Submission
to the
Department of Foreign Affairs and Trade on
Negotiations for a Free Trade Agreement
between
Australia and China
Issues and Implications for Australia's
Automotive Components Industry

June 2004

President	Mr Grant Anderson President PBR International Limited	Street Address	Level 6, Perpetual Building 10 Rudd Street CANBERRA ACT 2601
Chief Executive	Mr Peter Upton	Postal Address	GPO Box 295 CANBERRA ACT 2601
Telephone Facsimile	+61 2 6247 4177 +61 2 6257 4651	E-mail Website	info@fapm.com.au www.fapm.com.au

TABLE OF CONTENTS

Executive Summary

There would be very few automotive companies anywhere in the world that are not trying to assess what the impact of Chinese automotive production will eventually have, not only on their own business, but on the global industry as a whole. China automotive is on the move from a state-planned inefficient industry to one supported by huge capital injections from global car makers and closely tied component manufacturers, generous assistance by the Chinese Government and a potentially enormous domestic demand base. But some of the vestiges of socialist planning and intervention remain despite China's accession to the WTO.

Many Australian component companies are concerned about the prospect of increased future supplies of cheaper components from China eroding both the available OEM and the after-markets in Australia. There seems to be good reasons for this concern. Car makers such as GM are already looking at China to supply more components to their operations worldwide.

China remains a complex market. State and Chinese owned enterprises dominate the market commonly in joint venture arrangements with global auto companies. Despite all the rhetoric of a more open Chinese economy and WTO reforms, it is a difficult structure for small and medium-sized Australian companies to penetrate.

Only two Australian component suppliers have established, or have announced plans for, joint venture operations in China although a number of the global component suppliers with operations here also have manufacturing operations in China. Some Australian component suppliers are directly exporting to China but volumes are low.

FAPM has the view, perhaps cynically, that China agreed to significant reductions in auto tariffs because it knew the impact on auto imports would be minimal. Opponents of that view might point to the surge in China's imported component values since WTO accession in 2001. But our view is that such imports were deliberately manipulated under China's total automotive products import value quota to severely limit imports of vehicles. Also most of those component imports were at the higher value added end of the market, such as electronics, in which China has had a comparative disadvantage. But that situation is changing quickly. By the time the quota is abolished in 2006, we expect local manufacturers in China to be preferred for virtually all types of automotive components and that imports (and consequently export opportunities for Australia) will decline substantially. That would be entirely consistent with China's manufacturing and export flagship status for its automotive industry.

FAPM is of the view that any FTA with China, at least as far as the automotive components sector is concerned, would be best focusing on the restrictions on the free operation of foreign investment enterprises. Despite generous financial assistance to encourage foreign investment, there remains a raft of structural impediments to efficient business operation in China. Investors also face substantial and potentially ruinous market imperfections in terms of information on prospective partners particularly in terms of their competence, skill sets and financial stability.

We are not sure whether such issues are relevant to a potential FTA but they are the most significant practical constraints on Australian companies gaining a bigger share of the booming Chinese auto market.

FAPM members see little potential benefit in an FTA between Australia and China if most of the emphasis is on trade barriers. By 2006, both the Chinese and Australian tariff rate on imported components will be 10%. Frankly, eliminating that low rate of duty is unlikely to have any significant impact on potential exports of automotive components from Australia to China, especially since many of the production centres in China are already in duty free bonded zones. On the other hand, removal of the duty on imports from China would likely worsen the already substantial automotive trade imbalance in China's favour. Rather than being trade diversionary, such an increase is likely to be at the expense of Australian production.

1 Introduction

The Federation of Automotive Products Manufacturers (FAPM) represents the interests of Australia's major suppliers of automotive components.

This feasibility study for an Australia-China Free Trade Agreement is of particular interest to FAPM members and to the Australian automotive industry generally. China is the fastest growing automotive market in the world. All the leading multi-national automotive assemblers are looking to China to provide future sales growth rates not generally achievable in the more mature markets of Europe and the United States. Most have established joint ventures there. Components suppliers, including some Australian companies, have also established manufacturing operations in China both to supply local vehicle assemblers and to meet global competitive pressures to reduce prices.

The terms of reference for the joint FTA feasibility study, as set out in Annex II of the Trade and Economic Framework, are:

- to provide an overview of recent trends in bilateral trade and economic relations;
- to assess recent international trade policy developments and the possible implications for Australia-China trade and investment;
- to identify and describe existing barriers to trade and investment flows, covering goods, services and investment and other issues that might be addressed in a free trade agreement;
- to identify possible cooperation measures to promote trade and investment liberalisation and facilitation between Australia and China;
- to assess the impact of the removal and/or reduction of existing barriers to goods and services trade and investment; and
- make conclusions and recommendations as regards options for future action.

FAPM welcomes the inclusion of investment issues in this feasibility study. As shown later in this submission, access to the China automotive components markets for Australian suppliers is more likely to depend on minimizing impediments to manufacturing investment in China by Australian companies rather than on reducing or eliminating tariff barriers.

As a matter of principle, FAPM supports freer international trade. But it must be recognized that bilateral free trade agreements can have distorting effects both on existing patterns of local production and on the sources of imports and destinations of exports. In coming to an overall assessment of the net effect of any Australia-China Free Trade Agreement, each Australian automotive producer must weigh up the commercial costs and benefits on their own business. These will vary depending upon a firm's existing commercial linkages into the China automotive industry and the potential to either establish such linkages or grow existing linkages. Much will also depend on board room strategic decisions about the preferred locations for product sourcing following implementation of any Agreement.

The options for re-sourcing can increase with lower trade barriers. But there are a host of other factors which will ultimately determine the extent to which an Agreement will affect automotive trade creation and diversion including customer preferences and loyalty; being located geographically close to the market; ability to profitably meet niche markets; continued capacity to meet product specifications at a competitive price and quality; availability of skills; educational and other social and economic infrastructure; and so on.

Despite the fact that China is moving fast towards a market-based economy, it remains a socialist state. It has a regulatory system with a history of administrative interpretation, selective enforcement and "guanxi" (relationships). China's accession to the WTO means that the business environment must become more rules based, non-discriminatory and transparent. Existing regulations must be brought more in line with international standards. This pressure has placed considerable strain on many Chinese industries which remain dominated by large inefficient state-owned enterprises.

China's first move to bring its economy into the modern world by initiated by Deng Xiaoping in 1978. Its so-called "open door" economic reform was predominantly aimed at developing light industry for export markets. High import tariffs, non-tariff barriers and administrative and structural impediments protected local manufacturing. Various areas of China's southern provinces were designated as special economic zones in which foreign investors could establish manufacturing activities on favourable terms.

In 1994, China's foreign currency system and taxation systems were reformed. Since then a raft of major laws applicable to business have been overhauled to provide a more uniform, national and statutory basis for the incorporation and operation of companies. These reforms were pre-requisites to China's accession to the WTO in 2001. This development further encouraged China's transition from a totally planned backward industrial structure to a more globally competitive environment.

In this submission, FAPM offers our views on these matters in respect of the automotive components industry in particular and the automotive industry generally. We examine how an FTA would fit in this context and what it might mean for the Australian automotive industry.

2 Automotive Industry Profile in China and Australia

Compared with the global auto industry, China's auto industry is somewhat of a fledgling. It has been characterized by a relatively large number of automakers all with low production volumes. Its centralized planning system required the automakers to source the bulk of their components from local affiliated and often State-owned suppliers. These suppliers were mostly small-scale Chinese companies with little capital, virtually no R&D capacity and outmoded production and distribution systems. Over the last half of the 1990s, this inefficient structure underwent substantial rationalization under a deliberate Government policy and the infusion of capital and know-how from global auto firms under joint venture arrangements. That process has continued and was reinforced with China's accession to the WTO in 2001.

2.1 China's Automotive Industry

The Vehicle Market

Total vehicle sales in China in 2002 were 3.26 million units, up from 1.43 million units in 1995. Sedan sales grew by a staggering 48% over the first three months of 2004 compared with the same three months of 2003. Although buses and trucks currently account for around 60% of the market, sedans are expected to reach around 60% of an estimated total market of around 9 million units by 2015 (a compound annual growth rate of nearly 8%). Although private vehicle sales are expected to grow as personal incomes rise, most vehicle sales are to various government agencies. Imported vehicles make up only around 3% of the market.

Vehicle Production

In 2001, China was the 7th largest vehicle producer in the world. By 2015, it is expected to be ranked 3rd. Sedan production in China is fragmented regionally – Shanghai accounts for 40% of total sedan production, Jilin around 20% and Guandong around 11%. The remaining production is shared between 19 provinces and municipalities. By the end of next year, sedan production capacity is expected to reach nearly 5 million units.

Most of the world's major vehicle assemblers are represented including VW, GM, Nissan, Renault, Honda, Citroen, Hyundai, Daimler-Chrysler, Fiat, Suzuki, Ford, Mazda, Audi and BMW. The Chinese Government has majority ownership of nine of the largest 10 vehicle manufacturing JVs. Despite predictions of looming overcapacity in vehicle production compared with domestic demand, new investments continue to be announced. Nissan, Kia, and Ford have recently announced plans to build new plants while established car makers such as GM and the privately owned Chinese carmaker the Geely Group are looking to substantially expand manufacturing capacity.

Many car makers are looking to China to establish an export base although current export volumes are low. Honda has plans to export a China-made vehicle to Europe.

Volvo is considering production of its S40 sedan in China by early 2006; Daimler-Chrysler plans to build C and E class Mercedes sedans in a joint venture with Beijing Industry Holdings Co.; and Shanghai-Volkswagen will export 600 compact Polo sedans to Australia over the next five years to test acceptance of China-made cars in a developed overseas market.

Despite its reputation as a low cost center, total vehicle production costs are generally recognized as being about 15 - 20% compared with the US or Europe. However, with improving production efficiency, plant rationalization, greater economies of scale, higher quality raw materials and a supporting export focus by Government, costs will fall and substantial and growing vehicle export volumes from China can be expected.

The Components Market

The size of the automotive components market in China is estimated to be around US$25 billion. Car makers in China currently take around 85% of local component production. Imports of components have increased rapidly. The China Automotive Industry Information Network recently reported that the value of imported components rose from US$3.38 billion in 2002 to US$9.47 billion in 2003.

Components Production

In 2001, there were over 2,700 component producers in China, down from over 5,300 in 1995. Despite this rationalization, the industry remains fragmented regionally and structurally. The top 10 firms (some of which are State-owned) account for only around 20% of total industry revenue. The top four of that group (Wan Xiang Group Co., Dongfeng Honda Engine Co. Ltd, Shanghai Huizhong and Wuxi Weifu Group Co. Ltd.) dominate.

The world's biggest automotive component suppliers (Delphi, Robert Bosch, Visteon and Denso) operate numerous plants in China and account for around 10% of total industry sales. Between 1983 and 2003 around 620 foreign-owned automotive parts producers set up in China, mostly in joint ventures. Many suppliers were encouraged to establish operations in China by the vehicle manufacturers because local Chinese automotive components manufacturers were not competitive. GM for example sources around 75% of its components for car making in China from local international JVs.

In China other factors can also influence sourcing decisions. For example, regional protectionism has led to some automakers (whose principal shareholder is commonly a local municipal government) pressuring suppliers to set up close to vehicle production.

2.2 The Australian Automotive Industry

By contrast, the Australian automotive market is small by global standards. Annual Australian production of vehicles accounts for only around 0.5% of global production. And is centred on the local subsidiaries of four of the world's leading automotive manufacturers (Ford, General Motors, Mitsubishi and Toyota).

There are around 200 local component, tooling, and design and engineering firms providing products and services to the four Australian vehicle assemblers, to exports and to the after-market. Of these, approximately 20 firms produce 75% of the total value of Australian component production.

Automotive components manufacturing directly employs around an estimated 30,000 people. It is an important industry in a number of regional centers across Australia including Albury, Geelong, Ballarat and Launceston. It is also a significant employer in parts of Melbourne and Adelaide.

Total annual sales of automotive components are around $5 billion. Many of the world's leading automotive components suppliers are manufacturing in Australia. Four of the top five, seven of the top 10 and 11 of the top 30 component suppliers by world turnover are represented in Australia.

The Australian components sector manufactures the full range of automotive components. Manufacturers are well supported by a number of design and tool making firms. A wide range of components is exported including engines, electronics, braking equipment, wheels, driveline components, seating, transmissions, air conditioning equipment and friction material. Around 50% of the total Australian market for automotive parts and accessories is provided by imports, mainly from Japan and the US.

3 Bilateral Trade in Automotive Products Between China and Australia

Bilateral trade in automotive components and total automotive products between China and Australia is shown in Table 1.

TABLE 1: Bilateral Trade in Automotive Products Between China and Australia ($ M)

	CY2000	CY2001	CY2002	CY2003
Exports to China of auto components	4,257	12,553	13,451	54,413
Imports from China of auto components	172,220	196,003	162,291	235,792
Balance	-167,963	-183,450	-148,840	-181,379
Exports to China of all auto products	5,263	14,204	16,793	56,478
Imports from China of auto products	173,794	197,938	166,328	246,529
Balance	-168,531	-183,734	-149,535	-190,051

To date, the majority of bilateral trade in auto products with China has been in automotive components. While exports of components from Australia to China have grown strongly over the last four calendar years, imports of components from China dominate bilateral trade in automotive products. The resulting trade balance in favour of China was just over $190 million in the most recent calendar year.

In 2003, China was the 4th largest source of imports behind Japan, the United States and Germany. In the same year, it ranked 6th in terms of destinations for automotive component exports. Over the last four years, the rate of growth of automotive component exports to China far exceeds any other export destination but this should be tempered by the fact that 2001 was a low base for automotive component exports to China.

China accounted for 4.2% of all automotive component imports into Australia and 3.1% of all automotive component exports from Australia in 2003. Thus in terms of total Australian trade in automotive components, China's impact currently is relatively small. Most imports are probably finding their way into the after-market in Australia although an increasing volume is going into OEM production.

4 China's Trade and Investment Policies

4.1 China's WTO Accession

China gained accession to the World Trade Organisation (WTO) on 11 December 2001 and agreed to progressively reduce a wide range of trade and investment barriers.

Under the WTO, China's tariffs rates are bound; non-tariff measures that cannot be justified in the WTO must being eliminated; restrictions on the right of enterprises within China to engage in trade are being phased out; and China's system of product standards is being brought more into line with international norms. China is reforming other trade regulations and administrative practices and increasing the transparency in the way such measures are applied.

TABLE 2: The specific terms of China's WTO accession for the automotive industry

	Pre WTO	Post WTO
Import tariff rates on vehicles	70 to 80%	25% by 2006
Import tariff rates on automotive components	15 to 50%	10% by 2006
Import quotas	Annual value quota of $10 billion	Quota increased by 15% annually and phased out by 2006
Local content	40% in first year of production; 60% in 2nd year and 80% in 3rd year	No local content requirement
Auto financing	Foreign non-bank financial institutions prohibited from providing financing	Foreign non-bank financial institutions permitted in selected cities prior to gradual national rollout

WTO accession did not have an immediate impact on import volumes of vehicles which remained at around 3% of the market in 2002. Imports of vehicles were effectively controlled through management of the value quota with much of the quota of $10 billion (plus 15% annual growth) being used for component parts. It did send vehicle retail prices tumbling however, particularly towards the end of 2001 and through 2002.

Auto financing has progressed slowly with only around 15% of car purchases being financed. Some significant steps were taken in 2003 however with VW signing a deal with the Bank of China and Ford signing with China Construction Bank.

The growth in component importing under lower tariff rates has been important in reducing automaking costs in China. Most tend to be the higher value added prodcuts such as electronics. Just how long this arrangement will continue is however problematic. GM has already targeted electronics as a major potential growth area in China. In fact, its largest electronics supplier is already producing in China.

Accession to the WTO has brought other reforms including:

Non-tariff barriers: China has made a commitment to bring its licensing system into conformity with WTO rules. Additionally, other than those specifically identified in Annex 3 to China's WTO Protocol of Accession, the PRC will not introduce, reintroduce, or apply any non-tariff measure that is subject to phased elimination pursuant to Annex 3.

Trading Rights: Prior to accession, foreign investment enterprises could not engage in the import of motor vehicles, nor can they engage in distribution, operate repair centers, or provide financing. Post WTO, China has been progressively liberalising the scope and availability of trading rights so that all enterprises and individuals in China will be allowed to import and export all goods (except for certain products provided for in the protocol which will still be reserved for state-owned trading companies). In 2003, Ford, GM and Daimler-Chrysler were given group licences to import their own vehicles directly rather than having to use a Chinese importing group. However, such rights will not permit importers to distribute goods within China since distribution activities fall under a separate set of commitments.

Technical Specifications and Standards: China has committed to unify its laws, regulations, and standards applying to domestic and imported automobiles and parts. This replaces voluntary national, local, and industry standards in an effort to harmonize them with relevant international standards required under the WTO Agreement on Technical Barriers to Trade.

Technology Transfer: China will cease imposing, applying or enforcing laws, regulations and measures related to the transfer of technology, production processes, or other proprietary knowledge that are inconsistent with the WTO Agreement on Trade-Related Aspects of Intellectual Property Rights and the TRIMs Agreement. One of the most significant changes to the legislative framework governing foreign investment has been the repeal of previously restrictive legislation governing the transfer and licensing of technology. However, several key stipulations remain. For example, a registration certificate is still required to facilitate the remittance overseas of royalties and other payments under technology import contracts.

Establishment of Joint Ventures: Consistent with TRIMs, China will not be able to condition the approval of the establishment of an auto joint venture upon performance requirements such as foreign exchange balancing, trade balancing, local content and export restrictions.

4.2 China's Automotive Policies

China's automotive industry remains one of the most protected of China's manufacturing sectors. The PRC government deems the automotive industry an engine of growth and a pillar of the national economy. It hopes the auto industry will be an impetus for growth across the whole economy and have spin-off benefits for a wide range of associated industries such as service related activities, rubber, electronics, petrochemicals, textiles, auto financing, distribution and servicing and repair.

The Tenth Five-Year Plan for the Automotive Industry, issued in June 2001, emphasized the restructuring of China's automotive industry. It encourages the emergence of three domestic automotive manufacturing giants in China: Shanghai Automotive Industry (Group) Corporation, First Automobile Works (Changchun), and Dong Feng Automobile Group. The three domestic auto giants were singled out for new government support, including easy access to capital, priority approval in forming new foreign joint ventures, and assistance with their technology research centers.

A revised automotive plan is in the final stages of preparation and is due to be released around mid 2004. FAPM understands that it is expected to be less interventionist compared with previously released drafts which included requirements such as 40% or more of sales for auto parts manufacturers must be exports. Other elements of the revised plan are understood to include:

- an urging of manufacturers to "industriously enter" the international market;
- encouragement of independent R&D and larger scale production of components; and
- promoting greater brand awareness and development of products with independent intellectual property.

FAPM understand many interventionist policies are likely to remain including the 50% limit on foreign equity for car makers (an exemption from applying such a limit was granted to China under the WTO accession agreement but foreign investors were hoping this would be relaxed); discouragement of imports of CKD kits; and the requirement for parts distributors to show import licences from manufacturers. Chinese state planners will also continue to influence decisions on what types of vehicles will be built in China.

4.3 China's Investment Incentives

China operates various general and tax incentives to encourage investment. Many apply to operations establishing in designated special economic zones (SEZ) and economic and technological development zones (ETDZs). There are also bonded areas which are free trade zones. Goods imported into these zones are generally free of customs duty provided the goods are not subsequently sent to another area of China which is not a free trade zone.

Foreign investment is encouraged by allowing greater autonomy in their operations (such as being allowed to import their own raw materials for production without using the import-export companies set up by the state); reduced income tax rates; tax exemptions; and refunds on tax paid on reinvested profits.

5 Australia's Trade and Automotive Policy Environment

The Australian automotive market is open to international competition with around 70% of new vehicles sold being imported. Australia has no import bans or quotas on automotive products but special arrangements apply to imports of second-hand vehicles. Duty drawback provisions apply to duty paid imported components which are subsequently embodied in more elaborately transformed exports. Australia also imposes strict vehicle safety standards and has mandated environment protection measures with respect to vehicles but such polices are non-discriminatory between imported and domestically produced vehicles. Vehicle component approval is not required for the Australian market.

5.1 Import Tariffs

Australian applied imports tariff rates on most passenger motor vehicles (PMV) and related components were phased down to 15% on 1 January 2000. These rates will remain at 15% until 1 January 2005 when they will fall to 10%. There will be a further fall to 5% on 1 January 2010. Tariffs on light commercial and AWD vehicles and components for these vehicles are 5% with no change currently scheduled. Second-hand vehicles are subject to the relevant vehicle tariff plus a specific tariff of A$12,000 per vehicle.

TABLE 3: Australian Import Tariffs

Category (HS tariff classification)	**MFN Applied Tariff**			**WTO Tariff Binding**		
	Low	**High**	**Average**	**Low**	**High**	**Average**
PMV (87.03)	5%	15%	9.70%	15%	40%	27.70%
Trucks (87.04)	5%	5%	5%	5%	20%	14.30%
Buses (87.02)	5%	5%	5%	10%	15%	12.50%
Engines (84.07/ 84.08)	0%	15%	4.20%	1%	50%	21.40%
Body Stampings (87.08.29)	0%	15%	6.70%	5%	15%	6.25%
Transaxles/ Transmissions (87.08.50)	0%	15%	8.75%	1%	25%	14%

5.2 Industry Development Arrangements (ACIS)

The Automotive Competitiveness and Investment Scheme (ACIS) commenced on 1 January 2001 and runs for 10 years. ACIS is designed to encourage firms to make long term investments in Australia's automotive industry, based on production, investment, and R&D activity. Benefits are provided to individual companies in the form of transferable import duty credits, up to a maximum of 5% of sales. Consistent with WTO rules, ACIS does not discriminate against automotive imports nor favour automotive exports.

The likely ACIS impact of an Australia-China FTA would be marginal at best. Without a duty liability on automotive imports from China, some ACIS import duty credits currently being earned would be 'freed'. This would increase the supply of available credits. If the 'freed' credits were sold, it is likely to reduce the market price of credits transferred. However, because the total duty liability on all automotive products would still far exceed available credits, the effect on the market price of credits transferred could well be insignificant.

Most likely the 'freed' credits would be diverted to offset import duties on automotive products from non-China sources. Nevertheless, there would remain a liability on such imports that must be met. The import credits used have a cash value so there would be a real relative cost involved with diversion. The operation of ACIS would therefore not be expected to affect the relative import advantage that China automotive products would have. In other words, any trade diversion resulting from an FTA would occur because of the change in relative landed duty-paid prices. It would not be caused by the operation of ACIS.

5.3 Direct Government Assistance

Both the Federal and State Governments have provided direct assistance to particular firms. Under the Strategic Investment Coordination program, Holden received $12.5 million from the Federal Government and unspecified support from the Victorian Government to establish a new V6 engine plant in Victoria. In 2002, Mitsubishi received $35 million in cash assistance from the Federal and South Australian Governments to expand the capacity of its vehicle production in Adelaide. The Victorian Government reportedly provided funding to Ford in the form of infrastructure, training and R&D assistance in relation to its investment to produce a new AWD vehicle.

6 Accessing The China Automotive Components Market

6.1 By Direct Exporting

As indicated in section 3 of this submission, Australian automotive component exports to China are low in volume compared with total exports of components. Certainly, there was a substantial increase in exports in calendar 2003 compared with calendar 2002. The growth in exports over that period was part of a reported huge increase in China's automotive components imports over the same years from US$3.4 billion to US$9.5 billion. However, FAPM believes it is highly problematic as to whether that growth trend will continue.

The surge in imports was, we believe, due mostly to China wanting to limit imports of vehicles within its total automotive products value quota. Under its WTO commitments, China is to phase out that quota with a 15% annual increase until abolition in 2006. China is using that time and the quota to protect its car making base.

At the same time, it is importing components at the higher value added end of the market such as electronics in which China has had a comparative disadvantage while at the same time building its capacity to manufacture such products locally. By 2006, it will have the capacity to supply the complete range of automotive components and we expect its recorded imports of such components to decline substantially.

This analysis is supported by some large recent investments in China's capacity to produce automotive components and statements made by some of world's key automotive companies:

> GM's vice-president of worldwide purchasing announced recently that by 2009, the company plans to source US$4 billion worth of China parts for its operations outside of China compared with US$200 million in 2003. It also plans to source US$6 billion in Chinese made parts for its operations in China, more than double its 2003 purchases;
>
> Daimler-Chrysler has announced that it plans to source low-cost parts from China to supply to its global operations;
>
> Toyota is looking at China to supply engines for its Camrys and RAV4s sold in the US and has recently announced a partnership with the China FAW Group to make large stamping dies;
>
> Delphi Corporation aims to quadruple its automotive parts sourcing from China by 2007;

Dana Corporation announced a new joint venture in 2003 with Dongfeng Motor Co Ltd which will be the largest commercial vehicle axle and components manufacturer in China;

Delphi Corporation is investing in a new US$50 million R&D technical center in Shanghai;

Tenneco Automotive established a JV this year with Eberspacher International of Germany to manufacture emission control products and systems for BMW and Audi. It also recently signed a JV agreement with Chengdu Lingchuan Mechanical Plant to supply emission control products and systems to Changhan Ford Co.;

Visteon Corporation is expanding its already substantial presence with a new manufacturing plant and technical center set to open in 2005;

Robert Bosch GmbH will have a new manufacturing operation coming on stream later this year to manufacture electronic diesel fuel-injection systems for the Chinese market.

It is clear where the world's major automotive players see prospects in China and that is by investing in China rather than trying to supply that market by exporting. Most see China as a base from which to boost worldwide sales and reduce costs rather than as a market to supply from outside China. This business fact of life combined with strong Chinese Government support to foreign investment generally and the auto industry in particular and an exchange rate policy which many argue keeps the Renminbi at artificially low levels, makes direct exporting a difficult proposition.

Nevertheless, Chinese auto making is very regional with many plants having a capacity similar to those of the car makers in Australia. This may provide the opportunity to find some niche export markets in certain regions for small and medium sized firms in Australia but the chances look increasingly remote. As John Mackenzie of Pacifica Group Ltd said recently "at this stage it is very difficult to export out of anywhere into China, so we're seeing this (setting up manufacturing in China) as a move to tackle the local market*."- see Appendix A.*

6.2 By Manufacturing in China

Manufacture of entire automobiles and certain key components are "encouraged" categories for foreign investment in China. The extent of foreign investment in vehicle manufacture cannot exceed 50% if selling to the domestic market. No such restriction applies to the manufacture of components.

The 50% equity limitation on foreign investment in vehicle production has meant that all global participants have been forced to enter into joint venture arrangements with local companies. Prior to WTO accession in 2001, there were over 100 auto makers in China all with outmoded manufacturing technology and relatively low volume output. China's centralised planning system required those vehicle producers to source over 80% of those parts and components from local affiliated suppliers. This resulted in a

fragmented inefficient industry characterized by under-capitalisation, weak R&D and unsophisticated systems.

Investment by foreign owned enterprises in China's automotive components industry because it is subject to the 50% equity limitation and can take a variety of forms – an equity joint venture, a co-operative joint venture or a wholly foreign-owned enterprise. Because of the pre WTO 80% requirement in practice most foreign investment has been in joint venture form, simply to build on pre-existing relationships between components suppliers and car makers.

This structure has created challenges for foreign firms looking to form JVs with suitable partners. Also the quality and delivery of local parts and sub-parts have often been unreliable. As Australian components manufacturer, Air International recently commented "…companies deciding to joint venture in China should carefully research and value the financial and asset position of potential partners, ensure a strong say in human resources issues and build a company structure that requires robust ongoing commitment from the partners. Businesses also should ensure that customers are financially sound and able to pay." – *see Appendix A.*

Counterfeiting of products is a major problem in China due to a lack of a culture of protecting intellectual property and insufficient R&D resources to generate competitive branded products. A pirated version of GM's Chevrolet Spark, the Cherry QQ, began selling in China before the Spark began selling last December. Honda has sued China's Hebei Shaunghuan Auto Company for producing an SUV that is claimed to be a copy of the CR-V and the market for counterfeit components is substantial.

7 Conclusion

China is the fastest growing automotive market in the world. All the major players are already there. Market access is not easy either by direct exports or by on-shore manufacturing. China's accession to the WTO has led to a raft of reforms. These reforms have been welcomed by the global automotive industry.

Automotive is an export 'flagship' for China and foreign technology transfer built on a potentially huge domestic base will make the China JVs very competitive on world markets. An FTA if it concentrates predominantly on trade barriers would provide an additional advantage to what will be low cost Chinese imports of both vehicles and components. By contrast, it is unlikely that such an FTA would significantly increase Australian exports to China because of the tightly controlled component supply arrangements.

Australian companies wishing to participate in the China market most likely have to opt for manufacturing on-shore in China as per the Air International and Pacifica examples.

For these reasons, FAPM members see little potential benefit in an FTA between Australia and China at this stage of the feasibility study. By 2006, both the Chinese and Australian tariff rate on imported components will be 10%. Moving from a rate of 10% to zero is hardly likely to boost potential exports of automotive components from Australia to China, especially since many of the production centres in China are already in duty free bonded zones.

However, removal of the duty on imports from China would likely worsen the already substantial automotive trade imbalance in China's favour. Rather than being trade diversionary, such an increase is likely to be at the expense of Australian production.

Perhaps the most assistance an FTA type agreement could provide Australian automotive component companies in respect of accessing the Chinese market would be to improve the processes of identifying suitable joint venture partners in China; working with China to eliminate the problem of counterfeiting; removing non-commercial restrictions on the establishment and operation of Australian joint venture manufacturing; fast tracking any Australian investments through the maze of the Chinese Governments approval processes; and providing some practical assistance on due diligence of potential Chinese partners.

APPENDIX A: Two Case Studies of Australian Automotive Component Companies Establishing Manufacturing Operations in China

Case Study 1: Air International

Air International, a division of the Futuris Group, is a leading Australian supplier to the world's automotive industries, specialising in heating, ventilation and air conditioning, fabrication and seat and steering systems. As well as domestic manufacturing divisions in Victoria, South Australia and New South Wales, Air International has operations spread through Europe, North America and Asia.

In China, Air International has two manufacturing operations; the first of these, in Shanghai, was established in 1995 in partnership with a municipal state owned enterprise. In the late 1990s, Air International established another manufacturing venture in Chongqing and an engineering design centre in Shanghai. In 1999, Air International also moved its Asia-Pacific head office to Shanghai. Air International's major customers in China include GM, Ford, Mazda, Mitsubishi and local producers Jinbei, Changan and Nanjing Iveco. In all, China now accounts for about 10 per cent of Air International's global revenues.

Air International believes that companies deciding to joint venture in China should carefully research and value the financial and asset position of potential partners, ensure a strong say in human resources issues and build a company structure that requires robust ongoing commitment from the partners. Businesses also should ensure that customers are financially sound and able to pay.

Source: Air International, 2002

Case Study 2: Pacifica Group Ltd

Automotive brake technology company Pacifica Group Ltd is planning to establish a joint venture manufacturing operation with an American company in China. Pacifica said it had signed a letter of intent with the US automotive parts manufacturer and production is scheduled to commence in March next year. Pacifica would have a 60 per cent stake in the venture, representing a cost of $30 million to the company over the next two to three years.

Pacifica managing director John Mackenzie would not disclose the name of the American joint venture partner until the deal was finalised, but said he was confident the joint venture would proceed.

"We're obviously confident, but we've still got the final negotiations to do," he said.

"We have been reviewing our options to manufacture in China for some time and believe that this joint venture is an ideal entry point to enable us to enter the rapidly growing domestic OE [original equipment] market."

The company said it already had manufacturing operations in parts of Asia through its brake components business, PBR. "Our intended partner already has excellent government and business relationships in China and has very strong synergies with PBR," Mackenzie said.

He said the joint venture facility, to be based in Dalian in the Liaoning province in north-east China, would yield positive long-term results for the company. It would comprise a cast iron foundry, machine shops, and some assembly operations on a greenfield site.

Mackenzie said there would not be any initial exports of goods out of China. "Our plan is to get established and supply the local market with assemblies," he said.

"At this stage it is very difficult to export out of anywhere into China, so we're seeing this as a move to tackle the local market."

Source: Pacifica Group Ltd, 2004