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AT THE UNIVERSITY OF MICHIGAN BUSINESS SCHOOL

Competing Strategies of FDI and Technology Transfer to China: American and Japanese Firms

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Working Paper Number 218
January 1999

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COMPETING STRATEGIES OF FDI AND TECHNOLOGY TRANSFER TO CHINA: AMERICAN & JAPANESE FIRMS

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December 28, 1998

Abstract: This is a report based on four field site visits of Sino-foreign joint ventures in China. Two American and two Japanese joint ventures in electronics and auto parts were visited in the Shanghai area in December 1997. The joint ventures were Shanghai Raychem, Shanghai Fleetguard, Shanghai Mitsubishi Elevator, and Shanghai Koito. Although the sample size is extremely small, it does appear as if there are notable differences in how American and Japanese firms transfer technology to China and in their motivations for doing so. Further fieldwork-based research to capture and clarify these differences is recommended.

COMPETING STRATEGIES OF FDI AND TECHNOLOGY TRANSFER TO CHINA: AMERICAN AND JAPANESE FIRMS

Introduction

Technology transfer by introducing and localizing foreign sources of technology probably represents China's best chance to sustain high rates of economic growth. Indeed traditional models of economic growth suggest that countries can sustain high growth rates only by increasing total factor productivity (TFP), and that increases due to technical efficiency or the utilization of the best available production techniques are more important than allocative efficiency or the abilities of firms to lower costs (Wu, 1996; Jefferson and Xu, 1994).

The best available production techniques are not found in China for various reasons. Hence, foreign direct investment (FDI) has been the favored means by which technology transfer to China has occurred (Prime, 1998). FDI happens when non-Chinese firms decide for various reasons that it is prudent for them to invest in China. In the main, FDI is studied as aggregate flows: how much investment has occurred during a particular year or period of years from different countries. Considered as an aggregate, however, it is difficult to examine the reasons why firms engage in FDI.

Ideally, FDI should be disaggregated: by province or sub-national unit, by industry, and by the organizational structures and management objectives chosen to execute foreign direct investments. By disaggregating foreign direct investment, moreover, technology transfer may be effectively coupled with issues of technical efficiency or to what extent target investments make the best use of available technology. Hence, in this project our aim was to study how FDI flows impact the technology transfer process at the organizational level in China, and to do we decided to look comparatively at how American and Japanese firms were investing in China.

American and Japanese FDI in China

The project set out to investigate American and Japanese FDI in China. Our working hypothesis was that American and Japanese FDI might differ. In other words, the null hypothesis was that firms from different countries invest in China for the same reasons and in the same ways. Given a large enough sample of FDI cases in China, we believe that the null hypothesis would be rejected (Yan and Gray, 1994; Tse, Pan, and Au, 1997).

This premise, in fact, embraces the well documented finding that American and Japanese firms industrial differ in structure, strategy, and management systems (Aoki, 1988; Dore, 1973; Chandler, 1977, 1990; Fruin, 1992; Odagiri, 1992). American firms are larger and, as a rule, more vertically integrated and horizontally diversified. Japanese firms, by contrast, are more functional in organization and depend more on strategies of cross-functional integration. Such strategies depend on the cooperation and close collaboration of key stakeholders, such as labor unions, suppliers, and other business group member firms.

In particular, key differences in production organization and management between American and Japanese industrial firms are evident. The best-selling The Machine that Changed the World (New York: Ralston Associates, 1990), found differences in such areas as die changeover times, number of job classifications, number of daily JIT (just-in-time) deliveries, percent of total engineering hours carried out by suppliers, and proportion of parts single-sourced, just to mention a few of the categories of cross-regional comparison carried out in MIT and Harvard studies of the global automobile industry.

It is also likely that such differences, long established at home, will be continued overseas (Westney and Ghoshal, 1989; Fruin, 1997). With these assumptions in mind, Professors W. Mark Fruin, Penelope Prime, and Roy Groy approached the William Davidson Institute for preliminary funding to explore the question of how country-based differences in sources of FDI might affect the technology transfer process (1). Our approach was qualitative: we wanted to visit a small number of recent U.S. and Japanese joint ventures in China and to observe what was going on and to interview top foreign and Chinese managers on-site. In December 1997, the three traveled to Shanghai to visit four joint-venture enterprises, two American and two Japanese: Raychem, Shanghai Fleetguard, Shanghai Mitsubishi Elevator, and Koito Manufacturing. A brief write-up of the field notes from each site follows.

Site Visits in China

Raychem

Raychem began discussions about setting up operations in Shanghai in the Caohejing Hi-Tech Park in 1984. A feasibility study was completed in 1985 but it was not until January 1995 that the current Raychem facilities in Shanghai were completed. The current General Manager of the joint venture is Dr. Robert Lo, a native of Taiwan with a Ph.D. in polymer science.

According to Dr. Lo, Raychem is now a global company, meaning that Raychem no longer has to manufacture what it invents or to sell what it makes. Now Raychem goes anywhere in a worldwide division of labor to exploit attractive value chain opportunities. This is unlike "international companies" that go overseas to exploit opportunities associated with their own "invent-make-sell" model, according to Lo.

The ownership of Raychem in China is an 80-20 equity split with Raychem owning the larger share. According to Dr. Lo, few 50-50 joint ventures are successful. In fact, Raychem would be willing to gain a 100% share of their operations in China although they are happy with their Chinese joint venture partner, Shanghai Cable. Because it took a long time between the feasibility study period and the establishment of operations, the content of joint venture partnership evolved from third generation to fourth generation technology before operations actually began. The joint venture is risky for Raychem in this respect. However, if the joint venture succeeds, it also means that

Raychem will have a cutting-edge facility located in China, and that Raychem can serve the world from its low-cost, high-tech Chinese operation.

Raychem is using the joint venture to produce adhesives and insulation for electronic products while Shanghai Cable is making switching boxes and cable in the joint venture. The market for these products is growing rapidly, at about 20-25 percent annually. In terms of productivity, Dr. Lo indicates that the lines in China are not as fully automated as they are back home, but given the labor costs in China, it does not make good sense to automate the production lines more fully. Perhaps it will be sensible to do so sometime in the future but it may be decades before the breakeven point is reached.

Because Dr. Lo is Taiwanese born and a native speaker of Chinese, he does not believe that it has taken him a long time to build up an effective management team or to communicate effectively with them. He characterized Raychem's corporate culture in China as "open but close together," meaning that his management team discusses decisions in advance but once made, they are unanimous. Engaging in such discussions and reaching unanimous decisions are greatly facilitated by doing so in Chinese.

Shanghai Fleetguard

Shanghai Fleetguard is a subsidiary of Cummins Diesel, and a 50-50 U.S.-Chinese joint venture with Dongfang Motor established in 1992. The contract that defined their cooperation was signed in 1994, their current facility was built in 1995, and operations commenced in 1996. The sole products are oil and air filters and filtration systems.

Mr. David Nunan is the only foreigner at the Pudong joint venture site. He is 37 years old at the time of our visit and he arrived from Fleetguard operations located in

Nashville, Tennessee in 1994. His Chinese (Mandarin) is quite fluent although he does not read and write as well as he would prefer. He is an engineer and quite experienced with Japanese-style operations management and total quality management routines. In fact, Shanghai Fleetguard is seeking ISO 9000 certification. Mr. Nunan believes that Fleetguard's future in China is assured because they have a good joint venture partner and the Dongfang employees that have been seconded to Fleetguard are ambitious, learn quickly, and are always looking ahead.

A joint planning team was used to set up the joint venture using Dongfang employees who were originally from Shanghai but were sent to Xian during the Cultural Revolution. In fact, almost all of the joint venture's output is sent to Dongfang in Xian, one of China's largest truck makers. In the first two years of the project, four different Fleetguard employees came to Pudong for period of 1-2 months. Otherwise, the human resources involved in the start-up were all Dongfang employees.

The Shanghai facility is for assembly only. Dongfang Motor not only finds and recruits suppliers for inputs but also all logistic and distribution aspects of the operation are handled by Dongfang. The primary material used in assembling filters is steel although the number of plastic parts are increasing. About 30-40 different kinds of filters are assembled at Shanghai Fleetguard and Dongfang either uses them directly in its own manufacturing operations or makes them available as spare parts on the automobile/truck after market. The sales target for 1997 was 50 million rmb.

The assembly procedures developed at Shanghai Fleetguard are modeled on procedures first developed by Fleetguard U.S.A. Mr. Nunan believes that only 5 percent of what is done in China represents local adaptation of U.S. best practice. Assembly

procedures developed by Shanghai Fleetguard employees are authorized in the course of regular, internal audits of assembly processes to ensure compliance with U.S. best practices.

Although Shanghai Fleetguard would prefer to single-source most of the parts and components needed for its assembly operations, this is not always possible. Quality is the number one goal is sourcing inputs and price is second. Since there is not really a market for automobile assembly parts in China, prices with suppliers are negotiated. And on the other side, since there is not really a market for assembled automobile parts in China, good relations with Dongfang Motors is important.

Mr. Ma is Dongfang's top representative at Fleetguard. He believes that without a market in China, Fleetguard has to be "customer-led." And the customer is this case is Dongfang. Our aim is to have high quality, low cost products. We provide this by combining the quality assurance and manufacturing knowledge of Cummings with a Chinese team-based approach to work. Chinese teams need strong leadership from above, and this he (Mr. Ma) provides. At present, there are 16 project teams organized along functional lines at Shanghai Fleetguard.

Shanghai Mitsubishi Elevator

Mr. Shigehiko Suzuki, Deputy President of Shanghai Mitsubishi Elevator, met with us on December 12, 1997 at the joint venture site located in the Minhan area of Shanghai. This joint venture was established in 1987 with 60-40% (Chinese-Japanese) ownership. In actual fact, the ownership is divided among several investors on the Chinese and Japanese sides. Shanghai Mechanical Electrical Company has 52%; Shanghai

Mechanical Electrical Export-Import Company 8%; Mitsubishi Electric 32%; and a Hong Kong Trading Company has 8%.

The initial joint venture agreement was for a twenty-year period and renewable. Great Wall Elevator, our local partner, had been established for sometime in Shanghai as a freight elevator enterprise. Shindler, a Swiss firm, established itself in Tianjin in 1980; Otis in Tianjin as well in 1984; and, Koshu, another Japanese company, in Guangzhou in 1984. Mitsubishi Electric established its first China operation in 1983 for the manufacture and assembly of air conditioners, electric stoves, and semiconductors. Seeing that foreign firms were entering the elevator and escalator market in China, Mr. Suzuki says that Mitsubishi Electric decided that it too would enter the market. But Mitsubishi Electric decided that it could not do well on its own, so it looked for a local partner and found Great Wall Elevator.

In 1987, shortly after the joint venture was established, Mitsubishi Electric transferred its new controls and inverter systems to China; these systems cut the amount of electricity needed to run elevators and escalators in half. This led to a rapid increase in the joint venture's market share in China. Mr. Suzuki estimated that 30,000 elevators and escalators are sold yearly in China, and Shanghai Mitsubishi Elevator's market share is 20 percent. Of this total, escalators account for about 15 percent of sales.

Because of rapid economic growth in recent years, all of the major elevator manufacturers have set up operations in China. Among Japanese competitors, Hitachi, Toshiba, and Koshu are expanding their activities in China. In terms of sales of new elevators, Mr. Suzuki believes that Otis is number one, Shindler number two, and Shanghai Mitsubishi number three. Since service contracts represent a big part of sales,

tallying service contracts and new system sales together might raise Mitsubishi to the number two position ahead of Shindler while Otis retains its leadership position in this market too.

While quality has been the primary success factor, now that the economy is growing more slowly, pricing is becoming more important. The Chinese investors in Shanghai Mitsubishi Elevator handle sales and marketing functions almost entirely on their own. In fact, sales, installation, and service in China are done on the Chinese side, and Mitsubishi Electric worries about these functions only when product is exported. However, at present, exports are low, no more than 5 percent of production.

The Shanghai Mechanical Electrical Company, the Chinese joint venture partner, use to be elevator department of the Public Utility Division of the Shanghai city government. When the joint venture was first established, there were two full-time managers from Japan: one was the Vice General Manager of the joint venture and another was the head of technology. Now, ten years later, there are 6 managers from Japan, mostly providing functional support to various areas of the joint venture.

Blueprints, manuals, and personnel were brought from Japan, and Chinese personnel were sent to Japan for training. Although Mitsubishi Electric tried to anticipate what kinds of problems and issues might arise in the early years of the joint venture, in fact there were a lot of emergent problems that arose in areas outside of our expectations. So we have organized a series of conferences to deal with these issues as they have arisen. On average, we plan on having two scheduled conferences annually and, in addition, we have about 3-4 ad hoc conferences annually.

Much of the emergent system is a blend of Japanese and Chinese management methods. For example, although accounting is done in the Mitsubishi way, the accounts are rolled up to fit the Chinese reporting system. In terms of human relations, Mitsubishi pays special attention to individual talent in terms of promotion and compensation. Since state owned enterprises are the norm in China, seniority is an important consideration in determining pay and promotion. Mr. Suzuki says that Shanghai Mitsubishi Elevator tries to mix the two systems.

The quality of the elevators assembled and produced in China do not match Japan's quality standards. The biggest difference comes from the quality of parts purchased in China; between 30 to 50 percent of parts are bought locally, depending on the product model. In Japan, Mr. Suzuki says that Mitsubishi Electric would go directly to suppliers to fix quality assurance problems but in China, their Chinese joint venture partner does not generally huddle with suppliers to figure out where quality assurances problems are cropping up. In order to do so, Shanghai Mitsubishi Elevator would have to increase the size and improve the qualifications of the sales staff.

In terms of the future of the joint venture, Mr. Suzuki believes that there are two likely directions: first, an increase in the number of elevator/escalator models offered, and second, the introduction of more electronic controls on models sold in China. The future looks bright for the top firms. The top 5 firms enjoy a 60 percent market share; they're all foreign firms or Sino-foreign joint ventures. In the future there will be more competition from purely Chinese firms, but right now, especially with respect to price, performance, quality, and safety, Chinese firms are not competitive.

Shanghai Koito Manufacturing

Koito Manufacturing is a member of the Toyota Motor's group of companies. The Koito joint venture with Shanghai Autoworks began as a technology transfer agreement inked in 1982. The current joint venture facility opened in April 1989, as a 50-50 venture, with Shanghai Autoworks holding 50 percent ownership, Koito 45 percent, and Toyota Trading Company 5 percent.

The joint venture is quite successful, according to Mr. Katsuyoshi Mizoguchi, Director of Quality Assurance. Koito supplies 100 percent of the headlamps for the Santana automobile in China; this is 20 times higher than before the initiation of the joint venture. Taxes are paid to the city, county, and nation; the value added taxes (VAT) averages about 17 percent.

The technology transfer process to date has been mostly importing plant, molds, and equipment from Japan, and teaching Japanese personnel management approaches to the Chinese. "As much as possible" the Japanese approach to operations and personnel management is used. However, it is impossible to conduct business in a purely Japanese way. For example, we source oils, fluids, and other low-grade parts and components as much as possible from local sources, and this requires us to make adjustments in the machines and methods that are imported from Japan. Also, various human-dependent systems are different. In Japan, for example, QC circles meet at times other than work hours; we cannot do that here. In Japan, workers are more self-motivated; here less so. We have introduced the 5S system here, but since workers take less initiative here, it has been slow to take hold.

Nevertheless, we have been successful enough with the first phase of technology transfer to introduce the second. This involves computerization of production systems, JIT (just-in-time) production, localization of some design engineering resources and activities, and higher level training of local managers. The second phase, which we are just beginning, will take 3-5 years to complete.

In terms of our technology transfer strategy, some companies try to transfer the Japanese system intact and some try to make adjustments and adaptations at the outset. We are closer to the second, according to Mr. Mizoguchi. The biggest problem in our experience is that Chinese workers and managers have their own histories and ways of doing things. We cannot change them overnight. In our case since we took over the existing auto lamp division of Shanghai Autoworks, ours was a brownfield site. This means that we took over their labor, equipment, system, distribution routes, etc. We have to work within the givens of the existing system rather than set up entirely new ones at the outset.

In 1985, Shanghai Autoworks asked Koito to supply auto lamps for the Santana project. We took several years to decide, so by the time we set up shop in China, Santana had already been in production for about four years. However, in the beginning, the volume of production was quite small, about 2-3,000 vehicles per year. In 1989, ten thousand Santanas were made, but by 1997, including both Santana models in production, about 240,000 were produced.

As for productivity and quality, using Japan as a standard for comparison, the quality is consistent with ten-year old quality levels in Japan, and productivity is about 40 percent of that achieved in Japan. By the end of the 1998 FY, Mr. Mizoguchi related that

the target was to achieve 80 percent of Japanese productivity levels. If that goal is reached, then the quality of auto lamps produced in China will be sufficiently good to export them. If that goal is realized, Chinese auto lamps would be exported to Southeast Asia, Australia, and Europe. But the quality would not be good enough to export to either Japan or the United States.

Mr. Mizoguchi says that Shanghai Koito is a Chinese company. The head is Chinese and of the ten departments, Chinese head up half. In fact, of Koito's seven overseas plants, six are headed up by local managers. So, although we try to run production in the Japanese way, we are in China and we have to adapt to Chinese ways of doing things. A contradiction? Probably. We just keep trying to develop the best venture possible, and year by year we make progress.

Our scrap rate, for example, is just 1-2 percent; this is ten times higher than Japan but much better than most enterprises in China. The defect rate in assembly is just 1-2 percent and this is an outstanding achievement. The test illumination defect rate is higher, approximately 5 percent, but this depends a great deal on the model being tested. The defect rate ranges from 0-7 percent, depending on the model. Our current goal is to decrease the defect rate by 25 percent.

Our work-in-process inventory is more than twice what it would be in Japan, but we will work on reducing this rate during phase two of the technology transfer process. But it is difficult to reduce WIP (work-in-process) inventories until we have shorter die changeover times and less time spent on repairing and replacing production equipment. In general, we have to decrease the overall numbers of defects and difficulties before we can substantially decrease WIP inventories.

The future looks bright for Koito in China. However, there is still a long way to go before Shanghai Koito is operating at anywhere close to home country performance levels. Also, the macroeconomic situation in China is not certain and the nature of government regulation of the economy is not so predictable. So the economic circumstances could change quickly in China.

Summary

Without exception, the Japanese joint ventures that we visited emphasized high-levels of operational efficiency, required elevated levels of capital investment in plant, equipment, and personnel training. In the main, however, Japanese joint ventures in China do not manufacture full product lines, reserving for factories at home the design, development, manufacture, and assembly of the latest generation of high-end products. Nevertheless, there was stringent attention given to quality assurance, TQM, JIT production, and supplier training in Japanese operations in China.

By contrast, American joint ventures in China seemed to be more willing to manufacture full product lines and seemed more concerned with export from China, at least these observations were true of Raychem. There was less concern with reaching home country standards in terms of quality, JIT, and supplier relations, and perhaps this reflected a more sophisticated global division of labor strategy. If this premise is true, we would also expect to see different patterns of headquarters-subsidiary communications and decision-making between American-funded joint ventures in China and Japanese-funded joint ventures.

Obviously the size of the sample was small. No serious effort can be made to generalize, qualify, quantify, or compare findings on the basis of a sample of four joint ventures. On the other hand, we did observe country of origin differences in general goals as well as in operational standards with respect to the joint ventures that we visited, and we believe that surveying and analyzing a larger sample of American and Japanese joint ventures in China would prove to be well worthwhile (Tse, Pan, and Au, 1997).

In terms of China's efforts to advance its economy and to compete successfully around the world, FDI and technology transfer from advanced industrial economies, like the United States and Japan, will clearly play critical roles in the efforts. Indeed, without FDI and technology transfer from abroad, it might be difficult to sustain high levels of economic growth, given the inefficient and bureaucratic nature of the Chinese state, outmoded plant and equipment, anachronistic organization and management policies (Prime and Park, 1997). In this light, FDI and technology transfer hold the key to China's economic future, and we believe that fieldwork-based studies into the organizational and strategic components of FDI and technology transfer are indispensable.

Notes

1. Although Professor Roy Grow, Department of Political Science, Carleton College, accompanied Professors Fruin and Prime to China, visited the fieldsites, and engaged in interviews with local and expatriate managers, he did not participate in this write-up of the trip.

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