

# **6 SWOT Analysis for the Chinese Denim Industry**

## **6.1 INTRODUCTION**

After investigated the production, consumption, geographic distribution and distribution channels of the Chinese denim industry, we now carry out a further analysis, which is a critical part of the strategic management planning process.

As a producer absorbing 5 per cent of world's cotton, the principal supplier of Hong Kong, the most important trading center in Asia, and the fifth largest supplier of the US, the most important denim market, the Chinese denim industry is very powerful in the world market. However, in Europe, where denim has a higher fashion character, China is only the 25<sup>th</sup> supplier. In earlier sections, we found that business scope was wide, from denim fabric to denim apparel, from jeans to children wear, and the objective of the Chinese denim industry is to enlarge its market share in the markets (global and domestic). The industry was positioned as export-oriented when it was established. As more people in China's domestic market accepted the denim apparel, the industry also focused on its domestic market, which has one fifth of the world's population. We positioned the China denim industry as a power in the international market, and in its domestic market, and now go on to analyze its strengths, weaknesses, opportunities and threats, comparing it with its major competitors to identify its competitiveness.

SWOT is a common and widely recognized tool for finding a match between organizations capabilities and opportunities within a competitive environment. It was introduced in the second half of the last century help in analyzing a company's extra and intra environment as an important part of strategic planning [1]. The major work of a SWOT analysis is identifying and analyzing the threats (T) and opportunities (O) in the external environment and assessing the organization's weaknesses (W) and strengths (S). Then to design a strategy to position the organization, so as maximize the strengths and opportunities, and minimize the weaknesses and threats. Later, the tool was used in industry and for national analysis [2].

In this section, the operating environment and the industry's internal strengths and weaknesses are focused on. The SWOT items are summarized in Table 6.1.

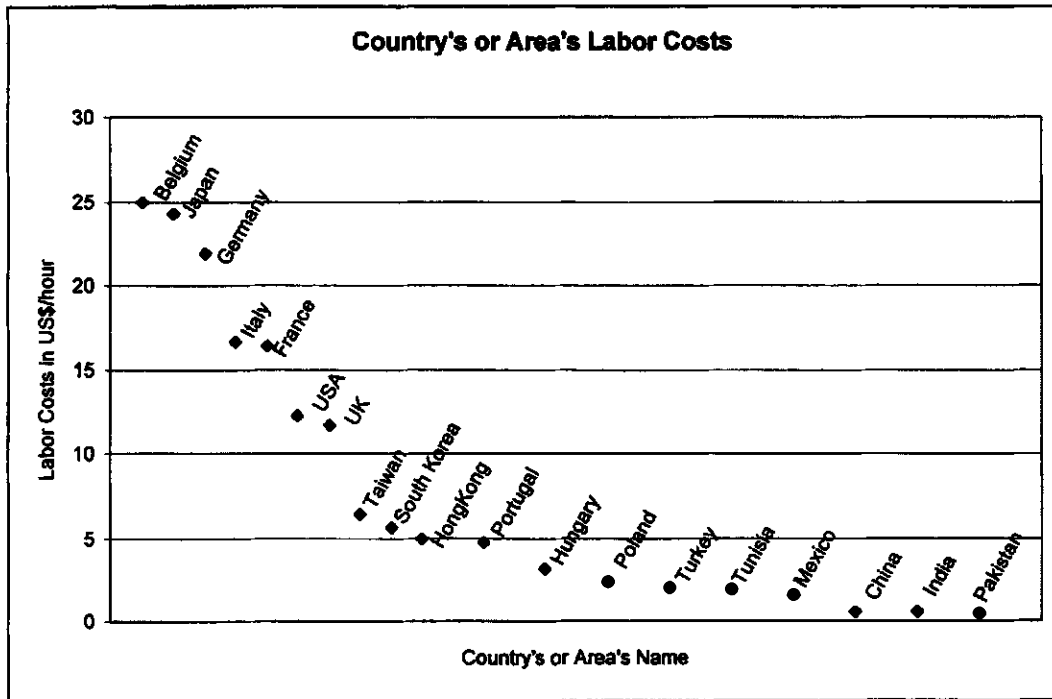
## 6.2 STRENGTHS

### 6.2.1 Huge product capacity

The Chinese denim industry processed 5% of the world's total cotton consumption in 1997 (Yi, L., and Lei, Y.,1999), and owned huge production capacity. The industry has been built up since the late 1970s, when China began its open door policy. In the database we built, more than one thousand enterprises manufacturing denim yarns, fabric and apparel were included. In term of location, we found that most of them were situated in the coastal areas (Guangdong, Fujian, Jiangshu, and Shangdong provinces) of China which are the relatively economically advanced areas. These coastal areas have better-developed physical infrastructure, no matter in energy, transportation, and communications, compared with other areas in China. They are also the earliest most practiced market-oriented economic areas in China. Since China's economy has become more market-oriented, the industry has learned to operate under market forces. They have relied on the market to obtain their input factors and sell their output, rather than having them allocated by state planning. Further, it was a sector that attracted much foreign investment at the beginning of the 1980s, when many Hong Kong denim factories shifted their manufacturing factories to the Chinese mainland. Our database showed that the Chinese denim industry consisted mainly of collectively-, joint venture-, and privately owned enterprises, which were regarded as having high autonomy, high flexibility and low governmental intervention compared with state-owned enterprises [3]. Factories in the denim sector have higher autonomy over determining how and with whom they will conduct business. The denim industry, in contrast to other industries, is more dynamic, flexible and "marketized".

Table 6.1 Summarization of the SWOT of the China denim industry [4] [5]

<p style="text-align: center;"><b>Strengths</b></p> <ol style="list-style-type: none"> <li>1. Huge production capacity</li> <li>2. Dynamic, flexible and "marketized"</li> <li>3. Huge labor force</li> <li>4. Lower production costs (compared with developed countries)</li> <li>5. Familiar domestic business environment</li> </ol>	<p style="text-align: center;"><b>Opportunities</b></p> <ol style="list-style-type: none"> <li>1. Growing domestic markets</li> <li>2. Liberation of restrictions on cotton supply from 1<sup>st</sup> September 1999</li> <li>3. Potential increase in foreign trading space</li> </ol>
<p style="text-align: center;"><b>Weaknesses</b></p> <ol style="list-style-type: none"> <li>1. Shortage of funds</li> <li>2. Low value-added products</li> <li>3. Weak in technology development, utilization, commercialization and marketing research</li> <li>4. Low product Innovation</li> <li>5. Low skilled labor</li> <li>6. Growing labor costs</li> <li>7. Unfamiliar foreign markets and low marketing skill</li> </ol>	<p style="text-align: center;"><b>Threats</b></p> <ol style="list-style-type: none"> <li>1. Restricted international trade space</li> <li>2. Competition from developed countries and other developing countries</li> <li>3. Concentration in US and EU clothing retail industry</li> </ol>



6.1 The labor costs in various countries and areas (Adapted from the Almanac of China's Textile Industry 1997)

### 6.2.2 Huge labor force

The denim industry is labor intensive rather than a capital intensive industry. The labor force is an important input factor. With a population of more than 1.2 billion, China is the world's most populous country, with more than 80% of the population in rural areas. As a result of the conflict between limited agricultural land and a huge rural population coupled with the big difference in life style between rural and urban areas in China [6], large numbers of unemployed and underemployed rural people immigrated to urban areas to find jobs. Most of these people from rural areas had poor skill levels and poor education, and provided virtually unlimited cheap labor resources to the Chinese denim industry.

### 6.2.3 Low production costs

Labor costs play an important role in the production costs that are involved in a labor intensive industry. There is data to indicate that the labor costs in China are low compared with those in other traditional denim manufacturing countries, such as USA, Italy and Belgium [7], and in some developing countries, such as Turkey and Mexico, as shown in Figure 6.1. The labor costs in the industrial countries such as USA, Belgium, and Japan were ten times higher than in China. Furthermore, the labor costs in some important denim producing developing countries such as Turkey and Mexico were also higher than in China. The low labor costs determined that the production costs of denim products in China were relative low compared with those in developed countries, where firms faced higher costs for labor, land, and environmental protection. In China, on the other hand, the low requirements on environmental protection meant low costs for wastewater treatment. This helps the

production costs of Chinese denim, but at the expense of a serious environmental problem for China.

#### **6.2.4 The familiar domestic business environment**

The size of the market for denim wear in China has been growing fast since 1978 when China opened its doors so that foreign culture and life-style were introduced. Jeans appeared on the China mainland in the 1980s, when people, especially the young, accepted them as a fashion, a symbol of Western life-style. Now, denim apparel is an important category of casual wear in China. As China's textile market hasn't yet fully opened to foreign competitors, domestic producers have dominated the home market. They are familiar with the Chinese domestic business environment because they have the same background and culture. China has a mystical aura owing to its long history and ancient culture. Unlike in with many Western countries, business in China has a special character. *Guanxi*, literally meaning in Chinese relationships, or more accurately, connections, probably is the key issue for business success in China, and many scholars have emphasized the importance of *Guanxi* in their research reports [8] [9]. The Chinese domestic market, determined by its huge population and increasing consumption, is an important target market for many foreign denim producers. China's unique culture and social environment are perhaps barriers for most foreign businessmen doing successful business in China. On the contrary, China's domestic denim producers have the advantage of knowing the domestic culture and social environment and operate their business in its unique business environment.

### **6.3 WEAKNESSES**

#### **6.3.1 Unfamiliar foreign markets and low marketing skill**

From its inception China's denim industry was export-oriented. However, unlike the US denim producers, who have more than a-century of business experience, the Chinese denim industry's history is very short, having developed only in the last twenty years or so. Further, since China closed its borders from the end of 1940s, most the local enterprises were short of direct experience about the foreign markets and consumers, and also lacked the marketing skills to promote their products in the stiff competitive markets.

#### **6.3.2 Shortage of funds**

As in other sectors in China, shortage of funds was a big problem the denim manufacturers faced. The manufacturers working in the sector were established in a short time and most of them were dependent on bank loans for their development. In the 1990s, China's money market was stringent; it was very difficult to obtain a loan from a bank. And if one succeeded, the interest was in two figures. In the second half of the 1990s, many investors invested in the denim business with little differentiation.

Competing in the same battlefield with little differentiation causes the profit margin of the manufacturers to be reduced. This made it difficult for the manufacturers to accumulate funds. The shortage of funds limited the manufacturer's ability to update machinery, invest in R&D, train its labor and indulge in marketing promotions.

### **6.3.3 Not the most advanced machinery**

China does not own state-of-the-art technology and techniques in the fields of spinning, weaving, dyeing, and finishing. The Chinese domestic textile machinery industry couldn't supply the most advanced machinery to produce efficiently high quality, products for the China denim industry. Most of the textile machinery in the denim industry was imported from industrialized countries, such as Italy, Germany and Japan in the middle 1980s, and denim firms had to pay huge capital for machinery imports. An imported production line would cost about US\$ 5 to 7 million. Because of the shortage of funds, the manufacturers have found it impossible to update their machinery quickly and the machinery currently working in the sector is not the most advanced compared with that of its competitors in the world market.

### **6.3.4 Weak in technology development, utilization, commercialization and marketing skill**

China's denim industry is also was weak in technology development, utilization, commercialization and marketing research. Most of the firms just have one production line in China; they are small or middle-size enterprises, so they can not achieve an economy of scale and have no ability to develop new products by themselves. They are also weak in utilizing new technology. New technology, such as CAD/CAM (digital design) and Electronic Commerce (Internet) was regarded as the major means to fight back competition from low cost countries by producers in USA and Europe. However, the technology is still not widely used in the China denim industry. The industry is also weak in new material research. In the 1990s, manufacturers in developed countries introduced new materials that led to softer fabric, that were easier care, more breathable and eco-friendly, and applied them in denim apparel to meet consumer requirement. Compared with its competitors, the Chinese denim industry did little work in this field.

### **6.3.5 Low value-added products**

There was information in our survey that indicated that the gap of processing-skill level between China and other advanced producers is narrow [10]. In the US market, the average price of denim jeans imported into the US was US\$7.2~7.5 per unit, and the price of denim jeans from China was US\$9-10 per unit. China denim apparel was positioned as middle quality products. However, when the price of denim apparel from China is compared with that from the advanced producers such as US, Italy, Belgium, and France, it was relative low. For example, the average price of denim apparel EU imports was around 10 Euro per piece, while the price from China was 6.67 Euro per piece in 1997. Although the processing-skill has improved and the price

for unit denim apparel has increased in the past years, Chinese denim products are still medium to low grade products in the international market.

Many of firms in China's denim industry have only recently joined the processing business. A big proportion of Chinese denim apparel enterprises process denim for foreign agencies; even though overseas markets are very important to Chinese producers, few of manufacturers have done business on the distribution channels in overseas markets. The value-added of Chinese denim products was relative low in the US and EU markets [11]. As its competitors increased consumerism, Chinese firms mostly acted as processors and did little work on marketing, and brand building. They recognized the importance of brands in the mid-1990s, and build some national famous brand such as Boton and Weipeng. However, this is far from the brand awareness seen across the world, and they did not sell products or supply services in overseas retailing markets directly, even though the overseas markets were their important target markets. Their products were given foreign brand names, just being marked *Made in China*, and could be found in every type of retail outlet in foreign countries. Similarly, in the domestic market, few enterprises integrated into retailing or provided services. Chinese denim firms competing in the market mainly rely on price oriented strategies and compete in price-sensitive market segments. Most firms are also weak in market understanding because they do little marketing and consumer research. In the middle of the 1990s, China produced mainly extra heavy & thick denim fabric, while ultra light & thin varieties were becoming fashionable in world markets. In China, most denim fabrics were still made of pure cotton yarn only for the domestic market. China's denim fabric production thus did not meet the demand of overseas markets, a big problem the Chinese denim fabric industry is facing.

Relying on price oriented strategies, low value added products, and higher liability interest, all these factors influenced the enterprises' margin and kept it relatively low. This prevented the enterprises from accumulating with which to upgrade the industry.

### **6.3.6 Low skill labor**

Another factor that weakened the industry was the low skilled labor. The Chinese denim industry employed many unskilled labors who had migrated from poor rural areas and were poorly educated. Although low skilled labor may imply the low labor costs, it is weak in understanding new technology, which affects the introduction of the latter as a means of increasing productivity.

### **6.3.7 Growing labor costs**

The most important strength of the China denim industry was low labor costs. However, gradually increasing labor costs in China's clothing sector have taken the edge off the most important strength of China. The labor cost in the Chinese apparel industry increased from \$0.28 per hour in 1996 to \$0.43 per hour in 1998 [12]. With economic growth, the labor cost will continue to increase.

## **6.4 OPPORTUNITIES**

### **6.4.1 Growing domestic markets**

The most important opportunity for the Chinese denim industry is the growing domestic market. 63.77 million units of denim apparel were consumed in China's domestic market in 1997. Between 1995 and 1997, the domestic denim apparel market size increased by 41.59% and its growing potential is expected to continue for some time. On the other hand, denim fabric is widely used in the non-apparel sector in foreign markets. With the Chinese economy developing increasing competitive power, China itself is becoming a large upholstery market. As more Chinese accept a foreign lifestyle denim fabric, with the feature of homeliness and durability, will be applied more and more in the Chinese upholstery market, where denim has a bright future.

### **6.4.2 Growing developed countries imports**

Some research has indicated that the clothing markets in developed countries will increasingly depend on imports [13]. In the two most important denim products markets, USA and EU, import values of denim products have been increasing. With a growth rate of 8.28% per year from 1995 to 1997, the USA imported US\$ 2.0 billion worth (at C.I.F. prices) of denim products in 1997. In the second largest denim market, the EU, the import figure has increased from 1.1 billions in 1994 to 1.5 billions 1997, a growth rate of about 6.11% per year. Denim wear is an important kind of casual wear that meets many people's requirements on comfort and easily maintain clothing. Furthermore, denim fabrics are becoming widely used in non-apparel products in overseas markets, such as bedspreads, solid denim pillows, denim rugs and so on, these products helping to create an atmosphere of relaxed comfort for everyone to enjoy. Denim products therefore have a bright future, and it is an opportunity for China's denim industry.

### **6.4.3 More free cotton sourcing**

Inside China, an opportunity also arose from the nation's reform of its cotton policy. China's textile manufacturers have had deal with a single cotton supplier because China's central government has had a strict monopoly over all cotton purchases, marketing and storage. At the same time, due to problems such as unstable cotton production, and the rapid growth of downstream processing capacity, China's textile industry faced scarcities of raw material supply. The controlled cotton price and single cotton sales channel created for the denim yarn industry high raw material prices and lost flexibility in raw material selection. The high raw material cost in denim yarn industry influenced the Chinese denim fabric and denim apparel industries, because they had to face the burden of higher raw material costs in competition with foreign companies. The high raw material costs eroded China denim products competitiveness in the world market. The Chinese government decided to

liberalize cotton prices from 1<sup>st</sup> September 1999 (China Economic Information Center, 1998), when the officially fixed price will be replaced by a "reference" price. Further, textile mills will be allowed to buy their raw materials directly from farmers, and China's denim yarn manufacturers should largely benefit from a substantial price reduction and increased flexibility in raw material selection.

#### **6.4.4 Enlarge foreign trade after entry to the WTO**

Till now, China has not been a World Trade Organization (WTO) member. The non-WTO member status has brought considerable difficulties to its textile foreign trade since it could not enjoy the WTO membership benefits of the textile quota and reduced tariff rates. China is the most powerful textile product exporter in the world, but many industrially developed countries have discriminatory that disadvantage rules textile products from China. China has had no opportunity to dispute these rules it because it was not a WTO member (we will discuss this later in the section on Threats)

After applying to enter the WTO, Chinese and US negotiators reached an historic trade deal in Nov. 1999 that removed significant trade barriers between the two countries, and cleared the way for China's entrance into the WTO. If China joins the WTO, the Chinese denim industry will benefit on two counts. The first is an improvement in China's macroeconomics improvement; another is an enlargement of the trading space for denim products.

The World Trade Organization (WTO) has its roots in the General Agreement on Trade and Tariffs, or GATT. The work they began in 1948 has continued for over fifty year, and their faith in freedom, open markets and the rule of law has been abundantly vindicated, through eight rounds of negotiations, and as 112 new members joined the 23 founders of GATT [14].

China has operated reform policies for some time, and most of the remaining reform requirements are of an institutional nature. Currently, China's economy and institutional framework are still underdeveloped and in transition. The administrative and legal environment (including judiciary procedures) requires considerable further development toward internal consistency, completeness, transparency, and enforceability to meet the demands of a more completely competitive market economy. They will require years of further social, legal, and administrative reform and development.

From the point of view of the macroeconomy, joining the WTO was an essential building block for completing the opening up and modernization process for China. It would help China to design and implement the difficult and often painful economic, financial, and institutional adjustments that still lay ahead [15]. It would provide structure and legitimacy to important components of the domestic reform process, particularly the most challenging parts of it, such as the creation of genuinely rule-based and transparent systems of governance and dispute resolution.

Joining the WTO would help China to accelerate its reform by having closer links with the international economy. Without WTO membership, China's remaining reform agenda will be harder to implement and China will face serious additional uncertainties regarding international market access for some of its exports [15]. The Chinese denim sector will benefit from China's economic reform and enhance efficiency that would result from joining the WTO [16].



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China is the world's largest textiles producer and exporter, and the production and export of textiles is of vital importance both to its economic development and its foreign exchange balance, as well as to the balanced supply and demand for textiles and sound trade patterns in the world market. The discriminatory rules of the industrially developed countries have limited its foreign trade space. If China joins the WTO, this will be helpful in enlarging that space.

Since the 1970s, the international textiles trading system, governed by the "Multifiber Arrangement" (MFA), has deviated from the fundamental principles of the General Agreement on Tariffs and Trade (GATT), and developed countries that import textiles have imposed discriminatory quotas on developing countries that export textiles.

After long and arduous negotiations, the "Agreement on Textiles and Clothing" was reached during the Uruguay Round of GATT talks. The agreement finally brought the MFA into the GATT orbit again and enabled the gradual liberalization of international textile trade. The World Trade Organization (WTO) Agreement on Textiles and Clothing (the ATC) provides for the phased liberalization and elimination over a transition period of quotas on textiles and apparel imported from WTO member countries. The ATC went into effect on January 1, 1995.

Under the agreement, world textile trade was liberated in two ways. One is product integration, including the phasing out of Multi-Fiber Agreement (MFA) quotas and the acceleration of quota growth rates for products not yet integrated into the WTO is to occur over 10 years, in three stages. ("Integrated" products are those removed from the universe of textile products subject to MFA-type quotas.) [17]. The timing of the 3 phases and the percentage of trade that must be integrated, and the increase in quota growth rates for products remaining under quota are shown in Table 6.2.

The second way was by applying increased growth rates to quotas outlined in the bilateral agreements under the Multi-Fiber Arrangement. Under the ATC, the growth rates allowed under the bilateral will increase in three successive stages over the course of the 10-year transition period. For major supplying countries the growth rates will increase by 16% in 1995, an additional 25% in 1998 and an additional 27% in 2002. The following chart shows how the quotas will grow.

Because of its non-WTO member status, China has lost the benefit of the quota liberation under the WTO between 1995 and 2000. After becoming a WTO member in the near future, China could enjoy the quota liberation in the subsequent stages.

In addition to the benefit from quota liberation, if China were a WTO member, China could settle trade disputes under the negotiated trade rules of WTO, reducing the negative effect of the discriminatory rules which are produced by industrially developed countries. This would help China's manufacturers to compete with their foreign competitors in a fairer way.

**Table 6.2 Phases of trade integrated and increase to the quota growth rate**

	STARTING DATE	MINIMUM TRADE INTEGRATED	INCREASE TO THE QUOTA GROWTH RATE
Phase I	1/1/1995	16%	16%
Phase II	1/1/1998	17%	25%
Phase III	1/1/2002	18%	27%
Final Phase	1/1/2005	all restrictions are eliminated	

**Table 6.3 Uruguay Round quota growth rates**

MFA GROWTH RATES	PHASE I 16% increase (1995-1997)	PHASE II 25% increase (1998-2001)	PHASE III 27% increase (2002-2004)
1%	1.16%	1.45%	1.8415%
2%	2.32%	2.9%	3.683%
3%	3.48%	4.35%	5.5245%
4%	4.64%	5.8%	7.366%
5%	5.8%	7.25%	9.2075%
6%	6.96%	8.7%	11.049%
7%	8.12%	10.15%	12.8905%

However, some trading barriers, such as the rule of origin imports in the US market, discriminatory restrictions under a special safeguard provision (Protocol of Accession of China), regionalism in North America and enlargement of the EU, anti-dumping, and new products stands, will not be eliminated after join the WTO. These will still have an adverse effect on China's exports.

## **6.5 THREATS**

### **6.5.1 Restricted international trade space**

Serious trading barriers exist for the exports of Chinese denim products. For example, the export of Chinese made Women's/girl's trousers, breeches, skirt, and divided skirt denim made via a third country (area) to the US was restricted by the rule on the origin of imports in the US market. These were important categories that China exported. Alongside the rule of origin, other discriminatory rules have existed. The textile and apparel agreement with China for the years 1994-1996 provided for no quota growth in the first year and for 1-percent annual growth, on an overall trade-weighted basis, in the following 2 years. Many of the largest apparel items that China exports to the US were subject to individual quotas with even lower annual growth rates ranging from 0.2 percent to 0.5 percent. In February 1997, the United States concluded new agreements with China on textile and apparel trade. One agreement extended U.S. quotas on Chinese non-silk goods for 4 years through the year 2000. This agreement reduced quotas for products in which China had repeatedly violated quotas by transshipping through third countries, strengthened enforcement terms against illegal transshipments, and, as in to the 1994 agreement, allowed the United States to "triple charge" quotas for repeated violation of the agreement [18].

In the meantime the US restricted Chinese denim (textile) product exports to US, while NAFTA and CBERA countries enjoyed the US "special regime" and "special access program". Some types of apparel import from Mexico entered free of duty and quota and similar CBERA goods enter under preferential quotas but are still subject to duty on the value added offshore. Affected by NAFTA and special treatment to CBERA, China lost its important position in many textile categories exported to the US.

### **6.5.2 Competition from developing countries**

In recent years, in overseas markets, China's denim industry not only faces competition from the developed countries, but also from other developing countries such as Turkey, Mexico, and India. Turkey benefits from an agreement with the EU; Mexico enjoys its membership of NAFTA; India is a powerful denim products producer, with an advantage of low labor costs, who invested much on technology and research, in alliance with leading denim producers (CONE) and benefited from its membership of WTO. Mexico had one third of the US imported denim products market in 1995. With a growth rate of 42.8% per year, Mexico owned 50.2% of the US denim import market, while from January to November 1998 Mexico contributed 52.3% of the US imported denim market (Data sources: USA-STAT). Turkey occupied 3.2% of the EU import market in 1994, and this grew to 4.6% in 1997. In the same period, India's market share was increased from 0.3% to 0.6% in the EU import market (Data source: Statistical office of the European Communities). Meanwhile, China's market share declined from 0.9% to 0.6% in the EU import market, and decreased from 2.3% to 1.9% in the US market (Data source: USA-STAT).

### **6.5.3 Challenges in the domestic market**

Apart from the threat from the international markets, as Chinese government has operated an open policy continue since 1978, China has opened her domestic market step by step, and there has been a heavy threat from foreign competitors in China's domestic market which previously had been protected. More foreign competitors appeared in China's domestic market to compete with Chinese firms with their huge capital, sophisticate marketing experience, wide international retailing nets and famous brands. Chinese domestic manufacturers did not seem to be prepared for this threat from foreign competition.

### **6.5.4 Retail concentration**

Concentration in the US and EU clothing retail markets increased their bargaining power, and they asked suppliers for better service and reduced order sizes and delivery times. When other countries employed a quick-response strategy to meet the concentration in the US and EU clothing retail markets, China simply acted as a processor creating low value added products.

## SUMMARY

Summarized the above analysis, the Chinese denim industry had huge production capacity, a huge and growing domestic market, low labor costs and an abundant labor force. However, the industry was facing weakness internally and threat externally. Internally, China's denim industry has faced problems that reduce its competitiveness, such as low skill labor, low technology development, utilization and commercialization. Externally, the industry has been facing a number of serious threats: (1) stiff competition from other developing countries such as Mexico, India and Turkey; (2) the trade regionalisms in North America and Europe; (3) the concentration of the clothing retail industry in Western countries, which has increased buyer's bargaining power on price, order size and delivery time [6]. However, there were opportunities such as entry to the WTO to enhance its foreign trade space, its growing domestic market and the liberation of the cotton supply.

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