Fragmented Liberalization: Sub-National Government Autonomy and the Auto Industry in Post-WTO Era China

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Defining the relationship between state institutions and economic growth has been a perennial quest in social science. The rise of China provides a new opportunity to evaluate how late developing countries guide their economic development paths while learning from earlier developers amid extensive globalization. In transforming from a socialist to a capitalist economy, China has followed a developmental path of inviting foreign direct investment (FDI) from the onset of its economic development reforms in 1978, creating a continuing tension between the state’s need to shield its infant industry through protectionist measures and its need to integrate into the global economy through pro-competition and pro-liberalization measures. China’s foremost goal is to create a policy framework and regulatory environment that best promotes economic learning from other countries’ experiences without creating severe dependency.

In this context, both policy makers and academics have grappled to define the mode of interaction between China’s long legacy of heavy state intervention in the market and the liberalizing forces of multinational companies’ (MNC) entry into China and the country’s accession to international legal agreements. Most significantly, when China joined the World Trade Organization (WTO) in 2001, its entry was hailed as a significant step forward in opening up China’s markets and curbing governmental practices that placed foreign firms at a competitive disadvantage. China’s entry into the WTO raises several questions: How does an emerging economy like China resolve the conflict between a history of state intervention with the strictures of the WTO? To what extent are China’s national and sub-national governments willing and able to create a rule-based economy? How does a specific region’s interaction with global and local
economies in a given sector affect its ability to sustain economic development and promote industrial upgrading?

This paper investigates the relationship between Chinese regional economic development and the global economy from a comparative perspective. To accomplish this goal, I undertake a sectoral analysis of China’s burgeoning automotive industry, where the Chinese Central government limits foreign enterprises’ involvement to JVs with Chinese state-owned enterprises (SOEs). This ownership structure situates China’s auto SOEs between multinational global auto firms and Chinese regional governments—effectively rendering SOEs as the mediator between global and local economic forces. In this paper, I investigate SOEs’ role in mediating and restructuring global-local economic relations through two lines of inquiry: 1) examining the varying modes of SOEs’ incorporation into global production networks, and 2) exploring the factors that explain different SOEs’ capacity to develop supplier networks.

This paper proceeds by first discussing the empirical puzzle, then explaining the importance of studying the Chinese automotive industry to answer my questions about how the Chinese governments at various levels develop their economy in a globalizing and liberalizing economy. Next, I present a new conceptualization of global-local linkages in the Chinese case and of China’s sub-national governments’ role vis-à-vis international legal agreements and MNCs. The fourth section provides a summary of my three main Chinese automotive sector cases, my findings, and what contributions these findings make to political science scholarship on this topic.
Empirical Puzzle: Variation in Automotive JVs' Industrial Upgrading Capacity

Once considered the land of bicycles, China has surpassed the United States as the world’s largest automotive market and has accounted for more than a 20 percent share of the global automotive market since 2009. The main actors developing the Chinese automotive market are the JV between Chinese SOEs and global automakers. To ensure that China benefits from its relationships with global automakers, the Chinese Central government requires global automakers to form a JV with at most 50 percent of ownership granted to fewer than two Chinese SOEs. Ownership regulations greatly affected the pattern of competition in the Chinese automotive market. For SOEs, its controlling ownership over JVs situates them between Chinese local governments and global automakers. For MNCs, entry mode restrictions constrain two key business considerations of global firms—the mode and timing of entry. Thus, the new tide of reform created an “obligated embeddedness” for foreign automakers, whose integration into the existing political and industrial structure of a given region depended partly on their Chinese partners’ actions.¹

Furthermore, Chinese government heavily focused on developing competitive local suppliers as a way to boost industrial growth, creating employment and modernizing industrial capacity through local content requirements. The success of certain industries largely depends on a broad network of firms and suppliers, the so-called supplier network. Especially in the auto industry, developing supplier network is vital as one automobile consists of more than 20,000 parts and about 70 percent of value comes from components as compared to 15 percent in assembly. Recognizing the importance of

developing indigenous parts suppliers, the Chinese Central government puts strict local content requirements on JVs as early as the 1980s. Specifically, it required automotive JVs to purchase or use inputs of domestic origin.

Local content requirements have been extensively discussed in the context of trade, foreign investment, and industrial development. International organizations, in particular the WTO, have strongly attacked these policies, but policy makers in developing countries continue to be firm believers in their potential benefits. In the pre-WTO era China, each JV would face a severe penalty unless it met a localization content rate of 40 percent in the first year of production, 60 percent in the second year, and 80 percent by the third year. Under such a regulatory framework, JVs struggled to meet the local content requirements either by nurturing Chinese local suppliers or persuading their foreign suppliers to come to Chinese market. In the post-WTO era, the local content requirement has been abolished following WTO’s Trade-Related Investment Measures. However, as of 2008, most automotive JVs in China have achieved a local content rate of 90 percent localization or greater—which means the vast majority of their parts are produced within China.

The composition of Chinese automotive JVs’ supplier networks, and the degrees to which they include Chinese suppliers, differ dramatically. In this section, I examine the “first-tier” of Chinese auto parts suppliers—Chinese-owned enterprises and JVs between Chinese companies and foreign parts makers. A tier is defined by its transactional distance from the automakers: first-tier suppliers provide parts and inputs directly to assemblers such as Toyota or GM and manufacture the most significant parts for auto assembly—including brakes, engines, chassis, and shafts. First-tier firms are parents of
(and subcontract to) second-tier firms, and second-tier firms are parents of (and subcontract to) third-tier firms. Parent firms at each level are responsible for checking the quality and coordinating the flow of parts, materials, and services from the next lower level in a production system organized on the model of an extended family tree. Developing Chinese indigenous suppliers and models (zizhipinpai, 自主品牌) has always been the main focus of Chinese industrial policy. The development of local suppliers serves as a proxy indicator of JVs’ incremental capacity building and industrial upgrading. When a JV operation uses local Chinese suppliers, it means that local suppliers have significant industrial upgrading capacity and meet global quality standards. In this paper, I focus on first-tier suppliers, because I regard the inclusion of Chinese suppliers in the first-tier as a proxy indicator for Chinese suppliers’ industrial upgrading capacity.

Interestingly, some JVs (like Shanghai GM) include up to 40 percent Chinese local suppliers, while other JVs (like Beijing Hyundai) have less than 16 percent local suppliers. This is puzzling given that both SOEs and foreign automakers benefit from developing local suppliers. For SOEs, developing local suppliers is not just an economic matter, but also a political one—since it has the potential to generate jobs, foreign exchange, skills and backward linkages. As a large enterprise group, each SOE has approximately thirty to fifty in-group companies and a total of 10,000 to 100,000 employees—and developing strong local suppliers is key to sustaining auto development in their respective regions.² For foreign partners, improving the quality of local suppliers

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² As of 2002 data, both central government owned SOEs of the First Auto Works and Dongfeng each have 100,000 employees. Regionally owned Shanghai Automotive Industry Corporation has 59,000, Beijing Automotive Industry Corporation has 35,000, and Guangzhou Automotive Industry Corporation has 14,000 employees.
greatly contributes to cost reduction, since 70 percent of an auto’s value lies in auto parts and only 10 to 15 percent lies in assembly. Given these circumstances, why do some JVs “thrust” local suppliers up the production ladder and create clear global-local linkages, while other JVs largely remain “stalled” at the low value-added segment of production? As all JVs face similar market conditions in the automotive industry, why do their supply networks differ? What factors explain such variations and why do these variations matter?

This paper attempts to understand such variations in the context of China’s efforts to create global-local linkages and promote industrial upgrading. Examining the variation in automotive JVs’ supplier network development will illuminate the Chinese method of promoting industrial upgrading at the sub-national level and the impact of different sources of FDI on local economic development. Moreover, sub-national governments’ ability to develop local suppliers demonstrate how they navigate through international and national regulatory environments to develop their own local economy in competition or cooperation with MNCs.

**Why Study the Chinese Auto Industry and Why Conduct a Sectoral Analysis?**

In analyzing the relationship between Chinese regional economic development and global firms’ market strategies, I conduct a sectoral analysis of the Chinese automotive industry. Labeled the machine that changed the world, the automobile has remained at the center of one of the most strategic sectors for economic development on account of its impact on job creation and industry capacity building. With its high visibility, the auto industry serves as the most representative sector for explaining

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different countries’ developmental paths in cross-national comparisons: Latin America’s “dependent development,”4 East Asia’s “developmental state” practices,5 and Iran’s underdevelopment.6 As such, studying the Chinese auto sector’s development reveals the core characteristics of the Chinese strategy for developing its economy and integrating itself into the global economy.

Second, as a latecomer to the global automotive scene, the Chinese automotive industry serves as an interesting case to examine the delicate interplay of rules at the international, national, and sub-national levels. At the international level, China’s accession to the WTO in 2001 reformulated the way that the country implements its tariff regulations and liberalization measures. The WTO compelled the Chinese Central government to lift more than 7,000 trade barriers, grant foreign companies’ greater market access, and treat foreign and domestic businesses on more equal terms. At the national level, the Chinese Central government has consciously guided the automotive sector’s developmental path ever since it implemented the country’s seventh five-year plan in 1986. In recent decades, the Chinese Central government has created a framework of market and non-market rules for sub-national governments and global automakers by setting ownership regulations, local content regulations, taxation policy, and corporate laws. At the sub-national level, China’s provincial and municipal governments implement WTO policies and Chinese Central government regulations in ways they hope will promote a successful automotive industry. The automotive sector is more decentralized

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and fragmented than other parts of the Chinese economy, as sub-national governments own automakers and attempt to create regional champions.

Lastly, the automotive sector provides the best illustration of the interaction between MNCs and China’s sub-national, government-owned enterprises due to strict ownership regulations. The required JV format has not only affected patterns of market competition, but have rendered SOEs as the node between local and global economic forces.  

The spatial configuration of supply networks and industrial clusters in a given region significantly impact the mode of JVs’ integration into the Global Production Network (GPN) and SOEs’ economic competitiveness. Different JVs—between SOEs in different regions and MNCs with varying national origins—develop their supplier networks and localize their production in varied ways. By demonstrating how different regional clusters and industrial districts are incorporated into the GPN, my paper demonstrates how 1) sub-national governments serve as a gatekeeper between global economic factors and local industrial upgrading, 2) different factors affect sub-national governments’ ability to insert their regional economy into the GPN, and 3) SOEs play an extensive role in mediating and restructuring global-local economic relations. I am especially interested in how certain regions developed their relationship with the global economy and how that process affected specific sectors’ industrial upgrading capacity. I focus mainly on industrial upgrading because sustaining economic growth requires a

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different set of capabilities and strategies than what is required at the initial phase of economic development.

**Conceptualizing Global-Local Linkages: The Double Forces of Dependency**

In promoting economic development, the Chinese Central government has used SOEs (rather than full privatization) as the main driver of globalization. These SOEs, which are owned either by the central or sub-national governments, serve as the node between global and local economic forces. They are in situations that I call “dual dependencies”—where SOEs have to rely both on the local government and global automakers for different resources and assets in order to maintain business operations (Figure 1).

The political science literature on global-local linkages helps in the conceptualization of this idea of “dual dependencies.” One useful concept is the *outside-in perspective*, which focuses on global firms’ organizational structures and global strategies and how particular regions “slot into” these networks with varying degrees of impact on industrial upgrading. However, this approach neglects regional institutions’ considerable impact in the industrial upgrading process and how MNCs’ operations in other parts of the world can be “lost in translation” when the company relocates to countries such as China. MNCs’ traditional “global strategy,” which is formulated in a

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developed-country context, may not work in emerging markets where institutional contexts are markedly different.\textsuperscript{11} In emerging markets, government institutions play a particularly important role in MNCs’ FDI decisions. Host governments can alter their policies quickly—and when host countries change their FDI policies, MNCs may need to change their strategies.\textsuperscript{12}

Another helpful concept for explaining dual dependencies is the \textit{inside-out perspective}, which focuses on indigenous institutional structures and their ability to “hold down” global networks.\textsuperscript{13} For example, Liu and Dicken have studied how MNCs fulfilled “obligated embeddedness” in China by adapting themselves to the existing industrial structure in a given local partner’s territories.\textsuperscript{14} Yet this approach places heavy emphasis on domestic conditions and ignores the possibility that MNCs shape the existing industrial structures where they become embedded. Specifically, this view falls short in accounting for 1) why some foreign partners are more successful than others in embedding themselves into a given region’s existing industrial structure and 2) how cooperation between SOEs and foreign partners prior to the formation of a JV affects the mode of obligated embeddedness (e.g., licensing cooperation or the entry of parts suppliers before assembly plants).


\textsuperscript{14} Liu and Dicken, \textit{Transnational Corporations and ‘Obligated Embeddedness’}. 
In striking a balance between the outside-in and inside-out perspectives, this paper situates SOEs as the focal point of interaction between insiders and outsiders in the Chinese economy and explains how these interactions produce different production network configurations and varying degrees of industrial upgrading capacity.

**Figure 1: Conceptualizing SOEs’ Dual Dependency in Supplier Network Development**

My primary dependent variable is China’s automotive JVs’ supplier network configuration—that is, the composition of suppliers as determined by their national origins and ownership structures. Different configurations reveal how SOEs develop their own local suppliers in cooperation or in competition with their JV foreign partners. Three actors deserve our attention in evaluating the development of local passenger vehicle supplier networks in China: 1) sub-national governments, 2) SOEs in the auto sector, and 3) foreign JV partners.

First, Chinese regional governments are most concerned about JVs’ impact on local economic development and potential economic benefits in the form of tax revenue, GDP growth, and employment. In the longer term, cooperation with MNCs is also
expected to yield technology transfer and capacity building to Chinese firms. Therefore, sub-national governments attempt to encourage both Chinese suppliers and regional JVs in their regions through various protectionist policies. Second, SOEs, which are owned and funded by local governments, also generally support the development of local suppliers. However, as SOEs evolve, they develop interests as a business group and face the need to be more competitive. The introduction of competitive market forces pushes SOEs to survive on their own by developing administrative distance from the government. Finally, because all Chinese passenger car development must take the form of a JV, foreign JV partners serve as the third important actor in boosting local Chinese suppliers’ industrial capacity building. The Chinese Central government has regulated global automotive firms’ most important early market strategies: the mode and timing of their entry into JVs for assemblers and important auto parts markets. These Chinese government regulations mean that foreign auto companies possess little control over selecting a local partner and must embed themselves into the existing local industrial structures and institutions. In addition, China’s strict local content requirements rendered the JVs to devise sourcing strategies not just based on business concerns but also based on political concerns. To maximize profits, MNCs tend to pursue supply chain optimization and purchase from suppliers with the best offers or from closely linked in-group suppliers rather than from local Chinese suppliers.

In examining the role different parties play in local supplier development, I focus on three explanatory variables. The first variable is macro-level governance, which refers to the role government policy and governing institutions play in a given region’s auto sector—both of which can demonstrate a government’s ability to manage the
development process. Examining a government’s industrial policy goals and government leaders’ incentive structure also helps explain the leadership’s willingness to develop a local supplier network.

The second variable I explore is the micro-level, institutional factors of intra-firm structures and inter-firm relations within individual auto-manufacturing groups. The auto SOE (qichejituan, 企业集团) is a large business group consisting of several dozens to several hundreds of auto assembly plants and supply firms under its own roof. The head office of an auto group structures and coordinates relationships among firms (between the assembly plant and suppliers) in its jurisdictions. It channels investment funds to its subsidiaries and oversees their development. The powers of automotive industrial groups vary from city to city, and micro-level institutional factors determine their level of control over firms within the group and their willingness to develop their own local suppliers.

The third variable I examine is the way a foreign partner embeds itself into a region’s institutional and industrial structures. As noted earlier in this chapter, all of China’s passenger car development has taken the form of joint ventures, where foreign companies have little control over selecting a partner and must embed themselves into existing local industrial structures and institutions. It is important, however, not to underestimate MNCs’ capacity to proactively devise their own strategies in China rather than just respond to Chinese regulations. Even though MNCs must enter the Chinese market as JVs with Chinese SOEs, my research reveals that pre-JV modes of cooperation between MNCs and SOEs and the path dependency they create are critical for future cooperation. Most of the research on foreign automakers’ entry into the Chinese market takes the formal negotiations leading to the formation of a joint venture as an analytical
starting point. MNCs, however, tend to start their informal negotiations or market entry preparation in advance of JV negotiations. When global automakers do not have arrangements in China prior to forming JVs, they face huge burdens in developing and identifying local suppliers. To avoid these problems, some foreign automakers began their Chinese operations by entering into technology licensing agreements with existing local auto manufacturers and then developing full-blown joint ventures. This mode of operation can serve as a litmus test for more extensive future investment. Another mode of engagement is the “pre-clusterization of suppliers,” where the foreign automakers send major suppliers into a foreign country to form a virtual supply plant prior to the entry of OEM. The last and the most common mode of engagement is “follow the flag,” where the OEM enters the foreign country and suppliers follow suit.

Given these circumstances, I have placed foreign automakers’ mode of industrial upgrading and supplier network development in China into four categories: obligated embeddedness, pre-clusterization, bandwagoning, and disintegration (see table 1). Obligated embeddedness (state-driven development, with a high local supplier presence) happens when the regional government, with help from MNCs, drives the industrial upgrading process. In this scenario, a regional government has a great capacity and willingness to develop local suppliers by nudging or coaxing foreign JV partners to help establish them. In the process, global automakers embed themselves into existing local institutions. Shanghai GM falls under this category of obligated embeddedness, where the municipal government–owned Shanghai Automotive Industry Corporation invested in co-developing and identifying qualified Chinese suppliers for GM in order to help the foreign company meet local content requirements and settle smoothly into the Chinese
market. Shanghai GM now obtains has about 40 percent of its “first-tier” automotive parts through companies that are either Chinese-owned or are Chinese-majority JVs with foreign companies.

*Pre-clusterization* (MNC-driven development, with a high local supplier presence) is a process where a business group’s suppliers and subsidiaries enter an emerging market before the core firm and begin to cluster in the location the core firm is targeting. This approach differs markedly from auto companies’ more common “follow-the-flag” approach to market entry. Usually, an automotive business group’s suppliers and subsidiaries follow the core firm’s lead and start investing in an area after the core firm has established factories. Toyota, for instance, followed this strategy with its entry into Southeast Asia in the 1960s and to the United States in the 1970s. Even after experiencing significant success with network-based foreign entry into Southeast Asia, many suppliers in the Toyota Group had initially been reluctant to relocate to the competitive North American market in the 1980s. Thus, Toyota had to provide parts suppliers with financial support and introduce them to potential local partners in order to encourage them to enter the U.S. market. Toyota’s China story, however, reversed such practices and became a representative prototype of the pre-clusterization strategy. Toyota’s major affiliated parts-manufacturing subsidiaries formed a virtual assembly plant by entering the Chinese market before the parent company. This was because when Toyota developed its interest in the Chinese market in the mid-1990s, the Chinese government announced a five-year moratorium for assembly JVs. Thus Toyota had to bear the status of absolute late entrant to the market. But the pre-clusterization of Toyota’s suppliers, in the form of JVs with Chinese parts companies, significantly
contributed to the Chinese suppliers’ industrial upgrading capacity, thereby enabling Chinese suppliers to participate in Toyota’s relatively closed supplier network. Among Toyota’s 104 parts suppliers, about 16 percent of its “first-tier suppliers” are either Chinese-owned or Chinese-majority JVs with foreign partners.

*Bandwagoning* (MNC-driven development with fewer local suppliers) happens when a foreign JV partner essentially controls the process of network development and the regional government wields less control over the sourcing strategy. In this type of development, exemplified by Beijing Hyundai, the foreign JV partner can transplant its supplier network from its home country, thereby spending less time and effort in identifying or developing Chinese local suppliers. The Beijing Municipal government allowed Hyundai Motor to bring its suppliers from Korea to China by abandoning the goal of developing indigenous parts companies. Such a strategy not only contributed greatly to Beijing Hyundai’s high localization rate, but also enabled Hyundai to expedite its adjustment to the Chinese market and initiate production more quickly.

*Disintegration* (state-driven development, with fewer local suppliers) occurs when the regional government has a weak capacity to develop the local supplier network despite its desire to do so. Most auto SOEs that lack clear ties to MNCs fall under this category, and they suffer from low-quality products and an inability to create economies of scale. Most JVs in this category represent failures to enter the Chinese market, including Beijing Jeep Corporation (a JV between Beijing Automotive Industry Company and American Motor Company) from 1984 to 1999 and Guangzhou Peugeot from 1986 to 1997. In both of those cases, the local government blindly imposed local content requirements without providing any policy support for the development of local
suppliers. The government relegated the obligation of developing local suppliers to these JVs’ foreign partners, and neither American Motor nor Peugeot wanted to use Chinese suppliers. They were only interested in using cheap Chinese labor to assemble imported, ready-to-manufacture car models (known as “knockdown kits”). Such tension over localization and the forced use of local suppliers not only damaged the health of these JVs, but also hampered cooperative relations between JV partners. This dissertation does not directly deal with this category of “disintegration,” as it does not include any successful examples of JVs creating industrial upgrading and global-local linkages in the context of supplier network development.

Table 1: Different Models of Supplier Network Development

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**RESEARCH DESIGN, FINDINGS, AND CONTRIBUTIONS**

To trace interactions between sub-national governments and global automakers, I conducted a structured comparison of three automotive JVs in China: Beijing Hyundai, First Auto Works-Tianjin Toyota, and Shanghai GM. I chose these cases for the following reasons. First, they show variation in terms of local supplier network development, allowing me to trace the process of sub-national governmental intervention
in the entry and operation of JVs, and the WTO’s impact on sub-national industrial policy. This approach reflects the methodological considerations of my project—since the research objective is to explain variations rather than the sameness in the dependent variable; the postulated independent variable should take on values as different from each other as possible. The analytical focus here is on the specific institutional arrangements between SOEs and MNCs in developing supplier networks. Second, I chose these cases because they are representative of other JVs in the Chinese automotive industry that fall within my own postulated categories of industrial upgrading: Shanghai GM represents the SOE-driven approach with a high local presence, Beijing Hyundai represents the MNC-driven approach with a low local presence, and Tianjin Toyota represents the MNC-driven approach with a high local presence. Third, these three cities tend to attract FDI from different partners: Beijing from Korean automakers, Shanghai from American automakers, and Tianjin from Japanese automakers. My research design will help us evaluate the existing debate in the scholarly literature about the impact of FDI’s specific national origin on local economic development, the so-called home-country effect.

Because this research examines the automotive industry in a single country through intra-national and inter-regional comparisons, I can hold the regulatory environments at the international level (WTO rules) and national level (Chinese Central government laws) constant. This enables me to further investigate how policy implementation varies across regions within one country. Also, the Chinese Central government’s regulations on ownership eliminates the importance of MNCs’ mode of entry, since all three cases under examination are 50:50 JVs between Chinese regional governments’ SOEs and global automakers. Unlike case studies within just one issue area
or large-N studies of undifferentiated auto groups, my process-tracing among representative JV models elucidates the extensive role SOEs play in mediating and restructuring global-local economic relations.

The Chinese automotive JVs examined in this project are representative cases of each category I developed to explain the varying approaches to industrial upgrading and supply network development. All three cases are strong and successful actors in the Chinese auto market, but the ways they developed supplier networks have varied. In the next section, I provide an overview of three different styles of industrial upgrading: bandwagoning (Beijing Hyundai), pre-clusterization (Tianjin Toyota) and obligated embeddedness (Shanghai GM). I also examine one unsuccessful method of industrial upgrading: disintegration.

1) Bandwagoning (MNC-led development, with a low local supplier presence): Beijing Hyundai

The development pathway for Beijing’s automotive industry represents a case where a municipal government and its protégé SOE developed a supplier network by completely relying on a foreign partner. Beijing Automotive Industry Holding Company (BAIC) became a pioneer by forming the first auto JV in China—Beijing Jeep Corporation, founded with American Motor Company in 1983. However, Beijing Jeep suffered from a lack of local supplier development and disagreements about localization strategy. The Beijing city government and the BAIC displayed weak leadership by failing to aggressively promote Jeep sales or adeptly manage BAIC’s fragmented organizational
structure. BAIC instead rigidly pressed the American Motor Company to follow local content regulations requiring the use of Chinese parts suppliers. Eventually, the JV failed in the market and became “a symbol of conflicting interests, hidden charges, miscommunication and unattained goals.”

After this failure, Beijing had to wait until 2002 to produce passenger vehicles with the city’s second JV—Beijing Hyundai Motor Company (BHMC)—and take its share in the rapidly growing passenger vehicle market. Unlike the first JV, BHMC reaped marked success within three years of operations and turned Beijing as one of China’s major passenger car assembly centers along with Shanghai, Guangzhou, and Changchun. Nevertheless, despite its half-century history of producing light trucks and Hyundai’s recent breathtaking market penetration in China, Beijing has never succeeded in developing a strong local supplier base and nurturing indigenous auto parts makers. In order to expedite Hyundai’s operation and revamp Beijing’s ailing auto industry, BAIC decided to source most of its parts from Hyundai’s own Korean-based suppliers and relegated the majority of sourcing control to Hyundai. This serves as a typical case of the “follow-the-flag” strategy, where suppliers only invest in foreign countries after the parent company has established its assembly lines.


18 Gregory Noble, John Ravenhill, and Richard F. Doner, “Executioner or Disciplinarian: WTO Accession and the Chinese Auto Industry,” *Business and Politics* 7, No. 2 (2005): 5. Beijing Jeep Corporation never found a mass market for its sports utility vehicles and struggled into the 1990s to produce just more than 15,000 to 20,000 vehicles. Its domestic JV partner, BAIC, had neither aggressively promoted Jeep sales nor swiftly implemented organization reform on the account of its fragmented organizational structure and the lack of strong leadership in the Beijing municipal government.
Many researchers have depicted Beijing city government and BAIC as two of the weakest domestic players in developing China’s auto industry. I argue, however, that Beijing found its own strategic advantages by combining both laissez-faire policies and protectionist measures. The Beijing city government relied on local protectionism by using government procurement to promote Hyundai’s model for its own taxi market. At the same time, it followed a more laissez-faire approach by allowing Hyundai to bring its Korean suppliers to China. Beijing did not receive much political criticism for failing to nurture indigenous companies under this arrangement, since it framed the decision as a consequence of WTO rules requiring China to treat foreign and domestic companies more equally. Such mixed use of protectionism and liberalization demonstrates the importance of sub-national government industrial policy in the context of fragmented liberalization, a topic I will discuss in greater detail later in this dissertation/book.

2) Pre-clusterization (MNC-led development, with a high local supplier presence): Tianjin Toyota

Tianjin, one of the most historically important heavy industry bases in China, spurred its auto industry development with the establishment of Tianjin Automotive Industry Company (TAIC) in 1983. TAIC incorporated the city’s five existing auto assembly plants and forty-five parts factories. However, the Central government’s alternating attempts to decentralize and centralize China’s automotive industry have disrupted the Tianjin Municipal government’s auto sector development, especially because of Tianjin’s proximity to the Central government and its status as a direct-controlled municipality by the Central government. Despite numerous administrative changes at the SOE level, however, TAIC was able to develop a strong supplier network due to its unique strategy
of attracting FDI. While Shanghai, Guangzhou, and Beijing participated in China’s automotive sector reform by establishing 50:50 JVs with MNCs, Tianjin established a technology-licensing agreement with the Japanese small carmaker Daihatsu in November 1986. TAIC and Daihatsu formed a seven-year contract to produce the Charade (Xiali in Chinese), which became the number one small car and the number one taxi model in China from 1990 to 1998. The Charade not only experienced five major upgrades and hundreds of improvements, but also had three generations products, which are all developed with their own independent intellectual property rights. Thanks to TAIC’s technology-licensing agreement with Daihatsu, Tianjin Xiali became China’s second-largest overall carmaker in 1991-1997 after Shanghai Volkswagen.

Tianjin’s cooperation with Daihatsu also opened the door for a JV with Toyota in 2000. Toyota only realized the value of the Chinese market in the late 1990s, after the Chinese government had declared a five-year moratorium on the launching of new assembly JVs in 1995. In this context, Toyota and its suppliers confronted an unpredictable situation in the 1990s regarding 1) whether it could establish an assembly plant, and 2) if so, when the core firm’s local operations would start. Consequently, Toyota had to bear the status of an absolute late entrant to the Chinese market when it finally obtained the Chinese government’s permission to form a JV with TAIC in 2000.

These idiosyncratic circumstances helped Tianjin build up strong local parts suppliers in its cooperation with Toyota, a company that is known for having a closed supplier network. First, Toyota merged with Daihatsu as a way to create a foothold in Tianjin and overcome its disadvantage as an absolute latecomer to the Chinese market. Toyota increased its equity stake in Daihatsu from 16.8 percent to 33.4 percent in
September 1995, establishing a controlling interest under Japanese commercial law. It then increased its stake in Daihatsu to more than 50 percent in early 1998, converting the company into a legal subsidiary of Toyota. Second, Toyota’s late entry into the Chinese auto market meant member firms in the Toyota Group had to devise an entry strategy for China that differed from Toyota’s strategies in other parts of the world. Toyota’s first-tier suppliers, such as Nippon Denso and Aishin Seiki, entered the Chinese market starting in the early 1990s and formed a virtual supply plant before the core firm fully entered the market. This pre-clusterization strategy contrasts to the common practice of “follow-the-leader” FDI investment, which Toyota’s suppliers followed in Southeast Asia in the 1960s and the United States in the 1970s. In other words, the Tianjin Municipal government’s licensing cooperation decision with Daihatsu and its efforts to develop local suppliers aligned well with Toyota’s particular situation in China, where the automaker was encouraging its parts suppliers to enter the market before the parent company.

These circumstances also explain why Toyota chose TAIC as its first JV partner in the passenger vehicle market. In the late 1990s, China’s impending accession to the WTO prompted preemptive price cuts among Chinese automakers, and Tianjin Xiali was rapidly losing market share due to the entrance of new competitors such as Shanghai GM. Even though Toyota’s first bid with the strongest auto SOE in Shanghai failed, Toyota made the strategic movement of approaching the relatively weak partner yet under the close supervision of the Chinese government of the Central government. In the end, the Tianjin Municipal government and TAIC began to look for another company to rescue Tianjin Xiali, and the Central government–owned First Auto Works merged with TAIC
in 2002. Toyota strongly supported this merger between the two Chinese automakers, which enabled Toyota to gain access to the Central government–owned SOE (First Auto Works) and expand its operations nationwide.

3) Obligated Embeddedness (state-led development, with a high local supplier presence): Shanghai General Motors

Shanghai’s automotive industry development followed the developmental-state model, but at the local level. Taking advantage of its status as a traditionally strong industrial base, Shanghai pursued various industrial policies to develop its local auto suppliers starting in the early 1980s. The Shanghai government developed a hierarchical institutional structure to govern its auto industry, which gave it a greater capacity to channel capital and monitor the sector’s development.

Yet the city’s first JV, with Volkswagen, did not initially help the Shanghai government’s effort to develop local suppliers—as Volkswagen was keen on just importing knockdown kits to China for assembly purposes only. Consequently, Volkswagen’s JV model, the Santana, achieved only a 2.7 percent local content rate by early 1987. However, the Shanghai government and Shanghai Automotive Industry Company began flexing their muscles by supporting measures to help Volkswagen identify and develop qualified local suppliers. The Shanghai government not only established a localization office to streamline the development process, but also charged customers an extra 28,000 RMB ($4,300) per Santana to fund parts localization. In order to make up its decline in Europe, Volkswagen was desperate to succeed in the Chinese market. The Shanghai government’s localization initiatives, combined with Volkswagen’s desire to succeed in China, led to Volkswagen increasing its local content
rate to 92.9 percent by 1997. Shanghai Volkswagen captured about 51 percent of the Chinese passenger car market by 1997, establishing it as the dominant market player throughout the 1990s.

Shanghai’s success with Volkswagen carried over into the city’s second automotive JV, a partnership with GM. Shanghai held the upper hand when foreign automakers entered bids to join the city’s second auto JV, because: 1) many global automakers wanted to enter the Chinese market before China’s entry into the WTO, and 2) Toyota, GM, and Ford had all placed bids to be Shanghai’s JV partner. For this second JV, the Shanghai government required the foreign automaker to achieve a higher level of technology cooperation than Volkswagen had established. As a result, GM, which entered the winning JV bid, ended up providing an unprecedented level of technical support for the JV by establishing the Pan-Asia Technical Automotive Center with SAIC. This center not only contributed to Shanghai’s local supplier development, but it also put huge pressure on other global automakers such as Volkswagen to increase their R&D activities in China and provide more up-to-date models. As such, the Shanghai GM case shows how the Shanghai government led the process of localization in the Chinese auto sector and helped its global automaker partners embed themselves into Shanghai’s existing industrial structure.

In addition, Shanghai GM is at the forefront of the merger and acquisition (M&A) wave in China, which GM sees as a way to extend its supplier network throughout the country. For more than ten years, M&A has been a central theme of the global automobile industry, brought on by automakers’ need to ensure sustainability and also to contend with inconsistent and excess production capacity. However, M&A activity is
constrained for MNCs, because foreign automakers are limited to two JVs in China. Yet MNCs can extend their networks in China via the help of their Chinese JV partners or their international affiliates. GM’s development in China is one such case. At present, the GM group has the most extensive network of automotive production in China, anchored in eight cities (Shanghai, Shenyang, Liuzhou, Yantai, Chongqing, Nanchang, Jingdezhen, and Anshun). GM itself has two JVs in China, Shanghai-GM and Jinbei-GM (in Shenyang) to produce passenger vehicles and off-road vehicles, respectively. But because it is not allowed to establish a new JV in passenger-vehicle production, GM has persuaded its existing Chinese partner, SAIC, to take over other local competitors such as the Liuzhou Automobile Plant (the biggest minivan producer in China) and a car-assembly plant in Yantai, Shangdong province. In effect, these new JVs are considered to be an extension of GM’s partnership with SAIC according to Chinese government regulations. Thus, Shanghai GM provides an interesting avenue to examine how strong regional players’ takeovers of minor regional players affect local suppliers’ industrial upgrading and the cross-regional expansion of suppliers.

4) Disintegration (State-led development, with a low local presence): Failed JVs

In a globalized market, the existence of sound market institutions and clear regulations in a country are considered to be important factors that reel in FDI and affect investors’ confidence. However, foreign investors have not been deterred by China’s inadequate institutional foundations, infamous bureaucratic mazes, and rapidly changing business environment. Even under these circumstances, investors have been willing to assume a certain degree of political risk in China based on the expected returns of their investments. As early as 1983, automotive companies were among the first foreign
investors to make inroads into China to vie for market share in the world’s largest potential automotive market. However, not all major global automakers proved themselves capable of competing, as illustrated in the failures of automotive JVs Guangzhou-Peugeot in 1998 and Beijing-American Motor Company in 1999. The most commonly cited explanation behind the failure of these two JVs, as well as the failures of other JVs in the Chinese market, involves local content requirements.

Guangzhou Peugeot followed a development path very similar to the JV between BAIC and AMC, which was discussed earlier in this chapter. In the Peugeot case, the local Chinese government in Guangzhou pressured the foreign auto company to increase local content requirements, but did not institute any specific policies that facilitated this goal. Despite the Chinese national government’s promotion of auto industry development throughout 1980s and 1990s, the Guangzhou SOEs often took the different route. In the late 1980s and early 1990s—the critical time period for the localization drive at Guangzhou Peugeot—the SOE’s head office decided to invest in profitable real estate or trading companies rather than investing in manufacturing operations and local supplier development. In addition, Peugeot came into the Chinese market with its most outdated model—the Santana—and wanted to take advantage of Chinese cheap labor for knock-down assembly rather than invest in local industrial upgrading. After over a decade of friction over the sourcing strategies and local content regulations, Peugeot retreated from the Chinese market by selling all of its factories and facilities to Honda in 1997. As in the case of Guangzhou Peugeot, Chinese local governments’ emphasis on local content requirements often hampered automotive JVs’ overall health.
SUMMARY OF FINDINGS

My paper investigates SOEs’ regional supplier network development within Chinese automotive JVs. My research started with the belief that capacity building and incremental local supplier development serve as alternative measures for SOEs’ performance within JV cooperation. Even though they do not have independently successful models outside of their JV brands, some SOEs are developing their Chinese local suppliers and bringing them into the orbit of JV production.

In explaining the variation in how Chinese automobile SOEs build their industrial capacity within the framework of JVs, I make three central claims. First, I find a great deal of variation in the extent to which SOEs have been able to engage in backward and forward linkages by drawing on the expertise and knowledge of their MNC partners. I argue that the formation of supplier networks and the efficacy of local supplier development in China’s auto industry depend not only on local institutional factors, but also on SOEs’ ability to juggle their “dual dependencies” on local governments and foreign partners. Evolving SOE reform provides opportunities for SOEs to reconfigure these dual dependencies—not only by altering their administrative ties with local governments, but also by using their bargaining power vis-à-vis foreign partners. By identifying SOEs’ different modes of incorporation into the global production network, my paper shows the extensive role SOEs play in mediating and restructuring global-local economic relations in China’s auto industry. Some SOEs develop cooperative mechanisms within JVs to foster local industrial upgrading. Others delay or altogether derail local industrial upgrading by creating inter-regional or intra-regional competition.
among suppliers, fragmenting the supplier network and often igniting tensions with the SOE’s foreign partner.

Second, in examining the impact of China’s accession to the WTO on the country’s liberalization and industrial capacity building, I argue that while the WTO constrains the Chinese Central government, sub-national governments retain significant autonomy. Ironically, by restricting the Chinese Central government’s ability to monitor and control local protectionism, China’s WTO entry has enabled local governments to protect their industries. Furthermore, the WTO’s pro-market rules have helped local governments engage in subtle anti-competitive practices at the sub-national level by providing preferential treatment to foreign JV partners. Under these arrangements, foreign companies provide SOEs (and thus, local governments) with technology and capital, while local governments manipulate public policy to ensure favorable market conditions for their JV partners against JVs that are based in other provinces. I call this process of market manipulation “fragmented liberalization”—namely, the process where sub-national governments selectively adopt measures of liberalization and protectionism rather than adopting all of the liberalizing measures the WTO has imposed on the Chinese Central government.

Lastly, in evaluating developing countries’ strategy of inviting FDI from the early stage of economic development, I contend that MNCs are not necessarily the main drivers of liberalization. Scholars such as Jeffry Frieden and Helen Milner argue that the rise of export lobbying groups promotes liberalization in countries where they operate. Instead, I find that MNCs often covertly support local governments’ protectionist

measures if they favor an MNC’s preferred form of market entry and strategy within the country. Thus, understanding the micro-foundations of industrial policy is critical to understanding industrial policy’s impact on the global economy and international institutions.

**CONTRIBUTIONS**

Although my study focuses on a cross-provincial comparison within a single country, its implications extend beyond the national borders of China. My focus on the interactions among global automakers, sub-national governments, and SOEs allows me to look at the intersection of comparative political economy and international political economy. Most importantly, examining SOEs’ role in mediating local and global economic forces sheds new light on the existing scholarship on China studies and international political economy in the following ways. For comparative political economy, my sectoral focus sheds light on the Chinese auto industry’s unique developmental path of inviting foreign investment, which stands in stark contrast to the paths pursued by Latin America and East Asian developmental states like Japan and Korea. Mexico’s auto industry was produced through “dependent development”\(^\text{20}\) and dominated by foreign MNCs, while Korea’s developmental state model\(^\text{21}\) approach to its auto industry has led to the establishment of one national champion – Hyundai/Kia (which controlled 72

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percent of the Korean auto market as of the late 1990s). China, meanwhile, has followed a route somewhere between these two approaches—by matching a Chinese partner with a foreign partner in the form of JV.

From an international political economy perspective, my work shows what kind of operational strategies sub-national governments can pursue in integrating into the global economy and how sub-national level compliance with international rules explains the course of liberalization better than the Chinese Central government–level compliance in a fragmented and decentralized country like China. As a latecomer to the global auto markets, China provides an interesting venue to examine the interplay of rules at the international, national, and regional levels. I especially highlight how China’s regional governments have reinterpreted the inter-state agreements of the WTO when implementing policy, and outline the operational strategies available at the regional level in an emerging economy. In short, my research highlights the importance of considering industrial policy at the sub-national level precisely because this is the level where nation-to-nation agreements and national regulations are implemented and reinterpreted. By examining the interplay of international, national, and sub-national politics, I show that international agreements like the WTO have complex effects that are both counterintuitive and heavily dependent on local contexts. Sub-national governments, in alliance with SOEs and their foreign partners, often thwart the liberalizing effects of international and national regulations. In these interactions, MNCs are hardly the consistent champions of economic liberalization that they are often taken to be, but rather ally with sub-national actors to support local protectionism. This phenomenon of “fragmented liberalization” is relevant not only to China, but also to other emerging
economies that share China’s fragmented economic structure and reflect the dominance of state-owned enterprises in key economic sectors.

Further, my study reveals the impact of external actors on the development of corporate and economic governance in a host region and how these sub-national entities interact with the governments at various levels through FDI flows. When government regulation constrains two of the most important strategies for MNCs—entry mode and entry timing—what other operational strategies are available to global automakers? Do they transport existing assembler and supplier relationships to the foreign market, or do they develop a hybrid supplier model depending on the institutional context of the foreign country? By tracing the interaction between foreign partners and Chinese partners within JV partnerships, this study reveals how different institutional factors impact MNCs’ strategies.

This paper also examines the advantages, if any, of being an earlier versus later entrant to a foreign market. Some scholars argue that early movers in an industry can achieve better performance by benefiting from technological leadership, preemptive possession of scarce assets, and the establishment of entry barriers for latecomers.22 Others point out possible disadvantages of early movers, such as forfeiting better opportunities that may surface later or establishing contracts for inadequate resources—both of which create junk costs.23 The performance of Chinese automotive JVs has produced mixed results in this regard: the three earliest entrants followed three different


routes: Shanghai Volkswagen has been the most successful JV since 1985, while Beijing Jeep and Guangzhou Peugeot stumbled and exited the Chinese market in 1999 and in 1997 respectively. My research pays particular attention to how different foreign automakers have embedded themselves into local industrial structures and institutions, such as Toyota’s pre-clusterization and Hyundai’s follow-the-flag strategies. This approach sheds light on whether foreign automakers of different national origins attempt to externalize their own intra-firm networks, inter-firm relationships, and state-industry relations across national borders (the so-called “home country effects”).

Lastly, my work sheds light on the ongoing debate about China’s mode of integration into the global economy. Steinfeld argues that while Chinese firms are integrating extensively within the global economy, it is a shallow form of integration involving labor-intensive manufacturing. On the other hand, Thun suggests that Chinese domestic companies and MNCs are fighting for the middle ground. In other words, domestic firms endeavor to upgrade their industrial capacity to escape the intense competition at the bottom of the value-added chain while MNCs seek to decrease costs in order to capture the rapidly growing markets. In this project, I specifically show that SOEs and MNCs’ “fight for the middle” plays out differently in different context and facilitates different types of supply networks.

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24 In 1997 Peugeot sold its stake in the JV to Honda, after losing tens of millions of dollars annually since 1995.
