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## **Development Strategy of Chinese Leading Automotive Manufacturer**

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## **Abstract**

First Auto Works (FAW) has held the leading position in the Chinese automobile industry for 50 years since its establishment in 1953. Moreover, in 2005, FAW's passenger car output propelled it to the first position in China. But, more than 90% of the group's profit was derived from passenger car sales and 90% of the passenger car profits, from foreign brands such as VW, Mazda and Toyota. The issues of this paper are as follows. How did FAW innovate and maintain its leading position in the Chinese automobile industry when it shifted from plan control to market competition in the external environment? Moreover, why did FAW's strategy not result in the development of its own passenger car brand?

## **Biography**

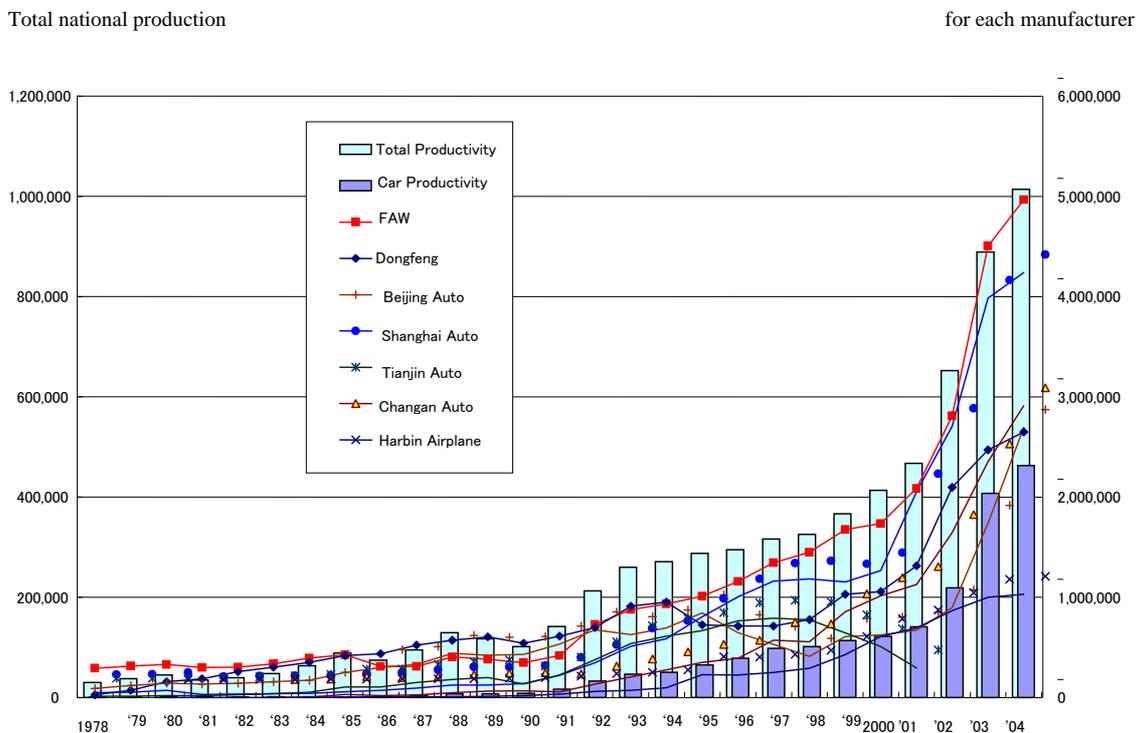
Jin CHEN (China, 1952) is a visiting scholar at Said Business School and Institute for Chinese Studies, Oxford of University from April 2007 to March 2008. He is a professor of Department of International Communication, University of Okinawa, Japan. He got Ph.D. in Economics at Tokyo University in 1999. He spent two years in Wharton School, University of Pennsylvania from 1993 as a visiting fellow and became an affiliated researcher of IMVP at MIT from then on. Jin Chen's current research interest is the enterprises of China and Japan, especially the strategy change and competitiveness accumulation of automobile and electric home appliance manufacturers. He is the author of *The Development Strategies of the Chinese Automobile Enterprises* (Shinzansha Press. 2000, in Japanese) which received Academic Honours of Japan International Business Academics in Oct. 2000, *Capacity of Chinese Manufacturing Industries* (Shinzansha Press. 2007, in Japanese) and over forty papers (including IMVP/MIT working papers) on development strategies of enterprises in Japanese, English and Chinese. From April 2008, Jin Chen will transfer to College of Business Administration of Ritsumeikan University (Japan) as a professor.

## Development Strategy of Chinese Leading Automotive Manufacturer

### Introduction

First Auto Works (FAW) has held the leading position in the Chinese automobile industry as ‘the eldest son’ for 50 years since its establishment in 1953, excluding a few years during the late 1980s when the total output of vehicles was exceeded by other companies (Figure 1). Moreover, in 2005, FAW’s passenger car output propelled it to the first position in China. In addition, the cover page of the only Chinese automobile industry history book (*History of the Chinese Automobile Industry*, 1996) published in China was the “signboard” of FAW’s truck factory, written by Mao Zedong, the first Chairman, and the back cover was the “signboard” of FAW’s passenger car production base, written by Jiang Zemin, former Chairman. Thus, it can be stated that FAW is a representative automobile manufacturer, which is closely associated with the central government and is an essential factor when discussing the development of Chinese automobile enterprises.

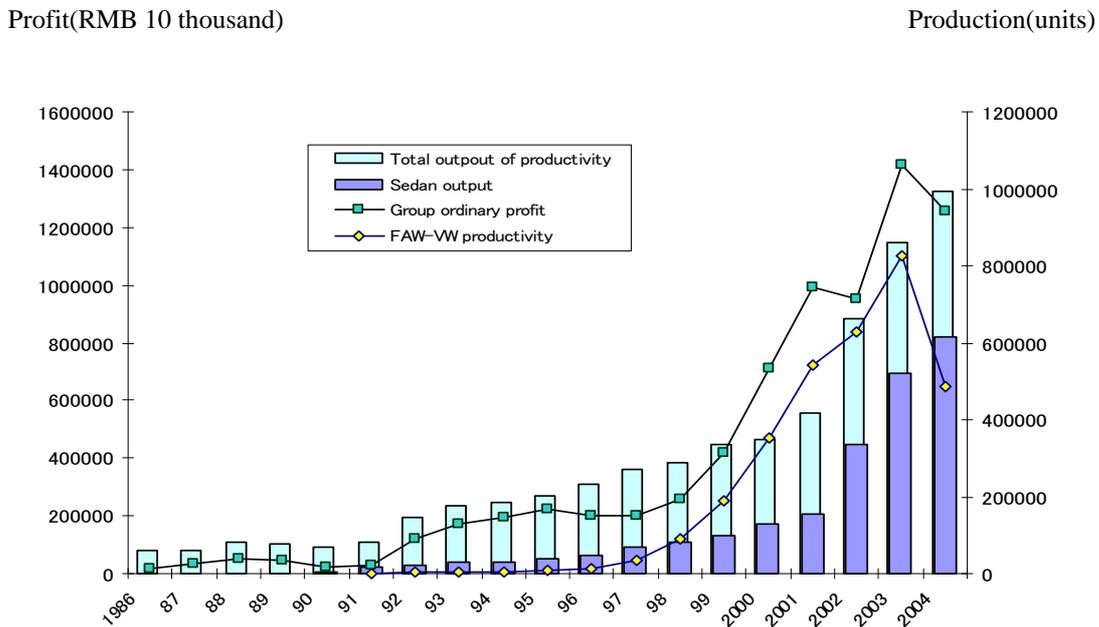
**FIGURE 1 Production Volume of Leading Manufacturers in the Chinese Automobile Industry (1978–2004)**



Source: Annual editions of *Yearbook of the Chinese Automobile Industry and Reference Materials of the Automobile Industry Development*, 1992

Note: The volume of each manufacturer includes the production by the joint venture manufacturer.

**Figure 2 A Shift in the Ordinary Profit and Output of the FAW Group (1986–2004)**



Resource: All annual editions of the *China Automobile Industry Yearbook*, *China Automobile Development Annual Report* (2001–2005), and *Automobile Industry Planning Reference* (1992)  
 Note: The group pretax profit includes profit derived from foreign brands such as Audi, Mazda, and Toyota, and excluding FAW-VW.

However, FAW, which is considered to be successful in the domestic market, has appeared weak and problematic after China joined the WTO and the market competition became intense. More than 90% of the group profit in 2003 was derived from passenger car sales and 80–90% of the passenger car profits, from FAW-VW, which involved the sale of VW brand products (Figure 2). Apart from the VW brands and few Red Flag cars (4% of the total passenger car production), FAW largely produced foreign brands such as Mazda and Toyota (Table 1)<sup>1</sup>. The sales of the Red Flag car in 2004 declined by more than 40% as compared to 2003. Subsequently, due to the abolition of the import tariff on passenger cars and globalization of the automobile market, maintaining its leading position in the future has been a major issue for FAW, which does not have its own brand.

<sup>1</sup> Tianjin Auto Works, which was integrated into FAW in 2002, produced the Charade car that was developed by Daihatsu; however, the production of Charade declined considerably due to the introduction of Toyota models.

**Table 1 Production and Ordinary Profit of Each Manufacturer/Model of the FAW Group (2004)**

		Production: units		Ordinary Profit: RMB 10 thousand	
Model	Manufacturer	Product Brand	Production (Units)	Introducing Origin	Ordinary Profit
Passenger Car	FAW Car Co.	Red Flag	14,438	Audi Technology Introduction	NA
		Mazda 6	35,571	Mazda	
	FAW-VW	Audi	59,109	VW	648,050
		Golf	17,008		
		Bora	61,993		
		Jetta	149,007		
	Tianjin FAW Toyota	Vios	33,545	Toyota	144,037
		Corolla	49,892		
	Tianjin FAW Charade	Charade	112,401	Daihatsu	35,278
		Vitz	5,622	Toyota	
		Bella	12,483		
Tianjin FAW Huali	Jiaxing and Terui	7,455	Daihatsu	NA	
Passenger Cars Total			613,672		NA
Truck	FAW Group	Jie Fang Large	29,172	Self-developed	NA
		Jie Fang Medium	41,797		
		Jie Fang Small	130,720		
		Jie Fang Mini	18,585		
Bus	FAW Group	Jie Fang Big, Medium, and Small Mini Bus	97,820	Self-developed	NA
	Sichuan Toyota Bus	Land Cruiser	3,115	Toyota	NA
FAW Group Total			993,554		1,258,241

Resource: This table was created by the author based on the *China Automobile Yearbook* (2005), pp. 52, 508, 516, and 521–526. The total production of passenger cars and other models does not match the group total due to the incomplete data for every model.

Based on the abovementioned present conditions, the issues of this paper are as follows. How did FAW innovate and maintain its leading position in the Chinese automobile industry when it shifted from plan control to market competition in the external environment? Moreover, why did FAW's strategy not result in the development of its own passenger car brand?

FAW was established in the 1950s by gathering skilled technicians from around the country and, for decades, faithfully adhered to the government's plan irrespective of the market changes. After the 1980s, due to an environmental change of market economization and with the aim of utilizing its position as a major state-owned enterprise, FAW positively changed its policy to accomplish beyond the limited government investment. On the other hand, the reaction to a change in market needs was always slow. Besides maintaining its leading position by accepting a large national investment and technical resources, FAW's passenger car production had to rely on foreign technology in terms of

production. This was due to the slow accumulation of technology related to the development of passenger cars in order to regain its superiority in terms of production.

The munitions factory in the north-eastern district, where FAW is currently located, was established for developing a prototype resembling the American truck of the late 1920s. Later, during the Sino-Japanese War, it was used for the production of KD trucks by Japanese manufacturers such as Isuzu and Nissan. However, after Japan was defeated, most of the machines and facilities in these factories were requisitioned by the former Soviet Union forces and were transported back to the mainland of the Soviet Union; consequently, the development of FAW was hindered. This paper will outline the process of the strategic formation of FAW in the development of the Chinese automobile industry over four-year periods after the founding of the People's Republic of China and its current achievements and issues.

## **1 National Project and the Observance of the Government Plan (from the early 1950s to the latter half of the 1970s)**

FAW was established as the national project in the 1950s by gathering many skilled technicians from all over China and introducing facilities and know-how related to mass production from the former Soviet Union. FAW had followed a passive management strategy, with its production adhering to the government plan and without primary operations such as product development and profit management or any concerns for market changes for many years. FAW merely produced few limousines for leading officials of the central government through manual labour, while producing single products such as the medium-sized truck for many years.

### *1.1 Geographical Conditions and Introduction of Technology from the Former Soviet Union*

In 1949, immediately after the establishment of the People's Republic of China, the Sino-Soviet Summit determined a project for the construction of a large-sized automobile factory (later known as FAW) by the Soviet Union, and, in March 1950, the Ministry of Heavy Industries of the central government formalized an 'Automobile Industry Establishment Group' as an organization to aid in the development of the automobile industry. The group nominated several municipal cities with auto parts infrastructure, such as Beijing, Taiyuan, Wuhan and Xi'an, for the construction of the factory. Finally, Changchun was selected based on the opinion of the Soviet Union due to its proximity to the railroad and the fact that it possesses infrastructure related to the use of energy and iron and steel industries. Moreover, its geographical proximity to the Soviet Union was believed to be one of the

most important factors.

In the 1930s, the Soviet Union introduced the Ford's mass production system and accomplished independent production practically without the external supply of parts and materials. In fact, it is not surprising that in its development plan, China, as the country in which the system was introduced, focused on the convenience of the transportation of machinery from the Soviet Union and proximity to the railroad rather than considering its conventional machinery infrastructure.

FAW established its 30 highly vertically integrated factories from casting/forging to manufacturing and assembling by introducing Ford's mass production system from the Soviet Union. Only one construction base was largely scattered within Changchun. In addition, China introduced one set including the factory design of FAW, plant facilities, vehicle model and production technique from the Soviet Union, because it not only wished to produce a domestic vehicle in a short period but was also challenged by the inability of the Soviet Union to supply China with a finished vehicle and parts in large quantities.

### *1.2 National Project and Gathering of Human Resources*

In 1953, the central government declared its instructions—titled the 'Whole of China is Supporting FAW'—throughout the country. At the same time, the central government made a huge investment towards the establishment of FAW. Later, skilled management executive officers, technical workers and construction workers were gathered from around China, and they ultimately became the main force of the construction and production of FAW. In addition, the construction materials were allocated nationwide, and two or three hundred trains arrived every day during the peak period. Furthermore, the manufacturing factories in the country experimented and produced machinery equipments for FAW. The construction of FAW was carried out as a national project in this manner, and was completed as scheduled in 1956.

FAW, with an annual production of 30,000 medium-sized trucks, was not inferior in comparison with Japanese truck manufacturers with respect to the standard of technology at that time. It is to be noted that until the 1970s, there was no automobile factory of a similar scale in Korea. Besides, the government gathered a large number of skilled people such as engineers from the automobile industry, experts, people with overseas study experience and university students from all over the country, and assigned them to the construction of the new FAW factory. Moreover, in 1956, the Automobile Research Institution of the Ministry of the First Manufacturing Industry (as the predecessor of the Changchun Automobile Research Institute), which was the first national automobile R&D institution with approximately 600 technicians, was transferred from Beijing to

Changchun.

From the 1950s, FAW was treated as a key national company by the central government, with a close association with the central government and, in particular, with automobile-manufacturing administrative municipalities. For example, many leaders had originally worked in FAW—namely, Jiang Zemin (the chairman of China, chief secretary of the Communist Party of China), Li Lanqing (the first deputy prime minister), Zou Jiahua (a deputy prime minister), He Guangyuan (minister of the manufacturing industry), Lu Fuyuan (minister of commerce, senior vice minister of the manufacturing industry, chief of the Automobile Bureau), Raobin (senior vice minister of the manufacturing industry, chief chairman of the Chinese Automotive Industry General Corporation), Chen Zutao (chief chairman of the Chinese Automotive Industry General Corporation); they were later promoted to the posts of senior officials of the central government.

### *1.3 The Observance of Government Plans and the Gradual Expansion of Production*

During the early stages of the founding of new China, the Chinese government considered introducing the Soviet management system for automobile production, which was based on the system of planned economy. The automobile design institute and factory of the Soviet Union assumed charge of the technical design and engineering processes of FAW; assisted in FAW's construction and production; trained its executive officers, engineers and workers; and disseminate the automobile production technology and know-how of the plan management. Similar to the major companies in the Soviet Union, FAW supervised most of the service sections such as nursery schools, elementary schools, junior high schools, universities, hospitals, shops, dining halls and lodgings as parts of the company.

Based on the plan system, FAW, which only functioned as a production factory, merely accomplished its normal production target based on the production schedule and profit plan of the government, without undertaking primary operations such as product development, sales, material supply and profit management. As one of the most important companies with a planned economy, for a long period, FAW followed a passive management strategy that involved faithfully adhering to the government policy and plan and receiving the government's investment without being interested in the market changes. This was done at the expense the active decision-making of the company with regard to investment and market competition.

Since its establishment to the first half of the 1980s, FAW always maintained its leading position in terms of output in the Chinese automobile market; therefore, the executives and employees were proud of belonging to the largest manufacturer. However, FAW's 100% share in

1956 gradually declined to 83% in 1966 and 42% in 1976 due to the diversification of demand and the entry of local manufacturers. FAW attempted to expand its production capacity in its normal production line from 1958; however, it ultimately failed. In 1965, FAW expanded its production capacity and in 1971, manufactured 60,000 units with a large national investment, while its production did not increase considerably for the subsequent 10 years.

#### *1.4 Formulation and Development of Products*

Since the beginning, the product formulation of FAW was always undertaken according to the industry policy of the government. Basically, the single model of medium-sized trucks called Jie Fang CA10 had been produced for around 30 years until the end of 1980, as the establishment of the factory and diversification and serialization of products could not be accomplished. From 1957, the Red Flag, a limousine for leading officials and a 2.5 t off-road vehicle for military use were trial-produced. These vehicles were produced on a small scale, and the single model formulation had not led to any change. For example, medium-sized trucks constituted 95% of the total output of 66,000 automobiles in 1980.

The Red Flag limousine imitated the modular architecture of the Sloan system in accordance with Chairman Mao's instruction in the 1950s (Chen/Lee/Fujimoto [2005]), and its trial production was undertaken on a small scale for a few leading officials using manual labour production. Moreover, despite a deficit, production was continued with the assistance of a government investment. In addition, the products of FAW, including their cars, were isolated from technological exchanges with developed countries for many years, and there was no change in the models due to the absence of competition when they were launched in the market.

The Chinese government had initially decided to establish one or two companies, including FAW, based on the oligopoly system. As a result, the Automobile Research Institution of the Ministry of the First Manufacturing Industry, which was engaged in automobile product development by imitating foreign products according to the central government's plan, was transferred close to FAW as early as possible. Under the direct control of the central government, this research institute was engaged in the development of automobile products produced by nationwide manufacturers such as FAW from all over the country. Moreover, it developed into China's largest automobile development institution before its integration into FAW.

## **2 Management Crisis and Policy Transformation to the Acquisition of Government Investment (from the end of the 1970s to the middle of the 1980s)**

FAW, when encountered with management crisis, shifted from a passive position of waiting for the investment plan to its current position for the acquisition of the government project investment and application of the priority treatment policy. However, FAW's attempt to adjust to the changes in market needs was delayed because the policy change was implemented later than the change in the market. On the other hand, a predominant position in the market was established with respect to commercial vehicles through the acquisition of R&D resources from the country. However, regarding passenger cars, due to the large gap between the luxury model for extremely few leading officials and the development ability of FAW, it had to discontinue the independent development of products.

### *2.1 Environmental Change and Crisis Evasion*

Due to the relaxation of the Cold War and the rapid decline in the demand for military trucks, from 1978, Dongfeng shifted to the production of the rival product of FAW's medium-sized truck Jie Fang . As a result, the market leadership of FAW was threatened due to the steadily increasing market share of the rival product. FAW then encountered slow sales of its medium-sized trucks for the first time since its establishment. The sales of FAW's products drastically declined, and its stock of finished vehicles during the peak period (1985) increased to more than 20,000 units, that is, one-third of its annual production at the time. FAW changed its president in June 1985 and Geng Zhaojie was appointed as the new president.

In addition, along with the increase in the number of imported cars since the end of the 1970s, the updated function of FAW's Red Flag passenger car, particularly its bad mileage became apparent. Since a full-scale energy crisis had initially occurred in China in the 1980s owing to the influence of the second oil crunch, an oil conservation regulation was implemented by the central government in June 1981. As a result, the mileage of the Red Flag particularly became a problem, and its production was cancelled. Later, local munitions manufacturers in Shanghai, Tianjin, Guangzhou and Changan rapidly flourished by introducing passenger car technology until the middle of the 1990s, and the Red Flag was subsequently withdrawn from the market.

Since the beginning of the 1980s, many new companies have entered the automobile industry. Dongfeng's market share unexpectedly increased; on the other hand, FAW's share rapidly declined from 40% in the latter half of the 1970s to around 20% in the middle of the 1980s. Moreover, Dongfeng deviated from the customs of state-owned enterprises, such as adherence to the

government plan and awaiting investments. Instead, it actively pursued the government's prior policy. Dongfeng established its own development path for the company in accordance with its reserved profit by introducing the company's 'reservation profit system' from 1980 and 'profit increase responsibility system' from 1983, which harmed FAW to a great degree.

## *2.2 Change in the Model of Medium-sized Trucks and Transfer of Management Policy*

In May 1980, FAW began to execute its management policy of 'increasing production and income, raising and allocating funds by itself and changing the model of its trucks' in order to resolve the company's crisis. This crisis had resulted from the challenge from Dongfeng when it decided to change the model of its medium-sized truck Jie Fang, which was financed for 30 years by reserved profit and bank loan. FAW chose to raise and allocate funds by itself because of the impossibility of policy investment in FAW by the central government. This was due to the financial difficulty and successful precedent set by Dongfeng through the utilization of its reserved profit.

Self-allocation of funds implies reserving a portion of the profit or depreciation expenses of the company that are usually paid to the central government by enjoying a priority treatment policy from the government. However, it appeared to be a serious difficulty for FAW to allocate an enormous fund of RMB 440 million towards the execution of the change in the model of its medium-sized trucks. For example, there were no essential funds for updating its manufacturing process due to the sudden decline in sales in 1985. In February 1986, the president Geng Zaojie proceeded to Beijing himself and spent a fortnight persuading Zhao Ziyang, the prime minister at that time, through acquaintances of the central government, whereby a loan of RMB 80 million was finally acquired.

This difficult experience of fund allocation made FAW realize the importance of acquiring government investment, which considerably influenced its strategy performance later. In other words, it was a lesson for FAW, which had with a close association with the central government and enabled FAW to identify an easier path to surpass other companies. On the other hand, the projects of state-owned enterprises were confronted with difficulties in the acquisition of government investment and the application of national priority treatment policy or project. However, the plan formulation and project execution of the government did not usually suit the market changes as FAW's marketing strategies to deal with these changes were probably delayed.

## *2.3 Affirmative Action in Accordance with Government Policies*

When FAW encountered a crisis from the 1980s, it began its affirmative action for the acquisition of the government project investment and application of the priority treatment policy instead of

passively anticipating the former investment plan. First, the development of a new Jie Fang, a 5 t medium-sized truck, was undertaken by the Changchun Automobile Research Institute, which was absorbed and merged while obtaining the policy support of the central government. During October 1980 and July 1983, FAW completed its vehicle design and development; trial production and testing of its unit and acquired national official approval in September 1983. Later, the manufacturing, designing, production preparations and construction of a new factory were completed in around September 1986, and the full-scale production of the new Jie Fang began in January 1987.

In addition, FAW, which started the process of change in the model of its medium-sized truck, proposed the construction of a light truck production base with a total investment of RMB 1 billion and an annual output of 60,000 units, in accordance with the government's diversification policy of entering 'down' (light truck). This plan was formally authorized by the Government Plan Committee in November 1984, and was included in the large-scale construction project of the 7<sup>th</sup> National Five-year Plan (1986–1990). At the end of 1986, FAW acquired a second factory area, a huge plot of land used for a light truck factory, which was larger than the former factory group site and located next to the main factory group.

Furthermore, in order to improve the performance of the Red Flag car and restore small-scale production from 1985, FAW imported 1,000 units of Benz models 210 and 230—as 168 finished vehicles and 832 CKD parts. Moreover, it began its research according to the government. Later, the assembling line of these Benz models was only used for the production of Audi from 1989. However, FAW developed its performance according to the government policy and rarely considered the mass production of passenger cars because the focus of the industrial policy of the central government during this period was the diversification of commercial vehicles instead of the mass production of passenger cars.

#### *2.4 Acquisition and Limitation of Development Ability*

Similar to FAW, the Changchun Automobile Research Institute belonged to the Ministry of the First Manufacturing Industry and operated in accordance with the plan of the Automobile Bureau of the Ministry. Nevertheless, for many years, it functioned as an independent organization that differed from FAW. According to the government plan, it was integrated with FAW and became its product development section in 1980 in order to smoothly accelerate the process of change in the model of Jie Fang medium-sized trucks. The technical introduction of the new Jie Fang under the integration, fund limitation and, in particular, restriction of foreign currency was different from the case of the

old Jie Fang. In the latter case, one set was introduced from the Soviet Union and was later replaced by a modular method by utilizing former and newly-designed parts (including technology introduced by foreign countries).

The modular ability of FAW was the result of the efforts of the Changchun Automobile Institute and the development of medium-sized trucks. Regarding the development of the light truck, the license for the body was introduced from Japan (Nissan); the carburettor technology was imported from Germany; the technology of the tire frame, spring and clutch were from Britain (AP); and the license and production equipment of the engine were from America (Chrysler). Therefore, by acquiring China's largest automobile R&D organization, FAW established its predominant position in the protected domestic markets as compared to other companies in the field of commercial vehicles.

On the other hand, regarding the change in the model of Red Flag, which was cancelled in 1981, the government considered a 'collected' method similar to the one initially applied in the case of the Jie Fang truck. However, the passenger car structure of developed countries had already evolved an integral pattern, which was impossible to accomplish by the collected pattern in the 1950s. The Benz was selected as a model for the luxury limousine car for a few leading officials of the government; however, the technological gap in the development level of FAW was too large, and the development was finally discontinued.

### **3 Strategic Development Prior to Recapturing the Leading Position in Production (from the latter half of the 1980s to the middle of the 1990s)**

FAW, which maintained its leading position while being under the protection and influence of the central government, was confronted with a management crisis that threatened its position. From the middle of the 1980s, FAW's most important purpose of its company development was to recapture its lost leading position by increasing its production. Although FAW displayed a radical transition in strategy in a short period and acquired the passenger car project early, it failed to recapture its lost leading position in terms of the total volume of vehicle production. Therefore, FAW concentrated its fund allocation on the intensive expansion of commercial vehicle production. However, it was both unable to expand its production scale of passenger cars at the appropriate time and emphasize the improvement of the development ability of passenger cars.

#### *3.1 Strong Motivation to Recapture the Leading Position and Strategic Adjustment*

From the 1980s, the market share of FAW declined rapidly and the leading position it had

maintained for 30 years was finally acquired by Dongfeng in 1986. Furthermore, Beijing Automobile captured the second position from 1987, and FAW had fallen to the third place for the next five years. Therefore, from the middle of the 1980s, FAW focused on capturing the leading position by increasing production and considered this as the most important purpose of its company development. 'Regaining power and inspiring awe again' became FAW's slogan and the purpose of the company.

In 1987, the central government proposed a policy to provide FAW with the project of manufacturing luxury cars and Dongfeng with the project of the mass production of small passenger cars. FAW, which carefully observed the policy change of the central government, considered this as an opportunity for its development and considerably adjusted its strategy in order to avoid being overtaken by its rival, Dongfeng. The light truck project, 'the guidance process' of luxury limousine cars and the mass production project of passenger cars were collectively planned. FAW strongly restricted its initial investment to the minimum and used every effort to persuade the government to sanction the passenger car production project and its investment at the earliest.

FAW finalized the installation of the light truck engine, which was under negotiation with foreign companies, into Chrysler's Dodge 600. This engine was also used in light commercial vehicles and passenger cars; however, it was largely installed in passenger cars. The engine production line was used for the annual production of 300,000 units, including 60,000 units of the light truck. Further, it was planned to be used for passenger car production. FAW also transferred its light truck production to its associated local companies and proposed a policy to convert a prepared factory site for light trucks into one for passenger cars.

### *3.2 Change of Introducing Origin in Passenger Car Technology and Early Accomplishment of the Project*

After the introduction of the engine for Dodge 600, FAW intended to expand the production scale of its Red Flag car to 30,000 units by introducing the manufacturing technique of Chrysler's luxury Dodge car and formulated a construction plan of a factory with a mass production capacity of 150,000 units. This was done by later introducing the manufacturing technique of the middle-class car. However, Chrysler observed the strategic trend of FAW and confirmed that the factory construction was only accomplished by the collective plan for both the light truck and passenger car, and demanded an extremely high price from FAW for the license of the Dodge car. The negotiations failed at the end of 1987 due to disagreements on the quotation price.

At the same time, VW considered the possibility of technical cooperation with FAW for the

production of the Audi 100 car. FAW clarified its tie-up with VW, including the experimental installation of the Dodge 600 engine (Chinese name for the CA488 engine) in Audi 100, and VW fully consented. In this manner, FAW was able to control the current expenditure through deferred payment for used dies and technical cooperation. Furthermore, VW aggressively promoted the advantageous conditions such as the offer of the used components of cheap cars for mass production and expense exemption for technical cooperation in the production of Audi in order to participate in FAW's project for achieving an annual car output of 150,000 units.

In May 1988, FAW acquired permission from the government to reserve the profit earned by the future production of Audi within the company and to invest it in the project for the production of 150,000 cars. This was at the same time that FAW signed the technical cooperation agreement with VW's Audi. In order to overcome the insufficiency of funds, particularly the shortage of foreign currency, in 1989, FAW purchased VW's old American factory of Golf/Jetta with an annual output of 300,000 units at 5% of the original factory construction costs. Thus, it managed to surpass Dongfeng by forming a joint venture with VW to achieve an annual output of 150,000 cars in November 1990.

### *3.3 Strategy Development with the Expansion of Total Production as Top Priority*

The CA488 engine, introduced by Chrysler, was restricted by VW's brand patent and FAW was restrained from installing it on Audi and Jetta cars. The installation of the engine in the derivation domestic car of Audi was hence postponed after 1995. The CA488 engine, which was already being manufactured at a volume of 150,000 units (with plans to further increase production to 300,000 units), was not only used for the '60,000 Capacity Project' for light trucks but also manufactured assuming their installation in the passenger cars. However, maintaining the sales unexpectedly arose as a serious issue because the installation of the engines in VW's cars was rendered impossible.

FAW began to establish the welding/painting/assembly plant of the derivation model of Audi which was named as Small Red Flag through self-allocation of funds from 1989 in order to maintain the market of the CA488 engine. Production was supposed to begin from 1995 with the design ability of 60,000 units. If this plan was accomplished, the production capacity of the cars manufactured by FAW and installed with the CA488 engine was expected to reach at least 90,000 units during the middle of 1990s, including 30,000 units manufactured with the advanced approach of the 'guidance process' (Audi→Small Red Flag).

However, from the 1990s, FAW merged with over 20 companies and subsidized them by investing a large amount of funds and reorganized itself as the manufacturer of parts or of light

trucks installed with CA488 engines or part manufacturer in order to immediately recapture the leading position. Such a series of mergers resulted in an increase in the productive capacity of FAW's light truck to 150,000 units. However, on the other hand, FAW encountered a shortage of funds due to a large investment and a rapid expansion policy. Therefore, the construction of the new production factory to be used exclusively for Small Red Flag, which was delayed, was finally cancelled at the end of 1994.

#### *3.4 Neglect of the Development Ability of Passenger Cars*

In the middle of the 1990s, the rising sales of FAW's Audi were hindered due to its high price. The sales of Small Red Flag improved due to the localization of its engine and transmission and prior adoption as the public transport vehicle for the government division. However, the production expansion was impossible due to the cancellation of the construction of the factory that was to be used for mass production. The localization of the parts excluding the engine and transmission became difficult due to the slow production expansion of Small Red Flag; moreover, most parts had to be acquired from the parts manufacturers near Shanghai. This affected the regular cost control as well as the performance of Small Red Flag.

Certainly, the absorption of car technology with a much more integral structure and the improvement became difficult issues for FAW. Since FAW could not intervene in the development and improvement of Audi and Jetta cars due to the restriction of the brand patent, FAW lost a good opportunity to increase its own development ability through the performance improvement of Small Red Flag. As a result, only a small change was made to the body of the Small Red Flag and the fault in its performance appeared to be insoluble with respect to the consistency between the engine (Dodge) and the body (Audi).

On the other hand, FAW showed no interest in the development and production of the modular mini vehicle and mini car, which had good sales in the market in the middle of the 1990s, given the lack of government investment and less profit. Jilin Light Vehicle Works, which used to be a nucleus maker of mini vehicles, switched to the production of the light truck after it was merged with FAW in 1994, and the production of the mini vehicle was cancelled. In addition, the mini car Sankoule (the happiness of the family with three members) was developed in the early 1990s by the engineers of the Changchun Automobile Research Institute. However, it did not accomplish its mass production target and lost a good opportunity of accumulating development ability.

#### **4 Reaction to the Intensification of Competition and Reinforcement of Cooperation with Foreign Companies (from the latter half of the 1990s)**

In 1996, FAW recaptured its leading position in terms of the total volume of vehicle production by expanding its commercial vehicle production. On the other hand, the profit of the entire company declined due to the increasing competition in the segment of commercial vehicles as well as the slow production of passenger cars. Along with the globalization of the market after the twenty-first century, FAW's management situation had improved by shifting the focus of its management policy to production expansion and profit, particularly expanding its market base and seeking the government's priority treatment policy. However, the passenger car production had to rely mostly on foreign technology due to its neglect of the accumulation of development ability of passenger cars.

##### *4.1 Management Aggravation and Change in President*

After the cancellation of the construction of a new factory to be used exclusively for Small Red Flag, FAW continued to spend a large amount of funds on purchasing Shenyang Gold Cup in 1995 and Yuannan Blue Arrow in 1997. This promoted its policy for the expansion of production primarily for commercial vehicles. Along with the production of commercial vehicles, particularly the production expansion of the light truck, FAW finally recaptured the leading position in terms of the total volume of production in 1996; however, its passenger car production was exceeded by that of Shanghai Auto Works and Tianjin Auto Works, and the profit of the whole company suffered due to the intense competition in the commercial vehicle segment. This occurred despite FAW owning the largest national car production base (with 150,000 + 30,000 units) built with government investment.

In 1997, FAW regarded the expansion of car production as the most important purpose of its company development after recognizing its slow development in the car segment. However, when FAW framed its construction plan for the small car factory with an annual output of 300,000 units through a joint venture with Daewoo Automobile in Yantai, Shandong, GM purchased Daewoo during the Asian financial crisis, and Shanghai GM later acquired Yantai's factory. In addition, in 1997, FAW reorganized its production factory of Small Red Flag into an independent profit-making company and resumed the construction of the new factory by listing its stock on the Shenzhen Stock Exchange and utilizing the accumulated funds. However, the sales began to decline due to the apparent performance problems in Small Red Flag.

From the 1990s, FAW used a large amount of funds for a series of mergers and acquisitions of local companies in order to recapture its leading position in terms of total vehicle production; however, the expansion of car production did not have the desired results. As a result, the profit

declined annually from the middle of the 1990s. In 1998, the profit of the whole company from the total sales amounting to RMB 37 billion declined to only RMB 125 million, which was lower than its previous performance and almost resulted in a deficit. President Zhaojie Geng was diagnosed with a disease and committed to long-term medical treatment in August 1998, and Yanfeng Zhu assumed office as the new president at the age of 38 in February 1999.

#### *4.2 Strategic Transfer to Profit Priority and Effort on the Downsizing of the Organization*

After Yanfeng Zhu assumed office as the new president in 1999, FAW proposed its new management policy focussing on profit, which consisted of the downsizing and rationalization of the organization as one of the most important techniques. In 1999, FAW had 128,000 employees, including its many public welfare staffs working in hospitals, stores, schools, lodges and dining halls. FAW separated these public welfare sections from its main body and encouraged them to introduce a self-supporting system. In addition, FAW switched from a strategy focusing on product development to one focusing on increasing production from the assemble plan in consideration of the market needs, and concentrated on staff relocation. This shift was based on the plan determined by the government.

On the other hand, FAW had affiliation with many parts factories, and most of them only supplied their products to FAW. Therefore, FAW integrated four casting factories and established a new company called FAW Four Rings. This new company allocated its funds independently, supplied parts to other manufacturers besides FAW and began to diversify into the production of motorcycle parts. In addition, nine parts factories including those involved in manufacturing air conditioners, steering wheels and other parts were amalgamated into a new company, which promoted its independence. However, the process of rationalization did not proceed smoothly as there was strong resistance from the employees of the vaporizer factory that was rationalized as the first model factory.

Fortunately, approximately half (RMB 8.6 billion) of the RMB 14.4 billion bank debits of FAW were converted into national stock, and its debt rate was unexpectedly lowered from the end of 1999 to March 2000 by the application of a priority treatment policy of the government<sup>2</sup>. Besides, FAW withdrew its capital from Shenyang Gold Cup, the largest local company (purchased in 2000), and began to concentrate on the arrangement and reorganization of its local production bases, including Jilin Mini Vehicle Works. With the help of a support policy of the government and its independent

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<sup>2</sup> *China Management*, September 21, 1999 and *China Engine Web* ([www.chinaengines.com](http://www.chinaengines.com)), March 27, 2000

effort, the total output of FAW increased from 270,000 units in 1998 to 410,000 units in 2000. Further, the aggregate sales of the companies increased from RMB 37 billion to RMB 56.4 billion, and the profit increased from RMB 125 million to RMB 2.2 billion<sup>3</sup>. At the same time, the management situation also began to finally improve.

#### *4.3 Adaptation to Globalization and Increasing Cooperation with Foreign Companies*

From 2001, along with China's decision to join the WTO, FAW began to switch from its former management policy emphasizing profit to a corporate strategy focusing on the consumer. Meeting the international standard in management philosophy, management level, formulization of cost and capital and the adaptation to the market globalization of technology, product and fund became important issues for FAW. This change was in keeping with the withdrawal of the protection policy and the advance of market globalization. FAW first boosted its product diversification by establishing associations with multinational enterprises and implemented its strategy for expanding production, particularly, by strengthening car overall.

The negotiations with Dongfeng in 2001 regarding technical cooperation for large and medium-sized trucks, failed. Later, FAW started negotiations with Daimler Chrysler with regard to the proposal of a plan to reform Jie Fang by introducing the brand and manufacturing technique of Benz for a large truck and the technology of Benz for a medium-sized truck. However, Daimler Chrysler disapproved of the continuation of the Jie Fang brand, and the negotiations were cancelled. Regarding the production of light trucks, FAW decided to expand two major local production bases in the south (Yunnan Province) and north (Jilin Province/Harbin) while seeking a new partner for technical cooperation.

FAW began to concentrate on a new model such as that of Bora, a passenger car, while expanding the production of VW's Audi and Jetta. Furthermore, FAW signed an agreement for technical cooperation with Toyota in August 2002, after merging Tianjin Auto Works in June 2002 with the cooperation of Toyota, in order to obtain the manufacturing technique of a small car. In Tianjin, FAW began to produce the Toyota Vios compact car from October 2002 and a light SUV of Daihatsu from the middle of 2003. The luxury model Crown by Toyota was scheduled to be produced in Tianjin in 2005, while the Toyota Prius hybrid car was supposed to be produced by FAW.

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<sup>3</sup> *Japan Economics News*, September 17, 2001 and *China Industry/Automobile Weekly*, (<http://www.autoweekly.com.cn>), March 22, 2002.

#### *4.4 Products Development and Reinforcement of Sales Ability*

FAW primarily emphasized investment on the R&D centre; secondly, in the network of purchasing and sale and thirdly, on the three largest unit parts, i.e. the engine, transmission and frame. It developed a strategy to concentrate on the three biggest processes—namely, painting, welding and assembling. The three biggest unit parts and the production, excluding the three biggest processes, needed external order. Further, FAW developed with the cooperation of the Shanghai Baoshan Iron & Steel Corporation due to the high price of the investment in Pries. In addition, FAW established the FAW Toyota sale in a joint venture with Toyota in October 2003 and continued to steadily develop sales.

By merging Tianjin Auto Works, the sales volume of FAW reached 902,000 units, with sales up to RMB 110 billion and an increase in profit to RMB 5 billion (*China Automobile*, March 16, 2004). FAW maintained its leading position in terms of annual total volume of production by acquiring approximately a 20% share in the domestic car market. The volume of car production in particular was the second largest in the country, and the domestic share increased from 12% in 1995 to 26% in 2003. Moreover, the gap with Shanghai Auto Works—the leading manufacturer (50%→30%)—gradually reduced. However, in 2004, the sales figures were considerably inflated; therefore, the profit declined considerably as compared to that of the previous year.

In addition, 80–90% of the company profit was derived from the sale of passenger cars, although from among the 120,000 employees, 70,000 were engaged in manufacturing trucks. Moreover, the profit in the passenger car segment was derived from the sale of foreign brands such as VW, Toyota and Mazda. Therefore, the important human resources specialized in product development, sales and administration management in FAW moved to private companies. FAW could not expand its brand products and left the problem unresolved, although it owned the strongest R&D institution in the country.

#### **Conclusion**

Based on the above discussions, the strategic construction and ability accumulation of FAW will be summarized here and the future direction will also be analyzed.

FAW was established as the national project from the 1950s by gathering many skilled human resources from across the nation and introducing the facilities and know-how for mass production from the Soviet Union. FAW merely functioned as a production factory without undertaking primary operations such as sales and profit management. At the same time, it was closely associated with the central government and was recognized as the greatest national enterprise in the automotive industry

in the planned economy control period. FAW faithfully adhered to the government plan of basically implementing the monopoly model of the medium-sized trucks without being intensively interested in market changes. Moreover, its passenger cars were produced in extremely small quantities based on the demand of the government.

Due to the intense competition in the commercial vehicle segment and a decline in its market share, from the 1980s, FAW shifted from a passive strategy of waiting for the investment plan to an active strategy to acquire the government project investment and application of the priority treatment policy; however, it was unable to do away with its dependence on the government investment plan. The change in FAW's policy considering the market needs was futile because the policy change was implemented after the change in the market. The competition predominance in the commercial vehicles segment was established by the acquisition of the R&D resources of the country; however, the formulation of the mass production system for cars was delayed, and FAW's independent development of the luxury limousine for leading officials required by the government also failed.

Using the leading position in production as an important point while negotiating with the government, FAW intensively concentrated its fund allocation on the expansion of commercial vehicle production; this was done to recapture its lost leading position in terms of the total volume of vehicle production. However, FAW was neither able to accomplish the production of its own brand of cars in time nor emphasize improvements in the development of passenger cars. As a result, FAW only accomplished the production target of commercial vehicles, i.e. only the light truck, and merely undertook a small change in the model of its own brand of car, without concentrating on the development and production of a mini car.

Unexpectedly, passenger cars replaced commercial vehicles as mainstream products given the rapid development of globalization from the middle of the 1990s, and in anticipation of China's membership in the WTO and the application of the WTO's framework on the Chinese automobile market. FAW finally began to shift its management policy by focusing on market orientation and company profit; however, it was unable to develop the R&D ability of its own company car. Therefore, the main profit, which should be derived from the cars produced by the company, was instead dependent on the sales of foreign brands produced according to the government's joint venture policy (which states that the share of foreign stocks should not exceed 50%).

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