

INDIGENIZING PRODUCTION OF THE SANTANA¹

DECEMBER 24, 1987

At the request of Lü Dong² and Yuan Baohua,³ I'm attending this conference on production of the Santana on behalf of the State Economic Commission, and I would like to express hearty greetings to all the delegates here!

This conference was convened by the China Automotive Industry Federation and the Shanghai municipal government following extensive preparations and in-depth, detailed research. Mayor Jiang Zemin and Vice Mayors Huang Ju and Li Zhaoji all personally focused on this meticulous work, which has ensured a smoothly run conference in all respects. I especially wish to point out that leading members of the State Council have also given their personal attention to indigenizing production of the Santana and have inquired about it many times, particularly this year. Various ministries and commissions of the central government have been very supportive as well. Given this wide government support and the enthusiasm whipped up by you in Shanghai, I think the project will undoubtedly succeed.

Now I'd like to discuss several issues.

1. The Significance of Indigenizing Santana Production

Broadly speaking, indigenizing Santana production is very important for the application of imported technology. Beginning in 1983 and in keeping with the State Council's overall plan, we imported 16,000 key technologies and pieces of equipment at a cost of over US\$10 billion. Of this sum, US\$3.7 billion came from the State Economic Commission and covered 3,900 items used to upgrade the technologies at a group of enterprises. These have played a major role in

1. This is the main part of a speech by Zhu Rongji at a conference on indigenizing production of the Shanghai Santana. It was jointly convened by the China Automotive Industry Federation and the Shanghai municipal government. At the time, Zhu was a vice chairperson of the State Economic Commission. On December 22, 1987, the Communist Party's Central Committee appointed Zhu deputy secretary of the Shanghai Municipal Party Committee and nominated him to be a candidate for mayor of Shanghai.

2. Lü Dong was then chairperson of the State Economic Commission.

3. Yuan Baohua was then a vice chair of the State Economic Commission.



Accompanying Deng Xiaoping on an inspection tour of Shanghai Volkswagen Ltd., February 6, 1991. Front row, second from left, Zhuo Lin, spouse of Deng Xiaoping; fourth from left, Deng Rong, daughter of Deng Xiaoping; far right, Lu Ji'an, chair of Shanghai Volkswagen Ltd.

stimulating the domestic market and increasing exports. However, these projects have yet to maximize their potential. Only 60% of them have started producing, with production expected to crest next year, and it won't be until the following year that their benefits can be fully realized. Moreover, a very big problem with this round of technology imports is that they have not yet been applied, absorbed, and indigenized. In some cases, we have imported technologies and equipment but lack the necessary raw materials and associated technologies, so it's still very hard for them to yield benefits. To truly obtain benefits, we must do a good job of application.

In 1985 the State Economic Commission began to shift its focus toward applying imported technology. This August, at a national work conference in Dalian, it drew up five preferential policies on applying this technology and indigenizing production,⁴ which, with the State Council's approval, have now

4. The "five preferential policies" were policies for applying and indigenizing imported technologies in key projects supported by the state. They consisted of (1) reductions or waivers of product taxes; (2) permission to collect forex for a portion of domestic sales; (3) reductions or waivers of customs duties and product taxes on imports; (4) special attention and priority for projects that are part of the "Dragon" program to be given by all departments and regions in forex allocations, loans, technology development funds, and allocations of materials; and (5) commendations and incentives for enterprises and publicly supported institutions that undertake key state projects for applying, absorbing, and indigenizing imported technologies if their work is completed on schedule and with outstanding results. A one-time monetary award may be given.

been circulated as National Document 99 (1987).⁵ The commission has created 300 “Dragons” to deal with the state of technology imports and their role in the national economy.⁶ Items in the first batch of 150 Dragons have already been chosen, and preparations are in full swing for the second batch. We believe that if indigenous production is achieved for these 300 Dragons within three years, the look of our enterprises will be greatly improved, and their technology standards will truly move up to a new level.

Any one of the 300 Dragons could include several dozen or even several hundred projects. At present, the largest project is for color TVs, which must achieve indigenous production within three years. At the moment, we spend US\$600 million a year to import color TV components. As the imported technology projects go into production and as the scale of their production increases, we will save in excess of US\$600 million a year in foreign exchange.

Indigenizing automobile production is an even larger project. We currently spend several hundred million dollars a year on imports of autos and auto parts. If we don’t speed up indigenous production, such imports will tend to increase. Indigenizing Santana production is one of the very important 300 Dragons. Next year we will implement policies to stabilize the national economy: fiscal and credit policies will have to be tightened, the investment structure will be adjusted, and no new projects may be started up. These circumstances will not be conducive to indigenizing production. However, the State Council supports our work on indigenization, so even with tighter finances and credit, it will still permit us to start up a few new projects. Recently, the State Economic Commission strengthened and expanded the China New Technologies Development Company, transferring over a dozen bureau chiefs there. This company’s main task is to implement the 300 Dragons and see that imported technologies are applied and absorbed. Its chiefs are attending this conference because with the support of banks and the Ministry of Finance, they want to work with the city of Shanghai and with the China Automotive Industry Federation to improve indigenization.

Given the present condition and needs of China’s automotive industry, the most urgent task now is to establish a Chinese auto parts production system based on indigenous production of the Santana. At a meeting in Beidahe on August 12 of this year, the State Council decided to develop China’s auto

5. National Document 99 (1987) was the “Notice of the State Council Approving Distribution of the State Economic Commission’s Report on Promotion of the Application and Absorption of Imported Technologies and on Indigenization.”

6. The 300 “Dragons” were 300 end-to-end projects designed to apply imported technologies and to indigenize them. They all received special support from the state.

industry and formed a group to oversee this endeavor, with Yao Yilin⁷ as group leader. This industry has great room for growth. While we have more than enough medium-duty trucks for freight transport, we lack heavy vehicles and have few light ones, a problem that is gradually being overcome. We've already brought in technology used in the Steyr⁸ and other heavy vehicles, and once these are developed, there will be enough vehicles of this category to meet domestic demand. Light trucks and mini trucks are also developing very quickly.

What we lack most is sedans, which still rely on provisions laid down in the past. Car imports got somewhat out of control in 1984 and 1985. After the first quarter of 1985, controls were tightened, and the State Council changed the approval procedure; now all auto imports must be under central authority and require State Council approval. In June of this year, [Premier] Li Peng and Hu Qili⁹ asked Gan Ziyu¹⁰ and me to draft a notice halting imports of sedans. Since then such imports have stopped, but there are no domestically made cars, so what should we do? Although we can still muddle through for two years because we imported a great many cars a few years ago, the pressure for imports is rising. I'm in charge of this work, and many departments have come to me asking for cars. They say that Beijing Jeeps are too slow, the standards of Shanghai Santanas are too low, and production cannot meet our needs, so the demand for imports is very great. The leaders of the State Council recognize that a major effort is needed to develop indigenously produced cars—and that the development of sedans is a key component of the revitalization of our auto industry.

It is important to indigenize Santana production for two reasons: first, this will enable us to apply imported technologies; second, the most urgent task before us is to develop the auto industry, particularly an auto parts production system. Development of the auto industry should be based on components that we produce ourselves—we can't rely on assembling parts because we can't afford the forex. This isn't just a problem in Shanghai; it's a national problem.

7. Yao Yilin was then a member of the Politburo Standing Committee and a vice premier of the State Council.

8. On December 17, 1983, the China Heavy Motor Vehicles Corporation signed a technology transfer contract with the Steyr-Daimler-Puch Company of Austria, whereby the technology of the Steyr 91 series of heavy vehicles, the associated steering mechanisms, and their transmissions would be imported into China.

9. Hu Qili was then a member of the Politburo Standing Committee and secretary of the Party Central Committee's Secretariat.

10. Gan Ziyu was then a vice chair of the State Planning Commission.

2. The State of Santana Indigenization and the Urgency of This Work

The city of Shanghai and the China Automotive Industry Federation have already done a great deal to facilitate indigenization, especially this year. This hasn't been easy, and our work still falls far short of what we need—we were late in focusing on it. Yet this is something we must do ourselves. We can't rely on the Germans because if we use CKDs,¹¹ they will still make money and won't be more eager than we are [for production to be indigenized]. Although considerable progress has been made in indigenizing Santana production, difficulties remain and are far greater than those encountered by Guangzhou Peugeot, Beijing Cherokee, or Tianjin Daihatsu. Aside from these difficulties, we still have to admit that the work is going slowly.

Before this year, the indigenization rate for horns, antennae, and tires was only 2.7%. Although it has reached 12.6% this year, overall this remains a low figure. Meanwhile, the indigenization rate for Beijing Jeeps is 17.8%; not only have their products passed inspection, but they've also stopped purchasing them from the United States. This is real indigenization. By contrast, not all of Shanghai's 12.6% is being used in autos, and only 6% is no longer purchased, so we still have to work hard.

My Shanghai colleagues must surely feel a sense of crisis: we don't have time to lose; we only have three years left. If we can't achieve 85% indigenization within three years, we may have to shut down. I'm not being unduly alarmist, because the Santana has its weaknesses. It's neither a high-end nor a low-end product: not high enough for official use, yet too high for public consumption. Its price is also not competitive. It costs US\$9,500 to import a CKD car, which then sells for US\$16,900—that's too expensive. Right now we rely entirely on administrative intervention, sustaining the Santana by halting imports of all other sedans. That's the only reason why supply can't keep up with demand. When I went to Detroit with Chen Zutao,¹² I could see that the Santana isn't competitive: it can't compete with American cars, let alone with Japanese and South Korean ones. A Santana of this caliber won't be able to hold off imports.

Shanghai has only three years of breathing room [to reach its goals]. You in Shanghai must summon your fighting spirit, achieve indigenization of the Santana, bring down costs, and not spend forex—only then will you be competitive, and it'll be a contest between Shanghai and the First Auto Works. That's why the State Council is now putting two restrictions on Shanghai: first, after the 89,000 CKD cars already written into contracts have been purchased, you

11. Completely Knocked Down, a form of automobile import in which entire cars are imported as kits that contain all the parts of each auto.

12. Chen Zutao was then board chairperson of the Chinese Automotive Industry Federation.

may not buy any more because we don't have the forex; second, the number of cars produced annually in Shanghai can only increase in tandem with the indigenization rate, and you may not make unlimited CKD purchases. CKDs might be profitable right now, but our country doesn't have the forex, so you may not do that. This is why we must use desperate measures in Shanghai, because our backs are to the wall. I'm sure that with the support of the entire country, you in Shanghai will tackle this seriously and will surely do a good job of it.

We're not indigenizing Santana production just for the sake of the Santana. We want to use the Santana as a foundation on which to draw up plans for an auto parts production system in China. We must view this as a national concern—one that is entirely necessary but also entirely possible to address. I came away from my study tour of the United States with several ideas on this subject. One arose out of our visit to some banks that invited us over as soon as we arrived in New York. They had collected information about the development of the American auto industry and its collaboration with various countries around the world and shared this with me. Why would they do this? Because when China develops its auto industry in the future, it will need to go to them to raise funds. They not only understand banking, they also understand technology. They have a team of talented people who are highly professional and who understand economics.

Let me give you an example. Volkswagen's factories in the United States have been shut down. When I asked the Germans why, they said it was because of changes in the exchange rate, but failed to be any more specific. However, American bankers were able to explain all the different reasons in detail, which included not only changes in the exchange rate but also high costs and models that didn't suit American needs. They explained everything very clearly. We also learned another bit of crucial information in Detroit: market competition in the global auto industry is becoming more and more intense. The Ford Motor Company told us that by 1992, there will be excess production capacity of 7 million vehicles. Thus their strategy is: high quality, wide product variety, and low costs. High quality means high technical standards; wide product variety means correctly assessing market demand and introducing vehicle types to meet it; low costs will be achieved mainly by internationalizing and moving factories to other countries. In light of these considerations, we have many of the conditions for developing our auto industry and should cooperate with them.

After we establish a production system for auto parts, because its costs will be low, we will be able to export a lot of these parts even though we can't still export complete vehicles at present. The Second Auto Works initially thought it wouldn't work to primarily be an exporter, but we found the American market to be quite open during my visit. If a joint venture with Americans can



Politburo Standing Committee member and Vice Premier Yao Yilin (right); Politburo member, Party Secretary, and Mayor of Shanghai Jiang Zemin (left); and Zhu Rongji attending a conference on indigenizing production of the “Shanghai Santana,” December 25, 1987.

export to the United States, half of the profits will also be theirs. Furthermore, the technical standards of the Shanghai Santana are low. However, if we first choose parts production sites by indigenizing production of the Shanghai Santana, import and use the technologies necessary for upgrading and reach international standards, then the First and Second Auto Works and all the auto factories in China will come to us, plus we will be able to export. I think at least three requirements must be met in order to establish such a parts production system.

First, we must have high standards and high quality, and absolutely must not use poor-quality substitute materials. If we make cars, we must make cars that are up to international standards; otherwise, they won't be able to compete with imports. Our country is now an open one. If we keep making the old “Shanghai” brand, would anyone buy it? We mustn't use administrative fiat. Therefore this system must be provided with the associated imported technologies, so don't think about it too simplistically. I hear that the carburetor factory of the Second Auto Works has already brought in technology from Japan, but in order to supply Shanghai Volkswagen with the necessary carburetor sets,

it will still have to import some software, so they will need several hundred thousand dollars. It appears that we'll have to form a joint entity in the future, and if we discover we are lacking certain skills or technologies, we can develop these ourselves or else import them. It won't do to rely on manual skills—that wouldn't make for a modern auto industry.

Second, we must become specialized and produce in large batches. Without large-batch production, costs can't come down. What would be the point of indigenizing production if costs can't be brought down to the level of import prices?

Third, we must have both domestic and international markets in mind. And we can't just focus on the Santana. We also have to think about the First and Second Auto Works, because the State Council has already decided that they, together with Shanghai Volkswagen, will be automobile production centers; at the same time, we have to think about exports. That's why we've recently paid a great deal of attention to negotiating with Volkswagen AG about exporting parts. When we discussed this matter with one of Volkswagen's directors during a recent visit here, we proposed a list of items that we could export, but the price he offered was too low. There is one possibility, however. It's an oil filter, and they want 5 million of them at 2.7 marks each, which is a little over US\$1.00 apiece. This deal alone would amount to several million dollars. Shanghai can do this. We can produce a big batch for them, which would be very effective for the batch production of parts. Everyone must look at this issue from the standpoint of long-term benefits.

3. An Indigenous System Should Be Built around Certain Principles

The following five principles are of the utmost importance.

First, our existing industrial production capacity should be used to the greatest extent possible, particularly the capacity of our defense industries. We should have existing enterprises do the work and try our best not to set up new sites. We must create a "national team," a "China" brand. As Jiang Zemin has repeatedly stressed, we don't want to build a "Shanghai" brand, we want to build a "China" brand, and we don't want to do so only in Shanghai—rather, we should set our sights on the entire country. The China Automotive Industry Federation can draw up a master plan for the country, make appropriate arrangements together with you in Shanghai, bring together the forces from all sectors, and build this system quickly and economically.

Second, take bids from around the country and select the best—competition is essential. Someone might say they can do the job, but their asking price might be too high and you don't have that much money, so you should be allowed to start afresh by taking bids from around the country and then choosing the best

offer. If you find its terms suitable, then you should negotiate an agreement that includes things like costs, sums to be invested, how much the state will subsidize and how much you will put in, your ability to produce large batches, whether quality can meet our demands, and whether the pace of development can meet our needs. If the conditions are met, then sign an agreement, a contract. If you can settle the matter this way, the project will become one of the “Dragons” and you will enjoy the state’s five preferential policies. If you can’t do it, then we’ll take bids from the entire country after this conference. But I must point out that site selection isn’t permanent. Of course, once a site is chosen, both parties must live up to their obligations. It won’t do if one makes a prototype and then the other doesn’t want it. But a contract can’t cover too long a period, nor can it be too rigid. That is to say, there still has to be some competition. If someone comes along who won’t need a penny [of investment or subsidies] from the state and can make it cheaper than you can, then you can’t forbid me to purchase his products.

Third, prices have to be reasonable. Everyone must have a strategic vision and operate from a long-term perspective. Price is always a major issue and surrounded by some uncertainty. Production runs might be small and prices low; some factories may find it difficult to manufacture. But I think the prices in a signed agreement must be fixed; otherwise, it would be meaningless and could be rejected at any time. For the two parties [Shanghai Volkswagen and the parts supplier], Shanghai Volkswagen should convert the delivery prices of CKD parts into renminbi and list these honestly. They can’t be any higher or else Shanghai Volkswagen won’t be able to bring its costs down. I know that even these prices may be unacceptably low to the supplier factories, especially in view of the money that needs to be invested. Although the state can give you a little subsidy, you still have to repay loans and pay interest, so costs will increase.

I hope all you factory directors have strategic vision and concentrate on the great prospects for future growth. Building this Chinese auto parts production system is a glorious historic mission. After setting up this “Dragon” and building this system, you’ll make a lot of money in the future. Eventually there’ll be a major change in your entire operating strategy, and your factories will enter the ranks of world-class enterprises. You must overcome temporary difficulties, or you won’t be able to agree on prices. I’m asking you to agree on next year’s prices for indigenously produced parts.

Fourth, if you really want to produce parts that are high in quality and up to international standards, you’ll have to raise funds for construction jointly, share the risks, and develop in tandem. If you don’t invest and rely on your existing equipment and techniques, I doubt you’ll succeed. Some factories in the defense industry may have already imported some technologies and can

make certain parts but are still unable to produce a fairly large number and will require new investment. We will raise the money for investment together: that is, you will have to come up with part of the money, and the state will also come up with a part. The government is already resolved to spend money on this, but finances and credit are very tight and it doesn't have that much money, so it can only subsidize a little. Forex in particular will be very difficult to rely on. Shanghai does have some forex resources that can be used to help with this problem, but other places do not. I hope that after you leave, you will report to the people in charge [at your units], ask them to give priority to this task, and urge them to spend their retained forex in this area. Is there any forex? I think there's plenty—especially where there's a fad for importing refrigerator and washing machine production lines. Where is all this forex coming from? You should stop doing that. If you continue, you'll wind up with stockpiles. I hope everyone will use their forex for the auto industry, as this will truly become an industrial pillar in China; it's a pillar industry. I hope you'll share the risks by jointly raising funds and jointly developing.

Fifth, you must sign contracts, form a joint entity, assume economic responsibility, and institute rewards and penalties. I hope that all the enterprises here will form a joint entity to produce parts for the Chinese auto industry, not just for the Santana. This joint entity need not change your current affiliations, although it will constitute a reform of our industrial structure. The resulting group could be either more loosely or more tightly organized. Every member of this joint entity will share some common destinies—this will be good for everyone. Beijing Jeep has such an entity, which can also be found in the United States and Japan. The entity holds frequent meetings to share experiences and engage in cooperation.

Your contracts must also have binding provisions, including

- Clear quality standards and technical certification criteria.
- Clear statements of prices and monetary sums.
- Clear requirements for the pace of installing sets of equipment and the quantities of such equipment, and also requirements for prototype production and certification, supply of production batches, and the pace of technical upgrading.

- Guarantees for funding and forex, which should be assigned to the responsible units.

- Clear specification of rewards and penalties, both linked to the economic interests of the enterprises.

Only by doing all this will we be able to truly reward the good and penalize the bad and have everyone assume their own responsibilities. And only then can we say that indigenous production of the Santana is being truly implemented. In my view, contracts that do not contain these articles are unreliable.

Of course, we can't expect all this to be achieved immediately after this conference. We're only making one demand: that at least by next year contracts meeting these requirements will have been signed for the projects needed for indigenization.

4. Proposed Goals

As noted earlier, the level of Santana indigenization has reached 12.7% this year. Try to make it reach 30% next year, and then push for 50% the year after that. I hope it can exceed 85% by 1990, rather than waiting till 1991. We must move more quickly and change, as soon as possible, everyone's impression that Santanas are all imports.

To achieve this goal, we must pay attention to two endeavors. One is to organize promotion, supervision, and inspection of the work. Who should be doing this? We'll have the State Planning Commission, the State Economic Commission, the State Machine Industry Commission, and the China Automotive Industry Federation work with Shanghai to form a joint organization to oversee implementation of this plan and to oversee resolution of the problems and relationships that arise in the course of this work. The State Economic Commission, in particular, will play a vital role because it's in charge of applying imported technologies. This is a huge systems engineering project, and close attention must be paid to expectations for the rate of progress. This is also a very important venture—we mustn't let it fall apart from the outset, with nobody at the top focusing on it. That won't do. If we are going to seriously and soundly see this work through, there must be monthly checks on the rate of progress, and problems must be dealt with through coordination in a timely way.

Second, it is essential to introduce competition, competition between horizontal and vertical equipment sourcing. What do I mean by vertical sourcing? I mean that 35% of a Santana's total parts, including the engine and chassis, will be handled by Shanghai Volkswagen itself. The other 65% will be produced by collaborating factories; this arrangement constitutes horizontal sourcing. At the moment, vertical sourcing appears to be falling behind horizontal sourcing. According to initial estimates, Shanghai Volkswagen is already a year or two behind the pace stated in its contract. General Motors takes only three years to build a factory. Two years have already gone by at our Shanghai enterprise, yet there still isn't any vertical sourcing, though of course a great deal of work has already been done in this direction. You at Shanghai Volkswagen must stand up for yourselves; otherwise, you won't improve and indigenous production won't be achieved.

A while back, we lost a lot of time. The reasons were very complicated and we shouldn't fault any one party—everyone bears some responsibility. The

other day, Liu Yansheng¹³ reported that the Germans don't understand the real situation in Shanghai, and this has slowed down progress. We must work to address this problem. I have just told one of their directors, if there's a problem with horizontal sourcing, come to me. If there's a problem with vertical sourcing, we'll come to you. In terms of responsibilities, both sides must mutually assume them and mutually support each other, but the respective responsibilities of Volkswagen AG and Shanghai Volkswagen must be delineated clearly.

In short, provided we are of one mind and see this through to the end, we will be able to smoothly indigenize Santana production. We will also be able to smoothly build a parts production system for the Chinese auto industry.

13. Liu Yansheng was then the Chinese-side manager of the planning department at Shanghai Volkswagen Automotive Co., Ltd.