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Beijing in the Driver's Seat?

Despite a new 'ban' on foreign investment in the auto industry, China still needs them to come in.

By [G.E. ANDERSON](#)

Some foreign businesses have complained over the past year or two that the business environment in China has become less friendly. And now it might appear as though the auto industry is the latest addition to the "not welcome" list. Beijing's National Development and Reform Commission, responsible for economic planning, recently announced it would stop supporting foreign investment in car manufacturing. But appearances can be deceiving. This is really a story of how, while the investment climate might not become "better" or "worse," it does become different, and foreigners will have to adapt.

On its face, the NDRC announcement suggests Beijing will not approve any more joint ventures between foreign and domestic auto companies (such arrangements are a precondition for foreign investment in the industry) and those that do have ventures will get no more approvals to expand their Chinese ventures. This would be a blow to companies such as General Motors that look to China for a significant amount of future growth.

But there is reason to believe the policy is not all it claims to be, and that Beijing simply is trying to change the terms of foreign auto investment instead of banning foreigners altogether. To understand this, it's important to understand why the foreign automakers were originally welcomed in China.

Beijing invited in foreign automakers because the government understood domestic companies couldn't manufacture modern cars on their own. Allowing in American, European, Japanese and Korean carmakers, but requiring them to partner with local companies, was supposed to facilitate transfer of foreign technologies to the Chinese firms.

This policy has never worked as well as hoped. At first the foreigners were only supposed to be there temporarily. But then Beijing realized they were not transferring much technology. The foreign companies brought in ready-made designs for Chinese workers to assemble, but never collaborated with Chinese engineers on design.

When GM formed a venture with Shanghai Auto in the mid-1990s, the Chinese demanded more. That deal included a research and development joint venture that has led to more transfer of technology and design knowhow. But before more such deals could come together, China joined the World Trade Organization, which forbids China from requiring transfer of technology in exchange for approval of foreign investment

While parts of China's auto industry benefited from WTO membership – lower import tariffs have made cars affordable for millions of middle-class Chinese, and foreign-owned factories employ

hundreds of thousands of workers – Beijing still didn't get everything it wanted. As much as 50% of the profit of every foreign car built in China flows out to the foreign company that designed it—a steep premium for the intellectual property that goes into a car.

Beijing can't simply kick out the foreigners to address this imbalance, however. First, the foreign companies remain on the cutting edge of auto technology and China will fall behind if it doesn't maintain partnerships with those firms. Second, state-owned Chinese companies are under pressure from Beijing to step up their own research and development investments significantly, and that money has to come from somewhere. Easy profits from assembling foreign-designed vehicles are the simplest source. So foreigners have remained very much a presence, although Beijing doesn't much like the fact that nearly 75% of passenger vehicles sold in China in 2008 still were foreign branded.

This history informs discussion of the NDRC's latest move. In recent years, Beijing has shifted tack to try to subtly sidestep some of its WTO commitments on technology transfer. During the past year, it became apparent that Beijing's permission for new ventures and expansion plans by the likes of Peugeot and Volkswagen was being withheld until the foreign company "voluntarily" agreed to transfer some technology to the local partner—violating the spirit, although not the letter, of WTO rules.

Yet while this has resulted in transfers of some outdated technology, as of the end of 2010, Chinese-branded passenger vehicles still accounted for only 30% of the market. Interim indicators for 2011 suggest a possible decline.

Now the NDRC says it plans to stop approving new investment by foreign firms in its auto industry. In reality, that foreign investment will continue to be welcome in some form. It has to be. Foreign carmakers are developing significant advances in engines, transmissions, turbochargers and electronic technologies, none of which Chinese companies are able to match. Logic dictates that the NDRC's announcement is more about improving Chinese leverage in negotiations with foreign automakers so Chinese automakers can more quickly overcome their innovation deficit.

That said, foreign companies can't bank forever on China's need for them. Chinese automakers are not only learning much from their foreign partners, but some of them are also buying foreign auto assemblers (such as Volvo) and component manufacturers – along with the engineers who work for them. While this current move by the NDRC is not likely to significantly restrict foreign investment in China's auto sector in the near term, foreign automakers would still be wise to plan for this eventuality.

Mr. Anderson is the author of "Designated Drivers: How China Plans to Dominate the Global Auto Industry," forthcoming from Wiley & Sons.

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