment. Below we examine that fit in more detail in our comparative case study.

### **III. VW AND PEUGEOT IN CHINA**

#### **A. Background**

For both European firms, the decision to invest in production facilities abroad was driven by the evolution of consumer and labor markets in the auto sector at home. By the early 1980s, the European auto market was considered very mature with well-formed and rigid consumer preferences. Profit margins were low and growth opportunities were limited by demographics and existing income distributions. Industry officials were

increasingly concerned with the growing ability of their Japanese competitors to continuously increase their market share on a global level. These considerations were exacerbated by increasing labor costs and slowly decreasing worker productivity characteristic of the European automobile sector in the late 1970s and early 1980s.

In particular, the long-standing bargaining power of the German trade unions placed a significant constraint on VW's ability to remain internationally competitive, especially in light of growing Japanese competition.<sup>11</sup> Indeed, the signing of the first VW deal came on the heels of the 1984 labor union strike that cost VW 160,000 units of VW and Audi cars and led to production losses that decreased profits by 500 million DM.<sup>12</sup> Between the early 1980s and mid 1990s, German hourly wage rates in the auto industry (including taxes and social welfare costs) increased from \$24.26/hr. to \$39.39/hr. — an increase of nearly 50%, which is significantly higher than all their competitors with the possible exception of the Japanese.<sup>13</sup>

As noted above, part of the strategy to counter these losses was to step up the internationalization of production facilities through the acquisition of auto firms abroad and the construction of new plants in target markets. And China was an important target. As Carl Hahn stated in an press conference at the 59<sup>th</sup> Geneva International Motor Show in Geneva, “in light of deteriorating labor costs in Germany, we consider these Chinese ventures to be most important for us as far as the long-term future is concerned.”<sup>14</sup>

An important key to a strategy for market penetration is knowledge about the preferences of officials in the host country who control market access. Chinese officials

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<sup>11</sup> For more on the bargaining power of German trade unions see Schonfeld (1965).

<sup>12</sup> *Handesblatt*, 7/13/1984.

<sup>13</sup> *Automotive Industries*, August 1996, by Richard Feast, p. 45.

at the national level were most interested in the acquisition of auto technology for building a domestic auto industry. The creation of foreign production facilities would also contribute to the emergence and growth of components, supply, distribution and services networks. Technology transfer would supply managerial skills, the influx of capital, the development of infrastructures, and access to export markets that could provide foreign exchange.<sup>15</sup> Officials also expected a multiplier effect: as the official Chinese news agency put it, “sino-foreign automobile joint ventures are playing a vital role in upgrading the country’s auto industry [because] they are helping the country bring up a new generation of automobile workers and management personnel, and forcing a large number of enterprises in related industries to reconstruct their production to meet the new needs.”<sup>16</sup>

Two additional concerns dominated in the Chinese preference for contracts with European and American firms: the loss of foreign exchange with the rise of Japanese imports and increasing economic dependence on Japanese auto firms. Contracts with European firms and intended technology transfer would stimulate the construction of locally-based production facilities that would decrease the need to generate foreign exchange for auto imports.

## **B. The initial joint venture deals : equity, investment, technology transfer and production volumes**

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<sup>14</sup> Reuters, 3/10/1989.

<sup>15</sup> Osland and Cavusgil (1996).

<sup>16</sup> Xinhua News Agency, 6/28/1987.

The above factors led to the Chinese government's invitation to Peugeot and Volkswagen to bid for joint venture contracts. The first agreement was signed with Volkswagen on October 11, 1984. It was preceded by active lobbying by the German federal government, both at the national and at the Laender level. Indeed, the last official visitor to China before the deal was signed was the Economics Minister of Lower Saxony, the home state of Volkswagen.<sup>17</sup> The equity investment in this deal was as follows: VW would invest 50 %, the Shanghai Tractor and Automobile Corporation would cover 35 %, and the Bank of China would provide 15 % of the total. The venture would establish production facilities for the Santana model, with the goal of producing 20,000 cars by 1988 and with the final goal of producing 100,000 cars by 1992. The agreement also called for the transfer of enough technology, training and equipment to raise the local component production to 90 %. The agreement also called for the opportunity to re-export back into Germany up to 80,000 engines by 1990.<sup>18</sup>

A similar agreement was signed with Peugeot five months later on March 15 1985. Equity investment shares were divided as follows: Peugeot would invest \$5.6 million; the Guangzhou Automobile Manufacturing firm would provide \$11.6 million, the China International Trust and Investment Corp. would provide \$5.1 million; the Banque Nationale de Paris \$1 million, and the International Finance Corporation would provide equity participation of \$2 million and a loan of \$15 million. Peugeot agreed to provide management direction with equity investment of only 22%. The production of the 504 pick-up model and of the 505 sedan would begin in 1988 with the an initial goal

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<sup>17</sup> Handesblatt, 2/28/1984.

<sup>18</sup> New York Times, 10/11/1984; Financial Times, 10/11/1984.

of 15,000 units by 1988 and with a maximum targeted goal of 30,000 units by 1993. Peugeot decided on the 504 and 505 models, because company officials predicted that the need for family and private cars in China would remain small for a number of years.<sup>19</sup> There was also an agreement to transfer 90 per cent of Peugeot's technology used in the production of these models, including engines, stamped body parts and axles.<sup>20</sup> This technology transfer was intended to cover Peugeot's 22 per cent investment share in the form of licenses, equipment, engineering and knowledge.<sup>21</sup>

China signed additional agreements with both firms in the early 1990s. Again, VW was first. VW agreed to produce the Golf sedan in the city of Changchun in the province of Jilin. Sixty per cent of the joint venture, called the FAW-VW Automotive Company, would be owned by the Chinese government and 40% would be owned by VW. The initial investment would be DM600 million, and the projected total investment would reach DM1.5 billion, including the construction of a car assembly, and an engine and gearbox plant. The venture was initially financed by a \$420 million, eight-year loan, syndicated jointly by Commerzbank and the Hong Kong unit of the Bank of China.<sup>22</sup> The plants were designed to reach a full capacity of 150,000 units.<sup>23</sup> Indeed, statements by Chinese officials went as far as to argue that this increased form of Sino-German auto production represented "the first step towards the target of stopping importation."<sup>24</sup>

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<sup>19</sup> Financial Times, 9/22/1986.

<sup>20</sup> South China Morning Post, 10/18/1985; Financial Times, 9/22/1986.

<sup>21</sup> Financial Times, 3/14/1985.

<sup>22</sup> NYT, 11/10/1992.

<sup>23</sup> Financial Times, 11/30/1990.

<sup>24</sup> Reuters, 11/20/1990.

Peugeot officials recognized that they had misjudged the market for passenger cars and made plans to compete directly with VW. In December of 1990, they began negotiations with the Chinese government to establish a Citroen plant in the city of Wuhan in the Hubei province. This venture would produce the Citroen ZX, a small-to-medium-sized car, designed to compete directly with the VW Golf. Citroen proposed to hold a 30% equity, with the long-established Second Automobile Works of China holding the rest of 4 billion yuan investment.<sup>25</sup> This deal was finalized in April 1992 with significant backing from French state-owned banks, with the French government directly providing 1.7 billion FFr in low-interest loans and 1.2 billion FFr. in buyer credits guaranteed by Coface, the French export credit agency and 1.1 billion FFr. provided by Chinese banks.<sup>26</sup>

### **C. Market Strategies**

#### *Localizing production: the multiplier effect*

Localizing production has both potential positive and negative benefits. We discussed the efficiency and standardization concerns above, and noted that consolidated auto firms are attempting to build regional (and even global) economies of scale through a rational division of labor among parts suppliers in the region. On the other hand, the localization of production and tight linkages between production networks and local suppliers can bring positive benefits. With local suppliers, a production base is created to launch an export strategy in the region---a more cost-efficient strategy for regional market

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<sup>25</sup> Financial Times, 12/21/1990.

<sup>26</sup> Financial Times, 4/10/1992.

penetration. Localizing production also gains favor with local authorities, because it stimulates the local economy and raises the profile of local officials. Localizing production also permits flexible production schedules; business officials can more quickly respond to market demands when its suppliers are in close contact.

Localizing production has its risks, however, in terms of quality control. Indeed, firms must face trade-offs between efficiency, currying favor with political elites, and the final quality of the product. Quality products are the key to long-term maintenance of market share. How did VW compare with Peugeot in managing this trade-off?

VW initially localized production in China in order to escape the constraints set upon it by the state allocation of import licenses.<sup>27</sup> This motivation, of course, was consistent with the preferences of the Chinese government; the goal was to create a locally-based system of components and parts suppliers that would further reduce the costs of shipping the parts from Germany and thus make the Chinese operation increasingly more cost-efficient in order to begin exporting in the near Southeast Asian markets. Substantively, the Shanghai VW joint venture established a captive supplier policy, encouraging use of suppliers within its locality. Nearly all of its suppliers were under the auspices of the Shanghai Auto Industry Corporation, the joint venture's Chinese partner. In turn, the supplier qualification process took up to four years and required approval for quality control from VW's German headquarters.

In contrast, Peugeot established an open supplier policy precisely because of lack of established Chinese suppliers that met the quality standards of the French firm. Thus, instead of following the VW example and establishing and training local components

suppliers, Peugeot opted for the import solution, continuing to rely heavily on suppliers in France.<sup>28</sup> What made the difference were the corporate strategic experience elsewhere and the corporate culture. VW had historically dedicated itself to a strategy of localizing content in all of its subsidiaries throughout Europe and Latin America; it was therefore able to draw on this experience in China. Peugeot, in contrast, had no such experience.<sup>29</sup> Out of the 120 suppliers that Peugeot wanted to locate in China only 30 had effectively done so by the end of 1994.<sup>30</sup> In contrast, VW had 100 components and licensing and know-how agreements and 40 joint ventures since it began local production and had another 30 joint ventures for parts and components under negotiation, effectively building the largest local supply network of any foreign manufacturer in China.<sup>31</sup>

Perhaps, more importantly, the localization of production within China, allowed VW the flexibility to produce at market levels and thus avoid the necessity of submitting to government-imposed production quotas and to avoid the need to generate the necessary foreign exchange for the importation of auto parts. In contrast, Peugeot maintained very low local content percentages in terms of its production, even though it faced the same, if not higher, import license quotas constraints. This problematic nexus between content localization and import licenses was particularly acute for Peugeot. It aimed for the production of 8,000 units in 1990 but only acquired import licenses for 4,700 units. It was not until October of 1990 that the licenses for more components were granted.<sup>32</sup>

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<sup>27</sup> Chicago Tribune, 1/14/1994; South China Morning Post, 11/20/1995.

<sup>28</sup> China Business Review, March 1994.

<sup>29</sup> Far Eastern Economic Review, 3/26/1992.

<sup>30</sup> L'Usine Nouvelle, 4/7/1994.

<sup>31</sup> Financial Times, 12/2/1994; 5/2/1995.

<sup>32</sup> Les Echos, 8/1/1990; South China Morning Post, 10/19/1990.

While VW quickly achieved its local content goal of 90 per cent, Peugeot never reached local content of more than 60 per cent.

### *Distribution and Service networks*

The creation of extensive distribution networks creates a powerful competitive advantage in that these networks act as a stronghold against market penetration by competitors. In China in particular, multiple distribution centers created before market liberalization could act as a barrier to potential market entrants when the market was opened. These networks, of course, also provide efficiency gains by permitting the product to reach the market quickly, thus assisting in maintaining targeted sales volumes. Extensive service networks pay off in reputation gains: they maintain product quality and longevity and thus increase brand loyalty.

VW officials were conscious of these benefits and created an extensive distribution network of over 400 centers that stretched the entire country.<sup>33</sup> Peugeot's distribution network was significantly smaller than VW's and played a role in Peugeot's inability to generate a profitable sales volume. Indicative is a quote from an executive of a western firm in China who was attempting to buy a Peugeot car: "When my company wanted to buy a Peugeot, there was no way to do so in Northern China. We had our driver sent to Guangzhou to get the car and drive it to Beijing."<sup>34</sup>

VW's extensive distribution network was accompanied by an equally extensive service network of over 200 service stations throughout the country. These stations

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<sup>33</sup> South China Morning Post, 11/20/1995.

<sup>34</sup> China Economic Review, January 1997.

proved to be crucial in increasing the reliability of VW automobiles, given the rudimentary and infrequently serviced nature of the Chinese road system. VW has at least one service center in every region of the country, from Tibet to Shanghai; its rule of thumb was that if there are more than 200 cars in one region, then there was to be at least one service center.<sup>35</sup> This reputation for paying attention to consumer needs was a first in the Chinese market. In contrast, Peugeot's service network of less than 100 stations was combined with an unfortunate geographical selection of the plant's location that further increased the costs of repairs and monitoring.

Finally, VW's customer loyalty was bolstered by the introduction of new models, i.e. by the creation of additional models to accompany the original VW Santana model. Peugeot, on the other hand, remained within the old framework of the 504 and the 505 models, even when there were signs that these models were not particularly in demand by the Chinese consumers as competing firms began to introduce newer and sleeker lines.

### *Human Capital*

Perhaps the most important market strategy was VW's emphasis upon human capital, both in management and in employment levels.<sup>36</sup> VW's management policy was to pair Chinese and German managers in such a way as to increase the learning curve of the Chinese managers. Furthermore, the German managers did not assume a patronizing tone towards the Chinese managers and the Chinese managers did not resent their better paid foreign counterparts. As we shall see below, Peugeot's strategy was quite different.

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<sup>35</sup> Financial Times, 5/2/1995; IPC Industry Week, 7/15/1995.

<sup>36</sup> By late October 1985, a total of 36 VW training staff were already on the ground in Shanghai, headed by Hans-Joachim Paul whose previous job was as the division head of the VW factory in Kessel (FT, 10/29/1985).

With regard to labor, VW was faced with the same problems that Peugeot faced: ill-disciplined workers who were grossly underproductive and often lacking the basic skills. The VW strategy was to create training institutes and workshops, both in China and in Germany. The training process was long, coordinated and extensive: Young workers were recruited from high school and given three-year courses, which included classroom lessons and practical training in such areas as machinery, welding and forging. After this training, they were given permission to work on the assembly line. Some of these workers were then sent to a two-year program in management training to Germany and upon their return to China, they were placed as assistants to managers in order to gain some practical experience. If their performance was satisfactory, then they were promoted to managerial positions. In the words of Fang Hong, senior engineer and managing director at the Shanghai VW plant VW's motto was to "train the people, organize the people, and motivate the people."<sup>37</sup> These training efforts were, of course, aimed at quickly increasing the technical know-how and the productivity of the Chinese auto workers.<sup>38</sup>

The creation of more training centers than were envisioned in the initial contract and the establishment of an independent R & D center spoke volumes about VW's commitment to worker training.<sup>39</sup> The R&D center would be supported by annually reinvesting 3% of the company's turnover. In the words of Martin Posth, the chairman of VW Asia-Pacific Group, this strategy would permit VW to "come up with cars engineered and designed between Germany and China with the latest technology,

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<sup>37</sup> China Business Review, September 1992.

<sup>38</sup> Xinhua News Agency, 6/28/1987.

produced in China and exported to the Southeast Asian market, which Japan and South Korea now dominate.”<sup>40</sup>

In contrast, Peugeot depended primarily on expatriate French managers and maintained limited interaction between Chinese and the French managers. The lack of contact between French and Chinese managers made it difficult for Peugeot to guarantee the productivity and the quality of the plant’s workers. And without the “socialization” that comes with extensive training, Peugeot managers found it difficult to overcome problems in labor negotiations, particularly in its effort to link pay with performance. Its Chinese partners feared that the workers would not support any paying scheme that would increase intra-firm employee income inequalities.<sup>41</sup> In contrast, the VW’s training program provided instruction on the link between pay and performance. As Fang Hong stated, “at Shanghai VW, we pay for the job and will only promote according to performance. If workers do well, they will get more wages, and will stand a better chance of being promoted.”<sup>42</sup>

#### **D. Non-Market Strategies**

The importance of non-market strategies cannot be overemphasized in the Chinese context. The need to deal with the Asian “developmental state” is magnified in the Chinese case. Recall the discussion of center-periphery relations and the importance of firm relationships with local and regional officials in privileged regions, and the

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<sup>39</sup> South China Morning Post, 7/2/1995.

<sup>40</sup> South China Morning Post, 11/20/1995.

<sup>41</sup> Asian Wall Street Journal, 1/27/1987.

<sup>42</sup> China Business Review, September 1992.

importance of understanding those officials' relationship with the center. The difference in region-level power greatly affected the survival and success of both joint ventures. Given a national context of politically determined preferential policies, it should come as no surprise that non-market strategies have been particularly powerful in determining the success or failure of business ventures.

The use of non-market strategies was particularly important in the Chinese automobile industry. Automobile production was considered by Chinese officials to be crucial to the growth and development of the national economy. Thus western firms were compelled to deal directly with Chinese government officials, both at the central and at the regional-local level. The Chinese central state determined the production levels of the foreign auto firms, the number of foreign participants in the auto sector, the price level of the products (something that determined not only the profitability of the joint ventures but also affected the ventures' long-term economic viability), and the allocation of import licenses for sorely-needed components and spare parts that could not be efficiently and quality produced in China. Indeed, during the early and mid-1980s, the central state set both automobile plant-level production targets as well as purchase orders for these production levels.<sup>43</sup> Furthermore, until 1994, the state provided the main market for autos produced in China.

For these reasons, both firms recognized the importance of political strategies aimed at government officials. However, while the German executives of VW were an almost constant presence in China, Jacques Calvet, the Peugeot CEO, did not visit China

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<sup>43</sup> Zongkun 1987, p. 234.

until 1997.<sup>44</sup> In contrast, Carl Hahn, the VW CEO, was in China on more than five occasions each time stressing the importance of the Chinese market to the German firm as well as the imperative need to create a fully localized product. Hahn made public statements to the effect that China represented a solid foundation as part of VW's long-term strategy and that VW had entered China with the aim of providing support not as a trader, but as a partner.<sup>45</sup>

### *The Presence of the State*

The German state, both at the local and at the federal level, was continuously and increasingly present in VW's Chinese venture, whereas the French state, especially the central government, remained conspicuously absent. The German government actively supported German firms in their efforts to penetrate the Chinese market. Indeed, the German government had discussed with Chinese officials the possibility of joint ventures for seven years before the 1984 agreement with VW was signed; it was the first Chinese joint venture with a European firm.<sup>46</sup>

High-ranking German officials made numerous trips with the explicit purpose of formally signing agreements and promoting even more joint projects. Indeed, Helmut Kohl accompanied Hahn to China for the signing of the Shanghai deal.<sup>47</sup> Close personal contacts paid off: for example, when the German parliament voted for the recognition of Tibetan independence, the Chinese government cancelled a visit by German Foreign

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<sup>44</sup> Daily Telegraph, 3/12/1997.

<sup>45</sup> Xinhua News Agency, 11/8/1989.

<sup>46</sup> Reuters, 2/28/1984.

<sup>47</sup> NYT, 10/11/1984.

Minister Kinkel, but did not alter the VW investment schedule. Kinkel was scheduled to visit China in July 1996, but after the Bundestag vote, Chinese officials postponed his visit until October, after what the Chinese government claimed was the restoration of “normal, healthy relations with Germany.” In the intervening period, according to the Chinese Foreign Ministry, the Germans had demonstrated that they were willing to discuss human rights issues “in a non-confrontal [*sic*] manner, based on mutual respect and equality.”<sup>48</sup>

Meanwhile, Mitterand maintained an open policy of support towards Taiwan, which extended as far as allowing the sale of Mirage jet fighters (something that could alter the military balance between Taiwan and China) to the Taiwanese. Further, he openly criticized the Chinese regime human rights abuses. It is instructive in this sense to observe how Chirac sought to change this policy perception by pushing for closer relations with China.

### *Technology Transfer and Quotas*

In the context of these foreign policy issues, firm relationships with government officials were also crucial. The Chinese had been adamant not only in their demand for total technology transfer at the end of the joint venture but also for the introduction of technologically advanced production and assembly lines. Again, VW came out ahead. Indeed, its use of extensive worker training, the voluntary creation of an R & D center and the increased localization of production afforded it a much more respectable position in the eyes of the Chinese decision-makers than Peugeot. Similarly, in terms of quotas

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<sup>48</sup> Financial Times, 10/23/1996.

(both production and import license ones) what mattered was the firm's willingness to demonstrate its goodwill vis-à-vis the Chinese authorities' plans and schedules.

### *Firm Relationships with Local Authorities*

Crucial in both dimensions of local non-market strategies was the role that the Chinese provincial and municipal authorities played in the determination of Beijing's policies towards the two firms.<sup>49</sup> Put succinctly, VW's operation in Shanghai was more favorably situated for the reception of preferential state policies than Peugeot's project in Guangzhou due to the increased power and access that the Shanghai party officials enjoyed at the highest central levels. As Burkhard Welkener, the deputy managing director of the Shanghai joint venture stated in 1989, referring to the Chinese local partners, "we have strong local support from the municipal government, which has invested over \$ 210 million thanks to the taxes, from the vehicles sold."<sup>50</sup>

Given the importance of guanxi networks in the determination of economic policy in contemporary China, it comes as no surprise that the two most important political actors in China in terms of economic policy in the 1988-1998 era were Shanghainese mayors who were instrumental in spearheading the regional economic liberalization drive. Indeed, the increased representation of Shanghai-based politicians within the higher echelons of the central state apparatus as well as their rapid rise has led some analysts to

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<sup>49</sup> Reuters 6/21/1986; Xinhua 1/18/1987.

<sup>50</sup> Journal of Commerce, 4/10/1990.

speak of a “Shanghai Mafia.”<sup>51</sup> Other analysts have stressed that the rise of Jiang Zemin and of Zhu Rongji in 1990 allowed Shanghai much more policy autonomy, which in turn led to Shanghai’s rapid rise as a foreign direct investment recipient area.<sup>52</sup> This emphasis on picking the local partner of a joint venture on the basis of their political connections cannot be underestimated. As Martin Posth, chairman of the VW Asia-Pacific Group argues, “if you have an investment with a bigger risk, you will need someone to deal with all those politicians and someone who knows the environment. As an example, what are you going to do if you don’t get enough energy? To whom do you speak? The local manager? ...My partner has sorted out many problems.”<sup>53</sup>

In the earlier stages of the project, the Beijing government allowed Shanghai a variety of flexible economic measures designed to provide the region with an inviting foreign direct investment environment. Most of these measures focused on foreign currency regulation including the increase in foreign exchange allocated to joint ventures and the granting of an authorization to the city government to demand payment for part of the joint venture products in foreign currency within China, which provided the VW joint venture with a more flexible way of raising foreign exchange for import licenses in the earlier stages of the project.<sup>54</sup> Indicative of this support for foreign direct investment in the Shanghai region was the establishment of an “International Businessmen’s Advisory Council” to provide input to local policy-makers.<sup>55</sup>

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<sup>51</sup> Miller (1996).

<sup>52</sup> Chow and Fung (1997), p. 254.

<sup>53</sup> IPC Industry Week, 10/27/1997.

<sup>54</sup> Xinhua News Agency, 7/15/1986.

<sup>55</sup> Economist, 3/17/1990.

Both Jiang Zemin and Zhu Rongji did their utmost to increase the preferential treatment that the Shanghai-based auto projects received from Beijing in terms of subsidies and financial assistance in moments of economic crisis. In contrast, the Guangzhou province was finding itself increasingly isolated in the decision-making circles of Beijing, a fact that played an important part in Peugeot's decision to place the Citroen in the Wuhan province, where the project was receiving strong central government support from the beginning.<sup>56</sup>

This crucial fact was illustrated aptly both in the 1989 economic crisis and in the 1993 central designation of the auto sector as a primary "pillar" (the most important and hence most heavily subsidized). Two issues were crucial: in 1989, in the aftermath of the Tiananmen Square demonstrations and an economic downturn, taxation was increased in the auto industry, and government demand for autos slumped. Already in 1988, the central government had levied new taxes, which included a \$6,750 tax on each car produced. This was followed March 1989 with a \$5,400 Special Consumption Tax. Bruno Gandeler, the General Manager of the Guangzhou Peugeot joint venture, lamented then that, "apart from the problem of getting a purchasing right ticket, the customer has to pay yuan 200,000 (\$54,000) for Peugeot 505 station wagon. We told them that they would kill the industry, but they ignored us. They say they are now considering cancelling the new taxes, but everything in China takes a very long time, and if they do not hurry up, we are dead."<sup>57</sup>

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<sup>56</sup> China Economic Review, January 1997.

<sup>57</sup> Financial Times, 10/19/1989.

The central government responded to this and other warnings about the fragility of the auto industry with an “emergency purchasing plan.” The plan was formulated by the China National Automotive Industry under the auspices of the Ministry of Materials and Equipment, and its aim was to “help sino-foreign joint venture automobile producers out of present difficulties.”<sup>58</sup> In 1989 VW received a bailout from the Bank of China in the form of a 100 million yuan loan for expansion. At the same time, however, Peugeot was still negotiating with the Bank of China for a smaller loan after one of its partners, China International Trust and Investment Corporation (CITIC), had failed to increase its equity stake in the company. Additionally, VW was permitted both a higher production quota and a higher quota of import quota licenses.<sup>59</sup>

Even in the process of the “emergency purchasing plan” there were different purchasing quotas: the State Purchasing Commission bought 1,500 Santanas from the VW joint venture, 500 Jeeps from the Beijing Jeep Corporation (the joint venture with AMC) and 800 Peugeots.<sup>60</sup> Both preferential actions were ascribed to the Shanghai Automobile and Tractor Industrial Corporation, Volkswagen’s partner in the joint venture. Shanghai Tractor was one of the most influential municipal-level organizations in China, with direct links to the central government in Beijing, and it was assumed to have been the initiator of the “emergency purchasing plan.”<sup>61</sup>

In 1993 VW was designated as one of the privileged firms in the auto sector pillar of the economy, which meant that it would receive increased state assistance and would

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<sup>58</sup> Xinhua News Agency, 11/29/1989.

<sup>59</sup> South China Morning Post, 12/7/1989.

<sup>60</sup> NYT, 11/20/1989.

<sup>61</sup> South China Morning Post, 12/7/1989.

be treated preferentially in the process of market liberalization. That meant that market barriers would be maintained as long as the VW products could not compete successfully with other imports and other domestically-produced autos. Peugeot, on the other hand, was deemed a mere domestic producer, possibly as a result of the distrust for the provincial government's allegiances at Beijing<sup>62</sup>. Other preferential treatments included tax exemptions, policy-oriented loans, and priority in using foreign funds and listing in stock and bond markets.<sup>63</sup> All these policies allowed VW to increase its chances to achieve economies of scale production capabilities, which for some analysts proved to be a powerful tool in solidifying its status as the pre-eminent Sino-Foreign automobile joint venture.<sup>64</sup> In short, VW greatly outmaneuvered Peugeot in that it was able to side with the most important and powerful (in terms of policy-making) provincial and local authority in China.

Finally, the VW management board publicly stated that China's entrance into the WTO should be delayed if the international community would not establish safeguards for the protection of domestic infant industries, like the auto industry.<sup>65</sup>

### **III. SUMMARY AND CONCLUSIONS**

For Peugeot the China experiment ended in disaster and in the sale of its production facilities. Part of the failure was market driven: Peugeot cars were too big and uneconomical for the size and the needs of the Chinese consumer. Production cycles

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<sup>62</sup> USA TODAY 9/10/1996.

<sup>63</sup> China Daily, 7/12/1995.

<sup>64</sup> De Bruijn, Jia and Konterman (1997), p. 357.

<sup>65</sup> South China Morning Post, 7/15/1997; Daily Telegraph 3/1/1997.

were not verticalized, and there was an overdependence on French expatriate managers that increased the costs of the investment. The distribution network was too small to increase the chances for product penetration. The Peugeot strategy had always been more oriented towards the Eastern European, Latin American and South Asian (Indian) markets. Part of Peugeot's failure can be accounted for by its faulty non-market strategies: Cooperation with the local authorities was slow to emerge, and given VW's prior entrance in the Chinese auto market and its increasing dominance, that flaw appeared to be driving Peugeot out of the market.

Conversely, the VW experiment showcased the particularly successful market and non-market strategies. The incentives for the internationalization of the German auto firms' production facilities were used most efficiently by VW which has consistently generated over seventy per cent of all the German auto firms foreign production.<sup>66</sup> There was a strong production network of assembly plants as well as components factories that fulfilled the Chinese requirement for domestic content. There was a strong distribution network that further increased brand loyalty and awareness. That brand awareness that was assisted by the fact that VW was the first major foreign auto firm to establish operations in China.

Non market strategies were also crucial. VW officials developed close ties with Chinese state officials in a favorable foreign policy environment. In a national economy that requires at least a 50 % stake in joint ventures and significant technology diffusion, this factor appears to have only helped VW. Given the different level of state support that these two firms were receiving from their national governments and given VW's prior

market entrance and capture of significant parts of the markets, it should not come as a surprise that VW has come out the victor out of this comparison. At this moment, VW and its local joint ventures in China have moved beyond the production of the sedan Santana in the South and have begun to include the production of more upscale Audis in the northern part of China. VW consistently maintains in excess of 50% of the local production and sales markets. This growth was maintained in the mid-to-late 1990s even in the face of the entrance of other auto firms in the Chinese market -- indeed, for the first five months of 1997, VW saw its China sales increase by 22.5% over previous year.<sup>67</sup>

Although not explicitly addressed in the above description of conditions for success and failure, it would appear that Hixon and Kimball's discussion of business organization sheds light on another dimension of VW's success.<sup>68</sup> While Peugeot simply constructed assembly operations that made autos locally, it used only designs, processes, components, and management approaches developed in France, VW established plant complexes in strategic locations that fabricated vehicles using local management talent and local components suppliers. Although quality control dictated standard operating procedures for management and labor developed in Germany, VW made extensive use of local management talent and local suppliers. This type of organization benefited both market and non-market strategies.

VW's victory has not gone unnoticed by American and Japanese competitors currently entering the market. In Asia, U.S. firms are facing Japanese firms which have built an extensive set of cross-national production networks, especially in Indonesia,

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<sup>66</sup> Automotive Industries, p. 45.

<sup>67</sup> Hong Kong Standard, 6/19/1997.

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Malaysia and in Thailand that allow for both the effective penetration of those markets and for the hedging of fluctuations in the economic conditions of China while maximizing the benefits of free-trade zones and low wages. This is a position that both Japanese and U.S. auto firms face vis-a-vis VW in China.

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