2 China's WTO Entry and its Impact upon the International Textile and Apparel Trade

2.1 COMPETITIVE POSITION OF CHINA'S TEXTILE AND APPAREL INDUSTRY

2.1.1 Historic review of the textile and apparel industry

China's textile industry emerged in the 1870s. However, continuous wars in the following years disrupted its normal development. Though the founding of the People's Republic of China in 1949 sent a positive signal to this labor-intensive industry, its fastest development was not achieved until the 1980s when government attention was shifted to economic construction and restructuring. In 1985, the industry was eventually included in the seventh "five-year plan" and, one-year later, it was selected as a priority industry by the State Council, hence entering a golden development period.

It is natural for China to choose the textile and apparel industry as the engine for economic takeoff due to its large labor force, relatively rich raw materials, and relating small capital and technology requirements. Table 2.1 shows the tremendous growth of the textile and apparel industry between 1978 and 1998.

With an average annual growth rate of 13.7%, textiles & apparel soon became a most important pillar industry generating almost one-fourth of foreign reserves from exportation. It has been the No. 1 textile and apparel exporter in the world since 1994. Between 1970 and 1998, China's textile and apparel exports grew at a rate five times faster than the world average level [39], amounting to US$ 43.1 billion in 1999.

However, the industrial performance itself is far less happy than its brilliant export achievement. The absence of appropriate planning, randomly repeated construction, a high percentage of outdated equipment and low efficiency have all contributed to today's loss-making situation. In 1996, the loss amounted to RMB10.6 billion with over 40% of the state-owned enterprises on the verge of bankruptcy [61]. Though great efforts have been made through strategic restructuring that started in 1998 and some positive results have been obtained, it still takes more time and inputs to completely solve these deep-rooted problems.

2.1.2 Competitiveness analysis of the Chinese textile and apparel industry

In view of China's huge output and export figures, no one will deny that China is a very important international player. However, if one considers the world's top fashion brands, none of the popular names originated in China, though many of them are actually manufactured in China nowadays. In world fashion circles, it is very hard to find either a top Chinese designer or a world-famous Chinese textile/apparel enterprise. China-labeled products are usually associated with a "cheap price" and

Table 2.1 Some facts about China's textile and apparel industry

China textile and apparel industry between 1978 and 1998		
	1978	1998
Cotton yarn (Million ton)	2.38	5.42
Wool knitting yarn (Thousand ton)	37.8	442
Cotton fabric (Million meters)	11030	24100
Wool fabric (Million meters)	89	268
Silk fabric (Million meters)	611	6390
Total textile and apparel exports (US$ bn)	2.43	42.8
Total textile and apparel imports (US$ bn)	0.2	12.15

(Source: China Customs; http://www.ctei.gov.cn/cteinew/english/fz.htm "China Textile Industry")

"street market" image. Thus, two questions must be asked: What is the competitive strength of China's textile and apparel industry that makes China the No. 1 exporter? And what is its competitive position compared with counterparts in the rest of world, especially those in the US, Italy and France that are the world fashion centers?

According to the Leeds Model, advanced by Peter Kilduff, who used seven factors to identify the different development stages in the textile and apparel industry, China's textile and apparel industry is now entering the third stage. [1] It features rapid growth in apparel exports and chemical fiber imports, increased vertical integration, a relatively large trade surplus and competitive advantages in the production of commodity products. In the view of Michael Porter's "Diamond Theory" [2], an industry's competitiveness is mainly determined by four aspects, including factor conditions, demand conditions, firm strategy and rivalry, and related/supporting industries. Analysis of these four aspects can give some insight into China's textile and apparel industry and help explain its dominant world position but "cheap label" image.

2.1.2.1 Factor conditions

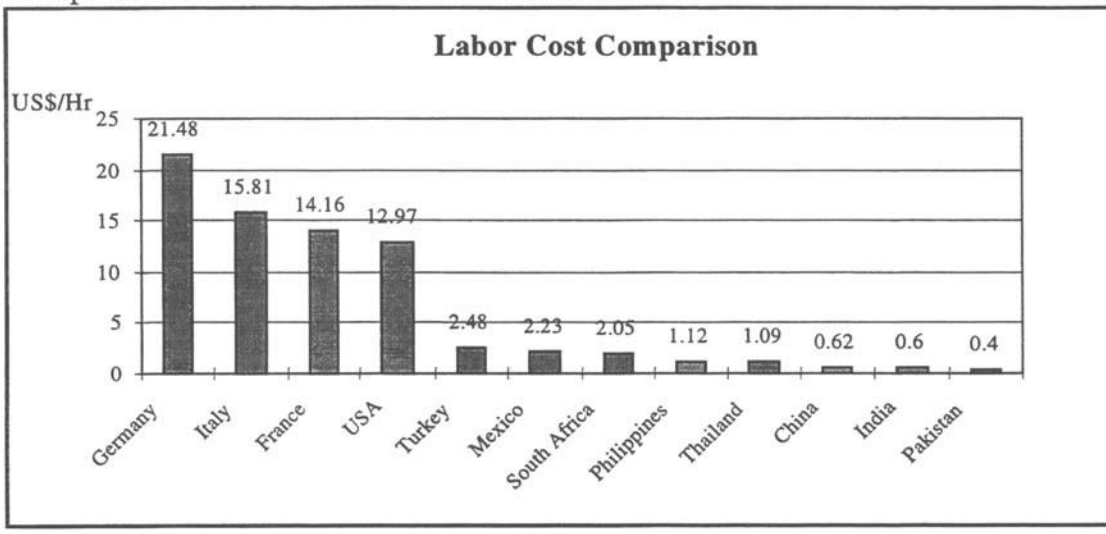
Production factors refer to the inputs required during the production process, including basic factors such as natural resources, land, labor (unskilled and semi-skilled), and debt capital as well as advanced factors such as high-tech, talented personnel, strong R & D capabilities and a technology-based infrastructure. [2]

A. Labor input

The quick emergence of the Chinese textile and apparel industry has largely been attributed to its low labor cost. According to a Werner International Inc. survey on labor costs in 1998, China ranked 52nd of the total 58 investigated countries.

Figure 2.1 shows that the labor cost in China is only 4.8% of that of the the US, 4.4% of France, 4% of Italy and 2.9% of Germany. Since the textile and apparel industry, especially the latter, is still labor-intensive in nature, this huge difference is by no means an insignificant factor for China's presence as a significant textile and apparel supplier in the world, especially concerning the basic products of low added value.

2.1 Comparison of labor cost in selected countries in 1998



(Source: Werner International Inc., from "Labor Cost Comparison", Textile Asia, December 1998, p77-82)

However, if one takes growth rate into consideration, the future prospect is not so optimistic. The labor cost in China increased by 230% from 1988 to 1998, surpassing India, Indonesia, and Pakistan in 1998. This increasing pace is much quicker than that of Mexico, the Philippines and Thailand. Therefore, though China has a distinct comparative advantage in labor cost compared with developed countries and most developing countries, the gap is being bridged very rapidly.

By sharp contrast to its abundant availability of unskilled and semi-skilled labor, China lacks qualified personnel with a higher educational background. Technicians in the textile enterprises only account for 2.7% of the sector's total work force on a nationwide scale, of whom those with master degrees account for 0.1%, with bachelor degrees 46.5% and with three-year college experience 53.4%. [3] Shanghai is a well-developed metropolis in China. Shanghai is a well-developed metropolis in China. The ratio of technicians to the total textile employment in Shanghai is 9.48%; however, it is still 5.41 percentage points lower than Shanghai average technician ratio.[4] The poor performance of the whole textile and apparel industry in the 1990s cast a grave shadow over the human resource situation. Take the former China Textile University for example. It is a multi-disciplined university well known for its strength in the textile field. But it has faced a dilemma during recent years. Top students are reluctant to apply for the university, partly due to its "textile" associations. As a result, the university had to give up the established name and drop the "textile" indication completely. Name change is easy but the implications are not desirable: with fewer students studying in this field, it is hard to build a strong and solid base of human capital to help sustainable development. This would be the largest loss for the domestic textile and apparel industry.

Lack of qualified managers is another problem. Managers used to think or act in a central-planning frame, and their decisions were not responsible for profits and losses. Promotion was based on seniority rather than qualification and capability. Though the situation has been improved, it is far less than satisfactory by market standards. The complex and unclear division of ownership and management further complicates the problems.

B. Resource input

In addition to the labor cost advantage, China is also relatively abundant in some natural resources if viewed in absolute figures. Cotton production in China during 1999/2000 amounted to 4.1 million tons, accounting for more than one-fifth of the world total output. [5] As regards cocoon and silk production, China holds a dominant share of about 70%. [6] There is also a rich supply of other natural resources such as wool, ramie and flax. At the same time, limited availability of arable land[1] has led to a rapid growth in the proudction of chemical fiber. China is now the No. 1 chemical fiber producer in the world. Though there appears to be no correlation between a nation's competitive advantage in natural fiber production and the success of its textile and apparel industry [7], the availability of some textile raw materials does lay a foundation for China to develop a comprehensive textile sector starting from fiber production.

However, if the above figures are viewed against population, China is actually a resource-scarce country. The insufficient market mechanism also constrains efficient distribution flows. The much higher domestic cotton price compared with the international level well explains this point. Though corresponding reform has been carried out since 1999, it takes time to establish a well-functioning market. On the other hand, large production capacity is not bound to bring about desirable results if it fails to realize high value-adding processes and/or leads to a reduction in quality. Thirty percent of chemical fibers consumed by the textile and apparel industry are imported from other countries every year despite the large domestic output. As regards domestic fabrics, a survey conducted by China Garment Association indicated that those used in apparel exports were only 45.18% in spite of the fact that the annual fabric output in China is 16 billion meters. [8] Table 2.2 illustrates the self-sufficiency rate of domestic fabrics based upon material type. The self-sufficiency rate for chemical-fiber fabrics is the lowest, indicating the poorest performance of this sub-sector. The main problems for domestic fabrics include high washing shrinkage, serious color differences and faults, poor hand feel, dull pattern styles and unsatisfactory development of new-type materials. Long delivery time has placed domestic suppliers in a more disadvantageous position when quick response has become more and more crucial in today's competition.

Table 2.2[2] Self-sufficiency rate of domestic fabrics in apparel production

Self-sufficiency rate of domestic fabrics in apparel production				
Fabric Type	Pure Cotton	Cotton Blends	Pure Wool	Wool Blends
Self-sufficiency rate %	70.47	74.40	77.59	83.14
Fabric Type	Silk	Flax & Flax blends	Chemical Fibers	Others
Self-sufficiency rate %	79.03	98.46	42.56	66.02

(Source: http://www.chinagarment.net.cn/m104.htm, [9])

[1] China has 22% of the world population but only 7% of the world arable land.

[2] The investigated enterprises totally used 13.8-million-meter fabrics.

Table 2.3 Comparison of textile machinery in China, Germany, Italy and US

Textile Machinery Comparison, 1996				
Nation	Spindles %		Looms %	
	Ring	Open-ended	Shuttleless	Shuttle
China	5.81	94.19	5.38	94.62
Germany	0.85	99.15	94.02	5.98
Italy	1.60	98.40	88.30	11.70
US	0.55	99.45	87.15	12.85

(Source: Taiwan Textile Industries Newsletter, Volume 6, Issue 9)

C. Capital, technology and equipment

Many countries once selected the textile and apparel industry as the priority industry to develop partly because of its relatively low capital and technology requirements. Nevertheless, Hi-tech, along with strong capital support, is now playing a more and more important role in product innovation and industrial upgrading.

In the ninth "five-year plan", the industry plans to invest RMB200 billion in fixed assets, of which RMB80 billion is for infrastructure and RMB120 billion for technological innovation. Considering that China is a capital scarcity country, such investment is by no means small. However, the weak technological foundation and a high proportion of obsolete textile machinery make these investments insufficient to upgrade the industry. The technology-content in pure fiber products is 38.8% in China; while it is 86.o% in Japan, 71.5% in the US and 61.2% in South Korea. [10] As regards present equipment, 25% of cotton spindles should be dismantled, with only one-third of the rest up to the level of the 1990s. [11] Only about 15% of wool spindles and 6% of dyeing and finishing machinery are up to the international advanced level. [12] Table 2.3 clearly shows that the ratio of shuttleless looms in China is much lower than that in other three countries. The overall technological level of equipment in China is 10 to 15 years lag behind the world advanced level. [63]

The heavy losses of the industry since 1993 make technological investment much more difficult. As a result, the technical upgrading in SOEs was only RMB1.75 billion in 1998, an 81.62% drop over 1997. [13] Low-level technology and outdated machinery can both be partly attributed to insufficient capital, a problem requiring fundamental reform in the capital market. For example, enterprises of different ownership still receive very different treatment as regards bank loans, which have usually favor state-owned enterprises regardless of market-based consideration. By contrast, while SOEs are enjoying "soft budget", private ones find it difficult to access capital through normal financing channels. Therefore, capital availability in China not only refers to absolute volume but also equal opportunity for enterprises to access.

D. Other important factors

Traditional comparative advantages such as labor cost and raw material availability have progressively lost their historic luster in today's global sourcing activities. According to Michael Porter, these generalized factors are easily imitated and acquired. The labor cost in some developing countries, including Indonesia and Pakistan, has been lower than that in China. Therefore, factors that used to help China achieve great success will promote others' rapid development as well. It is a location-specific advantage easily accessed and acquired nowadays.

Compared with their counterparts in well-developed markets, China's textile and apparel industry lacks strength in specialized factors such as productivity, intangible assets and product development, which greatly hinders the industry from moving upmarket.

In China, the advantage of low labor costs is partly offset by low productivity, which is only a fourteenth of the American, Japanese, Italian and German levels and a seventh of HK, Korea and Taiwan. [14]

While low labor costs have effects upon the final costs, they can be outweighed by other factors such as raw materials, capital costs, and other auxiliary expenses. Considering the production cost of 30-count cotton fiber in the US and China, it was US$ 3.60/kg in the US and US$ 3.47/kg in China [15], a difference which is not as significant as the labor cost differences.

China is a large textile and apparel supplier, but it is by no means a fashion center featuring historic-inherited fashion culture and sophisticated fashion consciousness, as is the case in Italy and France. Italy is considered a "Mecca" in the world fashion industry, well known for its design creativity, famous brands and superior quality. France is another world fashion center, having a great influence upon fashion and fabric trends. Among the world's top 30 fashion brands, Italy owns 19 and France has 7, while it is still a blank in China, no are any of the world's top fashion designers based in China.

2.1.2.2 Demand conditions

A. Urge domestic market

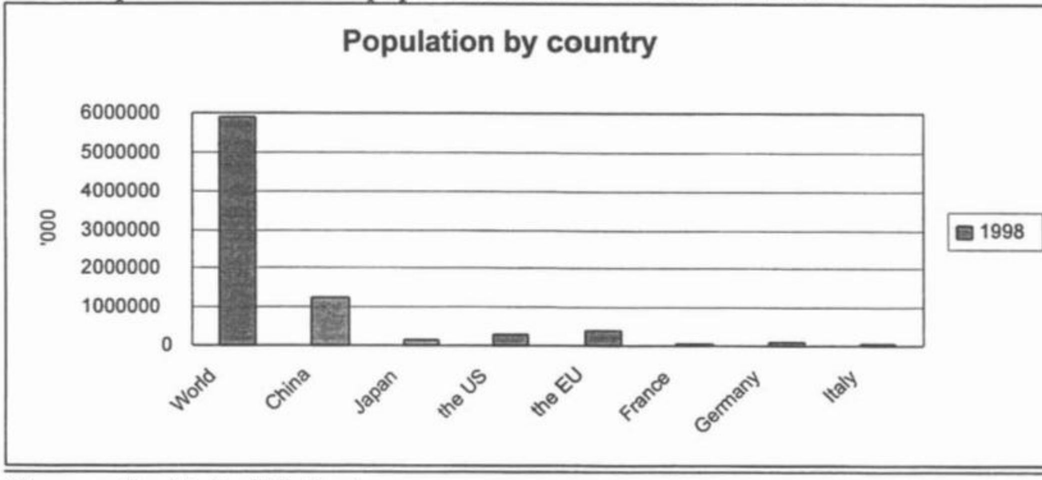
China's huge domestic market itself is a magnet. Its population is one-fifth of the world total population. The EU as a whole has only 30% of the Chinese population, not to mention the US whose area is just a little smaller than China. Figure 2.2 is a comparison of some countries' populations, including China, the US, Japan and some EU members. Thanks to the healthy and rapid economic development during the past two decades, Chinese consumers' interests in fashion items have been well developed, sending an exciting signal for domestic and foreign manufacturers.

At present, the fiber consumption per capita is only 5.5 kg in China, 2 kg lower than the world average level [6] and much lower than those in the US and Japan, According to some researches, when GDP per capita reaches US$ 1000, fiber consumption experiences a quicker growth. In 1998, GDP per capita in China was US$ 774. Therefore, if the economic growth rate is kept at 7-8%, it will only take four years for China to enter into a fast-growing period of fiber consumption. What's more, the vast territory, different peoples and unbalanced regional economic development all render a unique opportunity for textile and apparel enterprises to establish market niches and promote a large variety of products.

B. Customer sophistication level

The upmarket image of Italian and French counterparts can be partly attributed to their sophisticated and demanding consumers. Their sensitivity to fashion trends and critical requirements for quality place heavy pressure upon textile and apparel manufacturers to pursue technological innovation. The strong fashion culture has cultivated an ideal atmosphere for consumer development. By contrast, Chinese consumers were almost "fashion illiterate" before its adoption of an open-door policy before 1978. For a very long time, textile and apparel items were mere living necessities. Though the situation has changed a lot, especially in some big cities, Chinese consumers as a whole lack fashion education as well as self-protection consciousness.

2.2 Comparison of Chinese population with some other countries



(Source: the United Nation)

China is still a developing nation with about 80% of its population living in the countryside. Low income means that the textile and apparel market is still price-sensitive. Though brand-consciousness is spreading in some coastal regions and big cities, those in the vast hinterland are still focusing upon the basic functions of textile and apparel products. According to a nation-wide survey conducted in 1997 by the State Statistical Bureau[3], price is the most important factor in apparel purchase (30.3% of the interviewees chose this factor), followed by "fitness and comfort" (24.2%), "durability" (20%), "good looks" (12.9%), "personality embodiment" (5.8%), "high grade" (1.6%), "brand" (1.6%) and "fashion" (1.3%). [16] This survey partly reflects the fact that customer sophistication is still relatively low in China. The fact that the self-sufficiency rate of domestic fabrics for local-sale apparel is as high as 90.3% also supports the above argument.

Low consumer sophistication also lies in imperfect government regulation and consumer's lack of self-protection consciousness. The Law of Consumer Interest Protection was not enforced until the year 1994. At the same time, consumers endured a seller's market for a very long time and, they haven't yet developed the necessary knowledge to protect their own interests. What's more, even if they finally decide to take steps to address the problem, they would have to find and collect proof by themselves and pay all the relevant costs at their own expense. High complaint costs and complicated processes prevent domestic consumers from being demanding and knowledgeable.

In short, China is not short of consumers, but it badly needs educated and selective consumers who can push and inspire the manufacturers to innovate and develop.

C. Segment structure of demand

China is a big country with distinct regional economic and cultural differences. It is by no means a single market. Table 2.4 shows the different GDP per capita of selected cities and provinces in 1996.

The economic development imbalance leads to varied consumer demands. On the one hand, the low-/middle-grade products remain the most popular. (See Table 2.5) On the other hand, citizens in the coastal regions and big cities with more disposable income and frequent exposure to the outside world have developed a taste for fashion products. Entry of foreign brands further cultivates brand consciousness and pursuit. Though the market is still small, it has a great potential to expand.

[3] This sample survey was conducted in 72 cities, targeting 15,600 households.

Family planning policy in China makes parents place most of their attention on their son or daughter, trying to give the best to the only child in the family. Therefore, babies' wear and children's wear have become fast growing segments.

Another point worth mentioning is the rising demand for home and technical textiles. Though home and technical textiles are still undeveloped in China (Table 2.9), they are new growth areas in the future.

D. Size and growth rate of home demand

In view of China's population, which was 1.248 billion in 1998, the domestic market demand is really huge. From 1989 to 1998, the average growth rate of apparel retailing volume in China was 1213.0%. The first five years of the 1990s experienced the strongest growth momentum, reaching an average growth rate of 20.4%.

Table 2.4 GDP per capita in selected cities and regions in 1996 (units: RMB)

Coastal Region	GDP per capita	Central Region	GDP per capita	Western Region	GDP per capita
Beijing	16735	Henan	4430	Shan'xi	3707
Shanghai	25750	Anhui	4390	Sichuan	4029
Shandong	7590	Hubei	5899	Gansu	3137
Zhejiang	10515	Hunan	4643	Qinghai	4066
Guangdong	10428	Heilongjiang	7243	Guizhou	2215

(Source: Almanac of China Statistics 1998)

Table 2.5[4] Information from some large department stores

Apparel Sales in Beijing, Shanghai, and Tianjin Department Stores with over 100 Million Sales Volume			
	Men's Shirt	Men's Suit	Womenswear
Low-grade (%)	54	54	75
Middle-grade (%)	32	30	19
High-grade (%)	14	16	6
Average Sales Price (RMB)	117	645	263

(Source: State Information Center, from [65],)

[4] The division standards are as follows: (units: RMB)

	Man's shirt	Man's suit	Womanwear
Low-grade	<150 (Beijing) <100 (Shanghai, Tianjin)	<1000 (Beijing) <500 (Shanghai, Tianjin)	<400 (Beijing)
Middle-grade	150-250 (Beijing) 100-200 (Shanghai, Tianjin)	1000-2000 (Beijing) 500-1000 (Shanghai, Tianjin)	400-800 (Beijing)
High-grade	>250 (Beijing) >200 (Shanghai, Tianjin)	>2000 (Beijing) >1000 (Shanghai, Tianjin)	>800 (Beijing)

2.3 Growth rate of China's apparel retailing volume between 1989 and 1998

(Source: [16])

Income is still the key factor affecting textile and apparel expenditure since its demand elasticity is much higher than other categories such as food, transport and education. The actual income growth rate slowed to 3.4% in 1996 and 1997 while it was about 8% before 1995. At the same time, expectation of more expenditure on housing, medical care and education, as well as concerns about retirement life as the new social welfare system takes shape, all contributed to an anticipation of a drop in actual disposable income. Taking Shanghai as an example, apparel expenditure reduced from 9.6% in 1995 to 6.9% in 1998, while expenditure on medical services, education, entertainment, and residence increased from 16.1% to 25.7%. [66] Figure 2.3 also shows that the average growth rate of apparel retailing volume slowed to 7.1% between 1996 and 1998.

E. Distribution network

A sophisticated and well-functioning distribution system may render an additional stimulus to competitive advantages, since it puts manufacturers under intense pressure to enhance the products' quality. [7] Though efforts have been made to reform this sector in China, it still remains insufficient at present.

Prior to the 1980s, wholesale and retail businesses were monopolized by sate-run enterprises. The centrally-planned multi-tier distribution hierarchy operated as an allocation machine, rigidly separating the production sector from the distribution sector. Producers were extremely insensitive to the market changes. The textile and apparel production enterprises were neither responsible for the market demand nor concerned with the marketability of their products. The only thing they cared about was producing the planned quantity of planned goods within a scheduled time period. The wholesale and retail enterprises were also under strict central planning, merely acting as storage facilities for commodities rather than as active market players.

In 1978, China began to achieve rapid economic growth and gradually introduced a market mechanism to direct economic development. The problem of commodity shortage was alleviated in many industrial sectors. In 1983, ration coupons for fabrics and garments were abolished and, later, textile and clothing enterprises were given full autonomy to distribute their products. [17] At the same time, with the distribution door progressively opened to the outside world since 1992 (See 2.2.1.2), foreign counterparts began to make their presence felt in the domestic market. Many of the world's top brands as well as regional brands, having perceived the huge potential market, rushed to China to open their own retail outlets--which is also an effective way to circumvent the high import tariff and other import restrictions. Hot competition led to rapid market cultivation and development, particularly in the urban area. After 20-years of progressive reform, the distribution system has undergone remarkable changes. Major players in this sector include state-run department stores, foreign-funded/foreign-managed department stores, speciality stores, franchise stores, textiles/garment trade markets, and so on. Many textile and garment production enterprises are now actively engaging in retail and wholesale activities through vertical integration or other approaches in order to gain a better insight into the changeable market and consumer demand.

Despite the progress made in recent years, domestic distribution systems are still inefficient due to their malfunction for such a long time. They lack the necessary resources, such as capital, expertise and qualified personnel, to compete with the foreign enterprises. Though current liberalization in the wholesale and retail sectors is conducted on an experimental basis and subject to various restrictions, such as geography confinement and equity limitation, foreign entry has posed great challenges to their domestic counterparts.

State-run department stores occupy a key position in the distribution channels, but their problems are the most serious. Most of these stores, which enjoyed state protection and preferential treatment during past decades, failed to adjust to the new circumstances. Many still think that marketing is equivalent to selling products. In spite of the eye-catching slogans advocating that consumers are vital for a store's survival, they in fast act in the reverse direction. Therefore, the most important thing for a real change is to drop obsolete practices and cooperate closely with production enterprises based on strategic partnerships rather than the present weak and loose relationship[5]. Success of distribution reform does not necessarily depend on the capital input. It hinges upon a market-oriented attitude and an international-oriented vision of competition. In this sense, the distribution network in China is still far from maturity.

2.1.2.3 Firm strategy and rivalry

A. SOE in the textile and apparel industry

China adopted a planned economy for a long time with state-owned enterprises (SOEs) as the major players. With the establishment of a market economy, many township and village enterprises (TVEs) entered the competition arena, together with foreign-invested enterprises. Table 2.6 indicates that in 1998 SOEs account for 23.1% of the total textile enterprises, and they generate almost one-fourth of the total added value and industrial output value. The apparel sector provides a different picture, with SOEs only accounting for 9.3% in terms of enterprise number and less than 5% of total industrial added value and output value.

SOEs were once the sole players in the domestic market, facing little or no competition. They themselves weren't even concerned about their own profits and losses, both of which were under administrative control. The soft budget problem, lack of effective competition and incentives, government interference, rigid organizational structure and serious agency problems resulted in an unreasonably high debt/asset ratio, low capital utilization efficiency and poor management. Moreover, they have been over-burdened with too many responsibilities, such as pensions,

[5] Current practice of most state-run department stores is unfair for the production enterprises or sub-retailers who assume all the operational risks. Those stores just act as renters and take almost no risks.

Table 2.6 Economic indicators of China textile and apparel industry in 1998

Some Economic Indicators of the Textile and Apparel Industry									
Sector	No of Enterprises			Industrial Output Value			Industrial Value-added		
	Total	SOE	%	Total	SOE	%	Total	SOE	%
Textile	11276	2600	*23.1*	437.6	105.6	*24.1*	101.7	25.1	*24.7*
Fiber Processing	989	183	*18.5*	27.7	3.5	*12.6*	6.6	0.7	*10.6*
Cotton Textiles	4682	1261	*26.9*	223.0	73.6	*33.0*	52.2	17.5	*33.5*
Wool Textiles	1161	274	*23.6*	54.4	7.7	*14.2*	12.4	2.1	*16.9*
Linen Textiles	284	114	*40.1*	8.6	3.0	*34.9*	2.4	0.8	*33.3*
Silk Textiles	1732	369	*21.3*	60.1	12.0	*20.0*	12.7	2.6	*20.5*
Knitting	2018	351	*17.4*	51.4	5.0	*9.7*	12.6	1.1	*8.7*
Other Textiles	410	48	*11.7*	12.3	0.9	*7.3*	2.9	0.2	*6.9*
Apparel	5856	543	*9.27*	176.1	7.8	*4.4*	42.5	2.0	*4.7*
Chemical Fiber	803	176	*21.9*	82.7	14.5	*17.5*	18.5	2.6	*14.1*
(Unit: Billion RMB)									

(Source: http://www.ctei.gov.cn/cteinew/tongjixinxi/tjhome.asp, retrieved in November 2000)

medical care, and even housing. Though social welfare reform has been carried out, it will take a very long time to establish an improved social security system.

Corporatization has been a very popular trend for SOE reform recently, aiming to ultimately separate government functions from daily business operation, clarifying long-confused ownership/management relations, and providing a platform on which SOEs can act in a real market manner. The reform package is comprehensive, but whether it will achieve the anticipated result is still a matter of uncertainty. Since the textile and apparel industry has been chosen as an experimental sector, the final result is crucial to future SOE reform and government policy orientation.

B. Market competition

Chinese enterprises were subject to central planning for a very long time. The market itself was neglected in the decision-making process. SOEs were once the dominant players with little competition from other types of enterprises. Table 2.6 also shows that the proportion of non-SOEs in the textile and apparel industry has far exceeded that of the SOEs, especially in the apparel sector. Quick emergence of aggressive township and village enterprises (TVEs) as well as private and foreign-invested enterprises has greatly strengthened local rivalry, forcing the SOEs to be more market-oriented, especially when they lost privileges in many aspects and had to compete with other enterprises on a relatively equal footing. More and more enterprises began to realize the significance of quality and brand building. According to statistics released from the China Commercial Information Center, local brands occupied the first places in the men's suit and shirt market, taking 23.9% and 22.1% of the market share respectively in October 1998. [18][6]

However, domestic competition is still mainly limited to price wars and simple imitation, despite these positive results. Due to blind quantity expansion, the market is flooded with low-quality and low-grade mass products, many of which are unmarketable. In addition to weak competitive strength, domestic competition is not great. Commercial credit is continuously worsening among many enterprises. The inefficient distribution channel for raw textile materials makes domestic prices incompatible with international ones, placing extra cost burdens upon spinning and weaving mills and complicating the non-competition issue. For those enterprises that

[6] Man's Suit: Shanshan, Younger; Man's Shirt: Younger, Kaikai

are export-oriented, quota issues and foreign trade rights cause additional problems, such as rent-seeking. In view of the bid prices for the 21 quota categories in 1999, quota prices accounted for 10 to 30% of the export price.[7] Competition for quotas of hot-sale items is really heavy, driving their prices unreasonably high. Some enterprises even sold their quotas instead of actually using them for exportation, because this would make them a fatter profit. The other specific issue is about import and export rights. Many production enterprises still don't have the right to export their products and import some raw materials (See Section 1.2.5), artificially making them insensitive to changes in the international market and causing difficulties in adjusting their production schedule correspondingly. However, relaxation of foreign trade rights in recent years has negative consequences as well if it is not guaranteed by other effective administrative and legal measures at the same time. Take silk garment exports for example. In 1993, the average export price for a silk garment was US$6.1, which dropped to US$5.1 in 1994 because of blind expansion and a vicious price war. [19] It was only about one-tenth of the price of similar Italian products and one third of the Korean counterparts. It can be said that the reputation of Chinese silk products is destroyed by domestic enterprises themselves.

C. Firm size and strategy

Most domestic textile and apparel enterprises operate on a very small scale with limited capital and weak R&D capabilities. According to a survey on denim enterprises in 1995 sponsored by the former China Textile Council, those with one dyeing and sizing line accounted for 66.4% of the total investigated enterprises and those owning three or more lines only held 9%. Compared with some international players, domestic large enterprises find it hard to compete as regards annual output, sales volume and net profits. For example, Levi Strauss & Co. employed 1300 at its San Francisco-based headquarter and another 17000 worldwide[8]. In 1995, its net sales reached US$ 6.7 billion with a net profit of US$ 734.8 million. [20]

While foreign competitors attach great importance to strategic management, such as quick response (QR), merger & acquisition (M&A), global sourcing and relocation, many domestic companies are satisfied with gaining quick returns at the expense of long-term planning.

Unlike those in Italy which place emphasis upon product differentiation, most enterprises in China still act in an arbitrary and random manner. Lack of qualified managers with vision has not helped the situation. Moreover, upstream and downstream enterprises still stick to their own territories, lacking positive cooperation among individual links. The picture is quite different in some developed countries. For example, 65% of the local textile enterprises in the US have joined in the QR system. The Levi Strauss & Co. once declared that they could accept either an order for 100,000 pieces or 100,000 orders for one piece each. Italian firms are now looking for partnerships and strategic alliances. HdP recently purchased Valentino for around US$300m. In addition to M&A, banks now play a role in this industry to provide strong capital support, particularly instant liquid assets. The Union Bank of Switzerland (UBS) recently acquired 29.1% of the Turin sports fashion manufacturing group Basic (Kappa and Robe di Kappa). [67] There are also mergers and acquisitions in China, but most were propelled by political factors rather than by business considerations, such as realizing economies of scale or economies of scope. The most

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[7] "Evolution of international textile trade system and the effects of WTO entry upon China textile exports", by Wang Shouwen (head of Quota Allocation Office in the MOFTEC), during a seminar on "WTO and China Economic Development Strategy"

[8] http://www.levistrauss.com, retrieved on August 24, 2000

common practice is that a well-managed enterprise is required by the local government to merge with a debt-ridden one in the hope of maintaining employment and stability, regardless of whether the former is willing or not. It is certain that such a forced match is unlikely to bring about economic benefits and much worse, it may involve the profitable enterprise in a very difficult situation where it begins to lose money.

As regards export-oriented enterprises, many turn to the processing trade which requires less capital and technology and is almost risk-free. In 1998, the processing trade value was US$ 18.9 billion, accounting for 46.8% of the total export value. [21] There is no denying that the processing trade contributed much to the industry's rapid development. But over-reliance is harmful to creating the industry's own competitive strength. It does save money and effort to make clothes by using foreign fabrics and brands. But, in the long run, China will fail to achieve industrial upgrading and be unable to share the biggest profits out of the whole value chain.

All in all, the strategy most domestic enterprises choose to compete with is shortsighted, unable to create long-term competitiveness and secure a healthy growth. Other political and economic factors, such as government over-interference, less familiarity with market rules and lack of specialized factors also restrain strategy formulation and development.

D. Investment climate

China's huge market is itself a magnet attracting foreign direct investment (FDI). Preferential treatment and government policies, such as tax exemption and half reduction during the previous five years, further contribute to the increased foreign capital inflow. In view of the easy entry and the comparative advantage of cheap labor, the textile and apparel industry has been a popular FDI destination. Table 2.7 shows the significant role of FIEs, especially in the apparel sector in which FIEs accounted for about a half of the sector's total added value, sales volume, profit and collected taxes.

HK is the No.1 investor, accounting for 74.3% of the total foreign investment. The traditional textile bases in the east coastal region attracted 93.9% of the foreign capital due to its comprehensive advantages in economic development, infrastructure, and investment environment.

It should be noted that future FDI will be channeled into certain priority fields under the revised "Guiding Directory on Industries Open to Foreign Investment" which divides the foreign-invested projects into four categories: "Encouraged", "Allowed", "Limited", and "Prohibited". As regards the textile and apparel industry, the following sectors are encouraged to attract foreign capital to promote development:

-Raw materials of chemical fiber which provide of economies of scale;

-Hi-tech chemical fiber products which are domestic-absent or in urgent need;

-Technical textiles with chemical fiber as the major material;

-New-type textile machinery & parts; computerized control systems;

-Dyeing & post-finishing projects aiming to develop high-grade fabrics

Table 2.7 FIE in China textile and apparel industry

Analysis of Foreign-invested Enterprises in the Textile and Apparel Industry

Unit: %

	Number	Value-added	Total Asset	Sales Volume	Profit	Tax Collection
Textile*	16.42	20.28	18.81	17.88	#1	12.76
Apparel	29.81	50.02	47.91	50.81	56.66	50.30
Leather, Fur, Down & related products	24.01	51.23	46.45	54.14	32.00	33.59
Chemical Fiber	27.23	10.02	15.06	12.65	#2	10.23

*: Not include the chemical fiber sector

#1: The whole industry suffered losses of RMB4.13 billion; while FIEs had a profit of RMB793 million

#2: The whole industry had a profit of RMB4.6 billion; while FIEs suffered losses of RMB27 million

*All the figures in the table are proportions of FIEs to their corresponding sectors in terms of enterprise number, added value, total asset, sales volume, profit and collected taxes. (Source: the Third Industrial General Survey in 1995, [68])

2.1.2.4 Related and supporting industries

An industry will not be internationally competitive without the strong backup of its related and supporting industries. The "textile complex" extends the traditional concept into new downstream industries, such as the car industry, the medical industry and the decoration industry. However, the domestic textile complex is in its preliminary stage with only 30% of the fibers consumed in these technical and home fields. (Table 2.9) Its related and supporting industries are also not in a strong position to enhance the industry's competitiveness, though the industrial system is relatively comprehensive.

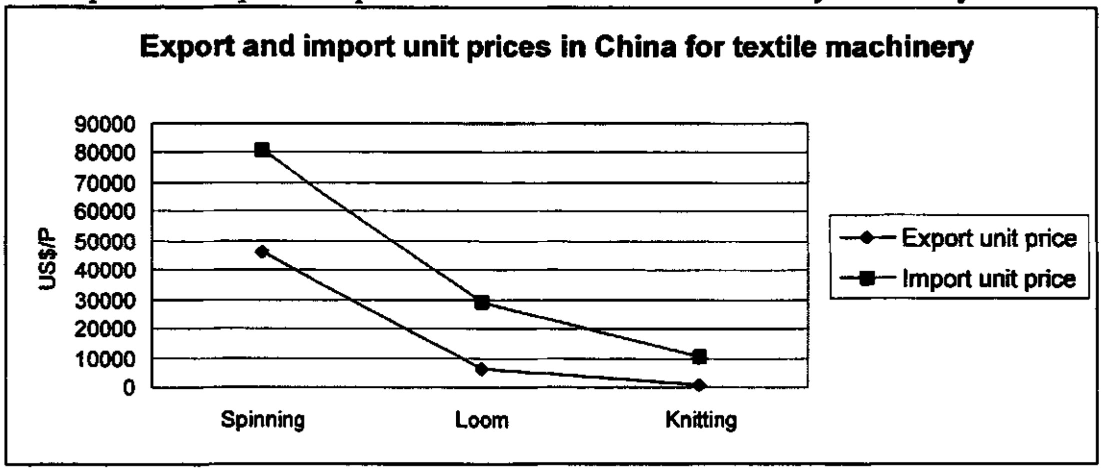
A. Related industries

The textile machinery sector is the major related industry, which lays a foundation for the production of high quality and high value-added textile items. The technological content of its textile machinery production partly reflects a country's engineering and innovation level. Though the sector in China has undergone some significant changes due to relatively heavy investment in certain sectors such as spinning and weaving, its overall position in the world still lags behind the European developed nations with a technological gap of 10 to 15 years. [22] A comparison of the average import and export price in Figure 2.4 clearly illustrates the lower technological content of China-made textile machinery. It shows that while the price difference between spinning machinery imports and exports was less than two times, those for looms and knitting machines were widened to 4.5 times and 23 times.

There are about 2000 textile machinery factories with an annual output value of RMB 10 billion. [23] By the end of 1997, about 50 foreign-invested textile machinery enterprises had been established in China, with a total capital input of US$ 100 million. [23] Constrained by a lack of the necessary expertise and R&D efforts, about two-thirds of the textile machines used in China are imported. [24] The export value is much lower than the import one. In 1998, China imported US$1,166 million worth of textile machinery, almost 7 times as much as the export value.[9] As regards textile machinery exports from China, 28% were spinning machinery, 7% weaving

[9] http://textile.unet.net.cn/imp-exp98.html, retrieved in July 18,1999

2.4 Export and import unit prices in China for textile machinery in January 2000



(Source: calculated based on data from Textile Asia, April 2000, p67)

machinery, 10% knitting machinery and others 55%. [22] The major export destinations are developing countries. Sewing machine production is of some strength in China. In 1999, the production output reached 10 million, of which 60% were exported to over 100 countries, accounting for about 34% of the world total exports. [25]

The technologically weak textile machinery sector can not meet the production requirements for high value-added quality textiles, forcing many textile mills to rely on imported machinery. Take shuttleless looms as an example. Domestic output was 12000 sets between 1991 and 1995, while those imported in 1994 alone amounted to 6500 sets. [22] In 1996, about a quarter of world total shuttleless loom exports were destined for China, of which Rapier/Projectile accounted for 29.2%, Air Jet 18.1%, and Water Jet 21.3%. [10] The proportion was raised to 28% in 1999. [26] Of all the imported machinery, finishing machinery accounted for about 22%, followed by spinning machinery 21%, knitting machinery 20%, weaving machinery 17%, MMF machinery 10%, and others 10%. [11] Japan, Germany, Italy and Switzerland were the major suppliers, representing 29%, 17%, 12% and 5% respectively of China total textile machinery imports in 1994. In 1999, China imported about DM 424 million worth of textile machinery from Germany, accounting for about 7% of total German exports. [27]

Since China is now dismantling obsolete spindles and enhancing control over the production of spindle frames, this will negatively affect the textile machinery industry whose focus is upon the spinning segment. In 1998, the industry suffered a loss of around RMB 100 million, making technological upgrading and innovation much more difficult. [28]

Based on the above analysis, it can be concluded that the textile machinery sector in China has failed to provide solid support for the necessary industrial upgrading in the textile and apparel industry, greatly limiting its capability to manufacture high value-added items. This is not the case in some developed fashion nations, such as Germany, Italy and France, whose textile and apparel industries have benefited a lot from their strong textile machinery sector. The German textile machinery industry holds a leading position in the world market with a share of more than 30%, followed by Japan 21%, Switzerland 11%, and Italy 11%. [29] France was the fifth largest

[10] Calculated based on data from [82]

[11] They were 1995 data from [83],

worldwide. [30] In 1997, the production of textile machines and accessories in Germany reached DM 8.5 billion, of which 93% were exported to other markets. As regards Italian and French textile machinery, about 65% and 85%[12] respectively of the turnover are destined for other countries. All of these nations attach great importance to R&D, product quality, customer service and technical innovation, which are the weakest fields in the China textile machinery industry which will take much time and effort to catch up.

Other related industries may include the press, exhibitions and models, all of which are still in the infant stage. The press industry fails to cooperate closely with the textile and apparel industry. Up to now, there are no textile and apparel-related newspapers or magazines of regional or world influence in China. As regards textile and apparel trade shows and exhibitions, China still has a very long way to go, especially compared with those held in Germany, France, Italy and the US. For example, Interstoff, held in Frankfurt, Germany, is considered one of the most important and largest international textile trade shows. It consists of 6 textile fairs each year, attracting more than 1,000 exhibitors from over 40 countries and 25,000 visitors. Premiere Vision, held twice a year in Villepinte, near Paris, draws more than 44,000 attendees from around the world. Others include Ideacomo held in Como, Italy; Texitalia held in Milan, and New York; Interstoff/Asia in HK; the International Fashion Fabric Exhibition in New York; the LA International Textile Show; and the Textile Association of Los Angeles Show, etc.

B. Supporting industries

Supporting industries refer to the transportation industry, information industry, communication industry, financial industry and so on. China has invested heavily in the infrastructure and communication facilities. The number of telephones is growing at an annual rate of 19.9%. There are 60 earth satellite stations accelerating communications with more than 200 countries and regions. The founding of the Securities Exchange in Shanghai and Shenzhen provides a good channel for domestic enterprises to raise funds. The newly emerged information industry has laid a basic foundation for the information era.

Despite the rapid growth rate of these industries, they are still not strong enough to support the textile and apparel industry due to their previous weak foundation. Take the stock market, for example; the imperfection of laws and regulations, the over-speculation of most investors, the immaturity of the market itself and the ignorance of many listed companies towards the market mechanism resulted in many problems, greatly discounting its original role.

C. Lack of a textile cluster

In the strict sense, the textile cluster has not yet been formed in China in view of its present low economic level and the weakness of the individual industries concerned. Some specific examples in Italy, France, Germany and the US may provide a deeper understanding of the weak synergies among domestic industries and the big gap with these international players.

Backed by centuries-old specialization, the Italian textile industry gains great momentum from sophisticated and advanced textile clusters. [31] Several of them can be identified in northern Italy: the cotton cluster of Brescia; the wool clusters of Biella and Prato; the knitting clusters of Carpi and Modena and the printing cluster of Como. Consider the wool cluster of Biella, for instance. About 2000 interdependent woolen companies are supported by 200 textile technology firms, a fair trade organization

[12] CHINA TEXTILE & APPAREL, 8/9,1999; Textile Asia, March 1999, p30

(Idea Beilla), a specialized magazine, and a research and development center (Texilia). The PV International Fabric Exhibition held in Paris, which is called "the first visual exhibition", is the world's leading fabric fair. It renders solid support for the promotion of French fashion items. The German textile industry has benefited great from the strong textile machinery industry. The US textile industry has also gained synergy from its suppliers. BASF is the global leader in nylon. Technological breakthroughs from the chemical giant "Du Pont", such as nylon in 1938, Dacron Polyester in 1950 and Lycra Spandex in 1960 which successfully replaced silk, wool and rubber respectively, have blazed new roads for domestic textile and apparel industry.

2.1.2.5 Strong government support

The rapid increase of Chinese textile and apparel exports during the past two decades can be largely attributed to the big changes in government policy since the 1980s. This shifted from a heavy industry orientation to a light industry orientation, from inward looking to outward looking, from central planning to market-based, and from SOE predominance to co-existence of diversified ownership forms.

Though the central government is now trying hard to enhance macro-economic control rather than over-interference in the micro-economic operation, the current political and administrative systems determine that active government support is still very crucial to an industry's future development. Some measures may have dual effects and even obstruct productivity improvement, but strong policy support from the government is indispensable when the textile and apparel sector is now undergoing painful structural adjustment and when China is still in the transformation process from a planned economy to a market economy.

Policy support at the present stage includes a compensation scheme for spindle elimination, asset re-arrangement, debt write-off and conversion into shares, export quota allocation reform, increase of the export rebate rate, and so on. Most of them aim at SOE reform, which is arguably the single most important issue upon which China's economic future hinges. [32]

Compensation scheme for spindle elimination

The first step is to eliminate 10 million obsolete spindles and lay off 1.2 million employees by the year 2000. [11] To overcome the immediate difficulties textile enterprises may face from the industrial restructuring, the government will offer capital guarantees by offering the firms RMB3 million in subsidy and RMB2 million in interest-free loans for every 10,000 spindles removed. [12, 33] As regards the lay-off, the government will provide guarantees for their minimum living expenses, usually ranging from RMB180 to 220 per month for three years. [34]

Asset rearrangement

Merger, acquisition and bankruptcy are employed to realize asset reshuffles. The domestic textile and apparel industry features high fragmentation, small scale and outmoded management. Asset rearrangement is designed to readjust the structural form of enterprises in the manner of capital flow, thus leading to the optimization of the asset reallocation. In view of the ninth "five-year" plan, it is now placing its focus on the establishment of 50 large-sized group enterprises and the development of collective and private entities.

Some enterprises with strength have been transformed into corporations and listed in the stock market. In 1996, 58 textile enterprises were listed in the stock market, attracting RMB8 billion. In 1998, five listed textile companies underwent asset reshuffle to replace the bad assets with good ones, successfully expanding their business into new lines such as home/technical textiles. [69] This move helped these enterprises expand into new textile-related fields with a better capital structure. The future trend for SOE reform is to transform more enterprises to corporations with private capital playing a more important role. The state will not be a controlling shareholder except in some strategically important sectors.

Debt write-off and conversion into shares

In 1997, RMB9.73 billion was earmarked to write off bad debts for state-run textile enterprises. In 1998, the government set aside another RMB12.6 billion, focusing upon the bankruptcies of debt-laden companies. [11] This step helped to decrease the loss of the textile sector by RMB2.6 billion, reducing the asset-debt ratio of these enterprises from 77% to 73%.

Another new idea is "converting debt into equities". The Shandong Ru Yi Wool Textiles Group signed an agreement with two asset management companies [13] recently. After debt conversion, these two companies will hold 43% of the equities and the debt/asset ratio will reduce from 78% to 58%, saving RMB22 million financial expenses every year.

In 2000, China plans to convert RMB 15 billion to stocks in 50 textile enterprises in the hope of reducing the debt/asset ratio by 3 percentage points. Moreover, through merger and a bankruptcy and debt write-off of RMB 15 billion, it is expected that the debt/asset ratio could be lowered by another 3 percentage points. [70]

Preferential loan and export credit arrangement

Banks provide a financial package of exporter's credit to those having import and export rights. For example, the Export and Import Bank signed an agreement with China Textile Machinery Co., Ltd. (CTM[14]) in March, 1999 for an amount of US$181 million, designed to support the company's exports. Banks also extend loans with lower and favorable interest rates to ease the financial burden of the debt-laden industry.

Export quota allocation reform

Under the quota allocation reform, enterprises will no longer own fixed "life-long" quotas. There are now three ways of quota allocation: open tenders, open application and performance-based allocation. [35] The first of these was introduced in 1998 in 21 textile product categories, which are usually hot sale items. Relevant quotas are to be sold in a bidding process through which bids are submitted simultaneously by facsimile and mail. The deposit required of the first 10% of winning enterprises has been raised from 30% to 80%. As regards quotas with a utilization rate of less than 50% in previous years, which covers 98 product categories in 2000, quotas are open to the enterprises on a first-come-first-served basis. The remaining quotas are allocated based on actual export performance of individual enterprises during the previous year, of which 30% are allocated to manufacturing plants with autonomous export rights in 2000, 10 percentage points higher than in 1999. [36] At the same time, MOFTEC has entrusted China International E-Commerce Net (CIECNET) to develop a feedback system to effectively evaluate the quota usage level. Those who fail to utilize over 30% of their purchased quota for the current year will be completely disqualified from participation in future auctions and those whose quota utilization rate is below 70% will not be allowed to bid for the same categories in the following year. [37]

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[13] China Oriental Asset Management Company and China Hua Rong Asset Management Company

[14] CTM is the largest state-owned textile Machinery Company in the country and one of the 120 pilot enterprises chosen in a trial program to be restructured into conglomerates.

Change of the export rebate rate

The export tax rebate is among the few permitted by the WTO as long as they do not exceed the actual tax imposed upon the exported products. China has simplified its present export rebate system to four levels: 5%, 13%, 15% and 17%. Textile machinery and apparel export rebate rates were raised to 17% in 1998. The export rebate rate for Xinjiang cotton also rose to 17% in order to encourage export of domestic cotton. From January 1, 1999, the export rebate rates for other textile raw materials and products have been increased to 15% in the hope that this will stimulate the current dull textile export scene due to cost reduction.

Some of the measures discussed above may violate relevant WTO regulation, such as direct export subsidies and debt write-off, which have to be eliminated after China enters WTO. This point will be further explained in the following sections.

2.1.3 Competitive position of China's textile and apparel industry in the World context

In view of the above analysis of the current diamond model and comparison with counterparts in some developed countries, it is clear that China's textile and apparel industry are only competitive in traditional low-/middle-end markets, with apparel production as the most competitive sector. According to the international competitive coefficient[15] in apparel, China was 0.93 in 1997, much higher than Korea (0.50), Italy (0.47), HK (0.21), France (-0.34) and Germany (-0.51). [15]

2.1.3.1 Low-/middle-grade apparel production is internationally competitive.

This sector is still labor-intensive, catering to China's present factor strength. The export composition also indicates that apparel is much more competitive than textiles in the low-/middle-end markets.

In 1999, the total textile and apparel exports were US$ 43.1 billion, of which 70% was attributed to apparel exports. The average export price is US$2.54 per unit of apparel--US$1.74 per unit of knitting apparel and US$3.92 per unit of woven apparel. [16] Figure 2.5 is a breakdown by various material types or categories. According to authoritative US organizations, the average unit price of Chinese garments exported to the US in 1998 was 26% higher than that of 77 countries; and in 1999 the gap has expanded to 33%. This means the overall level of Chinese apparel exports has been progressively upgraded, though it remains in the low-/middle-end markets.

The developed countries have turned to higher value-adding activities, such as R&D on new-type fabrics and fashion design. Other low-cost suppliers, though developing very fast, find it hard to compete with China at the present stage, because China has accumulated more than 50 years experiences in this aspect. Table 2.8 shows that among the four category groups, China registered the highest in three of them, the exception being the fabric category. However, the threat of other countries will be more prominent as time goes on, because these countries are also the major players in the low-/middle-end markets. Head-on competition cannot be avoided and will become hotter when the current quota mechanism ends in 2005.

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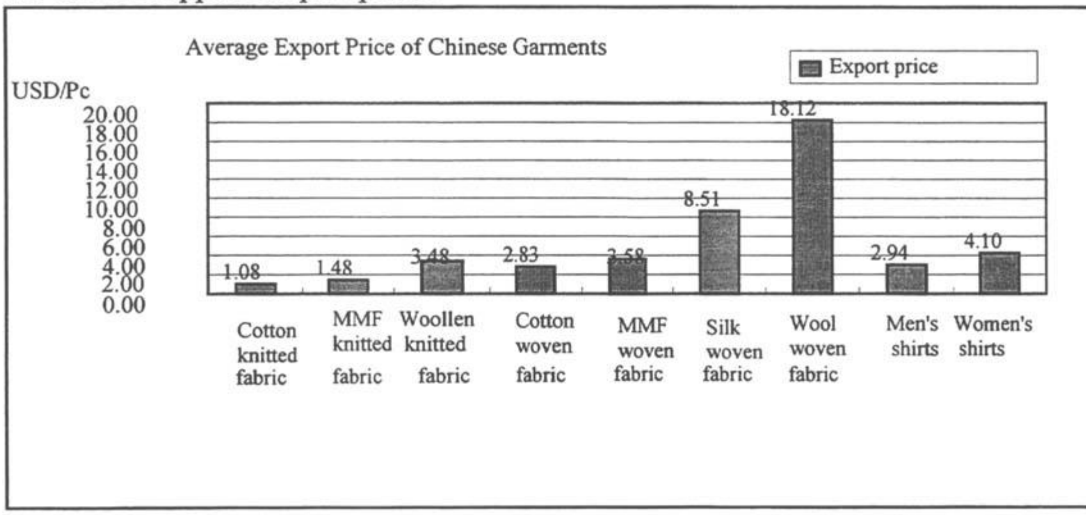
[15] The international competitive coefficient = (export value – import value) / (export value + import value)

[16] Calculation is based on the total quantity and total export value from January to November 1999.

2.5 Chinese apparel export prices



(Source: calculated based on data from Textile Asia, July 1999, p66)

2.1.3.2 Traditional low-technology-content textile products remain competitive

The cotton spinning sector is the pillar of the whole Chinese textile industry both in terms of industrial output value and export volume. During the first 11 months in 1999, cotton fiber, yarn and fabric exports accounted for 76.1%, 29.5% and 40.3% of the total fiber, yarn and fabric[17] export volume respectively. As regards the export value, the ratios were 29.1%, 24.7% and 31.3%, indicating the low-technology content.

2.1.3.3 Local brands have their voices in the low-/middle end market

Hot domestic rivalry has positively stimulated the brand building process. A number of local brands have been established in men's suits, shirts and knitted underwear, occupying a large market share. But they are still players in the low-/middle-end market. Take men's shirts, for example. Foreign brands, either directly introduced from abroad or manufactured through foreign-invested companies in China, still take the lion's share in the high-end market, with prices five to ten times higher than the local brands. [18] Such a pattern is an exemplar of the present domestic market for most product lines, indicating that local brands still have a long way to go.

2.1.3.4 Relatively comprehensive industrial system

Though many sectors in the industry are still weak and not internationally competitive, the industrial system is comprehensive, ranging from cotton to synthetic fiber; from intermediary products to branded end products. The production output of chemical fiber, yarn, silk fabrics, knitted fabrics and apparel all rank No. 1 in the world. The economic development imbalance and the status of "developing country" in nature will make low-grade products appealing for a long time.

[17] The total fabric export volume here doesn't include the chemical fiber fabrics.

Table 2.8[18] US import prices from China and some developing countries (US$/unit)

US Import prices from Some Developing Countries				
Country	Yarn	Fabrics	Clothing	Made-ups
Mexico	0.36	0.94	3.25	0.62
China	**0.46** [a]	**0.70**	**4.83**	**2.07**
Thailand	0.35	0.56	4.22	1.12
Indonesia	0.32	0.54	3.76	0.76
India	0.37	0.87	4.03	1.18
Turkey	0.39	0.99	3.74	0.92
Phillipines	0.39	0.70	3.60	1.12
a: This figure is the 1997 figure, from China Customs				

(Source: calculated based on data from [38])

2.1.3.5 An "assembly line" rather than a fashion leader

The developed countries embrace almost all the advanced textile-related technologies. The geographic re-location strategy provides them with a better opportunity to concentrate upon high-value-added activities. One good example is that the output of non-woven fabrics in the US, EU and Japan totally captures 86-92% of the world total output. [39] Therefore, when putting the Chinese industry in the global context, the whole picture is not encouraging.

The industry's success is still dependent upon traditional factor advantages which are less and less decisive in today's globalization trend. The weakest links lie in chemical fiber, dyeing & finishing, fashion design, product development and innovation, as well as new-type textile machinery resulting in a concentration upon low-value-added activities. The wide gap in the value-added processes between China and the developed countries is very difficult to bridge within a short time.

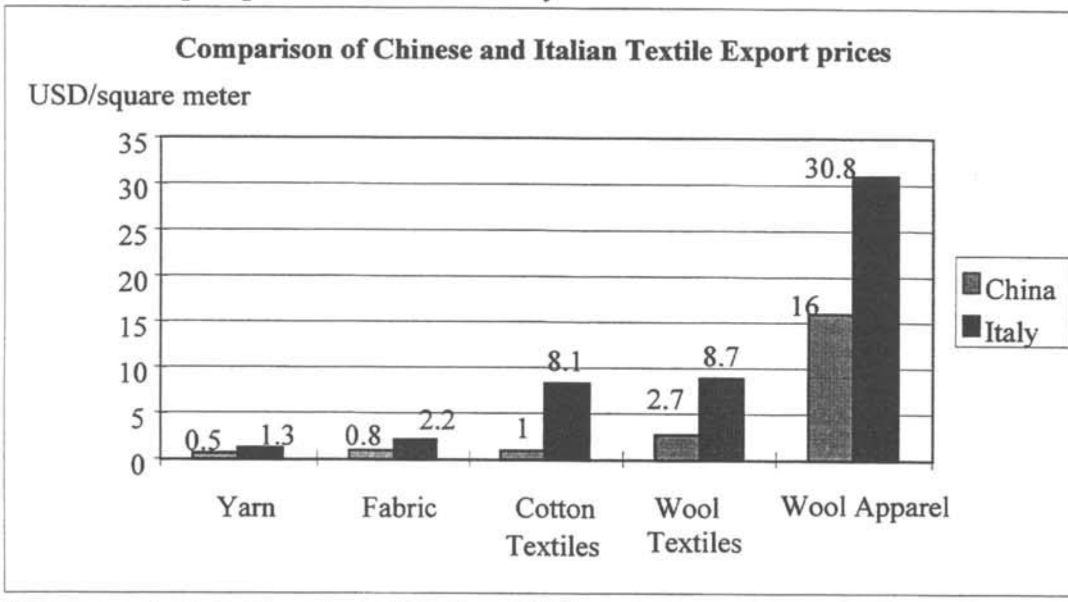
Figure 2.6 draws a comparison between Italian and Chinese textile and apparel export prices. As regards yarn exports, the average price difference is about US$0.7/$M^2$ while widened to US$1.4/$M^2$ for fabric exports. The gap in wool apparel exports is even more notable, reaching US$14.8/$M^2$.

Figures 2.7 and 2.8 provide a more comprehensive picture of the position of Chinese textile and apparel exports. The average export price of French fabrics to the US was US$20/$M^2$, the highest among the six countries. If silk fabric are considered for example, the US average import price from France was US$28.3/$M^2$, three times higher than the average import level and four times higher than that from China, a country known as the "No. 1 silk producer" for so many years.

Table 2.9 is a comparison of fiber consumption ratios in China and other markets, showing the big difference both in domestic consumption patterns and the export product mix.

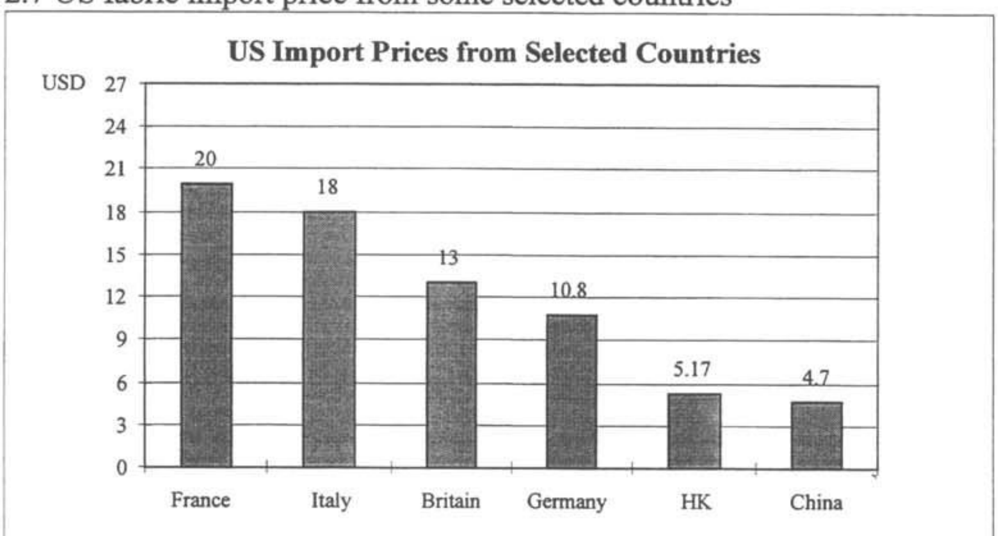
[18] Unit: US$/SME (square meter equivalent)

2.6 Textile export prices in China and Italy in 1997



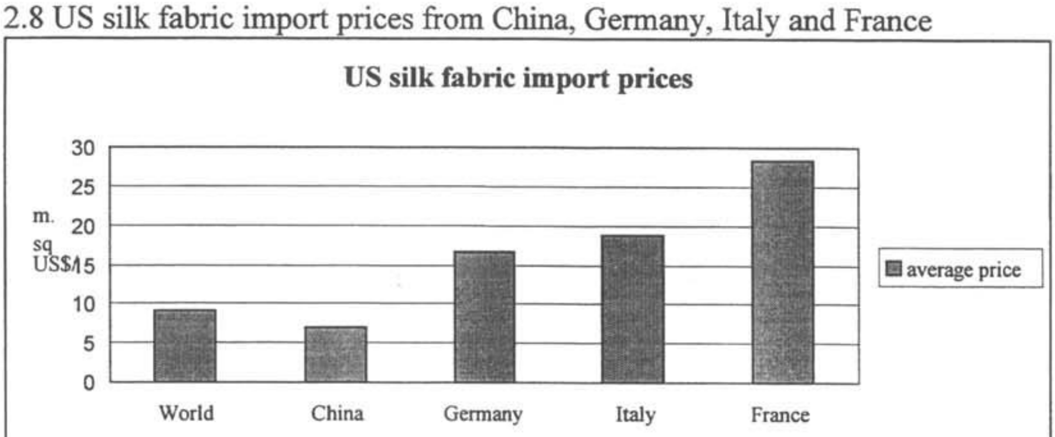
(Source: calculated based on data from [40])

2.7 US fabric import price from some selected countries



(Source: [9])

2.8 US silk fabric import prices from China, Germany, Italy and France



(Source: US Department of Commerce, from [41])

Table 2.9 Fiber consumption in the US, West Europe, Germany, China and Japan

Fiber Consumption in the Apparel, Home and Technical Textiles					
	US	West Europe	German	China	Japan
Apparel	39%	47%	45%	70%	30%
Home Textiles	39%	35%	30%	20%	31%
Technical Textiles	22%	18%	25%	10%	39%

(Source: [42]; [71])

The developed countries have shifted their production efforts to niche products with high added value in order to avoid head-on competition with low-cost manufacturers in the developing countries. For example, the US textile industry has moved away from staple fabrics for the apparel sector and moved toward niche products. Technical fibers that satisfy the sportswear and activewear industry such as surfing have witnessed outstanding growth. [43] Exportation of specialty fabrics that are not available in other countries offers the industry a unique competitive advantage. Many world famous brands have penetrated into the Chinese market through various routes, such as direct export, franchise and direct investment. However, the most important value-added links such as design, product development and marketing are retained firmly in foreign hands, which explains why China is just an important "assembly line" rather than an influential fashion leader, despite its large export volume.

2.2 PROSPECT OF CHINA'S WTO ENTRY

2.2.1 China's continuous efforts concerning WTO entry

2.2.1.1 Historic review of China's application for entry into WTO

China first applied to accede to the GATT in 1986 and its effort to join this multilateral mechanism has never been subdued since then. With the establishment of the WTO and its more and more important role in the world, it is essential for China to become a player itself in order to integrate better with the global economy.

The accession process involves preparation of a protocol "package", consisting of the protocol, the working party report and the market access schedules for industrial and agricultural goods and services. While the first two are discussed multilaterally, the last one is negotiated bilaterally with Members of particular interest.

China has entered into bilateral talks with 36 member countries (EU as one member), among which Japan was the first nation within the Group of Seven to officially approve China's application into WTO during Japanese Premier Keizo Obuchi's visit to China in July 1999. Australia was the second after Japan among the industrialized nations to finish negotiations on China's bid to join the WTO. Talks with the US and EU have not been smooth because of the political sensitivity and its related issues apart from economic concerns. The successful conclusion of US-China and EU-China talks paved the way for preparing the final "package"[19].

[19] According to the accession process, only after China successfully concludes negotiations with the above-mentioned 36 Members can the market access schedules form a part of the whole "package" for final approval.

During the negotiation process, China insists on three principles with respect to the entry requirements: (1) China will join the WTO as a developing country; (2) There should be a balance between obligations and rights for new members; (3) There must be no discriminatory clauses. China has taken great pains to become a WTO member by putting serious offers on the table during the past 13-years of negotiations, including tariff reduction, non-tariff removal and other liberalization measures. Some have been progressively enforced in practice. The following is a brief explanation, with the textile and apparel sector as the focus.

A. Tariff reduction (also see relevant points in Section 1.1.2)

China has cut import tariffs several times during recent years. In April 1998, China proposed a comprehensive tariff offer to the Working Party, promising that the trade-weighted average tariff rates for industrial goods will reach 10.8% by the year 2005. From January 1, 1999, China began a new round of tariff reduction covering 1014 commodity categories, an initiative to lower the average import tariff rate by 2 percentage points by the year 2000. The textile and apparel sector has experienced the most drastic adjustments involving more than 90% of textile and apparel imports. The tariffs imposed upon textile raw materials were lowered by the largest extent. On January 1, 2000, a total of 819 textile products listed on the tariff schedule underwent reduction by another 0.6 to 2.0%.

B. Non-tariff barriers removal

Most textile products are subject to compulsory prior import licensing managed by MOFTEC. China is committed to adopting a tariff-rate quota system instead of the present quantitative restrictions in some particularly sensitive sectors, such as wool and cotton.

China in July 1995 offered to progressively liberalize the trading monopoly within eight years after accession, aiming to bring its domestic foreign trade regime into line with prevailing international practice. [72] MOFTEC began to carry out reforms, entitling more manufacturing enterprises, either state-run or privately-owned, to conduct exports by themselves. It has further lowered requirements for obtaining foreign trade licenses, including: (1) A preferential system is designed for 120 key state-owned pilot conglomerates and 1,000 selected key state enterprises and large state industrial enterprises registered with MOFTEC. Production enterprises dealing in non-electromechanical products will have the right to set up wholly-owned or majority-owned foreign trade companies to handle the export of their own products or other related products, providing their annual export value surpass US$10 million. (2) The minimum registered capital of trading companies qualifying for import and export has been reduced to RMB5 million in the coastal area and RMB3 million in the central and western areas. (3) For foreign trade companies with annual exports of over US$100 million in the previous year, their wholly-owned or majority-owned subsidiaries will be entitled to import and export provided that their export volumes are not less than US$10 million. Since 1999, MOFTEC has extended foreign trade rights to the private sector on condition that they have a minimum of RMB8.5 million in net assets, RMB 50 million in annual sales and US$1 million in annual exports. About 142 private enterprises with a total export volume of US$450 million in 1998 were granted foreign trade rights up to mid-1999. In addition, 5 joint-venture foreign trade companies were established in Shanghai and Shenzhen with local partners holding 51% shares. According to the latest EU-China bilateral talks, China has promised to completely remove the state monopoly on silk exportation by 2005. [44]

A new "Contract Law" incorporating the original three relevant laws has been in force since October 1, 1999. This move sends a positive signal that the domestic legal frame work will be clarified and improved step by step.

C. New market access in the distribution sector

Joint ventures in China have to export most of their manufactures to meet the requirements of foreign exchange balance with only an approved portion for domestic sale. On the other hand, foreign investment in the distribution sector was prohibited before 1992.

However, the central government is now considering expanding the domestic sale ratio for these foreign-invested companies if the relevant products meet the national industrial policies and are not subject to quota limitations. The State Council approved 16 foreign-invested retailing enterprises with import and export rights and 2 commercial chain stores co-invested by local and overseas companies from 1992 to 1998, not to mention those approved by local governments. According to the recent pilot program, China has decided to further open up its domestic retailing and wholesaling market. Foreign companies can now enter the Chinese retailing market in the form of joint ventures or cooperatives with local partners in the capitals of all provinces, autonomous regions and other major cities. [45] Preferential treatment will be granted if foreign-based commercial entities pool investments in the underdeveloped central and western parts of China. (For example: 40-year operation period compared with 30-year in the coastal area). Chinese partner should hold dominant shares in principle, except those particularly approved by the State Council. Though solely foreign-owned commercial enterprises engaging in retailing and wholesaling are still forbidden at the present stage, the green light is given to the four cities, including Beijing, Shanghai, Tianjin and Chongqing, to each establish one pilot joint-venture wholesale enterprise.

2.2.2 US-China WTO-entry negotiations

When Premier Zhu Rongji visited the US in April, 1999 with a package of attractive offers, the US President Clinton failed to accept it due to huge domestic pressure. Bilateral talks between the two sides were suspended after a series of political events until October, and the two struck an agreement by the end of 1999. Detailed information about the agreement is not available at present stage. Therefore, we will focus upon the major concerns between the two sides over the textile and apparel issue.

2.2.2.1 Quota phase-out issue

The US once insisted that quotas imposed upon China's textile and apparel imports should be phased out over ten years starting from the date of its accession to ensure "fairness to other countries". Though, the US side did not put this clause in the final agreement, they still insist that there be soft standards upon China's textile and apparel exports into the US market. According to the 1997 Sino-US agreement, if China accedes to the WTO, the consultation mechanism will remain in force for an additional 4 years after the quota phase-out for WTO members in 2005. This indicates that China textile and apparel exports will be still subject to temporary quota impositions until the year 2009.

2.2.2.2 Non market economy issue

China is the major target in most anti-dumping and anti-countervailing cases raised by developed countries. US always labels China as a "non-market economy" regardless of its remarkable achievements in the building of market economic system. It can thus apply punitive measures not on a case-by-case approach and make decisions apparently randomly based on data from a third economy and other incomparable information.

2.2.2.3 Effective protection of "intellectual property rights"

China is often accused by the US for its failure to effectively protect intellectual property rights, including designs and trademarks concerning textiles and apparel. The US domestic "Super 301"Act often targets China as a serious violator on a priority list which is the ground for US to apply trade sanctions. Therefore, the US pressed China to take effective steps in addressing this tough issue, including legal and administrative measures.

2.2.2.4 Permanent MFN (NTR) issue

In terms of WTO basic principles of non-discrimination, the US shall grant permanent MFN status to China after its entry into WTO instead of the current annual renewal. Nevertheless, the US always regards its domestic laws as superior to international regulations. Under the American Jackson-Vanik Amendment to the Trade Act of 1974, MFN (now called normal trade relations, NTR) may not be extended to any "non-market economy" unless the President grants a waiver certifying that the country does not restrict free emigration. This can be overridden by the Congress through a joint resolution of disapproval. On May 25, 2000, the House of Representatives passed the PNTR bill agreeing to grant permanent NTR to China after it enters WTO and in September, the Senate approved, too. With the final sanction from President Clinton, one of the most uncertain issues was at last settled, signaling a happy message for enterprises in both countries.

2.2.3 EU-China WTO-entry negotiations

The EU is one of the major importers for Chinese textile and apparel products. In 1999, it imported 59.4 million Euro worth of textile and apparel products from China, accounting for 7.7% of the total imports from China. The bilateral textile agreements between China and the EU consist of two types: one is an MFA-type Agreement, and the other is an Agreement on Silk, Linen and Ramie. As regards textile-related issues, negotiations between the two sides are mainly focusing upon the following points.

2.2.3.1 Consolidation of tariff rates at a reasonable level

According to an EU report, the present level of Customs duties imposed upon EU textile and apparel products by China are high, ranging from 25% to 100%. [46] It has requested China to reduce and bind its applied tariffs for textiles and apparel as a basis for negotiation: 0% for raw materials, 5% for yarns and fibers, 10% for fabrics and 17.5% for apparel.

2.2.3.2 Abolition of non-tariff barriers after a transitional period

The EU insists that China should guarantee the application of the fundamental rules of the WTO under a specific safeguard mechanism. The above-mentioned non-tariff barriers practiced in China should be addressed and eliminated within reasonable transitional periods, such as the right of enterprises to participate in foreign trade, export subsidies in textiles and apparel products, etc.

2.2.3.3 Legal transparency and increased market access

Many EU manufacturers have often complained about the low import penetration level the EU textile and apparel products in China's domestic market. The trade balance with China in this sector is always negative both in value and in quantity. Therefore, in agreement with the US strategy, the EU demands more market access from China as well as enhanced legal frameworks. The principle of "reciprocity" was first raised by the European industry, and is now a powerful weapon by linking MFA phase-out with EU access to foreign textile and apparel markets.

2.3 GENERAL RIGHTS AND OBLIGATIONS AFTER CHINA ENTERS WTO

2.3.1 Rights

2.3.1.1 MFN (or NTR) status

When China enters WTO, it will immediately and automatically enjoy MFN status with every Member country. The permanent MFN status granted by the US is of particular importance to China since the US is one of China's most important trading partners. However, it should be noted that entry into WTO doesn't mean China will enjoy equal treatment from all foreign countries. There are exemptions from MFN under the WTO regime, including frontier trade, free trade areas and customs union.

2.3.1.2 Active participation in rules set and multilateral talks

China has been outside the multilateral trading mechanism for such a long time that it cannot voice its opinion upon many international issues, which adversely affect China's international profile as well as its economic and political interests. Entry into WTO enables China to actively participate in the multilateral talks and articulate its views in the global arena. China will no longer be an onlooker when setting international rules and regulations, which is of great importance to China's future economic performance and development path.

2.3.1.3 Dispute settlement in the multilateral mechanism rather than unilateral retaliation

WTO set up a special division—the Dispute Settlement Body (DSB)-- to handle worldwide trade-related disputes. Because of the particular role of the textile and apparel sector in almost every Member nation, the Textile Monitoring Body (TMB) was established to address controversial issues in this sector. After China joins this global organization, trade disputes will be settled within a fixed frame rather than by arbitrary and unilateral decisions. China's textile and apparel exports often suffer unexpected losses because of unilateral actions taken by the importing nations. For example, the US frequently resorted to a quota-cut by a third for Chinese textile and apparel products since 1994, totaling US$94 million against Chinese quotas. [73] Such action is obviously incompatible with the WTO rules and has to be discontinued after China becomes a Member. Dispute settlement procedures will be more predictable and transparent to domestic enterprises.

2.3.2 Obligations

Rights and obligations are the two sides of a coin—no obligations, no rights. China has to assume its own obligations in order to enjoy the benefits. Some measures may be detrimental to domestic industries in the short run.

2.3.2.1 Reduction of its own tariff rates and non-tariff barriers

Though China has continuously lowered its import tariff rates, current duties are still high, particularly in some highly-protected sectors such as automobiles and apparel. Non-tariff obstacles, as mentioned above, are the major concerns to many trading partners. Therefore, it is necessary and important for China to make improvements in this aspect despite the possible pressure from fragile domestic industries which are well protected partly by current non-tariff barriers.

2.3.2.2 More open market access

China has committed to opening up its service and distribution markets progressively. The pace not only depends upon the economic situation, but also hinges upon current bilateral talks with other countries. With more foreign companies entering the domestic market, national ones, which lack information and technological support, may be forced out of the market when competing with their foreign counterparts. This is the price China has to pay in order to find its way out of the present tight circumstances and integrate with global economy.

2.3.2.3 Non-discriminatory and national treatment

Some current industrial policies and practices favor local companies, an approach not consistent with the WTO rules which require treating foreigners equally with the nationals. On the other hand, preferential treatment granted to one country should also extend to other countries on the basis of non-discrimination. Therefore, China has to review and adjust many of its current practices in order to comply with its new obligations.

2.3.2.4 Stricter adherence to WTO regulations

Entry to WTO requires China to establish a more transparent legal and operational framework. The MOFTEC gazette has issued to carry official texts of national-level trade-related laws and regulations. Several official web sites have also been established to make domestic information available to all interested parties, such as http://www.moftec.com.cn and http://www.cei.gov.cn. However, the process is far from being complete and thorough. Transparency does not simply refer to information availability. It involves significant changes in the present legal framework and daily practices as well as the corresponding ways of thinking of every person. The transformation is by no means an easy task. There is a set of WTO rules to manage the world trade in a comprehensive way. For example, some trade-related investment policies currently enforced in China may violate the WTO spirit, such as local content schemes, import balancing requirements, and various incentives designed to direct investment to priority development sectors. All of these measures have to be reconsidered within the relevant WTO frames to create a more predictable and stable investment environment.

Therefore, successful entry into WTO is just a starting point for China. It has a lot of work to do after the entry. The most difficult part is to ensure that WTO-based practices are adhered to and to work out appropriate laws and regulations.

2.4 SPECIFIC IMPACT UPON THE CURRENT 'DIAMOND' STRUCTURE

China's entry into WTO itself is a normal issue, just as China became a member of the IMF or the World Bank. However, the 14-year pursuit of entry brought many non-economic factors into the unusually long application process. As a result, it is now one of the biggest issues not only to China but to the world as well. Even the declaration of the Sino-US agreement upon WTO entry by the end of 1999 triggered strong reactions from the world stock markets. Those for and against, though totally different in views, are all agreed that WTO entry is a great influential force upon the national economy. It is hard to predict its actual impact at the present stage, but an analysis of its possible influence upon the diamond structure of the textile and apparel industry may give some insight into the future picture.

2.4.1 WTO entry itself as a chance event

When President Clinton did not accept the accession package offered by Premier Zhu Rongji in April 1999, the prospect for China's WTO entry was clouded. The following political events between the two sides cast another shadow on the bilateral talks, together with huge domestic pressures, especially from some WTO-sensitive industries such as telecommunications and car industry. At that time, few people could predict whether and when China was able to become a WTO member considering its past 13-year pursuit during which politics played an overwhelming role. In this sense, China's WTO entry can be viewed as a chance event, which is conducive to shaping a nation's competitive advantages. [2]

Entry into WTO means China will truly compete in the interwoven global environment with WTO-based rules and regulations, triggering a series of both internal and external reactions. Generally speaking, acting in an international manner can better integrate the nation with the rest of the world, enhancing its international competitiveness in the long run. Significant changes are expected in domestic legal and trade regimes as a result of China's WTO entry. As regards the textile and apparel industry, the ATC alone indicates drastic changes in the competition platform, accompanied by new uncertainties. For example, urged by strong lobby forces, what new protectionist measures would foreign governments take to safeguard their domestic textile and apparel industry? To what degree would imports increase because of improved access and what would be the possible consequences? Would domestic enterprises be competitive enough to with stand increased competition both in the export and the domestic markets? Would domestic currency undergo

Table 2.10 US textile and apparel exports to China (in US$ million)

US textile and apparel exports to China					
Product	1997	1998	January-August		
			1998	1999	Percent increase
Yarn	4	6	4	6	50.0%
Fabric	40	40	28	36	28.6%
Made-up	16	19	9	9	0.0%
Apparel	8	6	4	6	50.0%
Total	67	72	45	57	26.7%

(Source: http://otexa.ita.doc.gov/tbrbal.htm, retrieved on November 5, 1999)

depreciation or appreciation with the progressive opening of the capital market? All of these questions cannot be answered at present, but they become more and more important when China's WTO entry is drawing near. It can be concluded that this event would change the game rules upon which domestic enterprises used to play, forcing individual firms to adopt corresponding strategies in the new competition picture.

2.4.2 Impacts upon the four aspects of the Diamond

2.4.2.1 Upon the factor conditions

A. Increased imports mainly due to raised market access

China enjoys a very favorable trade surplus as regards textile and apparel items with the export volume far exceeding the import one. From January to May 2000, the surplus was US$ 14.0 billion. WTO entry indicates a balance of rights and obligations for China. While Chinese textile and apparel exports may gain greater penetration in foreign markets, its domestic market has to be more open to foreign products as well. The continuous fall in import tariff rates and the removal of non-tariff barriers are leading to increased market access, and it is easier for foreign products to find their way into the domestic market.

Table 2.10 shows US textile and apparel exports to China from 1997 to August 1999. Among the four categories, only made-up products maintained the same export volume in the Jan-Aug period in 1998 and 1999. The other three categories enjoyed a rapid growth rate--this is one direct result of the increased access to China's domestic market.

MFA quota liberalization may also boost importation of intermediary inputs and textile machinery as a result of increased exports. The USITC report suggests that the elimination of textile and apparel quotas would result in US$ 2 billion of additional machinery and equipment being imported to China. [47]

Since most Chinese textile and apparel products are low value-added items, they are more sensitive to changes of raw material cost, which is relatively important in the cost structure, compared with fashion ones. Generally speaking, downstream enterprises gain most benefits from increased imports of raw material and intermediary products. In 1998, woven and knitting apparel exports reached 3.31 billion and 5.85 billion pieces respectively, among which 59.8% and 47.7% used imported fabrics. [6] With the reduction of tariff rates and the removal of non-tariff barriers, apparel manufacturers will be able to use less expensive fabric imports for their final products, further enhancing their cost advantage. As mentioned earlier, the chemical fiber sector is one of the most difficult links in the textile industry. High domestic prices for the raw materials are the major problem. For example, in 1999, the domestic price for PTA was about RMB 800/ton higher than the CIF price. [15] Therefore, when China lowers tariff rates as one of the WTO commitments, the chemical fiber manufacturers will gain benefits from such a move. While some sectors benefit from increased imports, some will suffer, such as the fabric manufacturers and apparel producers engaging in middle- or high-range products. As a result, the resources can be allocated to the more efficient and competitive sectors and the market mechanism will play a larger role instead of the current trade-distorting measures.

B. Rising labor cost

Economic development will no doubt raise labor costs. China's WTO entry is expected to bring more foreign capital into the country, especially to the east coastal region in which most textiles and apparel bases are located. Consequently, the labor cost will be pushed up to a higher level, making production of labor-intensive products more costly in this region. Some production facilities may have to be moved to less developed areas in the middle or western regions. (This point will be explained in detail later.)

C. Capital and human resources diversified to more profitable industries such as information industry

The past decade has witnessed the magical growth of computer-based industries. Its quick returns on investment and promising future blueprint have attracted much more capital inflow and active participation of qualified personnel. In sharp contrast to the disappointing enrolment of textile-related majors, courses with "computer", "information" or "communications" titles are the most popular with university applicants nowadays.

It is well recognized that WTO entry will have a strong impact upon fragile domestic hi-tech industries. But its positive affects cannot be ignored, either. More foreign investors will rush to tap China's huge domestic market, especially those newly emerged but still undeveloped sectors. Their strength and higher-than-average salary payments will significantly tilt the balance and capture a larger proportion of capital and human resources.

Management levels will be enhanced as a whole, since managers will be exposed to more open competition in the post-WTO era. Market-oriented ways of thinking will be facilitated and strengthened.

2.4.2.2 Demand conditions

A. More sophisticated customers due to economic development and increased access to world fashion

WTO entry will provide domestic consumers with a good opportunity to access world famous fashion brands and quality products because of their easier entry. The open-door policy has cultivated fundamental brand consciousness while the complete economic integration between China and the outside world will further boost this trend. Take Shanghai for example. Consumers in Shanghai are more sophisticated and demanding than those in other parts of China. This can partly be attributed to its traditional fashion center status. Many multinational corporations opened speciality stores in Shanghai due to its economic strength in China and attractive market potential. The easier access to world-class products has helped to develop Shanghai consumers' fashion tastes and boost demand for high-range products. It can be expected that domestic consumers will learn more as a result of the economic development. Though WTO entry is not the sole cause, it does provide a unique opportunity for more foreign counterparts to tap the Chinese market, with domestic consumers being the largest beneficiary.

B. Regional differences will be further widened

From Table 2.4, it is clear that regional differences are very distinctive. Rapid economic development in the east coastal region is due to its traditional economic strength and preferential government policies. The report entitled "China Sustainable Development Strategy" issued by the Chinese Academy of Sciences shows that Shanghai still occupies the first place as regards sustainable development capabilities, followed by Beijing, Tianjin, Guangdong and Jiangsu.

Figure 2.9 shows that the regional economic differences have been further widened. The average GDP per capita in the coastal region was 3.78 times that in the west in 1994 and increased to 4.14 times in 1997; The same is true when comparing the central and the west. In 1994, the difference was 1.37 times while it rose to 1.55 times in 1997. The contrast is greater if individual cities are taken into consideration. GDP per capita in Shanghai was 9.79 times than that in Guizhou in 1994, 10.64 times in 1996 and 11.63 times in 1997.

According to statistics from the former China Textile Council, 93.9% of FDI was concentrated in the east coastal region. [68] Though China has declared a series of policies, aiming to encourage investment in the west and central regions, the weak economic foundation and less favorable investment environment will hinder investors from taking further steps. Therefore, the east coastal region, backed by its relatively strong economic development momentum and well-established infrastructure, will continue to be the hot investment spot after China enters WTO. Most of the foreign capital inflow will be channeled into this region and will help boost economic development, further widening the regional differences.

C. Improved efficiency of distribution network

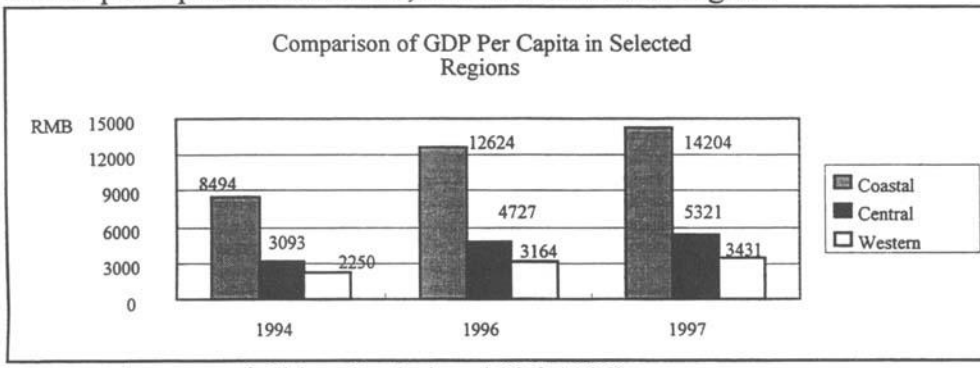
China's WTO entry will greatly change the current distribution network. The presence of foreign entities will not only sharpen local competition, forcing mal-managed enterprises out of the market, but will also provide useful expertise and examples for domestic enterprises to learn. Competition brings about progress. With the improved distribution network, manufacturers will feel the need to change as well. Closer cooperation between the two sides can be expected.

2.4.2.3 Firm strategy and rivalry

A. Hotter local rivalry

First, there will be more foreign presence in the domestic market. Some people point out that after China enters WTO, foreign enterprises may prefer direct export instead of direct investment. Their argument is mainly built upon three factors—the lifting of non-tariff barriers, reduction of import tariff rates, and withdrawal of non-WTO-based preferential treatment such as the preferential tax policy. They think that easier market access makes direct export more attractive than direct investment. However, more people view WTO entry as a new chance for foreign capital inflow, a more predictable and stable investment environment and improvement of the legal system. For example, in view of the trade-related investment agreement under the WTO regime, FIEs in China shall not be subject to the domestic-sale ratio or local-content requirement after China enters WTO. Therefore, to most potential investors, China's entry into WTO is a very positive signal.

2.9 GDP per capita in the coastal, central and western regions[20]



(Source: Almanac of China Statistics, 1996-1998)

Second, the competitive environment will be more open and fair to the non-state-owned enterprises. The state will gradually withdraw its control except in some strategically important sectors. As regards the textile and apparel sector, it can be predicted that the ratio of traditional SOEs will continuously decrease. More SOEs will be transformed to corporations and governed by a modern enterprise system. Loss of the state protection umbrella will expose SOEs to open market competition. In addition, government subsidies to the state sector is a practice not accepted by the Agreement on Subsidies and Countervailing Measures under the WTO regime.[21] Therefore, with the withdrawal of preferential treatment of SOEs after China's WTO entry, all the market players will enjoy a relatively free and fair competitive environment. The "Private solely-owned Enterprises Law" issued recently will also encourage entry of more private enterprises as well.

Third, China's commitment to liberalizing foreign trading regimes after its accession into WTO and the ten-year phase out schedule in the ATC will greatly alleviate the rent-seeking problem and other non-competitive factors in China. State trading will be relaxed progressively with more enterprises engaging in foreign trade. This point alone will bring about positive changes to the current market structure and competitive patterns.

B. More focus upon strategic competition

Strategic competition was totally ignored in the past since it was not important in winning the competition, which was subject to many non-competitive factors. With more market players and an improved competitive environment, competition will be upgraded to a higher level. "The jungle survival rule" will be justified with more real facts. Enterprises are bound to shift their efforts to more technical aspects such as product quality and innovation to survive the competition.

2.4.2.4 Related and supporting industries

WTO entry will no doubt be a competition-catalyst, because the door is scheduled to open wider to the outside world. All domestic industries will more or less feel its

[20] The average GDP per capita is calculated based on the 15 cities mentioned in Table 2.3.

[21] According to the Agreement of Subsidies and Countervailing Measures (SCM Agreement)--an integral part of WTO, "subsidy" refers to a financial contribution by a government or any public body within the territory of a Member which confers a benefit. There are three basic types of subsidies: prohibited subsidies (such as export subsidies and local content subsidies); actionable subsidies (such as production subsidies; and non-actionable subsidies. (including basic research and pre-competitive development subsidies, assistance to disadvantaged region, and assistance to adapt existing facilities to new environmental requirements)

impacts. The textile-related and supporting industries are no exception. The previous analysis shows that these industries are either newly burgeoning or fragile. Therefore, in the short run, it will be a painful experience for these enterprises, accompanied by increased bankruptcy and a rising unemployment rate.

Consider the textile machinery industry, for example. At present, the average import duty for textile machinery is around 8% to 10%, lower than in many other countries. [48] Therefore, the impact due to tariff reduction upon the domestic sector will not be very large. What may pose a bigger threat to local enterprises will be the increased foreign direct investment. As mentioned in Section 2.1.2.3 (D), new-type textile machinery is in the "encouraged" category under the "Guiding Directory on Industries Open to Foreign Investment". With the improved investment environment and anticipated good performance in China's textile and apparel exports, more foreign investors will be lured to play in this huge market. The big technological gap between China and foreign investors will make local machinery production less appealing, especially when the foreigners can enjoy the same labor-cost advantages, more easily access the domestic market and play on a more equal footing with domestic ones. Based on these arguments, textile machinery producers in China will face fierce challenges after it enters WTO, particularly in the short run.

On the other hand, competition stands for progress. The pains are the necessary price for future vigorous growth, otherwise, most domestic enterprises would continue to be uncompetitive and narrow-minded. From this perspective, WTO entry will, in the long run, facilitate the current industrial restructuring process with active foreign participation to secure the necessary capital and technology inputs as well as invaluable management experience.

2.4.2.5 Summary

WTO entry mainly changes the game rules, the macro environment and corresponding government policies. Its impact upon an individual industry is progressive and takes a long time, especially for the positive influences. In the short run, the industry will feel stronger negative impacts upon its fragile sectors and enterprises. So long as they can survive the first round attack, they can move toward a more stable and favorable development environment.

Table 2.11 is a summary of all the points mentioned above. It indicates that WTO entry has some direct and some indirect influences upon the current four constituents of the diamond. However, it is impossible to draw a definite conclusion that it is a 100 percent positive force in shaping the new competitive advantages of the textile and apparel industry.

2.4.3 The most possible scenario in the next five years

The above analysis depicts a general picture of the Chinese textile and apparel industry before and after China's entry into WTO. Evolution of the diamond model is a very long and slow progress. The four constituents interact, and each plays a role in this integrated and complicated system. Any drastic change in one factor will trigger a series of chain reactions within the model, leading to a new evolution direction. Because WTO impacts are progressive and slow, the four constituents will not experience drastic changes in the next few years, and there should be a relatively stable export performance. Some quantitative changes, such as quality enhancement and hotter market competition, will help strengthen the industry's present competitive

Table 2.11 Diamond structure summary

Diamond Structure	Present Condition		WTO-Effects	
	Positive	Negative	Positive	Negative
Factor Condition	1. Low Labor Cost	1. Fast growing rate		1. Further push up the labor cost
	2. Available unskilled and semi-skilled labor force	2. Lack of technicians and advanced talents	2.Improved management level	2. Further diversion of advanced talents
	3. Abundant Natural Resources	3. Lack of high-grade and quality intermediary input	3/4. Easier access to foreign market and cheaper imports / benefits to downstream enterprises	3/4. Impact upon the fragile sectors due to increased imports, especially on upstream enterprises
		4. Obsolete machinery and low technology		
	5. Continuously improved physical infrastructure	5. Weak information & communication infrastructure.	5. Increased FDI inflow in the information sector	5.Impact upon domestic enterprises
Demand Condition	1. Huge domestic market	1. Less sophisticated and demanding consumers	1. More sophisticated and demanding	
	2. Rapid growth of apparel retailing volume	2. Current deflation situation--anticipated drop of disposable income on apparel		2. Possible intensification of this psychological anticipation
	3. Regional difference catering to varying demands	3. Too small demand for high-grade/quality products	3. Widened regional differences and economic imbalance (both positive and negative)	
		4. Insufficient distribution network	4. Improved distribution network	4. Impact upon uncompetitive enterprises / increased bankruptcy
Firm Strategy and Rivarly	1. Establishment of market mechanism	1. Imperfect market mechanism	1.Market mechanism improvement	
	2. Formation of brand and quality consciousness; trading right liberalization	2. Low-level competition, featuring malicious price war and deteriorating commercial credit	2. Hotter but more orderly market competition	2. Increased bankruptcy of domestic enterprises and temporary rise of unemployment rate
	3. Large FDI investment		3. More predictable and transparent investment environment	
Related Supporting Industry	1. Comprehensive industrial system	1.Weak foundation, especially in technology	1. Service/hi-tech industry will be the hot investment fields	1. Strong impact upon the fragile industries, especially in the short run
		2. Lack of cluster	2. Dependent upon too many factors	
Government Policy	Strong, but some are not WTO-based		Remain strong and more in line with WTO rules	
	Focus on SOE reform, some involving direct protection		Strategic control rather than direct interference	
Oppor-tunites	Rising demand for home/technical textiles		More predictable dispute settlement mechanism	
	Increased fiber consumption level		Participation in rules-set and multilateral talk	
			Export growth based on ATC regulations before 2005	
Threats	Sharper international competition with entry of more low-cost exporters		Loss of secured market access in major export markets after 2005	
	Regional trading blocs		More serious	
	Non-quota barriers		More serious	

position in the middle-/low-range products. Therefore, the most possible scenario in the next five years is a relatively solid diamond model with international competitiveness in the middle-/low-end market.

2.4.3.1 Export volume will be relatively stable

The domestic textile and apparel industry is export-oriented. Therefore, export performance is very crucial to the whole industry. Many predict that domestic textile and apparel exports will enjoy a very quick increase after entry into WTO because of the immediate benefits of ATC and the future quota-free environment. The argument has a ring of truth, but over-optimism may prove to be wrong.

The ATC is, in some respects, a word game concerning its ten-year quota elimination plan. Big suppliers such as China benefit less than expected. Take the current Sino-US textile agreement for instance. The agreement reduces quotas in 14 apparel and fabric product categories in which the US believes that China has repeatedly violated quotas through illegal transshipment via third countries. What's more, the average annual quota growth rate (base rate) for China under this agreement is 1.3% for apparel and 2% for made-up textiles[22], ranging from 0.1% for wool sweaters to 4.1% for gloves and mittens of silk blends and non-cotton vegetable fibers.

Table 2.12 illustrates the expected annual quota growth rate if China enters WTO, which is not desirable at all. It should also be noted that quota-imposing countries leave most of the sensitive products, such as apparel, until the last stage. For example, the US quota integration schedule delays 89% of the apparel quotas until January 1, 2005. In addition, domestic exports will be subject still to temporary quota impositions for an additional 4 years after 2005. This clause casts uncertainty on future domestic export growth. Therefore, it is clear that China will not gain much from the liberalization process. Even when the quota is completely freed in 2005, China may fail to witness a sudden rise in export volume, because the MFA-type exports only account for one-fourth of total textile and apparel exports.[23]

Also, world demand will not change drastically as well. In 1998, world textile and apparel trade volumes were US$151 billion and US$180 billion respectively, down 5% and 1% over 1997. Trade diversion out of regionalism has posed a great challenge for China textile and apparel industry. (See relevant points in section 1) Mexico has replaced China as the leading exporter to the US and has continued to increase its share in the US textile and apparel import market.

There is another thing meriting special attention. In 2000, there are 32 commodities requiring quota bidding, 11 of which are truly voluntary export restraint. These 11 commodities are usually non-regenerated resource products whose international

Table 2.12 Expected annual quota growth rate in China after its WTO entry*

Annual quota growth rate		
Base rate(%)	1998-2002(%)	2002-2005(%)
0.10	0.13	0.16
1.30	*1.63*	*2.06*
2.00	*2.50*	*3.18*
4.10	5.13	6.51

*The figures in italics in the table means that most of Chinese MFA textile and apparel exports are subject to the base rates between 1.3% and 2%

[22] From the report "Assessment of the Economic Effects on the US of China's Accession to the WTO" issued by the National Retail Federation.

[23] The total textile and apparel export volume is around US$42-45 billion, among which the MFA-type exports are about US$10 billion.

market capacity is limited and whose supply exceeds demand. The major purpose is to effectively control under-price dumping activities. Domestic textile and apparel exports always face anti-dumping investigations. Though some of the export prices are really based on the low production costs, a number of others are the result of malicious price wars or simple pursuit of foreign exchange earning rather than profit considerations. Therefore, execution of VER is an appropriate approach to regulate the export market and shortsighted actions of some domestic enterprises. With quota liberalization in 2005, adoption of VER will be the natural choice for some textile and apparel exports to realize efficient resource allocation and orderly market competition.

According to the above explanations, domestic textile and apparel exports will not experience a rapid increase, neither will they slump after China enters WTO. The quota mechanism will continue to maintain current export market orders until 2005.

2.4.3.2 Basic factor conditions will remain relatively unchanged

Though WTO entry may push up labor costs, especially in the east coastal region, it will not increase by a big margin during the next five years. China will still enjoy comparative advantages in labor cost and available natural resources. As regards advanced factors, it takes time and efforts to achieve some qualitative breakthroughs.

2.4.3.3 Domestic demand will be further diversified, with middle-/low-end products remaining as the most popular choice

China will enforce its market access commitment step by step with its entry into WTO. In addition to planned tariff reduction, non-tariff barrier removal and foreign trading rights extension, its commitment in the service sector, including distribution, telecommunication, insurance, banking, securities and professional services, is significant. Foreign investors have long directed their attention to this well-protected sector, which generates high profits and has a very promising prospect. In view of China's current economic situation, the east coastal region will continue to be an attractive investment place for foreign investors because of its stronger economic foundation and favorable investment climate. The increased inflow of foreign capital and technologies will help develop the tertiary industry and boost the performance of the regional economy. As a result, regional economic differences will be further widened in terms of per capita GDP and disposable income. Though the government has set a series of industrial and investment policies in the hope of channeling more funds to the west and central regions, it will take quite a long time for them to catch up with the east coast region. Therefore, although demand in some big cities in the east coastal region will move upmarket and become more diversified, its market proportion will remain small and subject to regional limitation. Low-grade products will continue to find a ready market and cater to potential consumers in the vast hinterland and the middle-/low-income groups in the more developed areas. However, low grade doesn't necessarily mean low quality. The gradual establishment of market mechanisms will secure fair competition among enterprises of various ownership forms with a focus upon profit maximization—an approach centering upon quality improvement and product innovation. Consumers in tomorrow's buyer's market will be more selective, partly stimulating this development trend. For the next several years, domestic demand for low-grade products with improved quality will still account for the largest proportion of sales while demand for middle-/high-end products will be on the increase, especially in the bigger cities.

2.4.3.4 Firm-level competition will focus more on quality and low-/middle-range brands

In the textile sector, foreign investments are now focusing upon the chemical fiber projects which are capital- and technology-intensive. In the apparel sector, foreign entry usually brings along high-grade brands whose market segment is small at the present stage and for at least the next five years. Because of the lack of strong capital support, as well as a low technology level, domestic enterprises are mainly focusing upon the mass-product market. Thanks to vigorous domestic competition, some domestic brands in men's wear and underwear have attained a firm and large share in the low-/middle-end markets. It is difficult and unrealistic to predict now that local brands will become internationally competitive, considering the current technological level and weak support of the various processing links. But it is true that more and more enterprises have realized that brand is a powerful weapon in the fight to survive the hotter competition.

With this consciousness in mind and backed by the huge domestic market, domestic enterprises will make efforts to boost competitiveness through quality improvement and brand establishment. Therefore, if taking every aspect into consideration in a five-year framework, such as labor cost, technological level, capital support, demand conditions and firm strength, domestic enterprises will have a better performance in the mass product market and be competitive in the middle-/low-range products.

2.4.3.5 Some positive changes in cluster forming

After China enters WTO, the new game rules will provide a favorable external environment for domestic enterprises; at the same time, entry may accelerate industrial restructuring through more vigorous competition in a more open and rule-based environment.

However, cluster upgrading is no easy task. It requires close cooperation in every aspect. As mentioned earlier, lack of an effective textile and apparel cluster is a main reason for China's current competitive position in the international market. Though some measures have been taken to strengthen cooperation between the downstream and upstream enterprises through vertical integration or other policy support, it is still very hard to achieve close cooperation within the industry after actual separation for more than 50 years. In addition, even if the textile and apparel industry is successfully upgraded to a higher technological and productivity level, lack of strong support from its related and supporting industries would make such development unsustainable.

China is a capital-scarce country. Though foreign capital inflow has greatly alleviated this problem, it is not the solution to the problem per se because foreign investors have their own interests which may contradict or be incompatible with the national development plan. How to allocate the limited capital in the most efficient way is a question of key importance. Time is another important factor. Cluster forming and upgrading is a slow progress. It cannot be completed in one or two years, especially when the current foundation is weak and not solid. In this view, the textile and apparel cluster will remain in its current situation, with some positive changes, for several years to come.

2.4.4 Strategic implications for China's textile and apparel industry

In view of the above analysis, the primary task for the textile and apparel industry in China is to develop new competitive advantages, such as design and marketing strengths as well as product upgrading.

2.4.4.1 Transfer pattern of world textile and apparel industry

The transfer pattern of the World's textile and apparel industry may sketch a meaningful picture of the domestic industry. It follows the way in which the labor cost plays a dominant role.

The labor cost of the apparel sector in the US was 63 times higher than that in Indonesia in 1998. (Figure 2.11) Such sharp differences of labor cost among countries is the major driving force underlying the gradual re-location of the textile and apparel industry from the developed to the developing countries during the past decades as illustrated in Fig. 2.10. The textile and apparel industry in the developed countries, in order to circumvent the disadvantage of much higher labor costs, had to pursue high value-added processes through technical upgrading and innovation. They attach great importance to R&D and capital investment. Thus, though they may lose the race in the middle- low-end markets, they successfully maintain their monopoly presence in the high-end market and own most of the world-famous brands and trademarks. In some respects, the globalization trend enables MNCs to work out their strategy in a worldwide context, effectively combining the low labor cost of the developing countries with their research, design and marketing strength. The current prevalent practice of OPT arrangement is a good illustration of this cooperation pattern. The ultimate winners are those MNCs headquartered in the developed countries because they control the key links of the whole production chain. Most developing countries, including China, simply function as "assembly lines".

2.4.4.2 Geographic relocation within China as an effective way to boost competitiveness

Figure 2.11 shows that the labor costs in the Chinese apparel sector have already been higher than in some developing countries such as India, Bangladesh and Indonesia. The production cost is and will continue to be the key consideration for middle- or low-range products. Exports from China have been facing serious challenges from these lower-cost suppliers. Take the EU textile and apparel imports for example. In 1998, India and Indonesia ranked the third and ninth respectively with their share reaching 9.6%, compared with China of 12.2% of the market share. [49] It is estimated that 40% of Chinese textile and apparel exports have encountered head-on competition with those from Southeast Asian countries. [50] Therefore, if the industry fails to acquire new competitive advantages and continues to depend upon the basic factor strength, it will ultimately lose the competition.

The relocation strategy adopted by some developed and newly industrialized nations provides a useful example for the Chinese textile and apparel industry. China is a very big country, with one-fifth of the world's population and different economic development levels among various regions. This offers a unique opportunity to realize "relocation" within a single nation. Geographic proximity, the similar language and cultural background and a uniform legal framework make this cooperation pattern workable. However, geographic relocation is far more than simple spindle relocation.

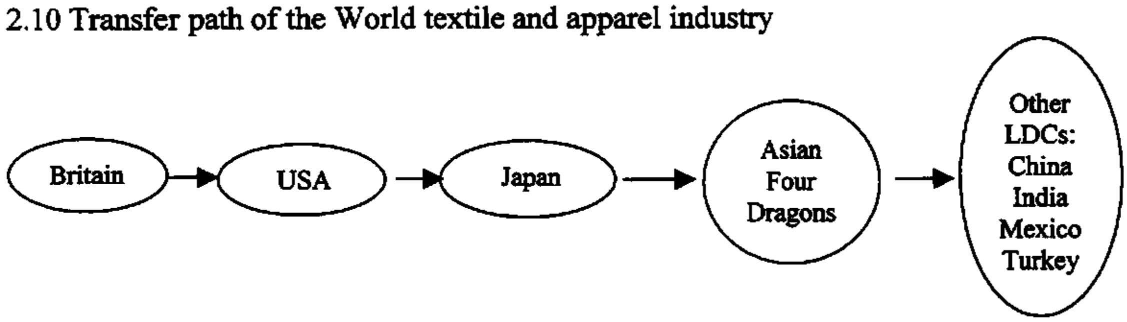
It contains profound implications, including corresponding policy support, market development and efficient firm-level strategies.

A. Factor specialization vs. generalization

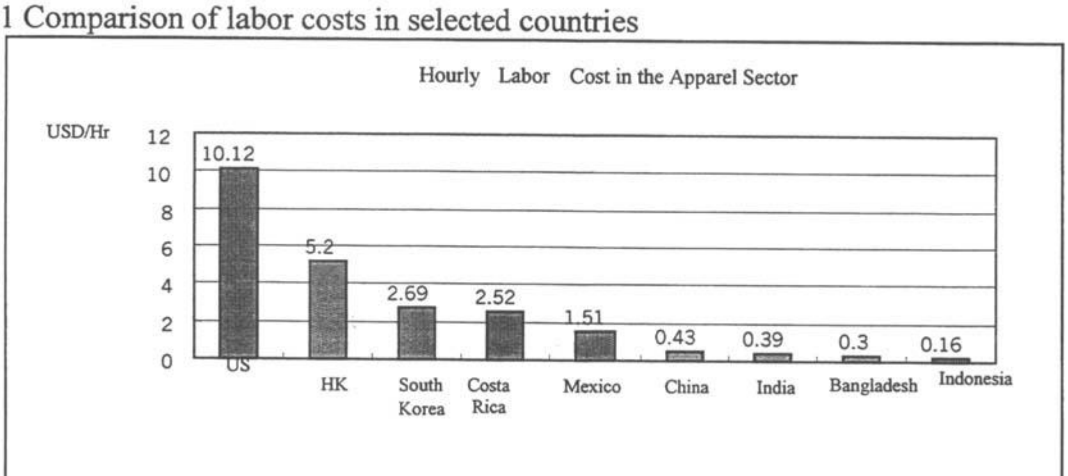
The traditional textile and apparel bases, such as Shanghai, are located in the east coastal region where the labor cost has been increasing continuously during recent years. It was natural for these bases to transfer some production facilities to the smaller cities in the east region or to more remote areas in the central and west areas in recent years. However, this move failed to achieve expected results. Though the central and west areas are rich in natural resources and low-cost labor, their weakness in other important aspects such as management and marketing are fatal to their development. Therefore, in order to make geographic relocation effective, the industry should, at the same time, equip these regions with qualified talents and machines based on local conditions. Transfer of production facilities is just the start of the relocation process. Cultivation of qualified managers and other marketing talents is most important, together with infrastructure improvement.

With the shift of production facilities to other regions, a traditional textile base such as Shanghai will place emphasis upon high-value added activities. Today's Shanghai is somewhat like HK in the 1980s, when HK textile and apparel manufacturers began to shift simple and low-value added processes to the Chinese mainland. After two decades' development, the HK textile and apparel industry has emerged as one of the famous fashion centers enjoying a high reputation for its design and high-quality products. The undergoing industrial upgrading is an opportunity for Shanghai and other traditional textile bases to transform their textile and apparel

2.10 Transfer path of the World textile and apparel industry



2.11 Comparison of labor costs in selected countries



(Source: Werner International Inc.)

industries. From January to November 1999, the textile and apparel exports and imports handled through Canton, Shanghai and Jiangsu accounted for 56.0% and 70.3% respectively, indicating their extensive foreign trade channels and network. Owing to the quicker and sounder economic development, talented people, especially new graduates, are very willing to work in these regions, which has further reinforced their human resource bases. Combined with relatively stronger research capabilities, improved infrastructure, and more sophisticated local demand, these cities/provinces have the potential and conditions to develop to an advanced level, focusing upon past weak links such as dyeing and finishing. The textile sector should focus upon home textiles and technical textiles, together with innovation in high-quality and new-type fashion fabrics. The apparel sector should attach greater importance to brand images, market promotion and fashion design.

More importantly, these enterprises should provide the necessary human and capital resources to help less developed regions to accumulate market experiences and gain market access. The merger of the Shanghai-based Hailuo Group and the Sichuan-based Chendu Apparel Group is the first case concerning transregional group integration. The Chendu Apparel Group, which is entitled to import and export, has 14 subordinate companies with total assets of 240 million RMB. However, its imperfect operational mechanism and weak management level make it run at a loss. The manager with the Hailuo Group, which has strength in marketing and brand management, is an attempt to achieve synergy in the long run. Effective end-market division and management cooperation are the prerequisites for its smooth operation.

B. WTO-based government policy

It is extremely important for the Chinese government to progressively shift its focus from direct supervision to strategic orientation. Direct government intervention has rarely generated a competitive advantage in textiles (Singleton 1997). Government's major functions are to create and maintain a favorable macro-environment within which the enterprises are responsible for their own actions and decisions.

- Preferential tax policy to all the investors

From January 1, 2000, a new preferential tax policy has been in force to encourage foreign investment in the west and central regions. These FIEs will continue to enjoy 15% income tax for another three years after the former 5-year preferential period is over. This policy is designed to attract more foreign capital inflow to boost these regions' economy. However, FIEs may be less willing to channel capital into these regions in view of their present investment environment. The government should extend this preferential policy to investors from the east coastal region as well. Domestic textile and apparel enterprises in the eastern region have been hampered by rising labor costs and limited expansion space during recent years. This tax policy will certainly help develop their interest in the vast hinterland and draw more local investors of strength to promote regional economic development. Such practice is also in line with the WTO rules which advocate national treatment.

- Equal emphasis upon SMEs

Current government policy places more emphasis upon large enterprises or company groups. They either encourage horizontal and vertical integration or give special attention (such as loose bank credit) to the present large enterprises, most of which are SOEs. By contrast, small and medium enterprises, though they account for the largest ratio in the industry, receive little or no support despite word commitment.

The healthy development of SMEs is of key importance to the diamond foundation. Government support does not mean direct interference in their daily operation. What SMEs need are a relaxed expansion space and an equal competition environment guaranteed by corresponding laws and regulations. What's more, government should help them to gain access to advanced technology, and to exchange with their counterparts in other countries to acquire more experience. To put it simply, government should not prejudice SMEs in policy setting and should play an active role in their technical upgrading.

- Secured market access for enterprises in the central and west

One of the biggest obstacles for enterprises located in the central and west regions is that they fail to have a sufficient market. Without market support, they lack the foundation to develop to a higher level, even if they are equipped with more advanced machinery. The government should play a role here. It should help the enterprises in less developed areas to improve their marketing capabilities for their manufactured resource-intensive products while encouraging those in the advanced areas to give up the low-end market and move upmarket. Though the ultimate aim is to let the market mechanism have the final say, it is still necessary for the government to take some steps at the very beginning in the hope of getting a good start, with sustainable development momentum. Otherwise, the central and west regions will still be reduced to simple assembly lines, which will greatly thwart the geographic relocation process and the macro aim of "developing the central/west region".

- Encouragement of overseas investment

With the progressive quota liberalization, major importing nations figure out other ways to protect their domestic textile and apparel industry. The NAFTA arrangement among Mexico, Canada and US paved the way for OPT activities between Mexico and US. The "yarn-forward" rule of origin makes non-member market access extremely difficult. Therefore, for domestic enterprises, it will be better to carry out foreign direct investment in some developing countries, such as Mexico, Turkey and the Caribbean Basin Area. Government should play an active role in this aspect, including information gathering, analysis of target market profiles, advice on efficient market access and training about important laws and regulations in the target market.

- WTO-based government protection

--WTO-allowed safeguard mechanism

With import tariff reduction and the removal of non-tariff barriers as well as direct state protection, it is now imperative for the government to set up a WTO-permitted safeguard mechanism. For example, the WTO permits a member country to take some unilateral remedies, such as anti-dumping and countervailing duty measures to ensure fair play. China did not publish relevant laws until the year 1997. Domestic chemical fiber suppliers have always claimed that some foreign producers dumped their products in China's market, causing material injury to the domestic industry. However, no further steps have been taken except oral warnings of possible anti-dumping investigations. At the same time, when facing foreign charges of dumping activities, most of the involved parties either didn't know how to handle this issue or adopted a non-cooperative attitude. As a result, they lost the case and had to endure all the consequences. All of this reflects the fact that domestic enterprises still don't know how to effectively protect their interests with rule-based weapons. After China enters into WTO, the government should make efforts to advocate WTO-based rules and regulations and help domestic enterprises to get familiar with these through various seminars and training programs. What's more, it should support and help develop trade associations to enhance exchange and cooperation among enterprises and organize enterprises to settle trade disputes with foreign partners.

--Important points in the trading regime

WTO entry means that domestic enterprises will compete in a more open environment. Reform of the foreign trading regime is more than simple relaxation of foreign trading rights. Stricter regulation is necessary to ensure the market order and to avoid blind and ill-considered price wars. The current performance evaluation standard, based on foreign exchange earning level rather than actual profit realization, should be dropped immediately. Furthermore, the government should help gather international market information, hold world-class exhibitions and fashions shows, and issue information about the latest development trends at regular intervals.

"Green consumption" is now another hot issue in the world, together with the formation of so called "green barriers". Germany's prohibition of azo dye usage in textiles has affected 15% of China's relevant exports. [51] Compared with the international "green" trend, China lags far behind. ISO14000 may be new to domestic enterprises. The government should take prompt steps to deal with the new situation, otherwise, more exports will be denied entry into the export market. The primary task is to advocate and enforce "cleaner production" [24] at each manufacturing step. Environment-friendly regulations should also be in force as early as possible.

--Follow-up of individual policies

The government should also establish a complete system to follow up the enforcement of individual policies. Take current SOE reform as an example. The government has carried out a reform package to help SOE out of the loss mire. Statistics show that there were some improvements in the SOEs performance. But there was a lack of detailed and in-depth analysis of each policy's contribution and the real implication of various statistics, such as loss reduction percentage and its underlying reasons. Close follow-up and continuous correction can ensure the overall coherence of government policies, which is crucial to its final effects.

C. Firm strategy

International success of a certain industry, in the final analysis, depends on firm-level strategy. To individual enterprises, WTO entry means that they should work out firm strategies based on new game rules and a new international environment. However, member status will not change the basic competition strategies.

- Genetic strategy

Many domestic enterprises don't have an insight into their own strengths and weaknesses and know little about the market operation. [2] As a result, current competition often ends in a malicious price war. Therefore, with or without WTO entry, domestic enterprises should always keep the market in mind and be strategic-minded.

There are two generic strategies with different emphases—one is upon cost, the other is upon differential products. [52] Since products in most domestic enterprises are still low and middle-range, production cost is the most important factor in future market competition, especially for standardized products. With the geographic relocation of the textile and apparel industry, those located in a raw-material supplying base should attach priority to cost control while downstream enterprises should focus more on product differentiation to gain their place in a more specific market niche.

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[24] This idea was first put forward by the United Nations in 1989.

At the same time, no matter what strategy a firm may choose, product quality is always an issue of prime importance, together with quick and prompt reaction to the market demand. Large buying houses in Europe have reduced the number of their suppliers to concentrate their purchases on more efficient ones based on their products and their logistical performance as well. Enterprises should pay close attention to this buying trend, trying to shorten their usual delivery time from 5-6 months to 8-12 weeks after order placing to meet the QR requirements.

- Focus upon "two-end" activities

Domestic enterprises often ignore "two-end" activities, including product development and marketing. This phenomenon is closely related to the old distribution system in China. Prior to the 1980s, wholesale and retail businesses were monopolized by sate-run enterprises. The central-planned multi-tier distribution hierarchy operated as an allocation machine, rigidly separating the production sector from the distribution sector. Producers were extremely insensitive to market changes. The textile and apparel production enterprises were neither responsible for the market demand nor concerned with the marketability of their products. The only thing they cared about was producing the goods based upon a planned quantity within a scheduled time period. With foreign direct investment in China, a common thing is that the "two-end" activities are retained in foreign hands. As a result, though China has enefited a lot from this foreign capital inflow, many enterprises are trapped in the lowest value-added links in the whole value chain. Thus, relocation in China should pay much attention to this aspect. With production facilities moved to the hinterland, the associated "market" should be given to these enterprises as well. This can help enterprises in the central and western regions to be really market-oriented.

- Long-term vision

There are few competitive advantages that cannot be imitated. Though a detailed and good firm strategy may be simple in nature, it should be drafted with a long-term vision.

The processing trade is very important to the quick emergence of China's textile and apparel industry. However, it is also an obstacle to building local brands in the long run. Many enterprises are satisfied with their processing activities, using buyer's samples and imported materials, as it is virtually risk-free. It is unreasonable to give up this processing trade immediately and it will stay for quite a long time. The important thing is that the enterprises, especially those of strength and ambition, should embody the idea of brand building in their long-term development plan. Engaging in higher value-added activities is the ultimate approach to survive the competition and acquire hard-to-copy competitive advantages.

The shortsightedness of some enterprises also casts a shadow upon the effectiveness of current reforms. For example, spindle elimination aims to reduce redundant production capacity by dismantling obsolete spindles. However, owing to some enterprises' myopia, some of the obsolete spindles were not eliminated but sold to the TVEs and private enterprises to continue production. These enterprises gained a little profit from the sale, but they brought a very negative impact upon the reform process.

The long-term vision of an enterprise ultimately means to its relentless pursuit of product innovation and technical upgrading. Enterprises of strength should establish their own R&D department, while small ones should learn to absorb from others. The development history of some Japanese industries after WWII provides a very good example to domestic enterprises. Limited capital should be used to create maximum profits. The past practices such as repeated introduction and blind expansion must be discarded right away. Size is not important, but economic efficiency is most important. Downstream and upstream enterprises should cooperate closely to share common information and technology. This is an inevitable trend and a necessary way to boost the performance of the whole industry.

D. Consumer market development

The latest government report emphasizes that China will continue to boost domestic demand through various measures, such as policies concerning housing, pensions, and income growth, especially for peasants. In the diamond model, consumer sophistication and market conditions play a role in forming an industry's competitive advantages. Consumer market development largely depends upon two aspects: government policy orientation and the enterprises' role.

- Government policy orientation

Local demand is sometimes influenced by government policy. The concept of "green consumption" first appeared in countries where government places great emphasis upon environment protection and promulgates many relevant laws. China for a long time was in a seller's market. It was not until the 1990s that consumers were able to be selective and demanding. Domestic law on consumer interest protection was only published in the early 1990s. Therefore, there is much to do for the government to cultivate consumers through policy orientation, such as nationwide environment-consciousness through promotion of environmental protection.

- Enterprises' role

Enterprises play a more direct role in forming market demand and upgrading consumer sophistication. Domestic enterprises usually focus on simple product advertising and neglect cultivation of their consumers. Better communication between enterprises and consumers not only helps enterprises to know better about the market conditions but also to enrich the consumers' knowledge about products and enterprises. Regular exhibitions and fashion shows also enable consumers to have access to the new products and new technology, thus broadening their horizons.

2.5 IMPACT UPON THE HK TEXTILE AND APPAREL INDUSTRY

2.5.1 Mutual importance of China and HK to each other's economy

2.5.1.1 Role of the mainland in HK economic transformation

HK is a place lacking the necessary natural resources for agricultural and industrial development. However, it is endowed with an ideal port and a strategic location acting as the doorway to South China. It is also in the international time zone that bridges the time gap between Asia and Europe. The HK economy has undergone some big and fundamental transformations during the past half-century. The Chinese Mainland, either passive or active, plays a crucial role in its economic development.

A. Before 1978

Before the 1950s, the economic activities of HK focused upon a transit trade. It was a bridge linking the Chinese Mainland and the outside world. There was almost no established industrial sector in HK at that time.

However, after the breakout of the Korean war and the subsequent trade boycott of China by the United Nations, HK lost its role as an entrepôt port for China's major importation from and exportation to the West. Because of the hostile external environment towards the newly founded Chinese regime during this period, the mainland turned to independence and a self-sufficiency policy for its economic construction. Foreign trade was mainly conducted with the East European bloc and the former Soviet Union. Therefore, the economic and trade link between the Chinese Mainland and HK stagnated. HK domestic exports and re-exports to the Mainland were HK$31 million and HK$175 million respectively in 1977, representing only 0.1% and 1.8% of HK's total domestic and re-export volume. Because of the limited availability of natural resources, there was almost no agriculture sector in HK. It had to import the indispensable living substances and other raw materials from the Mainland. That was the major reason for the relatively larger share of its import volume with the Mainland, which was 16.6% in 1977. (HK External Trade 1977)

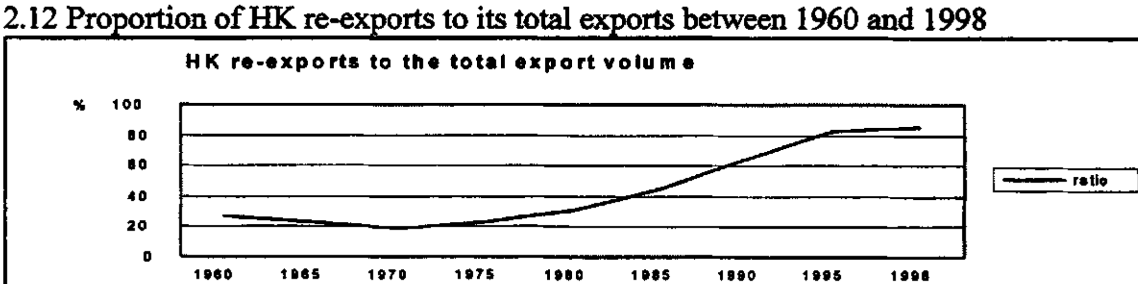
It was during this period that HK began to develop its own manufacturing sector in order to fill the blank of the loss of its entrepôt port role between China and the outside world.

B. After 1978

HK started exporting its own products with the quick emergence of the manufacturing sector after the 1950s, which were labor-intensive and export-oriented. Such a prompt move gave a new growth momentum for the economy when the entrepôt trade was declining sharply. However, with the continuous rise of labor and land costs, as well as more competitive new entrants, this sector faced a dilemma by the end of 1970s. The increased operational cost forced the manufacturers to find alternative approaches to survive the hotter international competition.

It was right after 1978 that the "open-up" reform in China ushered in the economic integration between HK and the Chinese Mainland, especially between HK and the Pearl River Delta. The imbalance of economic strength and different needs between the two sides at that time laid a foundation for close economic cooperation. HK was troubled with its soaring labor and land costs while the Mainland was abundant in these factors; the Mainland was in urgent need of foreign capital and advanced technology to boost its fragile economy, which HK was in a position to provide based on a decades' accumulation and development. What's more, the geographic proximity and cultural similarity were also a plus. HK manufacturers began to shift most of their production facilities to the Mainland to exploit its low labor and land costs as well as its huge potential market and various preferential policies designed to attract overseas investment. At the same time, HK retained the higher value-added activities such as quality control, product design, market promotion and distribution. The so-called "Front Store and Back Factory" pattern well illustrates the cooperation between the two sides. Backed by the production support from the Chinese Mainland, HK again resumed its entrepôt port role (Figure 2.12) and upgraded to a higher and more comprehensive level. According to the HKSAR government statistics, out of HK's total re-export volume, which was HK$1159.2 billion in 1998, 95% either originated from or were destined for the Chinese Mainland. [53]

2.12 Proportion of HK re-exports to its total exports between 1960 and 1998



(Source: HK External Trade, 1998)

After twenty years' development, the mainland is now the most important offshore production base for HK companies, while HK has developed into a very important international financial and trade center with a strong and well-established service sector. This new positioning of HK can be mainly attributed to the "open-up" policy adopted as the Chinese Mainland, which provided an excellent opportunity for HK to grow into an international service center.

2.5.1.2 Role of HK in China economic restructuring

A. The largest investor and major trading partner

HK has been the largest investor in the Chinese Mainland since the latter began to carry out its open door policy. In 1998, HK signed more than 7,805 investment projects in the Chinese Mainland, with contracted and utilized capital of US$ 18.8 billion and US$ 19.4 billion, representing 39.4%, 34.3% and 40.8% of the national total respectively. By the end of April 1999, there were 329,637 foreign-funded projects registered in the Chinese Mainland, among which 54.8% were tied to HK interests. Contracted and utilized capital inflow from HK reached US$ 300.7 billion and US$ 142.7 billion, accounting for 51.6% and 50.7% of the national total. More than 120,000 enterprises involving HK interests were registered in the Mainland.

At the same time, HK was the Mainland's fourth largest trading partner after Japan, the US and the EU in 1998. According to China Customs' statistics, bilateral trade between the Chinese Mainland and HKSAR was US$ 45.4 billion in 1998, accounting for 14% of the Mainland's total trade volume.[25]

B. Rapid emergence of the Pearl River Delta

With the shift of HK production capacities to the Pearl River Delta, which is close to HK and enjoys various preferential policies designed to attract foreign investment, this region experienced a very rapid and dynamic economic development. The Pearl River Delta is the hottest spot of HK-based investment. According to the HK Economy Yearbook 1996, about 80-90% of the plastics industry, 85% of the electronics industry and 90% of the toy industry have moved to this region. It now engages more than 5 million local people working for these HK-backed companies or factories, which is over 19 times the size of the local manufacturing workforce in HK. The capital, technology, management expertise and extensive international distribution channels introduced from HK are the major driving force for the quick emergence of the Pearl River Delta and help promote the economic integration between the Mainland and the rest of the world.

C. Intermediary between the Chinese Mainland and the outside world

In addition to its important role in the Mainland's economic development and restructuring, HK is a unique gateway of the Chinese Mainland to the outside world. Thanks to its strategic location, well-established banking and financial facilities, government non-interventionist policies and rich knowledge of the Mainland market, it has become a very important venue for multinational corporations to access and tap the Mainland market. Many foreign enterprises have moved their regional headquarters or head offices to HK as a way to further penetrate into the Mainland market, which is expected to be more open and vigorous in the future. Furthermore, as an important sourcing center, more than 75% of overseas buyers in a survey conducted by HKTDC replied that over half of their Chinese imports were sourced via HK. [55]

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[25] All the data in this part are retrieved from this web site: http://www.tdc.org.hk/main/china.htm

HK is also an efficient channel for foreign capital entering the Mainland. More than 70% of foreign capital was introduced into the Mainland of China via HK. On the other hand, because of HK's extensive external relations with the outside world, it is an ideal place for Mainland enterprises to raise capital. Almost every province, autonomous and municipality in the Mainland now has resident representative offices, agents or distributors in HK. According to the Chinese official estimate, there are over 1,856 Mainland-backed enterprises registered in HK, among which over 72 were listed on the HK Stock Exchange.

Another indication of the significance of HK's intermediary role is the average annual growth rate of 16.3% in HK's ordinary re-exports to China (not related to outward processing) between 1992 and 1997. [74] In 1998, re-exports of Mainland origin products through HK rose from HK$545.8 billion in 1994 to HK$691.2 billion. Goods re-exported to the Mainland via HK were HK$407.4 billion in the same year, 26.2% higher than that in 1994.[26] About 35% of HK's re-exports are destined for the mainland and 60% of the re-exports are of Chinese origin. [56]

2.5.1.3 Implications for HK trade and investment

A. Trade relationship with the Chinese Mainland

The Mainland has been HK's largest trading partner since 1985. The Mainland's share of HK's global trade jumped from 9.3% in 1978 to 37.7% in 1998. It is currently HK's largest import source and export market, accounting for 40.6% of HK's total imports and 34.4% of HK's total exports. (Table 2.13)

The shift of HK production facilities to the Mainland contributed to the drastic rise of the re-export volume between the two sides, which at the same time, boosted the prosperity of all re-export activities in HK. In 1998, HK re-exports to China accounted for 35.1% of the total re-export value. (Figure 2.13)

HK's trade with the Chinese Mainland mainly focuses upon outward processing activities. In 1998, 77.4% of HK's domestic exports and 44.1% of re-exports to the Mainland were concerned with outward processing activities; 82.7% of HK's imports from the mainland and 87.6% of HK's re-exports of Mainland origin to other countries and regions other than China were associated with outward processing.[27] Therefore, the manufacturing cooperation pattern between the two sides not only helps maintain

Table 2.13 HK imports and exports with China between 1975 and 1998

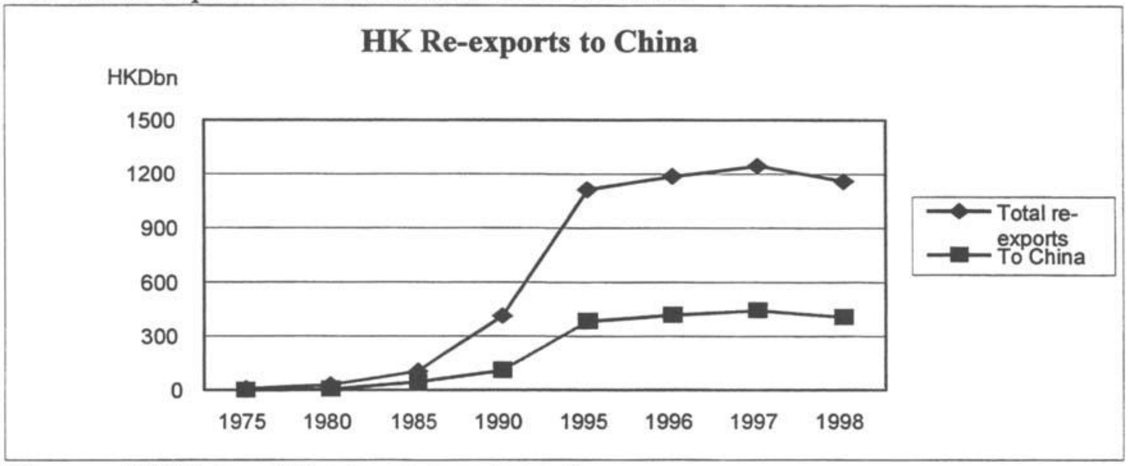
HK imports and exports with China, in HD$ bn								
	1975	**1980**	**1985**	**1990**	**1995**	**1996**	**1997**	**1998**
Total Trade	63.30	209.89	466.57	1282.41	2835.25	2933.50	3071.04	2766.74
With China	6.97	28.20	120.18	394.51	987.08	1049.81	1116.17	1044.11
share %	*11.01*	*13.44*	*25.76*	*30.76*	*34.81*	*35.79*	*36.35*	*37.74*
Total Imports	33.47	111.65	231.42	642.53	1491.12	1535.58	1615.09	1429.09
From China	6.81	21.95	58.96	236.13	539.48	570.44	608.37	580.61
share %	*20.3*	*19.7*	*25.5*	*36.8*	*36.2*	*37.1*	*37.7*	*40.6*
Total exports	29.83	98.24	235.15	639.88	1344.13	1397.92	1455.95	1,347.65
To China	0.17	6.25	61.21	158.38	447.60	479.37	507.75	463.44
Share %	*0.6*	*6.4*	*26.0*	*24.8*	*33.3*	*34.3*	*34.9*	*34.4*

(Source: HK External Trade 1998)

[26] HK External Yearbook, 1998

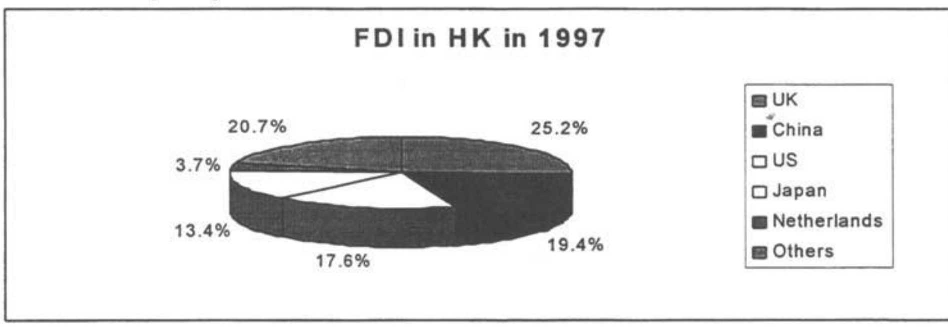
[27] HK External Trade, March 1999

2.13 HK re-exports to China between 1975 and 1998



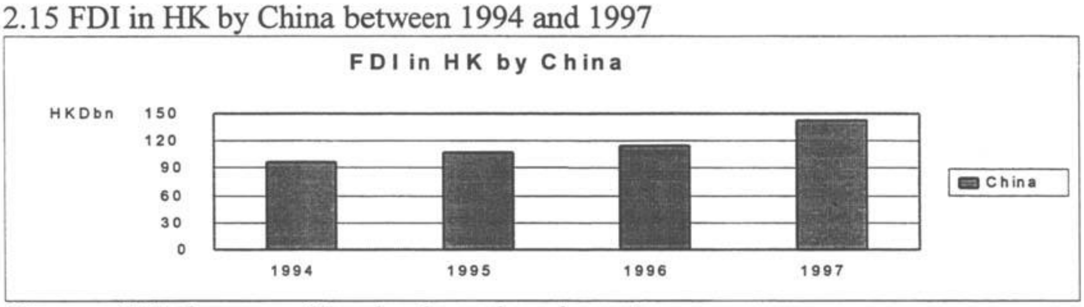
(Source: HK External Trade, various issues)

2.14 FDI in HK by major investors in 1997



(Source: HK Economy Yearbook, 1999)

2.15 FDI in HK by China between 1994 and 1997



(Source: HK Economy Yearbook, various issues)

the competitiveness of HK-labeled products, but also boosts the development of the service sector, especially trade-related services. The entrepot trade in HK nowadays is endowed with new characteristics, far beyond the traditional sense.

B. Close investment linkage

Trade and investment always grow hand in hand. As mentioned above, HK is by far the largest investor in the Mainland. However, such investment is not one-way traffic. China is also a major investor in HK, second only to the UK in 1997. (Figure 2.14) From 1994 to 1997, the Mainland investment in HK increased from HK$ 96.6 billion to HK$ 142.4 billion. (Figure 2.15) In a word, HK and the Mainland are each other's very important trading partner and investor. The close and complementary economic relationship is crucial to both sides.

2.5.2 Profile of the HK textile and apparel industry

2.5.2.1 Importance in HK economic development

A. Key importance to HK industrialization

The textile and apparel industry plays a very important role for HK economic development. In 1955, its employment accounted for 37.2% of the local manufacturing workforce and in 1975, the proportion rose to 51.8%. [75] Though it has faced many troubles and difficulties since the late 1970s, it remains as the backbone of the HK manufacturing sector. Today, the apparel industry is still the largest manufacturing sector in HK in view of its gross output, its employment or its domestic exports. Together with the textile industry, they totally employ 31.4% of the local manufacturing workforce. [75] In 1998, the textile and apparel domestic exports were HK$ 85.6 billion, amounting to 45.4% of the total domestic export volume; their re-exports topped HK$ 187.0 billion, or 16.1% of the total re-exports. If the two figures are combined, the sector's total export value reached HK$ 272.67 billion, accounting for 20.2% of HK's total exports. [76]

B. Present situation

Though the textile and apparel sector still plays a key role in the HK economy, it is facing a lot of difficulties and challenges. In addition to the reasons mentioned above such as rising labor and land costs, the limited domestic market and fierce competition in the international market, the overwhelming challenge is the inevitable declining trend of the manufacturing sector in HK. The territory itself is now engaging in fewer manufacturing activities and shifting to a service-oriented economy. Table 2.14 gives some insight into the present situation of the textile and apparel sector. Both the export and import share of the textile and apparel sector shrank by various degrees, accompanied with descending employment from 16.5% in 1980 to 3.6% in 1998 of the total workforce.

The HK economy is now more interwoven with the outside world, especially with the Asian region. It is prone to suffer from world or regional crisis. The 1997 Southeast Asia Financial Turmoil dealt a heavy blow to HK, causing a setback in the economy until the second quarter of 1999 when GDP experienced a small positive growth of 0.5% in real terms.[28] The increasing dependence upon other economies makes HK more sensitive to the external environment and changes. There are various

Table 2.14 Textile and apparel sector in HK's economy

Textile and Apparel Industry in HK's Economy				
	1970	1980	1990	1998
T & A exports to total exports (%)	39.8	34.3	28.8	20.2
T & A imports to total imports (%)	18.7	16.4	20.8	15.1
T & A employment to total employment (%)	NA	16.5	11.7	3.6

(Source: Calculated based on data from HK Economy Yearbook and HK External Trade, various issues)

[28] Half-Yearly Economic Report 1999

Table 2.15 Breakdown of HK textile industry in 1998

Textile Industry Composition By Some Major Sectors

Sector	Spinning				Weaving		
Sub-sector	*Cotton spinning*	*Wool Spinning*	*Synthetic Fiber Spinning*	*Other Fiber Spinning*	*Cotton Woven Fabrics*	*Wool Woven Fabrics*	*Silk Woven Fabrics*
Establishment	7	1	3	20	96	1	3
Employment	2128	100	94	169	3329	9	8
Average	304	100	31	8	35	9	3
Sector	**Dyeing & Printing**				**Knitting**		
Sub-sector	*Yarn*	*Weaving Fabrics*	*Knitting Fabrics*	*Clothing*	*Cotton*	*Wool*	*Others*
Establishment	38	70	31	26		298	
Employment	671	2063	376	296		4461	
Average	18	29	12	11		15	

(Source: HK Economy Yearbook 1999)

arguments with respect to the future road the manufacturing sector should take, among which are the "Shell" versus "Balance" argument. The former stresses that HK should focus on service-related activities and further re-locate the manufacturing sector to other regions; while the latter points out that HK should maintain a manufacturing sector featuring hi-tech and industrial upgrading in order to keep the economy healthy and sound. It is beyond this paper's scope to discuss these arguments in detail. However, they indicate, from certain aspects, that the textile and apparel industry is now at the crossroads. To shrink or expand depends not only on the local conditions, but also on the stance the whole manufacturing sector will hold in the future.

2.5.2.2 Hong Kong's Textile industry

A. General conditions

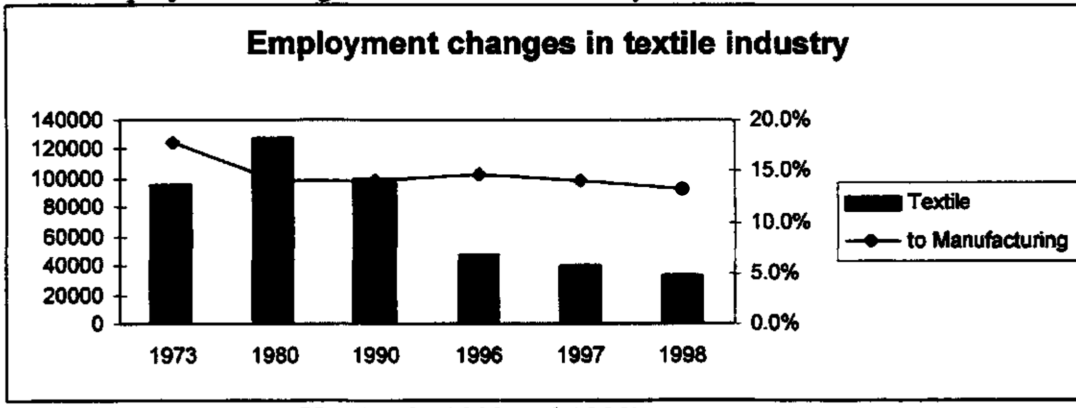
The textile industry in HK has a history of more than 50 years. The first cotton mill was established in 1947. [75] Table 2.15 is a recent breakdown of this industry by some major categories. The 1950s and 1960s saw the rapid development of the textile industry. In 1973, it employed 17.7% of the total manufacturing workforce. [75 (1975)] At the beginning of the 1970s, the cotton spinning industry turned to using the open-end spinning approach instead of ring spinning. Automation and computerization also play a role in the knitting, dyeing and printing industry. Absolute employment in the industry experienced a downturn from the late 1970s in the face of soaring land, labor and energy costs. Figure 2.16 illustrates the employment changes between 1995 and 1998. It should be noted that though the employment reduced to 18533 in 1998 from 28811 in 1995, its proportion to the total manufacturing sector was relatively unchanged. The average number hired in each establishment was around 13 in 1998.

B. Major characteristics

- Products

The textile industry is export-oriented. Most of the products are for export, among which woven fabrics accounted for approximately 48% in 1998. (Table 2.16) It is also a major supplier to the local apparel industry, in addition to its export orientation. It specializes in cotton yarns and natural fabrics. With the shift of low-end products to the Chinese Mainland and other regions such as Southeast Asian countries, the

2.16[29] Employment changes in HK textile industry



(Source: HK Economy Yearbook, 1998 and 1999)

manufacturing operations in HK mainly concentrate upon high value-added items.

- Foreign investment

As mentioned earlier, most of the foreign investments coming into HK have been poured into the more advanced sectors such as electronics or the auto industries. The textile industry attracted foreign investment of US$ 182 million (equivalent to HK$ 1.42 billion), with 21 establishments with a total of 2,063 workers by the end of 1997, accounting for 2.8% of the total foreign investment in the manufacturing sector. Liberia was the major source of investment, followed by Japan and Taiwan. [57]

- Strengths

--Computer-aided design and computer-aided manufacturing are widely used to offer quality fabrics to the apparel industry.

--The local textile industry, based on close cooperation and a complete information network, is able to meet promptly orders from the apparel industry, at a very short notice. At the same time, an intranet communication infrastructure funded by the SAR government has been launched to ensure efficient electronic communication and trade between the two sectors.

--The textile enterprises pay much attention to product innovation and upgrading in order to compete with low-cost suppliers such as Pakistan, Thailand and India. New features are developed and incorporated into products, including anti-bacteria and anti-UV agents, crease-resistance, water-repellence, as well as easy-care characteristics.

- Weaknesses

--Because of its export-orientation feature, this sector is prone to be negatively affected by an unfavorable outside economic environment. In 1998, textile exports registered a drastic year-on-year drop of 10.7% mainly due to the Southeast Asian Financial Crisis which resulted in a sluggish demand in HK's major export markets.

--Though the local enterprises make great efforts to introduce state-of-the-art technology to the textile sector, which is relatively capital-intensive, the research & development capabilities in HK are not strong enough to provide a firm foundation for sustainable future development. Most of the textile enterprises are of small size, except the cotton and wool spinning sectors, hampering long-term capital as well as R&D investment.

[29] In Figures 2.16 and 2.25, original data are from HK Economy Yearbook, 1998 and 1999. Then, they are calculated with some adjustments. Here, knitwear is deducted from the textile sector and added to the apparel sector. The same adjustment is made in Tables 2.16 and 2.18.

Table 2.16 HK textile exports by categories

Textile exports by categories		
Category	**1997%**	**1998%**
Textile Yarn	21.8	22.1
Woven Fabrics	49.0	47.9
Cotton	*22.7*	*24.0*
Man-made	*21*	*18.6*
Others	*5.2*	*5.3*
Knitted or Crocheted Fabrics	13.9	15.1
Special Yarns and Fabrics	7.4	7.0
Finishing Accessories	3.3	3.5
Textile Made-up	4.1	4.0
Floor Coverings	0.5	0.4

(Source: [58])

C. Textile trading

- Import and export volume

In 1970, the total textile export value was HK$ 1.67 billion, and it increased to HK$ 101 billion in 1998—60 times more than that in 1970. The total textile imports increased from HK$ 3.0 billion to HK$ 104.4 billion during the same period. (Figures 2.17 & 2.18) Textile domestic exports topped HK$ 17.2 billion in 1992 and then declined on a year-on-year basis for the next six years. By sharp contrast, the re-export value jumped from HK$ 0.4 billion in 1970 to HK$ 90.2 billion in 1998 accounting for 89.3% of the total textile exports.

The textile trade in HK was clouded in 1998 mainly due to the aftermath brought about by the Southeast Asian Financial Turmoil. The sluggish demand from Asian countries, especially from the Chinese Mainland, contributed to the 13.9% drop of the total textile trade volume in 1998, of which the textile imports and exports experienced a 16% and 10.7% decrease respectively.

- Major textile trading partners[30]

According to Figure 2.19, approximately half of the textile domestic exports were absorbed by the Chinese Mainland,[31] followed by the US and Indonesia. The Chinese Mainland was also HK's largest textile re-export market, holding 71.4% of the total re-exports, 33 times more than that re-exported to Bangladesh, which is HK's second re-export destination. (Figure 2.20) As regards textile imports, the Chinese mainland was again HK's biggest trading partner, contributing 39.1% of the total import volume. (Figure 2.21) If exports and imports were combined together, the Chinese Mainland accounted for 53.8% of HK total textile trade.

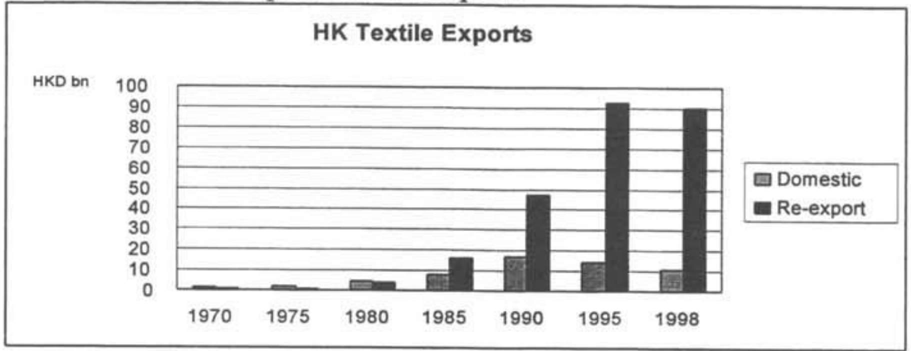
- Textile trade pattern

--The Chinese Mainland is HK's No. 1 textile trading partner, both in terms of export and import value. From Figures 2.22 to 2.24, it will be seen that trade volume registered a rapid increase from 1975 to 1985 and then developed at a relatively moderate speed. Section 2.5.3 will give a more detailed illustration discussion of this aspect.

[30] Data in Figure 2.19, 2.20 and 2.21 are from HK industrialist, November 1999

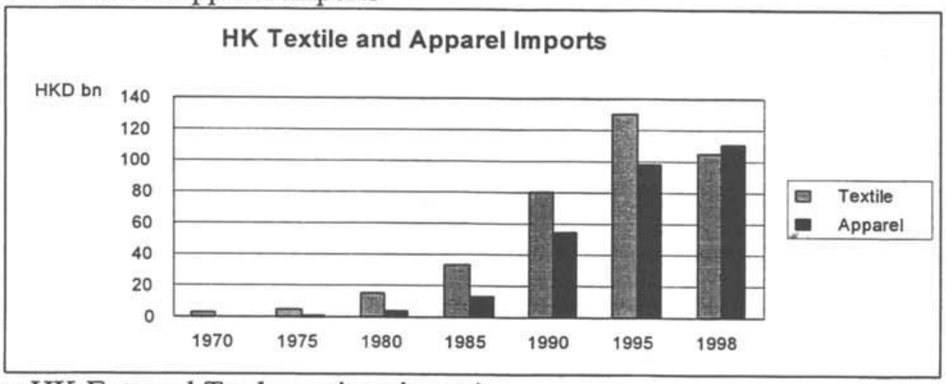
[31] In the figures, China refers to the Chinese Mainland.

2.17 HK textile domestic exports and re-exports



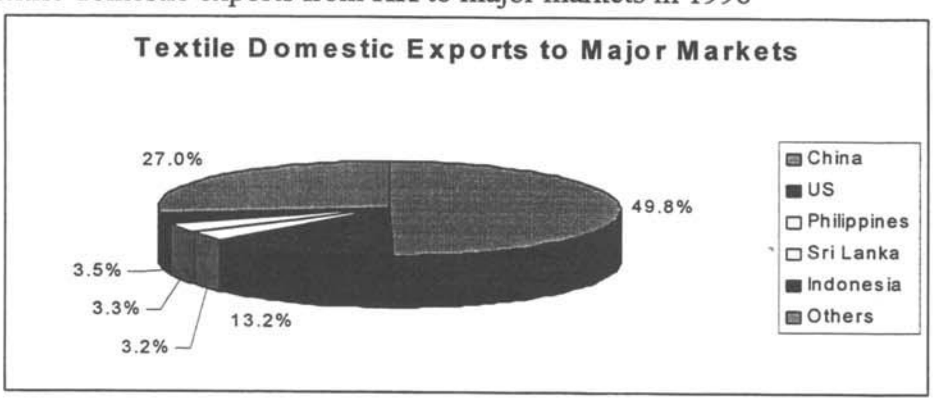
(Source: HK External Trade, various issues)

2.18 HK textile and apparel imports

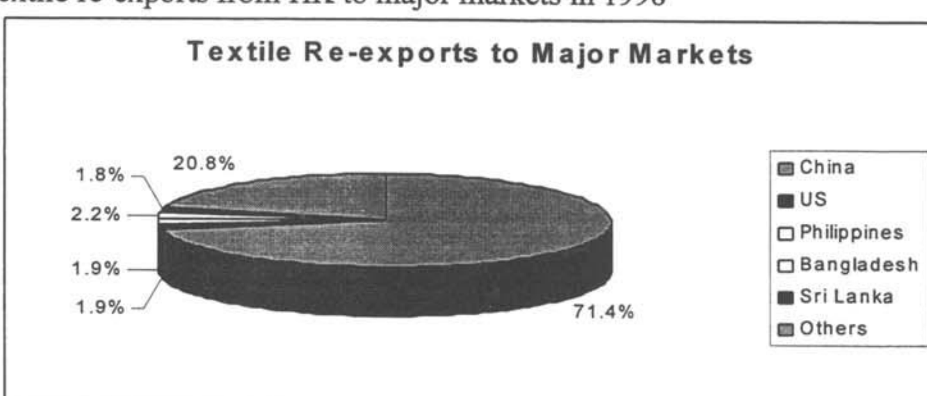


(Source: HK External Trade, various issues)

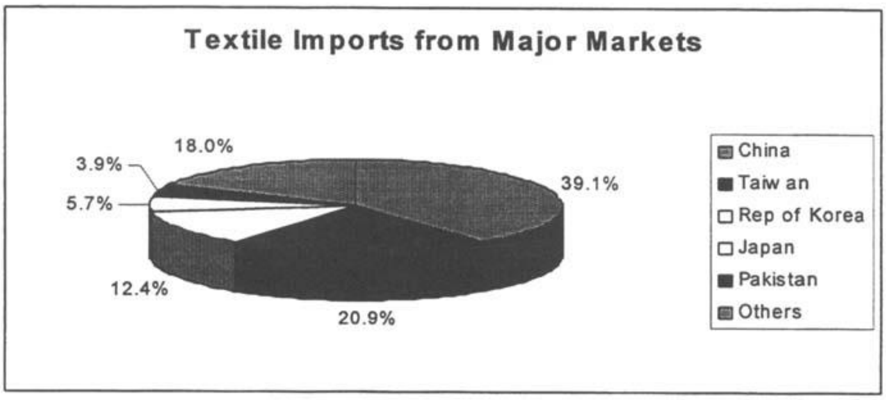
2.19 Textile domestic exports from HK to major markets in 1998



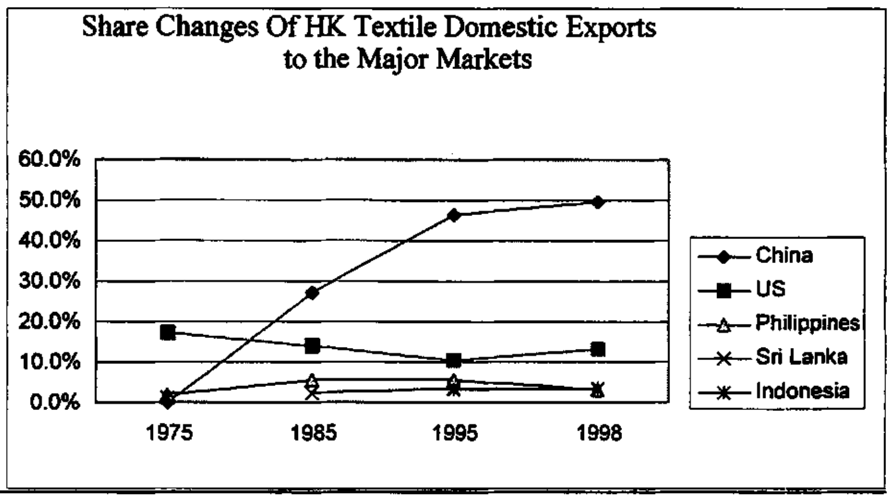
2.20 Textile re-exports from HK to major markets in 1998



2.21 Textile imports from major markets to HK in 1998



2.22 Share changes of HK Textile Domestic Exports to the Major Markets



(Source: Calculated based on data from HK Industrialist, various issues; HK External Trade, various issues)

--Except for the US, several Asian developing countries, including the Mainland, the Philippines, Sri Lanka, Bangladesh and Indonesia, were HK's major textile export destinations; at the same time, Taiwan, Korea and Japan were the major textile suppliers to HK apart from the Chinese Mainland. They supplied 39% of the textiles to imported into HK while the Mainland provided another 39%. Such a pattern shows that the HK textile trade is concentrated upon the Asian region.

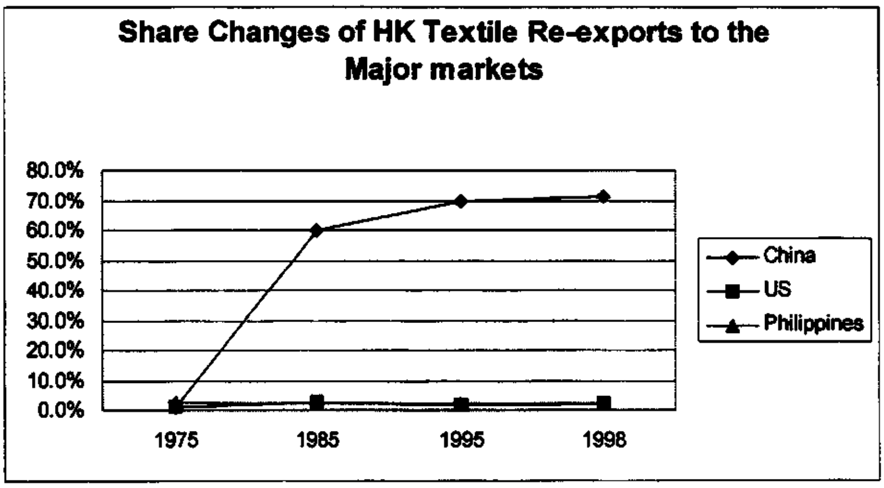
--Though HK is still the world's leading textile exporter, its domestic exports play a less significant role. Textile domestic exports only accounted for 10.7% of total textile exports in 1998, compared with 76.6% in 1970. This indicates trend of the local textile industry during the past three decades. Based on these figures, it can be said that HK is now a world textile sourcing center rather than a manufacturing base.

2.5.2.3 Hong Kong's apparel industry

A. General conditions

Hong Kong's fame as an famous apparel-manufacturing center has developed in less than five decades. It has been a very important pillar of the HK manufacturing sector since the early 1960s with the largest employment, the highest gross output value and biggest domestic export volume. Over the years, the apparel industry has

2.23 Share Changes of HK Textile Re-exports to the Major Markets



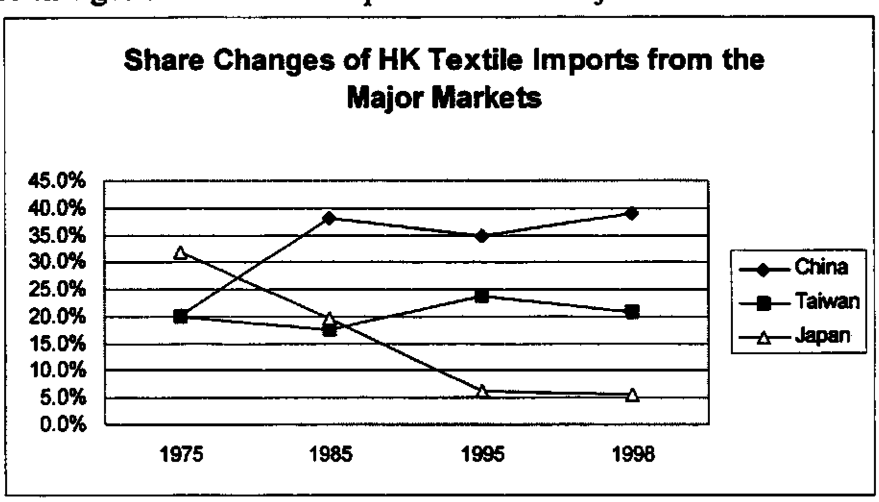
(Source: Calculated based on data from HK Industrialist, various issues; HK External Trade, various issues)

Table 2.17 HK apparel industry structure

Apparel Industry Composition						
Sub-sector	Wovenwear	Knitwear	Underwear & Pajamas	Fur	Other	Total
Establishment	1,938	742	120	15	239	3,054
Employment	36,855	14,142	1,297	123	6,095	58,512
Average	19	19	11	8	26	20

(Source: HK Economy Yearbook 1999; [16])

2.24 Share changes of HK Textile Imports from the Major Markets



(Source: Calculated based on data from HK Industrialist, various issues; HK External Trade, various issues)

successfully evolved from a low-cost supplier to a regional fashion center featuring good quality, prompt delivery, quick response and excellent fashion sense.

The HK apparel industry mainly comprises the following sub-sectors: woven wear, knitwear, underwear, and other small divisions including leather & fur apparel and apparel accessories. (Table 2.17) The wovenwear sector accounts for about 63%

Though many production facilities have been shifted to other regions since the 1980s, the sector is still very active in providing one-stop services ranging from design and production to marketing and retailing. It focuses upon high value-added activities, functioning as a strategic control and sourcing center for its extensive production network. Though troubled by rising costs and protectionist measures adopted by other countries, the apparel industry is still the largest employer in the manufacturing sector, despite the sharp drop of 47% in its absolute employment level between 1995 and 1998. (Figure 2.25)

B. Major characteristics

- Products

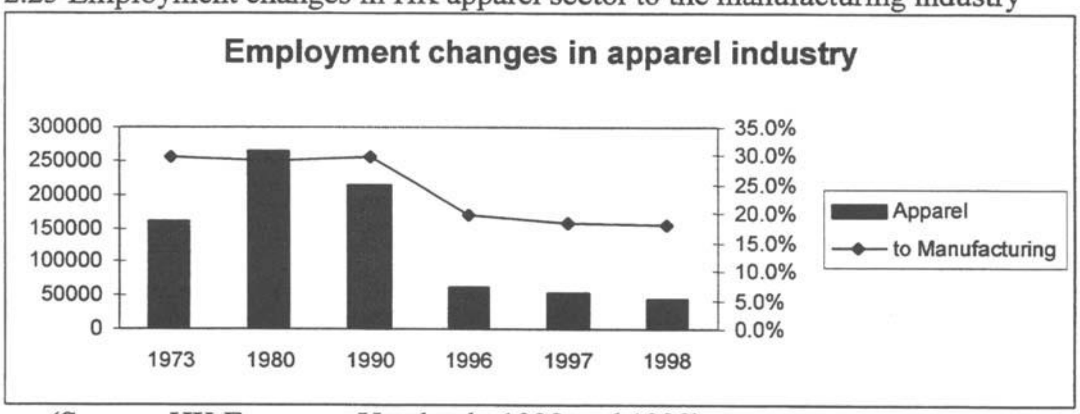
HK is the world's second largest apparel exporter after the Chinese Mainland. It has successfully built up its upmarket image based on design, workmanship and quality. Since most enterprises have set up offshore production facilities outside HK, particularly in the Chinese Mainland, the local enterprises are mainly responsible for quality control, logistic arrangement, fashion design, sales and marketing.

The apparel sector is also export-oriented with a variety of products ranging from woven and knitted apparel to clothing accessories. Table 2.18 shows that woven wear is the largest export item, holding 39.4% of the total apparel exports in 1998.

- Foreign investment

FDI in the apparel sector amounted to US$ 110 million, or 1.7% of total FDI in all the manufacturing sectors by the end of 1997, with 34 establishments of with a total 5039 employees. Switzerland was the largest investor with a 55.3% share, followed

2.25 Employment changes in HK apparel sector to the manufacturing industry



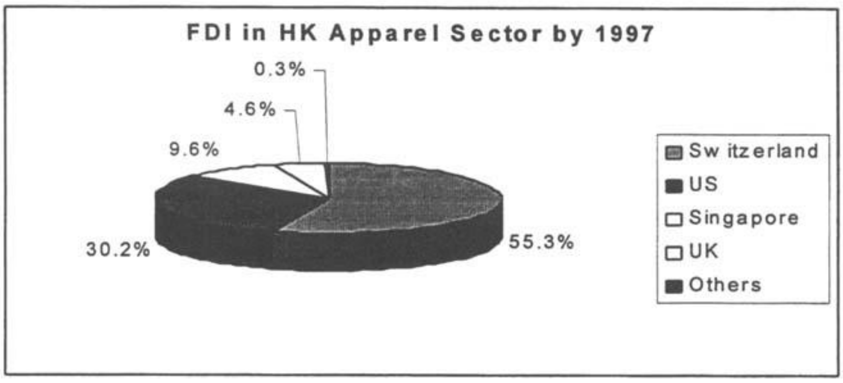
(Source: HK Economy Yearbook, 1998 and 1999)

Table 2.18 HK apparel exports by category

Apparel exports by category		
Category	**1997%**	**1998%**
Woven Wear	40.8	39.4
For Men or Boys	*16.8*	*15.9*
For Women or Girls	*24.0*	*23.5*
Knitted Wear	16.6	17.2
For Men or Boys	*5.6*	*5.6*
For Women or Girls	*11.0*	*11.6*
Clothing Accessories	9.6	9.6
Of Textile Fabrics	*3.5*	*3.9*
Of Non-textile fabrics	*6.1*	*5.7*
Other Apparel Articles	33.0	33.8

(Source: http://www.tdc.org.hk/main/industries/ipclot.htm)

2.26 FDI in HK apparel sector by 1997



(Source: http://www.igsd.gov.hk/investment/html/m_sector_industry_11.html)

by the US, Singapore and the UK. (Figure 2.26)

- Strengths

--Given the importance of "Quick Response" in the worldwide textile and apparel trade, a Quick Response Center for Textiles and Clothing Industries was set up in 1995 to help deal with customer needs and strengthen awareness towards quick response. Many manufacturers have applied "supply chain management" to their daily operation, especially to the offshore production network. Electronic Data Interchange (EDI) is employed among various parties to facilitate the coordination process and working efficiency. A full EDI service for production notification has been implemented since February 28, 2000.

--Like the textile sector, computer-aided design and computer-aided manufacturing approaches are adopted to boost productivity and value-added volume. A three-dimensional pattern design technique has been developed to reinforce the apparel quality, fitness and silhouette in the manufacturing process. The apparel samples can also be designed on three-dimensional mannequin images with wearing effect visualization and then sent electronically to buyers abroad.

--Fashion changes with time. Therefore, "time is money" is the golden rule of the apparel sector. Almost all the enterprises in the apparel sector are small, with the average employment of 20 per establishment. Such a small size enables the enterprises to adapt swiftly to market demands and make corresponding adjustments easily and flexibly. It can produce a broad range of products both in bulk and in customized items within a very short lead time, backed by an advanced transportation and communication system.

--The international competition nowadays covers many more aspects in addition to production cost. Over the years, the apparel sector has been making great efforts to build up an international profile for quality and fashion items with identifiable images and brand names. There are 400 to 500 fashion designers in HK with an average annual billing per firm of HK$ 2.3 million. Four local design schools turn out 70 to 80 graduates each year. The fashion designing strength is one of the key elements in the current status of the HK apparel sector.

- Weaknesses

The apparel sector has some common weaknesses with the textile sector, such as relatively inadequate R&D foundations and a lack of long-term vision for capital and technological investment. On the other hand, it has its own difficulties and dilemmas.

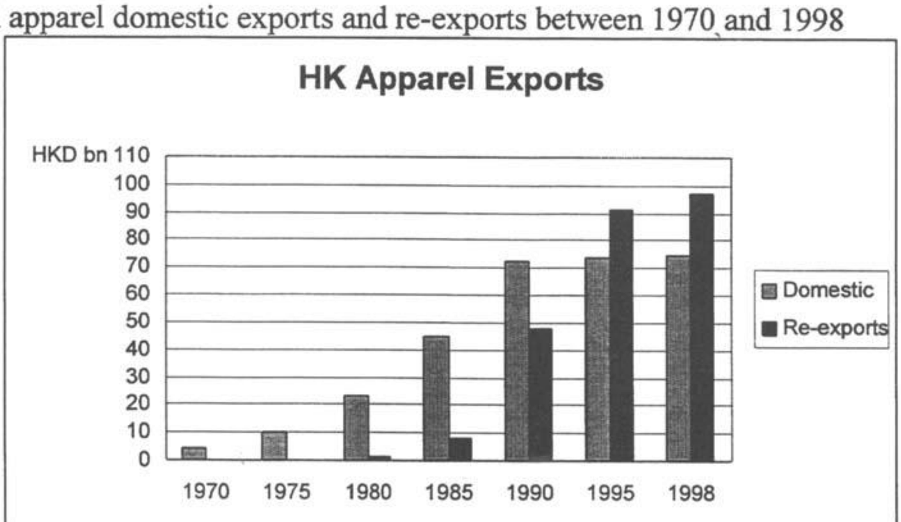
--Clothing exports to the United States are continually affected by trade disputes over illegal transshipments, and US Customs has published a list of HK companies that were prosecuted for illegal transshipment. Due to the unclear and sometimes confused information of the list, imports from an innocent company might also have suffered unnecessary losses. At the same time, US Customs officials have made several factory visits to ensure legal exports since 1996. Such action will no doubt disrupt normal production activities.

--The apparel industry is more labor-intensive than the textile industry. Therefore, the production cost is crucial to the product competitiveness. The HK apparel sector has found an efficient way out of the cost dilemma during the past years by OPA arrangements with low-cost regions; however, the changing trade policies of major importing nations poses a great uncertainty towards overall manufacturing plans. For instance, the change of the origin rule of the United States with respect to apparel origin forced local manufacturers to make corresponding adjustments in order to conform to the new rule. Under the old rule, a manufacturer could cut the fabric in HK and send it to the Chinese Mainland for assembly, then bring it back to HK for exportation, with HK as the country of origin; but now it will be categorized as of Chinese Mainland origin under the new rule.

--The major export destinations for HK apparel exports are the US and EU. Though the apparel manufacturers work very hard to shorten the delivery time with these major markets, the emergence of Mexico and Turkey as important apparel suppliers to the US and EU respectively poses a great threat to the HK apparel sector. The comprehensive information network and short lead time cannot completely make up the relatively longer geographic distances to these markets, while the countries mentioned above enjoy this natural advantage together with preferential arrangements between them. Therefore, it can be imagined that the international competition faced by the HK apparel sector will be hotter and heavier in the coming years.

--With the rising demand for protectionist trading policies in the major importing nations, various new trading barriers were designed to protect domestic industries. The Green Barrier is one of them, carrying a lofty slogan of environmental protection. To meet these extra and new requirements, such as "green labels" and the ban on azo dyes in certain European countries, the manufacturers have to make additional efforts, which constitute an extra cost burden upon them.

2.27 HK apparel domestic exports and re-exports between 1970 and 1998



(Source: HK External Trade, various issues)

C. Apparel trading

- Import and export value

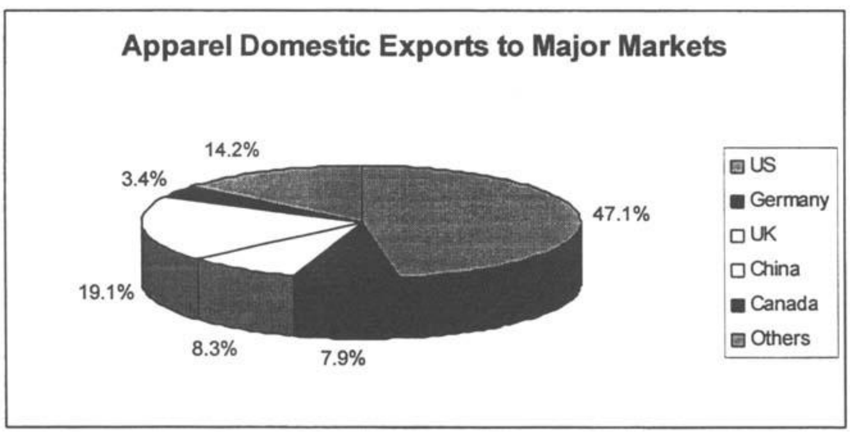
Total apparel exports increased 39 times between 1970 and 1998, rising from HK$ 4.39 billion to HK$ 171.67 billion; the import performance is even more remarkable, increasing from HK$ 0.28 billion to HK$ 110.74 billion during the same period. (Figures 2.27 & 2.18)

The apparel domestic exports reached record high of HK$ 77.2 billion in 1992 and fluctuated between HK$ 72 and 74 billion for the next six years. The re-exports value topped HK$ 106.7 billion in 1997 but experienced a 9.3% drop in 1998 for the reasons mentioned previously. However, the decreasing margin for apparel imports and exports were much smaller than the for textile trade--4.8% and 4% respectively.

- Major apparel trading partners

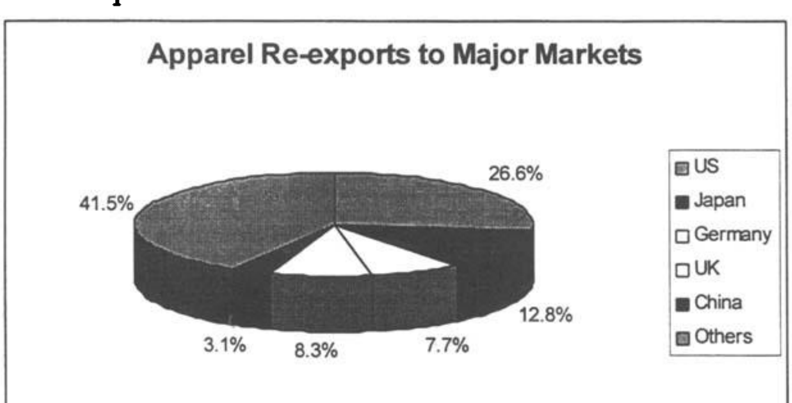
Figure 2.28 shows that 47.1% of the apparel domestic exports went to the US market in 1998, followed by the Chinese Mainland and the UK. The US was also HK's largest re-export market, accounting for 26.6% of the total re-exports. Compared with the domestic exports, the export markets for HK apparel re-exports are more diversified. The top five markets only accounted for 58.5%. (Figure 2.29) As regards apparel imports, the Chinese Mainland was the single most important partner, holding 92.5% of the total apparel imports. (Figure 2.30)

2.28 HK apparel domestic exports in 1998



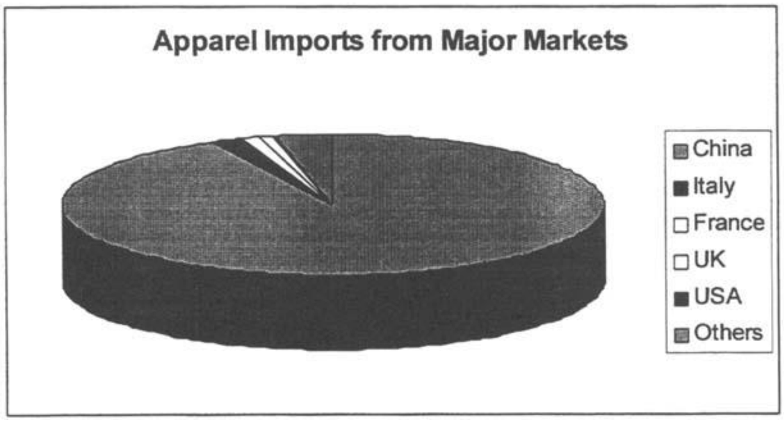
(Source: HK Industrialist, June 1999, p52)

2.29 HK apparel re-exports in 1998



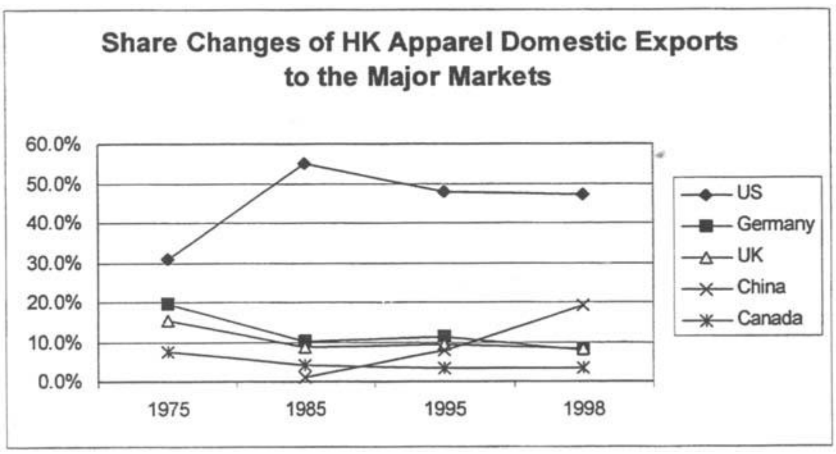
(Source: HK Industrialist, June 1999, p52)

2.30 HK apparel imports in 1998



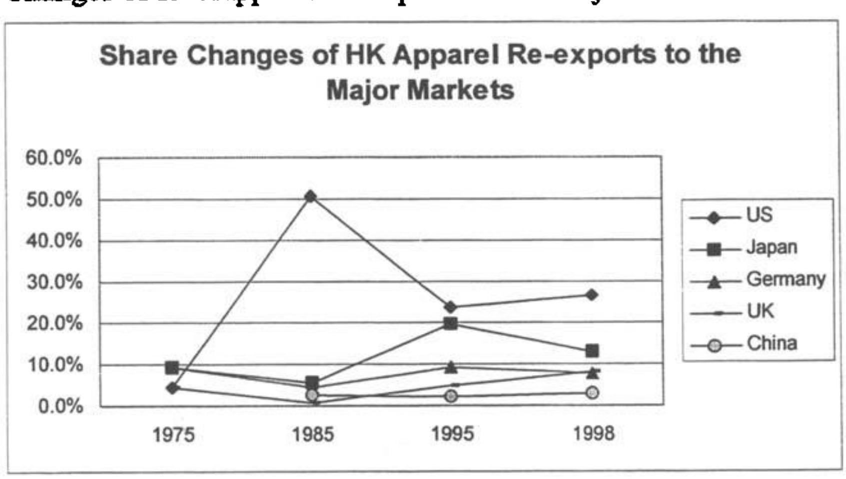
(Source: HK Industrialist, June 1999, p52)

2.31 Share changes of HK Apparel Domestic Exports to the Major Markets



(Source: Calculated based on data from HK Industrialist, various issues; HK External Trade, various issues)

2.32 Share Changes of HK Apparel Re-exports to the Major Markets



(Source: Based on data from HK Industrialist, various issues; HK External Trade, various issues)

- Apparel trading pattern

--In contrast to the textile trade pattern, the US and EU are the major export markets for HK apparel. This reflects the labor-intensive feature of the apparel industry. China only accounted for 1.1% of the domestic exports in 1985, but its share jumped to 19.1% in 1998. This partly demonstrated the market potential of the Mainland for fashion items because of its rapid economic development.

--The Chinese Mainland is the single most important apparel supplier for HK. Considering its unparalleled role in HK's textile and apparel trade, one can come to the conclusion that the textile and apparel trade links between the two sides are unique and vital to their textile and apparel industries.

--The re-export value first surpassed that of the domestic exports in 1992. The gap between the apparel domestic exports and re-exports volume is not so striking as in the textile trade. The former accounted for 43.6% of the total export volume while the latter accounted for another 56.4%. This indicates that the local apparel industry is still an important player in the world apparel trade regardless of its re-location trend to the Chinese Mainland in recent years.

--The HK textile and apparel trade is subject to quota restrictions set out in individual bilateral agreements with the US, EU, Canada and Norway. Table 2.19 shows the quota utilization rates for HK textile and apparel domestic exports to the four markets. The US is the largest importer for HK domestic apparel exports as well as the second largest importer for textiles, so its quota utilization rate is the highest among the four, over 81.9% in 1998. Except for some hot-sale items, such as woven blouses and trousers, the quotas for many categories are somewhat meaningless, as the utilization rates are low.

The year 1998 marked the beginning of the second stage of quota liberalization. The US removed quantitative restrictions upon 23 HK textiles and clothing categories, the EU liberalized quotas on 4 categories and Canada on two.[32] However, since it is the importers that decide the liberalization process at each stage, the most sensitive categories are deliberately left to the last minute. In this sense, the phase out effect is really of limited significance to the HK textile and apparel industry until the year 2005.

Table 2.19[33] Quota utilization level for HK textile and apparel exports to four markets

Quota Utilization Rates		
Markets	1997	1998
US	75.4%	81.9%
EU	53.8%	53.0%
Canada	49.4%	48.7%
Norway	68.9%	60.5%

(Source: http://www.tdc.org.hk/main/industries/ipclot.htm, retrieved on November 17, 1999)

[32] http://www.tdc.org.hk/main/industries/t2_2_38.htm

[33] As regards Norway, the ratio is calculated based on data from HK Trade Department, Notice to Exporters, Series 3A (Countries other than USA & EU) No.31/98, "Export of Restrained Textiles to Norway: performance against quota limits as at 31/12,98", Miss Wong Ying for Director-General of Trade

2.5.3 Impact of China's WTO entry upon the HK textile and apparel industry

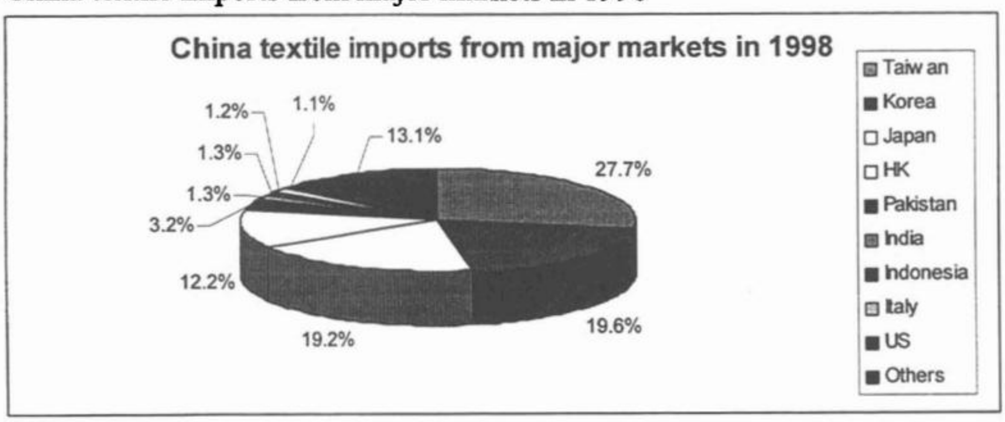
2.5.3.1 Impact upon HK textile and apparel exports to the Chinese mainland

A. Textile domestic exports

Figure 2.19 shows that about half of HK textile domestic exports went to China in 1998 and HK is the fourth largest textile supplier to the mainland as well (Figure 2.33). In view of the mainland's great need for textile items, which accounted for about 91.6% of its total textile and apparel imports in the first five months of 2000 (Table 2.20), HK suppliers will have much room for future development. Various studies indicate that after China enters the WTO, the apparel industry will be one of the biggest beneficiaries due to quota liberalization and tariff reduction in intermediaries. (Section 2.6)

According to Table 2.21, the first 11 items are among the top 50 HK exports to the mainland and the remaining three are of interest to HK. It shows that tariff rates upon most of these items will undergo a more than 50% cut by 2004 or 2005. With the expected increase in apparel export volume and the big tariff rate cut for many HK export items to the mainland, demand for HK quality textiles such as fabrics will rise as well. Moreover, HK textile manufacturers have the edge to meet the need based on

2.33 China textile imports from major markets in 1998



(Source: based on data from "Almanac of China's Foreign Economic Relations and Trade, 1999/2000; the same source was also the basis for Figures 2.34-2.36)

Table 2.20 China and HK textile and apparel import and export mix during January to May 2000

China and HK textile and apparel exports and imports

Item	Domestic exports		Imports	
	China	HK	China	HK
Textiles	33%	12.7%	91%	49%
Textile Yarn	*6%*	*1.0%*	*20%*	*13%*
Textile Fabric	*27%*	*11.7%*	*71%*	*36%*
Apparel and Accessories	67%	87.3%	9%	51%

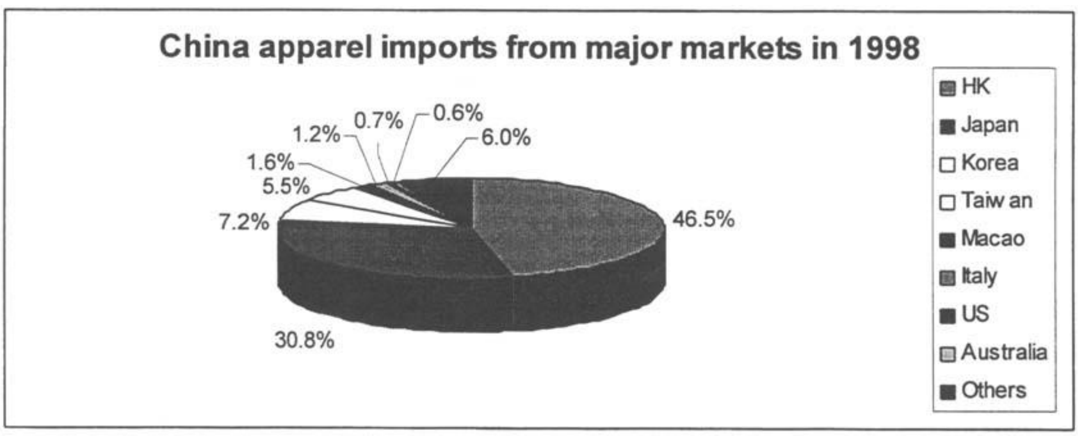
(Source: based on data from "HK external trade, May 2000" and "http://textile.unet.net.cn/imex05.htm, "Import and Export of Textile and Garments in January-May Period 2000, Table 3 & 4)

Table 2.21 Tariff cut schedule between 2000 and 2005 in the Sino-US agreement

Tariff reduction schedule of some selected textile and apparel items			
Item	Base rate %	Bound rate %	End date
Cotton Yarn	10–11	5	2002
Woven cotton fabrics weighting not more than 200g/sq.m	19	10	2004
Woven cotton fabrics weighting more than 200g/sq.m	19	10–12	2003–4
Synthetic filament yarn	17–23	5	2004
Woven synthetic fabrics	36	10	2005
Synthetic yarn	20–23	5	2004–5
Plastic impregnated textile fabrics	15–26	10–12	2002–4
Other knitted or crocheted fabrics	24–32	10–12	2004–5
Knitted or crocheted jerseys, pullover, cardigans, waistcoats and similar articles	28–33	14–16	2004–5
Knitted and crocheted clothing accessories	33	14	2005
WG suits, ensembles, dresses, trousers, etc. (woven)	31–36	16–25	2004–5
MB suits, ensembles, trousers, etc. (knitted)	31–36	16–25	2004–5
WG suits, ensembles, dresses, trousers, etc. (knitted)	31–36	14–25	2004–5
MB suits, ensembles, trousers, etc. (woven)	31–36	16–17.5	2004–5

(Source: [59])

2.34 China apparel imports from major markets in 1998



geographic proximity, available quality products and rich experience in trading with the mainland.

B. Apparel exports

Though the mainland is not the largest export market for HK apparel exports, it has become more and more important during recent years, rising from 1.1% of HK apparel domestic exports in 1985 to 22.0% in 1999. At the same time, HK is the largest export supplier to the mainland market, accounting for 46.5% of the mainland's total imports in 1998. (Figure 2.34) The huge population and rapid economic development in the mainland provide a golden opportunity for HK apparel manufacturers. The improved market access, including the significant cut in tariff rates (Table 2.21), will make exports to the mainland easier and more attractive. Consumers in the mainland market, especially in some big cities such as Beijing, Shanghai and Shenzhen, have developed a sense of fashion and brand awareness. HK, as a fashion center, has some regionally-famous brands which cater to the middle and up markets. Based on this argument, it can be expected that domestic apparel exports will enjoy an increase after China's WTO entry.

However, there is one thing worth attention: With full quota liberalization in 2005, the country of origin will definitely lose its current significance. As a result, HK textile and apparel manufacturers will have more incentives, based on the sharp comparison of the cost structure between HK and the mainland, to re-locate their low-value added production facilities such as apparel assembly lines to the mainland. Because of this, HK apparel domestic exports may experience a decline in the long run while textile exports may take the opposite direction due to the well-anticipated increased outward processing activities.

C. Re-exports

As an entrepot port, textile and apparel re-export volume via HK each year is very large. In 1998, about 71.4% of HK textile re-exports and 3.1% of HK apparel re-exports were destined for the mainland market. Based on TDC's survey of offshore trade, about 37.5% of textiles and 53.8% of apparel were sourced from the mainland. [60] In 1997, there were US$ 72.4 billion worth of textile and apparel exports from the mainland, of which 37% were re-exported via HK. Considering those destined for Japan, the US and EU markets, about 18.7%, 45.3% and 51.7% respectively were re-exported via HK. [47]

As regards China's WTO entry, there are two different opinions concerning HK's future role as an intermediary between the mainland and the outside world. One is optimistic, predicting that HK will acquire more opportunities with China's further integration into the world economy; the other is quite pessimistic, arguing that trade liberalization and improved market access on the mainland will overshadow HK's re-export performance. Both views have a certain ring of truth. China's WTO entry means more trade opportunities, particularly for labor-intensive products. Based on extensive trade channels, qualified personnel and a well-developed service sector, HK has competitive advantages in providing quality and prompt service for the mainland's small and medium enterprises, which lack the necessary expertise and skills in imports and exports. These are invaluable assets which can be maintained for a long time. Of course, with more enterprises on the mainland obtaining foreign trade rights, it is inevitable that some shadows will be cast upon HK re-exports. The key is whether HK manufacturers and traders can adjust quickly to the new competition picture and take positive steps to bring their competitive strength into full play.

2.5.3.2 Impact upon HK textile and apparel exports to other countries/regions

A. Comparison of HK and the mainland's textile and apparel exports between the two sides

- Major export markets

Both HK and the mainland's textile and apparel industriesy are export-oriented. Figures 2.19 and 2.35 show that the two sides are each other's most important textile export market and the US market is of importance for both sides. However, compared with their apparel export markets, the export markets for textiles are quite different and diversified for HK and the mainland.

As regards the two sides' apparel exports in 1998, the mainland was HK's third largest export market (if EU is taken as a whole) and HK was the mainland's leading export destination.[34] (Figures 2.28 and 2.36) Both the US and the EU are important markets for the two sides' apparel exports, though to various extents. More than 70% of HK domestic apparel exports went to the two markets in 1998, while the mainland

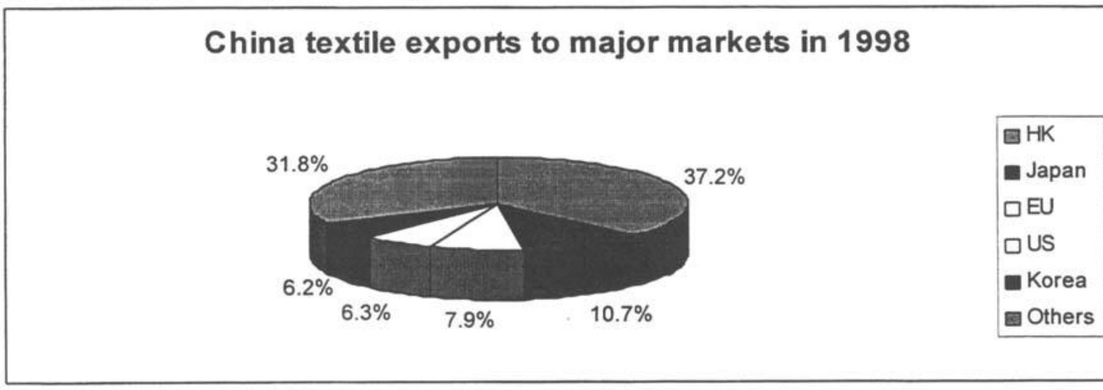
[34] But in 1999, Japan replaced HK as No.1 importer for the mainland's apparel exports.

exported less than 13% to the two[35]. Another difference is that Japan held a large share of the mainland's apparel exports, accounting for about one-fourth in 1998; but of HK apparel exports, Japan only imported 1.0%.

- Export products[36]

The proportion of textile exports to apparel ones is 1:2 in the mainland and 1:7 in HK, indicating that HK relies more on apparel exports. (See Table 2.20)

2.35 China textile exports to major markets in 1998



2.36 China apparel exports to the major markets in 1998

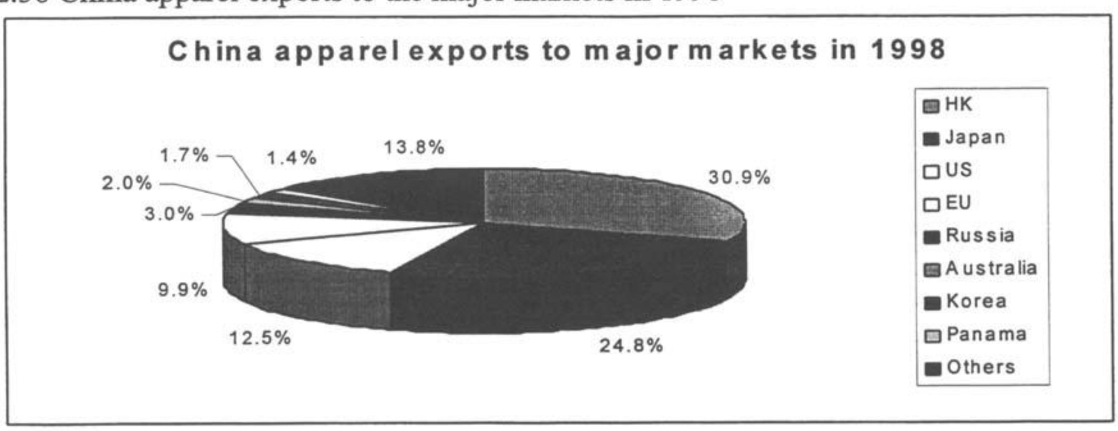


Table 2.22 Apparel exports from the mainland and HK during January to May 2000

Apparel exports from the mainland and HK by category

	China	HK
Total apparel and accessory exports	100.0%	100.0%
Knitted apparel & accessories	37.6%	43.4%
Woven apparel & accessories	54.2%	55.8%
Of which, accessories	7.9%	5.0%
Other apparel articles and accessories, other than textiles	8.3%	0.8%

(Source: calculated based on data from "HK External Trade, May 2000" and http://textile.unet.net.cn/imex05.htm, retrieved on August 1, 2000)

[35] One thing should be noted is that, of apparel exports from the mainland to HK, some are further re-exported to other markets including the US and EU, though the exact proportion is very difficult to determine due to lack of data support. Therefore, the actual apparel exports to the two markets are larger than the statistics' indicate.

[36] Proportions in this part are calculated based on data from "HK External Trade, May 2000" and "http://textile.unet.net.cn/imex05.htm", retrieved on August 1, 2000

As regards the mainland's textile exports, textile fabrics accounted for 82.8%, of which cotton and MMF woven fabrics held a relatively large share. In the first half of 2000, these two categories accounted for 25.1% and 35.6%[37] of the mainland's total textile exports. Textile fabrics from HK constituted 92.1% of HK total textile exports. Cotton woven fabric was the most important export category with 65.3% of HK total textile fabric exports. [76]

Woven apparel exports are larger than knitted ones on both sides. If apparel exports are divided by material, about 59.1% and 26.7% of HK total apparel exports during January to May, 2000 were apparel of cotton and man-made fiber; while the corresponding proportions in the mainland were 38.2% and 37.7% respectively in the first half of 2000.[38] Compared with HK apparel and accessories of non-textiles exports, China had a much larger share of 8.3%.

Knitted and woven apparel made from textile fabrics constituted the major export categories. (Table 2.22) Woven apparel exports are larger than knitted ones on both sides. If apparel exports are divided by material, about 59.1% and 26.7% of HK total apparel exports during January to May, 2000 were apparel of cotton and man-made fiber; while the corresponding proportions in the mainland were 38.2% and 37.7% respectively in the first half of 2000.[39] Compared with HK apparel and accessories of non-textiles exports, China had the much larger share at 8.3%.

- Export price

Since the US and the EU are key markets both for the mainland and for HK, it is necessary to compare the export prices of some hot export items from both sides. As regards US MFA textile and apparel imports in 1997, China was the largest supplier in value, with 11.2% of the market. HK ranked third with 7.6% of the market. The average import prices from the two were US$ 2.9 and US$ 4.8 per square meters equivalent, both higher than the world average level of US$ 2.4. [77] China was the fourth largest supplier of MFA textiles to the EU, accounting for 8.2% of total EU imports. Its far as EU MFA apparel imports in 1997 and 1998 are concerned, China was the No. 1 supplier both in terms of value and volume. Its export value reached 4.8 billion ECU in 1998. HK came third, with a value of 2.5 billion ECU in 1998. The average import prices were 17.2 ECU/kg for Chinese apparel exports, a little lower than the average import price (17.3 ECU/kg) from non-EU suppliers. Those from HK were 20.5 ECU/kg. [78]

Figures 2.37 to 2.39 show a comparison of some apparel categories, for each of which the two sides were suppliers of consequence. As regards US imports of the catogories mentioned in Figures 2.37 and 2.38, those from the mainland and HK were imported at prices higher than the world average level. Except for Categories 338 and 339 where the price differences between the two sides were relatively large, the two were among the same price-range suppliers for the other apparel categories. As to EU imports from the mainland and HK, import prices of the two sides were above the world average level except for Categories 6, 15 and 27[40]. The price differences between the two sides were small except for Category 26. (Figure 2.39)

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[37] The definition for MMF-type fabrics is obscure in the mainland. According to the data retrieved from http://www.ctei.gov.cn/cteinew/haiguan/hghome.asp, MMF-type fabrics mentioned here actually refer to chemical (17.8%), synthetic (15.1%) and man-made (2.7%) ones.

[38] These two proportions are roughly calculated based on the data from "http://www.ctei.gov.cn/cteinew/haiguan/hghome.asp, retrieved on August 4, 2000

[39] These two proportions are roughly calculated based on the data from "http://www.ctei.gov.cn/cteinew/haiguan/hghome.asp, retrieved on August 4, 2000

[40] As regards Category 27 imports from the two sides, only those from HK were imported at a price lower than the world average level.

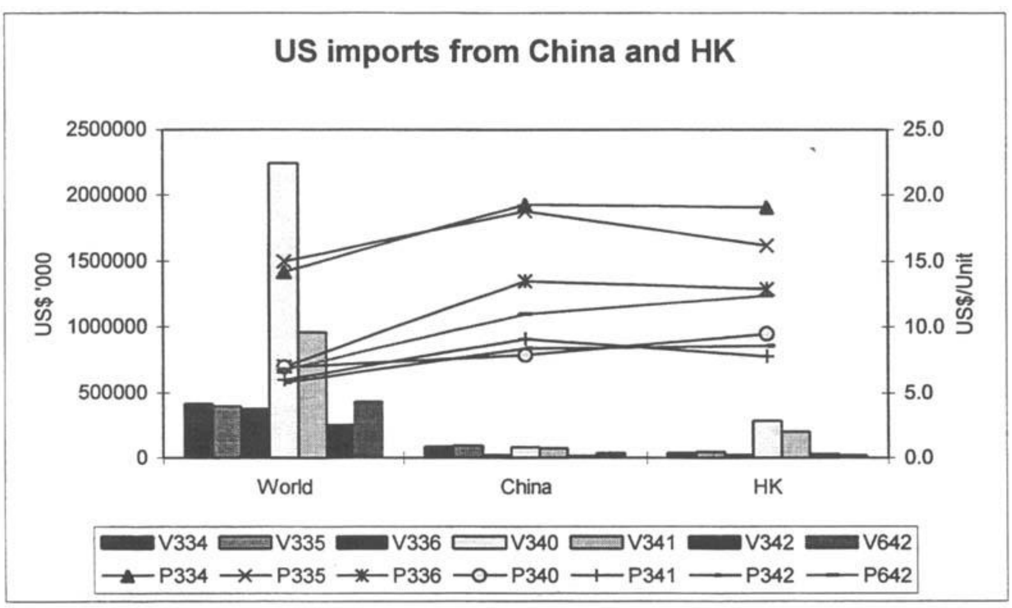
B. Possible impacts

Based on the above analysis, it is clear that competition between the mainland and HK will be much hotter after the quota liberalization process, especially in the apparel sector.

Chinese textile and apparel exports have been subject to very restrictive quota limits in the US and EU markets during the past two decades. Take Category 335 for example. In 2000, the quota imposed on Chinese exports to the US was 390,241 dozen with a mere 0.5% growth rate; while that on Turkey was 421,166 dozen with a growth rate of 8.7%. The tax equivalents for Chinese textile and apparel exports to North America were evaluated at 18.9% and 40.4% respectively; while those from Latin American countries were much lower, 9.6% for textiles and 20.2% for apparel. (Table 2.22) However, exports from the mainland have still managed to enlarge their market share in the restrictive importing countries. In 1983, MFA textile & apparel exports to the USA from China were 8.6% of total US imports, and those from HK were 19.2%. In 1997 the proportions had changed to 11.2% and 7.6% respectively [77] For MFA apparel exports from the mainland and HK to the EU, the comparison is more obvious. In 1989, those from the mainland held 8.3% of EU total MFA apparel exports from non-EU suppliers, ranking No. 3 and those from HK had 13.8%, ranking No. 1. But in 1998, the mainland replaced HK as the leading supplier to the EU, accounting for 13.1% of the market share and those from HK slumped to 6.9%. [78]

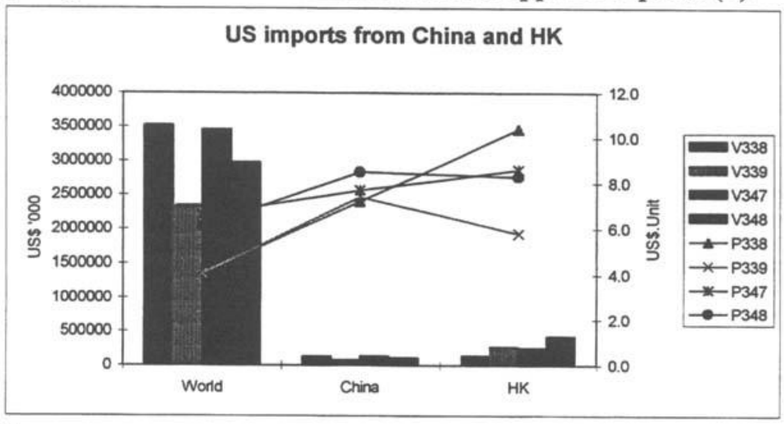
The different development track of the mainland's and HK's textile and apparel sectors indicates that the traditional comparative advantages have shifted to the mainland. In view of the export price comparison, though exports from HK as a whole have a higher export price than those from the mainland, the latter has made progress in product upgrading and has successfully raised prices for some items to a level higher than those from HK (Figures 2.37 to 2.39). The product differentiation between

2.37[41] US import prices for the mainland and HK in 1997 (1)



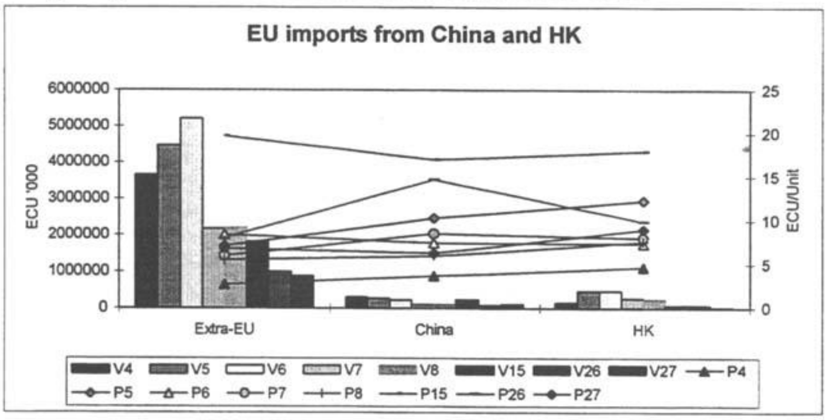
[41] Category 334: MB cotton coats; 335: WG cotton coats; 336: cotton dresses; 338: MB cotton knit shirts; 339: WG cotton knit shirts; 340: MB cotton non-knit shirts; 341: WG cotton non-knit shirts; 342: cotton skirts; 347: MB cotton trousers; 348: WG cotton trousers; 359: other cotton apparel; 435: WG wool coats; 642: MMF skirts

2.38[42] US import prices from the mainland and HK apparel exports (2)



(Source: [77])

2.39 EU Import prices from the mainland and HK in 1998



(Source: [78])

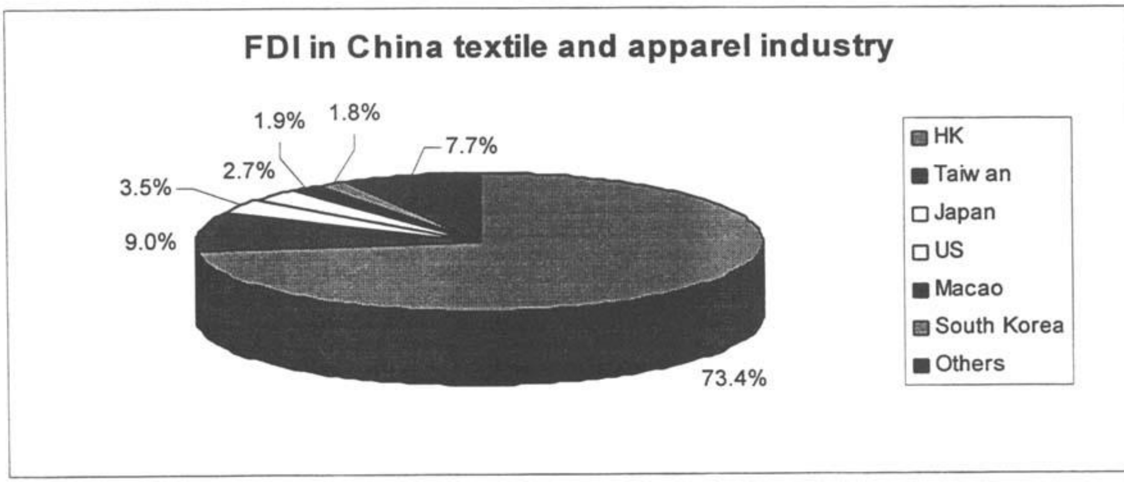
the two sides is not large enough for HK to avoid head-on competition with the mainland. What is more, as mentioned earlier, the quota elimination in 2005 may boost another round of re-location activities from HK to the mainland, a move which would contribute to HK textile and apparel industry's further decline. According to the USITC report, China filled most of its quota group limits by 95 to 100 percent from 1994 to 1998. Therefore, when the quota is fully phased out in 2005, textile and apparel exports from China, particularly the commodity products, will enjoy a relatively rapid growth in the US and EU markets. Since the HK domestic textile and apparel industry has relied more on the US and EU markets, sharper competition is inevitable. If HK fails to move upmarket and achieve more obvious product differentiation in the next few years, it will lose the edge in the competition. Generally speaking, HK apparel manufacturers will face more challenges than the textile manufacturers.

2.5.3.3 Impact upon HK's FDI in the mainland

HK has been the leading investor in the mainland for many years. It is estimated that about 80% of HK manufacturers have set up their own plants or processing trade arrangements with the mainland's counterparts [61]. HK's geographic proximity to the

[42] Category 4: T-shirts; 5: pullovers; 6: trousers; 7: Women's blouses; 8: Men's shirts; 15: Women's overcoats; 26: Women's dresses; 27: Women's skirts;

2.40 FDI in China textile and apparel industry



(Source: [68],)

Pearl River Delta plays an important role in its heavy investment in this region.

Figure 2.40 shows that HK investors hold a dominant share of 73.4% in the Chinese textile and apparel industry. Many HK apparel brands, particularly the casual wear ones, have established various retailing outlets in the mainland, most of which are specialty stores. These brands, such as Apple, Gold Lion, Crocodile, Bossini and Jeanswest, have won wide recognition and acceptance among the mainland's growing middle-class consumers and fashion-seeking youngsters.

Previous sections have mentioned the efforts made by China to liberalize foreign trading rights and the distribution system. According to the US-China bilateral WTO agreement, China is committed to gradually liberalizing the wholesaling and retailing of most commodities[43] within five years of accession. Quantitative, geographical, equity and incorporation restrictions on the establishment of joint ventures by foreign companies will be phased out. Moreover, requirements of foreign exchange balancing, local content and export performance will be eliminated as well. Trading rights will be progressively granted to foreign companies within three years.

Since the above commitment guarantees a more open and liberal market access, securing more investment opportunities for HK investors, China's entry into WTO has sent a positive signal to those who are interested in the mainland's huge domestic market. As Dr. Victor K. Fung, chairman of the HK Trade Development Council, pointed out, for the first time HK would have a "domestic market" of continental scale.[44] Generally speaking, the HK textile and apparel industry will grasp these opportunities to invest more in the mainland, especially when decision-making is no longer subject to quota and "rules of origin" considerations and when the huge mainland market is accessible in a real sense.

There may be negative effects upon HK re-exports. With the improved investment environment and trade liberalization drive in the mainland, HK companies may tend to establish foreign trading companies there, directly conducting exports from and imports to the mainland rather than re-exports via HK. Thus, increased capital flow to

[43] For example, wholesale distribution of salt and tobacco as well as retail of tobacco are not allowed even after China enters WTO

[44] This speech, with the title of "Hong Kong in China's WTO Era—Building a New Partnership", was delivered by Dr. Victor K. Fung at a luncheon following the 40th annual general meeting of the Hong Kong Federation of Industries. It was retrieved from http://www.tdctrade.com/tdcnews/0007/00070501.htm on July 25, 2000.

the mainland may be realized at the expense of shrinking re-export volume associated with the mainland. Another thing worth mentioning is that benefits enjoyed by HK investors after China's WTO entry are also open to other foreign investors. Therefore, the "big pie" will induce more fierce foreign competition, within which HK investors will feel great pressure.

2.5.3.4 Impact upon FDI in HK

In view of HK's special relationship with the mainland and its strength as a world sourcing center and "bridgehead" between the mainland and the outside world, HK is chosen by most MNCs as their regional headquarters, particularly as a base to tap the mainland market. A survey conducted by HKTDC shows that 83% of the surveyed MNCs have used HK as the springboard to boost and run their businesses in the mainland. [79]

Some people have argued that, In the future, more MNCs may prefer Shanghai as their regional headquarters instead of HK in the future, as the former is closer to the mainland market and enjoys lower cost of operation than the latter. However, according to a HKTDC report in January 2000, HK is still superior to Shanghai in terms of management levels, financial services, infrastructure, communication, and supporting services, all of which are key to investment considerations [62].

Therefore, China's WTO entry may bring about two different results concerning FDI in HK's textile and apparel sector: one an increasing trend and the other a decreasing trend. Both are dependent upon certain pre-conditions, such as the economic restructuring reform in the mainland and the sustainable edge of HK over the mainland in services and infrastructure.

In the short run, HK's role as a guide and springboard for small and middle MNCs will be strengthened because of its well-developed infrastructure, good investment environment, free market access, rich knowledge of the mainland market and easy communication with foreign partners. All of these advantages can be maintained for some time and overshadow other benefits enjoyed by direct investment in the mainland, such as low costs, direct access to the target market and better control.

2.5.3.5 Impact upon the current cooperation pattern between the two sides

As explained earlier, the cooperation pattern between the mainland and HK textile and apparel manufacturers can be characterized as "Front-store-back-factory", which is just a preliminary step and natural choice determined by the circumstances at that time. Economies in the mainland and HK are complementary in many aspects. The mainland has the labor, land, local distribution network, and solid scientific research bases while HK owns the capital, skills, overseas distribution network and necessary professionals in the service sector. However, this complementarity between the two sides has failed to realize synergy due to various limitations in past decades, such as less open market access in the mainland, quota restrictions in the export market and insufficient market information. Moreover, many of the mainland's manufacturers, which do not have foreign trade rights, are forced to go through extra and usually unnecessary links when promoting their products in foreign markets.

With China's accession into the WTO, there will be fundamental changes in the whole picture and, as a result, the cooperation pattern will undergo adjustment as well. The mainland's enterprises will no longer feel satisfactory as "back factories" for HK companies, while the latter have long been attracted by the lucrative mainland market. Consequently, a new kind of strategic partnership, on the basis of the present labor division, will be formed between the two sides' textile and apparel sectors.

First, closer R & D cooperation between HK and the Chinese mainland. Research institutes in the mainland often meet problems of how to commercialize their scientific and technological findings. Knowledge in the textile and apparel sector is of a commercial nature. For example, a fashion design, though excellent from a purely artistic view, may prove to be a market failure because it doesn't suit consumer tastes. The market success of a certain product range is not just subject to technological innovation. It also requires elaborate marketing and promotional strategies. HK enterprises are more experienced in these aspects. If the two sides can work more closely in this aspect, synergy could be generated to benefit enterprises in both sides

Second, HK textile and apparel enterprises should be more specialized. For basic items requiring low capital input, little product innovation and mass production, such as low-/middle-end men's wear and low-end women's wear, mainland enterprises have an obvious cost advantage over their HK competitors, either in the mainland market or in the export market. Therefore, HK players should completely give up these sectors and shift to manufacturing and marketing fashion wear and middle-/up-market women's wear, together with high quality fabrics. Efficient merger with the mainland's enterprises can not only realize the economies of scale, but also bring each other's strength to full play.

Third, diversification of foreign investment to other parts of China in addition to the Pearl River Delta. It is estimated that about 95% of HK's outward processing activities are carried out in Guangdong Province [61], a region of higher labor and land cost compared with the vast hinterland in the mainland. China's WTO entry means that the old special economic zones will lose many privileges and the government will attach more priority to less developed areas in the central and western parts of the country.[45] Moreover, these regions are usually abundant in raw material supplies, such as cotton, wool, and leather. In 1998, cotton produced in Xinjiang accounted for 31% of the national output, and wool and cashmere output in the Northwest region represented 37% and 25% of the national output respectively. [63] However, these regions are relatively poor in further processing activities. With preferential policy support and abundant resource bases, HK textile and apparel enterprises can find good investment opportunities on this underdeveloped area. HK has benefited much from the mainland's open-up reform since 1978. This new government policy in the mainland provide HK textile and apparel enterprises with another development opportunity. HK should become an early mover in major inland cities such as Wuhan and Chengdu, where second-tier markets accounted for 60% of the mainland's imports in 1999.

2.5.3.6 Summary

The relationship between the textile and apparel industries of the two sides, which is different from those formed by artificial preferential arrangements, such as between the US and Mexico, and the EU and Turkey, is built on the basis of close political, cultural, economic and geographic links. To the HK textile and apparel industry, China's WTO entry means far more than quota elimination. Its impact is

[45] For example, some investment projects restricted in the coastal region are allowed to carry out in central and west regions, with an open domestic market or a relatively high domestic sale ratio; Projects with foreign investment over 25% can be regarded as FIE, enjoying corresponding preferences.

comprehensive, embracing both opportunities and challenges concerning structural adjustment, foreign trade and investment. HK textile manufacturers will gain more than apparel ones.

The removal of NTBs and reduction of import tariff rates provide good prospects for HK textile and apparel exports to the mainland. Moreover, the expected growth of apparel exports to the mainland with quota phase-out indicates growing demand for imported textile items. Apparel production facilities in HK will be further re-located to the mainland, more good news to HK textile manufacturers. Consumers in the mainland have somewhat similar fashion tastes to those in HK due to cultural and geographic proximity as well as imitation psychology. Compared with some world top brands, HK brands are priced at a level more acceptable to the mainland consumers. These factors will lead to the increasing apparel exports to the mainland.

However, HK textile and apparel exports to other markets, such as the US and EU, will meet great challenges from mainland competitors, especially after 2005 when all the exporters have to compete in a quotaless environment. The comparison of export prices of some popular apparel items shows that the gap between the two sides is not large enough to avoid head-on competition. With trade liberalization and increasing quality and brand awareness in the mainland, apparel exports from the mainland will definitely pose a great threat to HK apparel manufacturers. HK apparel domestic exports to the outside world except to the mainland, will continue to shrink. As regards HK textile exports, the prospect is relatively not so serious since HK still enjoys obvious advantages in quality fabric production, which is the largest textile export category on both sides. The dyeing and finishing sector in China remains the bottleneck. As a result, a large proportion of the grey fabric produced on the mainland has to be exported, mainly to HK, for dyeing and finishing and then re-imported by China. Therefore, if China fails to solve the problem, its textile exports will still tend to be low value-added basic items.

HK's economic success in the past 20 years has been partly built upon the economic opening of the mainland in 1978. The economic gap between HK and the mainland promoted HK both as the largest investor and as the key intermediary agent between the mainland and the outside world. As many view China's WTO entry as the second economic opening, HK will no doubt grasp this opportunity to reap more fruits on a much bigger scale and scope. The mainland will be more than a manufacturing partner of HK. With the new game rules in a new competition picture, HK textile and apparel manufacturers will move beyond the former "front-store-back-factory" pattern and form strategic alliances with mainland partners in various aspects, including R & D and domestic/overseas distribution. Investment from HK in the textile and apparel sectors will not only increase, but also be diversified to more fields and geographic locations.

Past experiences have proved that HK companies have the strength to quickly adjust themselves to a new environment. China's WTO entry renders more opportunities than threats for the HK textile and apparel industry. The most significant thing is that this event facilitates structural adjustment of this sector, resulting in more efficient resource allocation. Job losses due to facilities re-location will be compensated by those created in the service sector. HK is most likely to be a typical sourcing center and logistics base, with a small but competitive textile sector and an apparel sector featuring high fashion and highly concentrated upon "two-ends"--design and distribution.

2.6 IMPACT UPON WORLD TEXTILE AND APPAREL TRADE AFTER THE QUOTA PHASE-OUT

The textile and apparel sector is one of the sensitive issues in China's WTO application. The major importing countries, such as the US and EU, are afraid of a possible import surge of textile and apparel items from China after it becomes a WTO member who can enjoy full ATC benefits. Various researches have been conducted to study the ultimate effects upon individual countries and the world as well. Though the results are not identical because of different analytical methods and focus, one view is common--China's textile and apparel sector will be one of the largest beneficiaries of China's WTO entry.

In China, opinions on China's entry into WTO are divergent. Some economists argue that WTO membership of China will boost GDP growth while opponents warn that a premature participation in globalization would not be good for China's national security until it has developed the same level of economic sophistication. However, as regards individual sectors, almost all public opinions favor the textile and apparel industry, considering it as one of the biggest winners after China enters WTO. According to an article in the official CTEI web site [15], Chinese apparel exports to the US and EU will grow by US$ 11 billion per annum after the quota liberalization, of which about US$ 5 billion is the gain from competition with other foreign suppliers and about US$ 6 billion is squeezed from domestic industries in these countries.

The US domestic market is one of the major export destinations for China's textile and apparel products. The US textile and apparel industry, which has been protected by various bilateral and multilateral agreements for more than 4 decades, views China's WTO entry as a big threat given its abundant raw materials, low-cost labor force and increased efficiency and quality. Various government agencies in the US have conducted studies to investigate the possible consequences of China's entry, particularly the impact upon its domestic textile and apparel industry. In the view of the report released by the US International Trade Commission in September 1999 [47], if China eliminates all quotas in 2005, it would gain a slightly expanded share of about 11% of the US textile import market and a whopping 30% of the apparel market. At the same time, China's world market share for apparel would rise by more than 6 percentage points in 2006. Another study conducted by Nathan Associates Inc., for the American Textile Manufacturers Institute (ATMI) drew a similar conclusion, predicting that apparel imports from China would capture 31% of US total apparel imports and that 154,500 jobs would disappear.[46] An analysis by the Ford Fund points out that Chinese textile exports will increase by 60% while and apparel exports by 200%, with the textile and apparel output growing by 25% and 74% respectively and the creation of 5 million new job opportunities.

The quota phase-out issue is not only causing upset in the developed nations, but also concern in some developing nations whose textile and apparel exports to the major importing countries have been guaranteed by the MFA regime and other preferential arrangements. Young, Martin and Yanagishima analyze the effects of quota liberalization upon the major textile and apparel exporting nations/regions, predicting that China will gain substantially at the expense not only of developed nations, but also developing ones subject to fewer MFA restrictions, such as Latin America, Sub-Saharan Africa and North Africa, particularly regarding apparel exports. [80]

[46] http://www.atmi.org/NewsRoom/releases/pr199932.html, retrieved on November 5, 1999

Based upon the above study results and analyses of China's WTO entry upon the diamond model in the previous section, several conclusions can be drawn concerning China's textile and apparel exports.

First, the export growth will not be strong before 2005, for reasons mentioned earlier. (Section 2.4.3.1) Therefore, the impact upon the world textile and apparel trade will be small and the present order will be maintained without significant changes.

Second, China's apparel exports will gain momentum after 2005 based upon the following arguments:

--Apparel exports from China have been subject to very restrictive discriminations under the MFA regime, including relatively low quota allocations compared with its large production and export potential, and much higher tax equivalents of MFA quotas compared with other regions. (Table 2.22) The year 2005 promises a quota-free competition environment in which apparel exports from China will be more competitive when competing with other low-cost suppliers.

--Though the US and EU are the major importers for China's apparel exports, they are not dominant in the whole picture. Compared with those suppliers in Latin America or Africa whose exports are highly concentrated upon these two markets, China's apparel exports are in an advantageous position, which is another plus after 2005.

--The reform of the foreign trade regime as well as the alleviation of rent-seeking problems caused by the quota allocation scheme will lead to increased economic efficiency and better resource allocations. As a result, apparel production and exports will be more market-oriented and efficiency-based, greatly enhancing the competitiveness of domestic apparel exports.

--When China becomes a WTO member, it will enjoy other countries' improved market access, especially those of developing nations. Since China's apparel exports are competitive in the low- and middle-end markets, they will find more outlets other than traditional export markets.

--China's WTO entry also provides its exports with a more stable external environment in which dispute settlement mechanisms will at least control the usage of unilateral measures by the major importing countries, such as the US.

Third, the future for China's textile exports is not so optimistic as for its apparel exports. Problems in this sector are more serious and hard to resolve in a short time frame. Compared with apparel production, price elasticity for textile goods is much lower and the technological gap between textile exports from developing and

Table 2.23 Comparison of tax equivalents of MFA quotas among major exporters[47]

Exporter	Tax equivalents of MFA quotas, % of FOB: Textiles		Apparel	
	North America	EU	North America	EU
HK/Korea/Taiwan	8.8	10.3	18.9	16.3
ASEAN	12.0	16.0	36.5	38.2
China	18.9	27.4	40.4	36.1
South Asia	19.0	27.4	40.4	36.1
Latin America	9.6	14.2	20.2	17.6
ROW	4.6	6.2	8.6	8.7

(Source: [80])

[47] ASEAN here include Indonesia, Malaysia, Philippines, Singapore and Thailand; ROW refers to Sub-Saharan Africa, Middle East, North Africa, Economies of Transitions and the rest of the world.

developed nations is too large to be narrowed in the near future. Some key production links, such as MMF and dyeing and finishing, are still weak at the present stage. Moreover, domestic apparel producers may turn to using more imported fabrics, which may become cheaper than domestic ones after significant tariff reduction. Obsolete textile machinery, lack of talented people and debt-ridden textile enterprises are another three bottlenecks for the sector's future development. Therefore, though quotas will be freed in 2005, it is not good enough to help solve these deep-rooted problems, which involve a more comprehensive reform package, such as the SOE issue, the educational system and the capital market.

Fourth, though China's textile and apparel exports are expected to gain from China's WTO entry, several conditions may have negative effects upon this scenario:

--The diamond upgrading process in China itself is an issue of overwhelming importance. If the result is disappointing, then the export prospects will be lusterless even in a more favorable external environment. Based on a World Bank report [81], between 1986 and 1987, the comparative advantage indexes of the apparel sectors in India and the Philippines were 79 and 76 respectively, given that the index in China was 100. However, between 1992 and 1994, the indexes in the former two nations rose to 94 and 84 respectively, considerably narrowing their gap with China. If China fails to move up the value-added ladder, pressure from these competitors will be sharper.

--China's textile and apparel exports will continue to be subject to possible quota imposition for additional 4 years until the year 2009 and product-specific safeguards for an additional 12 years after its WTO entry. (US-China WTO agreement) These will the potential weapons against China's textile and apparel exports in the future.

--Enhanced regionalism. Despite the political factors of today's regionalism trend, economic considerations play a key role, too. As regards textile and apparel production and trade, quick response is one of the underlying reasons for the current closer cooperation between border countries. Competition has extended to many non-price factors, of which geographic proximity, demand-oriented production and prompt delivery have become more significant. In this sense, China's relatively long distance from the US and EU markets will be a disadvantage in foreign partners' sourcing decisions.

--Entry of more low-cost suppliers. Without quota limitation, any textile and apparel supplier can export in theory. Moreover, the US and EU, for various political and economic reasons, offer preferential policies support to help some least developed countries to establish a textile and apparel sector as a preliminary step for further economic development, something like the 807A arrangement. Though these late movers don't pose a material threat to China's textile and apparel exports at present, their growth, backed by preferential Customs entry and close cooperation with manufacturers in the US and EU markets, may successfully secure a certain market share from traditional exporters, including China.

All in all, the quota phase-out arrangement completed in 2005 will be likely to trigger drastic changes in the world textile and apparel trade pattern. China, as the world No. 1 textile and apparel exporter, will be one of the beneficiaries after it becomes a formal WTO member. China's WTO entry will have the most significant impact upon the apparel sector. Apparel manufacturers in the developed nations as well as some developing nations may be negatively affected due to the increase of apparel exports from China. Corresponding adjustment processes and new policy measures will interact together to establish a new order after 2005.

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