The Chinese auto industry at a crossroads

China's auto production has grown exponentially in recent years, responding to a rapidly expanding domestic market. But the "new normal" in economic growth is taking a toll.

November 10, 2016

China is the world's biggest automobile market, recording sales of over 24 million units in 2015. Given China's enormous population and growing middle class, this shouldn't come as much of a surprise. It overtook the United States as the world's largest auto market in 2010 and hasn't looked back.

What is less well known is that China is also the world's biggest automobile producer, making more cars than the United States and Japan combined (the global industry's No. 2 and No. 3, respectively). China has been the top producer for the last seven years, yet it exports only 3 percent of its production.

This is according to *The Chinese Automotive Industry in 2016* — a book updated biennially since 2012, jointly produced by CEDARS (a consultancy for the Chinese automotive industry), CEIBS (China Europe International Business School) and IESE. According to its team of authors, led by Prof. **Jaume Ribera** and Prof. **Marc Sachon**, there is still a lot more room for growth in this relatively young (and complex) industry.

Ten years ago, there were roughly 600 million automobiles in the world. By 2050 there may be as many as 2.95 billion, according to IMF forecasts. China may have more cars on the road than the United States by 2030 and more cars than the entire world has today by 2050. However, there are doubts as to how many will come from its domestic firms.

©IESE Business School

A shifting narrative

During this fledgling century, the Chinese auto industry's growth has been spectacular. In 1999 — two years before joining the World Trade Organization (WTO) and thus opening up to foreign markets — the country produced fewer than 2 million vehicles. By 2015 that number had reached 24.5 million.

However, the growth rate is slowing down. As the report points out, the average growth rate was much larger between 2006 and 2010 than between 2011 and 2015. The past two years have seen mid-single-digit growth — a trend likely to continue in coming years. Moreover, Chinese local manufacturers have seen their share of domestic sales drop from 60 percent in 2010 to 49 percent in 2015. The situation is even worse for the passenger vehicle market, where local brands took only a 43-percent share in 2015.
One reason for this is that Chinese companies are still technologically weak, despite the government's controversial joint-venture policy of 1994, which requires international auto companies to form joint ventures with Chinese companies if they want to access the local market. The idea was for foreigners to share some of their technical know-how in the JV partnerships, but knowledge transfer has not met Chinese expectations, the authors note.

To improve their image and reputation, both at home and abroad, Chinese brands need to invest more money, time and effort in R&D. As the report indicates, most of the big companies that were ostensibly profitable in 2015 would not have been able to survive without government subsidies and the profits made by their foreign partners. The three biggest players in China are SAIC, FAW and DFM — all supported by the government. Together these three have more than 50 percent of the domestic market share.

The domestic industry's future outlook will depend on the ability of its private sector to move in on the many state-owned enterprises. And for that to happen, the C
hinese government should phase out subsidies as well as the 1994 joint-venture shareholding rule, the authors note.

Green shoots

One area that offers promise for future growth is China's electric-vehicles sector, which the government recently identified as one of the 10 key industries under its "Made in China 2025" national plan. Electric vehicles could help reduce the severe air pollution choking many Chinese cities (assuming the Chinese energy mix moves away from coal to sustainable sources) and clear the way for more sustainable growth ahead. It seems to be on the right

©IESE Business School

track. By 2015, China had sold 450,000 New Energy Vehicles (NEV), just short of the government's target of 500,000 units, set in 2012.

China is now the world's biggest market for electric vehicles. With the recent entry of international players such as Daimler, Samsung and Tesla into the market, this trend is expected to intensify. According to a McKinsey report, by the end of 2014 the Chinese government had spent around 37 billion RMB ($5.47 billion) on the electric vehicle industry, of which around 15 billion RMB went toward subsidies and a further 11 billion RMB was spent on electric infrastructures, a vital component of the electric vehicle revolution.

Room for improvement

But there is still plenty of room for improvement, in particular with regard to the domestic parts industry and Chinese auto exports. Despite undergoing sweeping transformation, China's industry still struggles to compete with foreign rivals in areas such as technology and brand reputation. Instead of competing on quality and technological development, Chinese companies continue to compete on price, leading to rising trade frictions with other car-producing nations in North America and Europe.

For the moment, Chinese exports are still insignificant compared to domestic sales (just 3 percent vs. 97 percent, respectively). Brands such as Chery and JAC continue to dominate Chinese automotive exports but their cars are still hampered by quality issues, as most models fail to meet European and U.S. safety and quality standards.

Nevertheless, Chinese companies are exporting to markets in Africa, Eastern Europe and South America. The industry is also likely to benefit from the government's "One Belt, One Road" initiative, which promises to boost international trade and foreign investment by better connecting China with the rest of Eurasia, along the lines of the old Silk Road and beyond.

With relatively low car ownership rates, China's automotive sales will surely continue to grow. As for its domestic industry, China is at a crossroads. The future may depend on the government's willingness to loosen its hold on the industry and further its support of electric vehicles and automotive R&D in order to differentiate its offerings.

©IESE Business School