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"The concern is that as China slows—and it's not only the slowing volume but the increasing competition—there's way too many brands and way too much capacity," says analyst John Humphrey.

A Chinese worker on an assembly line at the Zhejiang Geely auto factory in Zhejiang province.
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After a summer slump where light vehicle sales fell year-over-year, the auto market in China crawled out of its cave in November. Sales picked up—as much as 72% in the lower-priced SUV market--after the Chinese government slashed the automobile sales tax in half.

But the higher numbers won't stick, predicts John Humphrey, senior vice present of global automotive practice for J.D. Power and author of a recent report on China's Five-Year Plan for the auto industry. The industry can't keep going the way it has without repercussions, both at home and abroad.

Humphrey sees warning signs that China—which is hammering out its next five-year plan for the economy –can't sustain the current structure of its auto industry.

"In the last decade, China's been on a tear," he said. "The growth has been considerable. And clearly being the world's largest auto market, China has fueled a lot of the volume and profitably for the OEMs.

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"The concern is that as China slows—and it's not only the slowing volume but the increasing competition—there's way too many brands and way too much capacity. And pricing in many segments is deflationary."

China's economic slowdown puts pressure on the international OEMs because other potential growth areas--Brazil, Russia and India--have not materialized. Brazil is in recession, Russia is in the midst of economic sanctions and India is a small-car market "and smaller cars mean smaller profits," said Humphrey.

This puts pressure on foreign automakers because they have come to depend on China, the world's largest automaker, "as a major source of their revenue and profitability," Humphrey wrote in his report.

Some things bode well for the future of the Chinese auto market, including a growing middle class and low vehicle penetration—about 115 vehicles per 1,000 inhabitants vs. 800 per 1,000 in the U.S. But "there are concerns about the lack of market-based reforms that are needed to avoid sliding into a period of deteriorating profits," said Humphrey.

Too Many Brands

Humphrey likens the relatively young auto industry in China to the U.S. auto industry of the early 1900s, a Wild West where dozens of small carmakers, many of them local outfits, were battling it out to see who survived—and got bigger. China has 90 automotive brands—three times that of the U.S.

But unlike the Stutzs and Pierce-Arrows of American yesteryear, the Great Walls and Guangzhous Automobile Groups of modern-day China enjoy heavy government subsidies and reap the benefits of forced partnerships with foreign automakers.

Usha Haley, professor of management at West Virginia University and the author of the book "Subsidies to Chinese Industries" estimates that in 2014 alone, China provided more than $1 billion in subsidies to its auto industry, up 75% per year from 2011. "Roughly, financial subsides are about 30% of listed companies' profits," she estimates.

In order to do business in China, international automakers from Volkswagen to GM must partner up with state-owned enterprises (SOEs) and cannot own more than 50% of any auto company. The foreign partners must share their intellectual property with their Chinese partners and do research and development in partnership as well. Beijing assigns the partnerships and dictates which brands the foreign automakers can bring in.

“This arrangement has created huge inefficiencies in terms of redundancies in the design, engineering, production and distribution of vehicles,” Humphrey wrote.

To compound things even more, every Chinese province has its own subsidized auto company, said Haley, sometimes in partnership with a foreign auto interest. The provincial car companies, a point of civic pride and pillars of their local economies, have overbuilt their production facilities with the help of land and tax incentives and tend to keep their production numbers up to look good even if the cars aren’t being sold.

“There’s been an enormous amount of money and investment and pride poured into this,” said Haley. “So there’s overcapacity, and there’s cutthroat rivalry. ... One province even went so far as to issue some currency so [residents] couldn’t buy cars from another province.”

In mid-November, the number of cars on the lot at Chinese dealerships were 1.5 times the monthly sales, said Haley.

Humphrey said that with overcapacity throughout the entire industry, automakers—GM is one—have started exporting the surplus.

Because economies are also slowing down globally, “the challenge is how many of those markets can absorb any more product,” he said. Foreign carmakers won’t scale back their production in the U.S. because of surplus in China, he guesses, but “you’ll see some of the Chinese domestics looking at additional markets to go to.”

Big Cities Saturated

Despite its low vehicle penetration, China simply doesn’t have the room to expand car ownership in some places. Humphrey said that the most mega-cities in the eastern part of China—Shanghai, Guangzhou, Beijing—are maxed out on the government’s allotted number of cars for the amount of land and infrastructure they have. In densely populated areas, you can only own a car if you win a state lottery to buy a license plate.

Because carmakers “can’t count on Shanghai selling a lot more new cars in any one of those large cities, they go out into the Tier 3 and 4 markets, which are less economically developed, and then the affordability issue comes into play,” he said.

Mercedes Benz and BMW are still doing relatively well in China, adds Haley, partly because a “huge car buyer” in China is the government, and state officials tend to buy the higher-end vehicles.

Out in the provinces, people are feeling the brunt of the economic slowdown and aren’t rushing to buy the cheaper cars, said Haley.

“Now that the market has started shrinking, very noticeably, the Chinese have started issuing warnings to the foreign joint ventures to cut back because the provinces want their own companies to be doing better,” she said.