

JD POWER/AUTOMOTIVE NEWS  
THE CHINESE AUTOMOTIVE INDUSTRY AND ITS IMPACT ON THE US  
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DETROIT, MICHIGAN

GOOD MORNING. I MUST SAY THAT IT IS A GREAT PLEASURE AND HONOR TO BE HERE TODAY. WHEN TOM ASKED ME TO SPEAK ABOUT CHINA, I GOT PRETTY EXCITED ABOUT THIS TOPIC BECAUSE CHINA IS VERY CHALLENGING VERY TROUBLING AND VERY PERPLEXING. TO PARAPHRASE SOMEONE I CAN'T REMEMBER, CHINA IS A CONUNDRUM INSIDE A KALEIDOSCOPE UNDER A BLACK CLOUD. BUT IT HAS ENORMOUS OPPORTUNITY. I'LL DISCUSS THESE AND THE MARKET, CHINESE AUTO POLICY, THE RISKS OF DOING BUSINESS IN CHINA – AND THEY ARE CONSIDERABLE – AND LASTLY THE POTENTIAL IMPACT OF CHINA ON THE US.

I ALSO WANT TO BE CLEAR UP FRONT, THIS IS NOT A STATEMENT OF ADMINISTRATION POLICY. SUCH STATEMENTS ARE MUCH BETTER MADE BY PEOPLE MUCH MORE SENIOR THAN ME. THESE ARE MY VIEWS, BASED ON MY EXPERIENCE AND WHILE THE DEPARTMENT HAS APPROVED THIS PRESENTATION, IN THE END IT IS REALLY MY VIEWPOINT.

LET'S BEGIN WITH THE OBVIOUS. IN A WORD, CHINA IS AMAZING. IT IS IMPOSSIBLE NOT TO USE SUPERLATIVES WHEN DISCUSSING IT. I BELIEVE IT WAS FORMER GM CHAIRMAN JACK SMITH WHO SAID THAT THE FUTURE OF THE AUTO INDUSTRY IS IN CHINA, OR SOMETHING CLOSE TO THAT. AND IT IS IMPOSSIBLE TO QUARREL WITH THAT ASSESSMENT.

THE CENTRAL FEATURE OF THE COUNTRY IS PEOPLE. THEY ARE CHINA'S BIGGEST ASSET AND BIGGEST PROBLEM. EVERYTHING IN CHINA COMES BACK TO THEM. 1.2 BILLION OF THEM, OVER 300 MILLION FAMILIES. HOW TO EMPLOY THEM, GET BASIC SERVICES TO THEM, PROVIDE HEALTH CARE, FEED THEM, HOUSE THEM, ETC., ARE CHINA'S PRIORITIES. IT HAS SO MANY PEOPLE, MANY WITH RAPIDLY GROWING INCOMES THAT ITS FUTURE IS NEARLY LIMITLESS.

SOME SAY THAT SURE PEOPLE ARE THERE, BUT WITH A GDP PER CAPITA OF ABOUT \$500 THE MONEY ISN'T. HOWEVER AS YOU ALL KNOW, PORTIONS OF THE CHINESE POPULATION HAVE INCOMES WHICH ALLOW THEM TO BUY LOTS OF THINGS - CARS AMONG THEM. I HAVEN'T SEEN A GOOD ESTIMATE OF THE SIZE OF THIS GROUP, BUT THE WORLD BANK SAYS THAT FOR THE LAST HALF OF THE 1990'S THE HIGHEST 20 PERCENT OF THE POPULATION ACCOUNTED FOR NEARLY 50% OF TOTAL CONSUMPTION. THAT WORKS OUT TO ABOUT 240 MILLION PEOPLE, SLIGHTLY SMALLER THAN THE ENTIRE US. THIS GROUP WILL GET MUCH LARGER.

SO WHAT'S GOING ON IN CHINA'S AUTO MARKET? WELL, A LOT AND SOME OF IT VERY CONFUSING AND CONTRADICTIONARY, BECAUSE IT IS STILL IN A VERY COMPLEX "SORTING OUT" PROCESS. AFTER ALL, ANY MARKET WITH OVER 100 COMPETITORS, CAN'T BE ORDERLY. AND, AS ALL OR NEARLY ALL OF THE GLOBAL COMPANIES HAVE SET UP FACILITIES, COMPETITION IS INTENSE AND WILL ONLY GROW. OF THESE 100+ FIRMS (PRODUCING GOD-KNOWS WHAT AND MOST OF WHOM WILL UNDOUBTEDLY FAIL) 12 ARE WORLD CLASS. IN ADDITION, THERE ARE A FEW CHINESE FIRMS WHICH LOOK LIKE THEY COULD MAKE IT. IN FACT, I WOULD NOT BE AT ALL SURPRISED IF TWO, THREE OR MORE HYUNDAIS DEVELOP IN CHINA.

SO WHILE THIS SOUNDS CHAOTIC, IT MIGHT NOT BE SO BAD. IN FACT ONE INVESTOR RECENTLY SAID THAT IT'S REALLY NO WORSE THAN OPERATING IN THE US! HE WAS PERHAPS UNDERSTATING THE SITUATION. TWO YEARS OF 30 PERCENT PLUS GROWTH PER YEAR - AROUND 70% IN PASSENGER CARS LAST YEAR - HAS CAUSED AN EXPLOSION OF AUTOMOTIVE INVESTMENT AND COMPETITION.

THE INDUSTRY IS CLEARLY RUSHING TO CHINA. AND IT'S HARD TO ARGUE THAT THEY SHOULDN'T. CHINA IS SIMPLY TOO LARGE, ITS POTENTIAL TOO GREAT TO PASS UP AND IT IS THE ONLY MAJOR GROWTH MARKET IN THE WORLD. IT CAN'T BE IGNORED.

CHINA'S PROBLEM IS THAT IT IS TRANSITIONING FROM A HIGHLY PROTECTED ECONOMY TO ONE WHICH IS WTO COMPLIANT AND IS MUCH LESS PROTECTED, WHILE AT THE SAME TIME TRYING TO MANAGE AN ECONOMY GROWING AT 7-8% PER YEAR. NOT AN EASY TASK AND THE CHINESE GOVERNMENT DESERVES MUCH CREDIT FOR BEING PRETTY SUCCESSFUL, SO FAR.

LET'S TAKE A LOOK AT HOW THE WTO ACCESSION HAS AFFECTED AUTOS. CBU TARIFFS HAVE FALLEN FROM 61.7 % IN 2001 TO 37.6% NOW AND WILL REACH 25% IN 2006, AT WHICH POINT, PARTS WILL HAVE A 10.5% DUTY. THIS HAS CAUSED VEHICLE PRICES TO FALL - ABOUT 10 PERCENT LAST YEAR - AND COMPETITION TO INCREASE. OVER THE SAME PERIOD YOU CAN SEE WHAT HAS HAPPENED TO AUTO SALES AND GDP GROWTH. NOW THESE GDP GROWTH RATES ARE SOMEWHAT DECEIVING AS CHINA HAS GROWN AT THIS LEVEL FOR ABOUT THE LAST TEN YEARS.

	2000	2001	2002	2003
GDP (\$US billions)	750	1,167	1,232	1,414
Auto Sales (millions)	2.0	2.3	3.1	4.4

I'M ALWAYS HESITANT TO ASCRIBE CAUSALITY TO ONE FACTOR, BUT IN THIS CASE IT'S HARD NOT SAY THAT THIS DRAMATIC AUTOMOTIVE GROWTH, COMBINED WITH A RELATIVELY UNCHANGING OVERALL ECONOMIC GROWTH RATE, WAS NOT CAUSED IN LARGE PART BY THE PRICE DECLINES RESULTING FROM WTO ACCESSION.

IT'S CLEAR THAT THESE DRAMATIC GROWTH RATES HAVE BEEN UNEXPECTED BY FORECASTERS. NOW THESE FOLKS ARE, OF COURSE, ESPECIALLY VULNERABLE, BECAUSE THEY PUT OUT A NUMBER FOR ALL TO JUDGE, BUT WHAT THE HECK, LET'S PICK ON THEM AND SEE HOW GOOD THEY'VE BEEN. AND LETS PICK ON OUR HOST. LET'S LOOK AT THE FORECASTS FOR 2003 WHICH WERE MADE BY JD POWER IN MAY OF LAST YEAR. THESE ARE IN THE FIRST COLUMN. THE SECOND COLUMN SHOWS THE ACTUALS. THE THIRD AND FOURTH COLUMNS SHOW THE FORECAST FOR 2004 AND 2010. NOTABLY THESE 2003 FORECASTS, MADE IN 2003, UNDERESTIMATED SALES BY NEARLY 25 %. INCREDIBLY, THIS FORECAST IS TYPICAL OF THOSE MADE LAST YEAR.

JD POWER CHINA AUTO SALES FORECASTS VS ACTUAL SALES (millions of units)

	2003 Forecast	2003 Actual	2004 Forecast	2010 Forecast
JD Power - May 2003	3.0	4.4	3.7	7.0
JD Power, May 2004			5.3	11.6

2004 IS OFF TO A ROARING START WITH SALES FOR THE FIRST QUARTER BEING NEARLY 30 PERCENT AHEAD OF LAST YEAR. JD POWER SAYS SALES THIS YEAR SHOULD BE A LITTLE OVER 5.3 MILLION UNITS. CONTRAST THAT WITH LAST YEAR'S 3.7 MILLION AND YOU CAN SEE HOW DIFFICULT IT HAS BEEN TO FORECAST CHINA'S AUTO MARKET. SIMPLY ANNUALIZING THE CURRENT RATE YIELDS SALES THIS YEAR BETWEEN 5.5 AND 6.0 MILLION UNITS.

NOW LET'S LOOK AT 2010. LAST YEAR JD POWER FORECAST 7.0 MILLION UNITS. THIS YEAR JD POWER SAYS 11.6. AN ASTONISHING CHANGE, ESPECIALLY WHEN YOU CONSIDER THAT MOST FORECASTERS HAVE DRAMATICALLY UNDERESTIMATED ACTUAL GROWTH RATES.

WHICH LEADS US INTO THE OVERCAPACITY DEBATE. IN FACT YOU MAY REMEMBER THAT RECENTLY MANY WERE PREDICTING OVERCAPACITY IN CHINA IN THE NEAR FUTURE. WELL, I KNOW OF ONE ANALYST WHO HAS RECANTED THAT CLAIM, BECAUSE IT IS CLEARLY NUTS. COMPANIES SIMPLY CAN'T BUILD CAPACITY FAST ENOUGH TO KEEP UP WITH DEMAND AND THAT DEMAND GIVES NO SIGN OF ABATING AS LONG AS THE ECONOMY HOLDS UP.

IN THIS DEBATE ABOUT OVERCAPACITY, IT IS IMPORTANT TO FOCUS ON THE DIFFERENCE BETWEEN TOTAL CAPACITY AND PRODUCTIVE CAPACITY. IN CHINA BECAUSE OF THE MULTITUDE OF SMALL FIRMS, THERE IS MAYBE TOO MUCH TOTAL CAPACITY, BUT THERE IS CLEARLY A SHORTAGE OF PRODUCTIVE CAPACITY – THAT IS WORLD-CLASS, EFFICIENT, HIGH QUALITY CAPACITY. AND THIS IS WHY THE CHINESE GOVERNMENT IS ENCOURAGING FOREIGN FIRMS TO BUILD MANUFACTURING FACILITIES. EVIDENCE OF THIS SHORTAGE IS THAT VOLKSWAGEN, THE MARKET LEADER IN CHINA SOLD 36 PERCENT MORE CARS LAST YEAR THAN IN 2002, BUT ITS MARKET SHARE FELL FROM 38 PERCENT TO 30 PERCENT BECAUSE OF A SHORTAGE OF CAPACITY.

A COMPANY LOOKING TO DO BUSINESS IN CHINA NEEDS TO BE VERY CAUTIOUS. AND THE ONES WHICH ARE IN THERE NOW, ARE BEING JUST THAT. THE ONE REALLY INTERESTING THING TO ME ABOUT CHINA IS THAT, EXCEPT FOR LOST INCOME - AND I DON'T MEAN TO MINIMIZE THAT - THERE IS NO REAL REASON TO RUSH INTO CHINA. A COMPANY DOESN'T NEED TO BE FIRST TO REAP THE REWARDS OF SELLING THERE. THE COUNTRY IS SIMPLY SO BIG AND WITH SO MUCH POTENTIAL THAT EVEN THE LAST ENTRANT WILL BE ABLE TO DO WELL. IN FACT, THE LAST ENTRANT MAY BE ADVANTAGED BY COMING INTO A MORE SETTLED POLICY ENVIRONMENT.

BUT HAVING SAID THAT, GLOBAL COMPANIES NEED TO MAKE PLANS TO COMPETE IN CHINA. I THINK THE ONLY WAY FOR THEM TO DEAL WITH CHINA IS TO PLAN TO PUT A MAJOR HEADQUARTERS AND INFRASTRUCTURE IN THERE. WHY? WELL SIMPLY BECAUSE OF THE POTENTIAL.

BUT IN ADDITION TO THIS, IF YOU LOOK AT HOW THE JAPANESE BUILT THEIR NORTH AMERICAN OPERATIONS AND ASK THEM WHAT THEY WOULD DO DIFFERENTLY, THEY ALMOST ALWAYS SAY THAT THEY WOULD HAVE OPENED SMALL STYLING AND R&D OPERATIONS HERE AND A COORDINATING HEADQUARTERS EARLIER. GET IN EARLY, UNDERSTAND THE MARKET RIGHT FROM THE BEGINNING AND MAKE PRODUCT PLANS ACCORDINGLY, BASED ON LOCAL CONDITIONS.

AND THIS STRATEGY IS EXACTLY WHAT THE COMPANIES ARE DOING. BUILDING OPERATIONS TO UNDERSTAND THE MARKET AND GROW WITH IT FROM THE BEGINNING. NOW I'M A PRETTY CAUTIOUS, SKEPTICAL GUY. I'VE WATCHED BRAZILIAN GROWTH ESTIMATES AND NEVER BELIEVED THEM. THE SAME FOR MEXICO AND INDIA. SO WHAT'S THE DIFFERENCE? WELL LET'S COMPARE INDIA AND CHINA. SAME POPULATION, BUT LOOK AT THE GROWTH RATES, THE SIZE OF THEIR CAR MARKETS, IT IS CLEAR THAT THE CHINESE GOVERNMENT IS FACING IT'S POTENTIAL IN MUCH BETTER WAYS THAN INDIA'S.

	<b>CHINA</b>	<b>INDIA</b>
<b>GDP/Capita</b>	<b>\$974</b>	<b>\$480</b>
<b>Vehicles/Capita</b>	<b>.0099</b>	<b>.0078</b>
<b>Population</b>	<b>1.3 billion</b>	<b>1.0 billion</b>
<b>GDP Growth (2002)</b>	<b>8%</b>	<b>2.5%</b>
<b>2003 Sales</b>	<b>4.4 million</b>	<b>1.0 million</b>

The Economist

THE SALIENT POINT IS THAT WHILE COMPANIES ARE RUSHING TO INVEST, THEY ARE NOT GOING IN WITH LARGE INVESTMENTS. FOR EXAMPLE GM'S CAPACITY IN CHINA IS LESS THAN IT IS KOREA AND IS ONLY ABOUT 3 TIMES THE SIZE IT IS IN THAILAND. MOST INVESTMENTS ARE SMALL AND LAG DEMAND, BECAUSE, THE MARKET GROWTH HAS BEEN LARGELY UNANTICIPATED. ONE DIFFICULTY OF THE CHINESE PROCESS IS THAT ALL FOREIGN INVESTMENTS MUST BE APPROVED BY THE CENTRAL GOVERNMENT. AND THIS PROCESS HAS PROBABLY REDUCED THE CURRENT LEVEL OF INVESTMENT. WHICH, IF IT HAS MODERATED INDUSTRY GROWTH, MAY ACTUALLY BE A GOOD THING.

BUT HAVING SAID THIS, THAT INVESTMENT IS GROWING AND GROWING FAST. IN FACT BY 2008 IT IS EXPECTED THAT AUTO INVESTMENT IN CHINA WILL BE ABOUT 6 MILLION UNITS.

LET'S LOOK AT SOME OF THE GOOD AND BAD ELEMENTS IN CHINA. ON THE GOOD SIDE, THERE IS A GROWING MARKET WITH ENORMOUS POTENTIAL. AT SOME POINT IT WILL PROBABLY BE THE LARGEST IN THE WORLD. IN ADDITION, IT HAS A STABLE GOVERNMENT, WHICH IS SEEKING FOREIGN INVESTMENT, AN INTERNATIONALIZING FINANCIAL SYSTEM, A LIBERALIZING ECONOMIC POLICY, AND, REPORTEDLY, IT'S NOT A BAD PLACE TO LIVE.

ON THE OTHER HAND, CHINESE GOVERNMENT POLICY-MAKING IS STILL CENTRALIZED, MYSTERIOUS, AND ONLY SEMI-TRANSPARENT AT BEST. THE WTO ACCESSION AGREEMENT HAS YET TO BE FULLY IMPLEMENTED AND IT'S A GOOD QUESTION OF HOW HARD THE CHINESE GOVERNMENT IS TRYING. SOMETIMES IT APPEARS THEY ARE, SOMETIMES NOT. THE REALITY APPARENTLY IS THAT CHINA'S TRADE AND INVESTMENT POLICIES ARE LIBERALIZING, IF AT A SLOWER PACE THAN IT PROMISED, OR WE WOULD LIKE. BUT GAINS ARE BEING MADE AND THERE APPEARS TO BE A FAIRLY SOLID CORE OF OFFICIALS WHO ARE GENUINELY INTERESTED IN LIBERALIZING.

ANOTHER CONCERN IS THAT CHINA'S ECONOMY RISKS OVERHEATING AND THE SIGNS ARE STARTING THAT IN THE NOT TOO DISTANT FUTURE, THE ECONOMY WILL SLOW DOWN AND MAYBE SEVERELY. BUT, WHEN AND HOW SEVERELY ARE REALLY THE QUESTIONS. THE CHINESE GOVERNMENT IS TRYING TO DO

THIS IN AN ORDERLY FASHION, BUT I'M NOT SURE THEY ARE GOING TO SUCCEED, ESPECIALLY IF THEY DON'T START RAISING INTEREST RATES ABOVE THE CURRENT 5-6 PERCENT AND START AN ORDERLY REVALUATION OF THE YUAN. ALSO MOST OF THE INFRASTRUCTURE NECESSARY TO SUPPORT INVESTMENT AND OPEN MARKETS IS LACKING. THE FINANCIAL SYSTEM IS STILL THIRD WORLD, THE LEGAL SYSTEM IS SUSPECT, ELECTRICAL POWER CAN BE INTERMITTENT, ETC.

IN ADDITION, THE CHINESE GOVERNMENT FAVORS DOMESTIC - THAT IS CHINESE - COMPANIES AND THAT HAS MANY CONSEQUENCES. CURRENTLY FOREIGN INVESTMENTS REQUIRE A DOMESTIC PARTNER. DESPITE CHINESE ASSURANCES THAT THEY WOULD ELIMINATE THIS REQUIREMENT, THEY HAVEN'T. THE AUTO PLAN THEY DRAFTED A YEAR AGO OPENLY VIOLATED THE WTO SO BADLY THAT I WAS CONFIDENT THAT IT WOULDN'T BE IMPLEMENTED. AMONG OTHER PROBLEMS, IT FAVORED CURRENT INVESTORS TO THE DETRIMENT OF NEW ONES; MANDATED SEPARATE DISTRIBUTION POINTS FOR IMPORTS AND DOMESTICS, AND CONTAINED A LOCALIZATION POLICY. BUT THE BIGGER PROBLEM WITH THIS FAVORITISM HAS BEEN THE LACK OF PROTECTION FOR INTELLECTUAL PROPERTY.

AND THIS INTELLECTUAL PROPERTY PROBLEM IS SERIOUS, AND IT MIGHT MAKE INVESTORS THINK TWICE. FOR QUITE A WHILE THERE HAVE BEEN STORIES AND EVIDENCE OF SUPPLIERS COPYING A PART AND SELLING IT UNDER THEIR OWN LABEL AND COPIES OF OLD MODEL VEHICLES HAVE BEEN RUNNING AROUND, BUT OLD CARS ARE ONE THING. CHINESE MANUFACTURERS ARE NOW COPYING THE LATEST AND GREATEST MODELS, INCLUDING SOME OF THE LATEST OFFERINGS FROM TOYOTA, HONDA AND GM. NOW CLEARLY THESE COPIES AREN'T UP TO THE QUALITY STANDARDS OF THE GLOBAL MANUFACTURERS, SOME ARE REPORTEDLY EVEN DIFFICULT TO DRIVE, BUT THEY ARE PRICED LOWER AND CHINESE ARE BUYING THEM. LEGAL REMEDIES ARE BEING PURSUED, BUT SO FAR THEY AREN'T FORTHCOMING.

CLEARLY, THIS IS VERY SERIOUS AND BRINGS UP WHAT I BELIEVE IS THE REAL PROBLEM WITH DOING BUSINESS IN CHINA - THE LEGAL SYSTEM ISN'T UP TO THE JOB. NOW THE LARGER GLOBAL VEHICLE MANUFACTURERS AND TIER 1S, CAN, BUT NOT WILLINGLY, DEAL WITH THIS. BUT SMALLER COMPANIES, WITH FEWER FINANCIAL RESOURCES, SIMPLY CAN'T. AND THIS HAS HURT THOSE CAR COMPANIES DOING BUSINESS IN CHINA. THE LOCAL TIER 2 AND 3 SUPPLIERS AREN'T ALWAYS UP TO THE JOB AND THE GOOD ONES IN THE US, JAPAN AND EUROPE, CAN'T AFFORD TO COME. ACTUALLY, I WOULD ARGUE THAT WITH THESE BUSINESS CONDITIONS, THEY SHOULD BE VERY CAREFUL. AND IF THEY DON'T GET INTO THE MARKET, OF COURSE, THEY WILL MISS OUT, AS THE CHINESE COMPANIES WILL IMPROVE THEIR TECHNIQUES, OTHER FOREIGN SUPPLIERS WILL INVEST, AND THE INVESTMENT OPPORTUNITY FOR U.S.

SUPPLIERS COULD BE LOST. BUT EXPORTING IS POSSIBLE AND I WOULD ENCOURAGE THEM TO LOOK INTO DOING THAT AS A WAY TO ESTABLISH A PRESENCE AND THEN, ONCE THEY ARE COMFORTABLE, INVEST.

SO WHAT IS THE U.S. GOVERNMENT DOING TO HELP U.S. AUTO INVESTORS IN CHINA? WELL, WE ARE DOING ALL THEY WANT US TO DO. AND LARGELY THAT IS TO STAY OUT OF THEIR WAY. WE CONSULT WITH THEM, BOTH HERE IN THE STATES AND IN CHINA. WE STRATEGIZE AND AT THIS POINT, DO MORE QUIETLY THAN PUBLICALLY. THIS STRATEGY RECOGNIZES THAT, BY AND LARGE, THE CHINESE GOVERNMENT IS TRYING. ON THE OTHER HAND IT LETS THEM GET AWAY WITH A LOT. BUT ALL IN ALL, IT SEEMS TO BE WORKING. U.S. INVESTORS ARE LARGELY SUCCESSFUL AND IF THE STRATEGY WORKS FOR THEM, IT WORKS FOR US.

BEFORE I GET TO THE QUESTION I AM SUPPOSED TO BE ANSWERING AND HAVE BEEN AVOIDING, I'D LIKE TO SAY SOMETHING ABOUT AN INTERESTING TREND IN CHINA - THE ENVIRONMENT. AS YOU KNOW MANY CHINESE CITIES ARE AMONG THE MOST POLLUTED IN THE WORLD. BUT THE CHINESE GOVERNMENT IS BELATEDLY WORKING TO CORRECT THE PROBLEM AND THE CAR COMPANIES ARE ASSISTING THEM. THEY ARE DEMONSTRATING THE LATEST AVAILABLE TECHNOLOGY AND WORKING WITH THE GOVERNMENT ON CLEAN AIR REGULATIONS. THIS IS AN AREA WHERE THE INTERNATIONAL CAR COMPANIES HAVE ENORMOUS EXPERIENCE AND ARE TRYING TO GET ON TOP OF THE PROBLEM BEFORE IT SWAMPS THEM. IT IS ALSO AN AREA WHERE THE U.S. ENVIRONMENTAL TECHNOLOGY COMMUNITY CAN HAVE A SUBSTANTIAL IMPACT.

ALL RIGHT, I'VE STALLED LONG ENOUGH AND TOM WILL GIVE ME A DEMERIT IF I DON'T TALK ABOUT HOW CHINA IS GOING TO IMPACT THE US. CLEARLY THIS IS A DIFFICULT QUESTION. GENERALLY I DON'T AGREE WITH THE "SKY IS FALLING" ARGUMENT. I DIDN'T BECOME TOO CONCERNED ABOUT THE JAPANESE THREAT IN THE '80'S BECAUSE I THOUGHT IT WAS SOMETHING TO TAKE ADVANTAGE OF AND LEARN FROM AND OUR INDUSTRY WOULD PROFIT FROM COMPETING WITH IT AND THE COUNTRY AND U.S. CONSUMERS WOULD BE BETTER OFF FOR THAT COMPETITION. ALTHOUGH GIVEN THE ENORMOUS UPHEAVAL THEY CAUSED TO OUR WORKERS, THIS WAS NOT AN EASY ATTITUDE TO MAINTAIN. I THOUGHT SOME POLICY MODIFICATION MIGHT BE APPROPRIATE, ESPECIALLY IN TERMS OF WORKER ADJUSTMENT PROGRAMS, BUT THERE WAS NO NEED TO PANIC ABOUT JAPAN.

BUT CHINA IS DIFFERENT AND MORE CHALLENGING, SIMPLY BECAUSE OF IT'S SIZE AND SHEER DETERMINATION TO BECOME INTERNATIONALLY COMPETITIVE. IT'S PEGGING OF THE YUAN, TREATMENT OF WORKERS AND SUSPECT LEGAL SYSTEM, ALL ADD UP TO A DIFFICULT AND DETERMINED

COMPETITOR. I WAS TEMPTED TO CALL CHINA TROUBLING, BECAUSE IN MANY WAYS IT IS, BUT IT IS ALSO FULL OF OPPORTUNITY, WHEREAS JAPAN REALLY WASN'T. U.S. COMPANIES WEREN'T GOING TO BE MAJOR COMPETITORS IN JAPAN. BUT THEY ARE AND WILL CONTINUE TO BE IN CHINA.

SO, WHAT DOES IT ALL MEAN FOR AUTOMOTIVE? LET'S BEGIN WITH THE EASY ONE - VEHICLES.

MY OWN GUESS IS THAT ABSENT A SEVERE RECESSION IN CHINA, SUBSTANTIAL EXPORTS OF CHINESE-MADE VEHICLES TO THE U.S. ARE A WAYS OFF. CHINESE-MADE VEHICLES ARE CURRENTLY BEING SENT, OR PLANS HAVE BEEN ANNOUNCED, TO SEND THEM TO EUROPE AND JAPAN. SO CLEARLY THE QUALITY ISSUE IS BEING ADDRESSED, BUT EQUALLY CLEARLY THIS HAS BEEN GAINED AT THE EXPENSE OF INCREASED COST, AN ISSUE WHICH WILL BE RESOLVED AS THE CHINESE SUPPLIER BASE IMPROVES.

BUT CARS WILL BE EXPORTED TO THE U.S. AND I'M SURE PLANS ARE BEING DEVELOPED. HOWEVER, I THINK THERE ARE TWO SIGNIFICANT BARRIERS. ONE IS CAPACITY. EXCEPT FOR HONDA AND HYUNDAI, THE PLANTS BEING CONSTRUCTED IN CHINA ARE BEING BUILT TO MEET DOMESTIC DEMAND AND THEY ARE STRUGGLING TO MEET IT. THE CAPACITY SIMPLY ISN'T THERE TO EXPORT NOR ARE THE TYPES OF CARS. IS THIS BARRIER FIXABLE? OF COURSE, BUT IT EXISTS NOW.

THE SECOND BARRIER IS POLITICAL. COUNTRIES LIKE CHINA, INDIA, BANGLADESH ARE AT THE HEART OF THE "OFF-SHORING" DEBATE IN THE US. I MAY BE NAIVE, BUT WHY IN THE WORLD WOULD A US-BASED AUTOMAKER WANT TO FAN THESE FLAMES BY BRINGING IN A CHINESE-MADE CAR. AT THIS POINT, THEY HAVE TOO MANY OPTIONS TO BUILD SMALL, LOW MARGIN VEHICLES IN "SAFE" COUNTRIES - KOREA, MEXICO, BRAZIL, THAILAND, ETC. I CERTAINLY WOULDN'T WANT TO FACE THE UNION REACTION TO CHINESE CARS. HOWEVER, WHILE THIS IS A CONSTRAINT FOR US-BASED CAR MAKERS, IT'S NOT A CONSTRAINT FOR CARS MADE BY FOREIGN AUTOMAKERS. CONSEQUENTLY, THERE IS A DEFINITE POSSIBILITY OF CHINESE-MADE CARS EXPORTED TO THE U.S.

NOW, COULD AN AMERICAN ENTREPRENEUR BRING IN A CAR FROM A CHINESE COMPANY - LIKE THE YUGO? YEP, BUT IN THE NEAR TERM, IT WOULD BE A YUGO - CHEAP, LOW QUALITY, SELL FOR A LITTLE WHILE UNTIL PEOPLE WISED UP AND THE FRANCHISE WENT BROKE. THE DIFFERENCE FROM THE YUGO MAY BE THAT THERE IS MORE COMPETITION IN CHINA THAN YUGOSLAVIA AND, AS A RESULT, OVER THE LONG TERM, THE QUALITY OF CHINESE PRODUCTS WILL IMPROVE. THUS, THERE IS A GOOD CHANCE THAT WE WILL SEE GOOD QUALITY VEHICLES FROM CHINA IN THE U.S. AND MAYBE, SOONER, RATHER THAN LATER.

WITNESS GEELY, BUT I HAVE AN IDEA THAT US SAFETY REGULATIONS WILL SLOW THAT EFFORT.

SO MY GUESS IS THAT THIS IS WHERE INITIAL U.S. IMPORTS OF CHINESE VEHICLES WILL COME FROM. IF THESE WORK AND ARE ACCEPTED, THEN THE GLOBALS WILL LOOK TO FOLLOW. AT THAT POINT THE TRADITIONAL DOWNSIDES OF EXPORTING IN VOLUME WILL COME INTO PLAY - EXCHANGE RATES, LONG SUPPLY LINES, POTENTIAL GOVERNMENT IMPORT RESTRICTIONS, AN UPSET UNION, ETC. - AND EACH COMPANY WILL HAVE TO FIGURE THAT OUT ON THEIR OWN. SO I'M NOT SURE ABOUT WHEN CHINESE CARS WILL ARRIVE HERE, NOR IN WHAT NUMBERS AND I WOULD BE SKEPTICAL OF THOSE WHO CLAIM TO BE ABLE TO PREDICT THIS. THE ISSUE GOES WAY BEYOND SIMPLE COST FUNCTIONS.

BUT THERE IS CREDENCE TO THE BELIEF THAT CHINA WILL BE A SIGNIFICANT SOURCE OF PARTS AND COMPONENTS FOR THE US. SOME PLANS ALONG THESE LINES HAVE BEEN ANNOUNCED. AND IT MAY WORK, BUT EVEN A LIBERAL, IMPORT CAR BUYER LIKE MYSELF WOULD DRAW THE LINE AT BUYING A CAR WITH A CHINESE ENGINE AND I SUSPECT I'M NOT THE ONLY ONE.

HAVING SAID THAT, I THINK THAT IT IS INEVITABLE THAT U.S. IMPORTS OF CHINESE-MADE PARTS WILL INCREASE AND RUN WELL UP INTO THE BILLIONS OF DOLLARS. U.S. IMPORTS OF CHINESE PARTS HAVE ALREADY RISEN OVER 100 PERCENT OVER THE PAST 3 YEARS, FROM \$1.3 BILLION IN 2000 TO \$2.8 BILLION IN 2003 AND MANUFACTURERS HAVE ANNOUNCED PLANS TO INCREASE THEM BY MANY MULTIPLES OF THIS. THIS, COMBINED WITH THE CHINESE GOVERNMENT'S ANNOUNCED GOAL OF EXPORTING \$100 BILLION WORTH OF AUTOMOTIVE PRODUCTS WORLDWIDE BY 2010, COULD MAKE A BELIEVER OUT OF YOU!

EXPORTS TO THE U.S. BE WILL BE DRIVEN BY THE HYPER-COMPETITIVENESS OF THE U.S. MARKET AND THE RESULTANT COST PRESSURES. BUT I DON'T KNOW IF THESE EXPORTS WILL LAST. MAYBE THIS IS MORE WISH THAN ANALYSIS, BUT THE JAPANESE MANUFACTURERS WHO LOCATED HERE LEARNED THAT SUPPLY LINES THOUSANDS OF MILES LONG ARE A BAD BET. THEY ARE SIMPLY TOO VULNERABLE TO OUTSIDE DISRUPTIONS - PORT STRIKES, TRANSPORTATION DIFFICULTIES IN THE EXPORTING COUNTRIES, UNION CONTRACT DIFFICULTIES, GOVERNMENT TRADE RESTRAINT ACTIONS, AND EXCHANGE RATE CHANGES - AMONG OTHER PROBLEMS. IN ADDITION, THESE JAPANESE COMPANIES ALSO REPORT THAT IT IS VERY DIFFICULT TO MANAGE QUALITY OR MAKE RUNNING CHANGES WITH PARTS SUPPLIERS WHO NEED A MONTH OR TWO OF LEAD TIME JUST FOR TRANSPORTATION.

NOW THE MAJOR WAY TO CORRECT THESE PROBLEMS IS TO INVENTORY AT SOME POINT IN THE SYSTEM, WHICH IS EXACTLY WHAT THE LEAN

MANUFACTURING SYSTEM WORKS TO ELIMINATE. I DON'T KNOW THE INTERNAL NUMBERS, BUT TO ME IT MAKES NO SENSE TO GET INVOLVED IN THIS TYPE OF OPERATION. LEAN WORKS ON SO MANY LEVELS BECAUSE IT IS A STRESSED SYSTEM. WHY RELIEVE THIS STRESS?

I KNOW THIS ISN'T A TALK ON SUPPLIER RELATIONS, OR LEAN MANUFACTURING FOR THAT MATTER, BUT TO ME THE BEST WAY TO DEAL WITH THIS PROBLEM IS TO REALIZE THAT THE VEHICLE MANUFACTURERS AND SUPPLIERS ARE INEXTRICABLY LINKED IN A SYSTEM - DEVELOP GOOD RELATIONS WITH THOSE SUPPLIERS AND WORK TOGETHER TO REDUCE SYSTEMIC COSTS.

THE OTHER EFFECT WHICH CHINA WILL HAVE ON THE US, HAS ALREADY BEGUN. ALMOST ANY COMMODITY WHICH YOU CAN IMAGINE WILL SEE ITS DEMAND INCREASE. IN SOME CASES THIS WILL LEAD TO SHORTAGES AS IN STEEL SCRAP, IN OTHERS TO PRICE INCREASES WITHOUT SHORTAGES. IT WOULD TAKE ANOTHER SPEECH TO GO INTO ALL THE IMPLICATIONS OF THIS, BUT FOR THE AUTO INDUSTRY IN THE US, NONE OF IT WILL BE GOOD. ONE OF THEM ADDS TO THE REASON FOR SUPPLIERS TO LOCATE IN CHINA. BECAUSE, IF YOUR INPUTS ARE PRESENT IN CHINA AND IN SHORT SUPPLY IN THE US, A COMPANY WILL CERTAINLY CONSIDER RELOCATING.

BUT, I REALLY THINK THAT LOCATING IN CHINA TO SUPPLY THE U.S. IS A BAD IDEA AND IN MOST CASES WILL REBOUND BADLY FOR THE COMPANY DOING IT. THE BEST STRATEGY WILL PROBABLY BE TO LOCATE IN BOTH PLACES AND FOR SUPPLIERS, IT MAY BE MORE IMPORTANT THAT THEY DO SO SOONER RATHER THAN LATER SO AS TO PARTICIPATE IN THE GROWTH OF THE CHINESE SUPPLIER BASE AND PERHAPS PREVENT SOME COMPETITION FROM DEVELOPING IN CHINA. BUT, AS I SAID EARLIER, BE VERY CAUTIOUS AND IT MIGHT BE BEST TO TRY EXPORTING.

WHICH LEADS TO THE POSITIVE NOTE I'D LIKE TO END ON. AS I HOPE I'VE POINTED OUT, CHINA IS A FASCINATING TOPIC FOR DISCUSSION. THERE ARE MANY VARIED OPINIONS ABOUT WHAT THE FUTURE HOLDS, BUT ONE I REALLY HAVEN'T HEARD DISCUSSED MUCH IS CHINA'S POTENTIAL AS AN EXPORT MARKET. EARLIER I MENTIONED OUR EFFORTS TO OPEN THE JAPANESE MARKET IN THE 1970'S, 80'S AND 90'S. AS THOSE 25 OR 30 YEARS OF EFFORTS INDICATE, THE JAPANESE GOVERNMENT NEVER REALLY HAD ANY INTEREST IN OPENING IT'S MARKET AND, TO BE FAIR, I WOULD SAY THAT STRUCTURAL ISSUES MADE TRUE MARKET OPENING, WHICH WOULD LEAD TO A SIZEABLE IMPORT COMPONENT IN THAT MARKET, VERY, VERY DIFFICULT.

BUT CHINA IS DIFFERENT. THE GOVERNMENT WANTS TO OPEN THE MARKET. THEY REALIZE THAT IT IS THE ONLY WAY TO SATISFY THE RAPIDLY GROWING AND ABSOLUTELY HUGE DEMAND. INTERNAL CAPACITY IS NOT BEING BUILT

FAST ENOUGH AND ANYWAY WILL NOT SATISFY A POPULATION WHICH CRAVES FOREIGN-MADE GOODS. IN FACT, IN THAT WAY, THE CHINESE CONSUMER MAY NOT BE THAT MUCH DIFFERENT FROM THE U.S. CONSUMER. NOW I CAN'T TELL YOU WHAT CARS WILL WORK AS EXPORTS TO CHINA, THAT LARGELY DEPENDS ON MANUFACTURERS' PLANS, BUT THE POTENTIAL FOR INCREASED U.S. EXPORTS OF VEHICLES AND PARTS TO CHINA IS CLEARLY THERE AND WE IN THE DEPARTMENT HOPE THAT U.S. MANUFACTURERS TAKE ADVANTAGE OF THAT POTENTIAL.