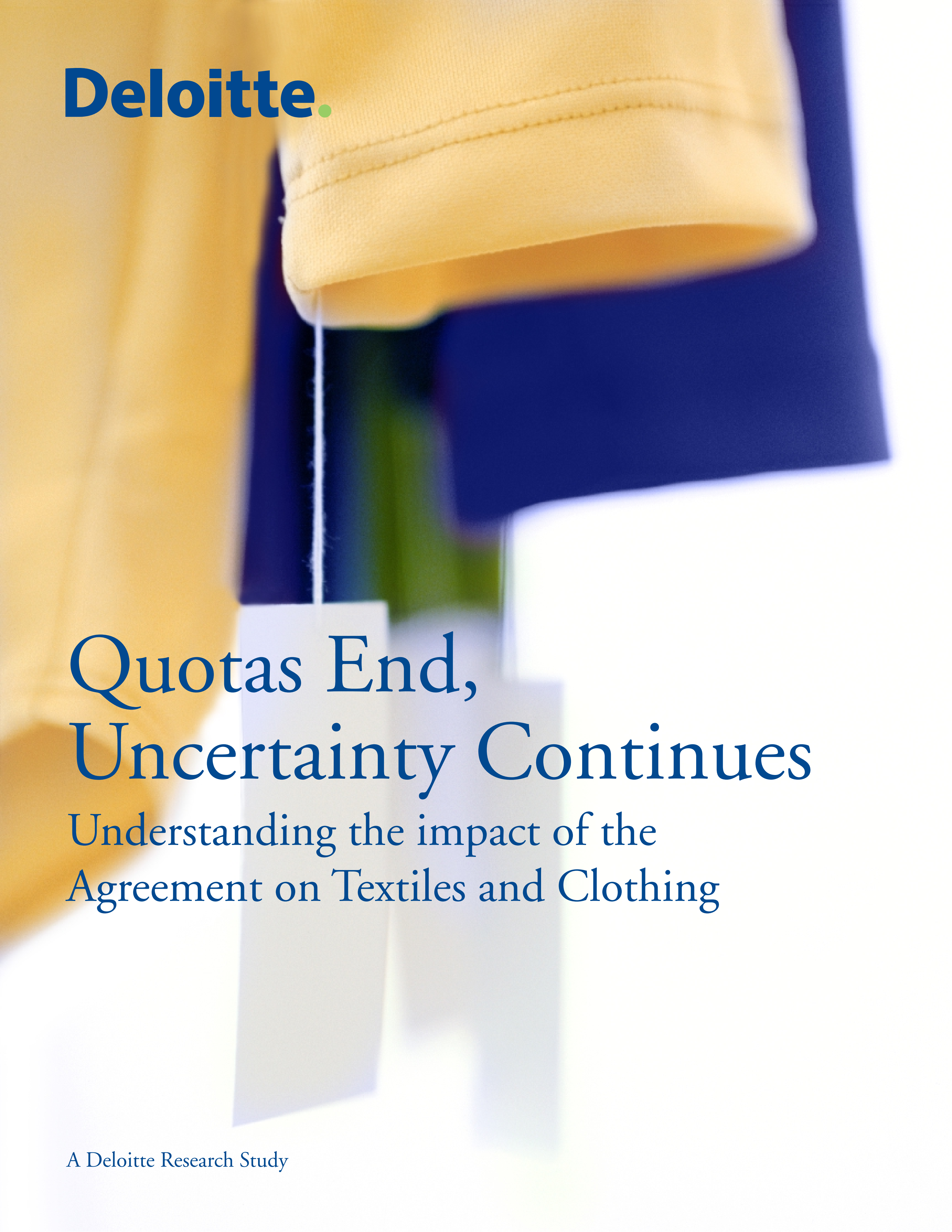

Deloitte.

# Quotas End, Uncertainty Continues

## Understanding the impact of the Agreement on Textiles and Clothing

A Deloitte Research Study

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# Introductory comments

This year, global trade in apparel and textiles is changing. In January, the regime of quotas that governed such trade for the past 30 years was eliminated. In its place will be freer trade, but not completely free trade. How free depends on decisions yet to be made by importing country governments. And there lies a problem. Apparel producers and distributors would like to be able to plan on the basis of precise knowledge of the future trading regime. Yet that is not possible. Importing governments may or may not act to limit apparel and textile imports depending on the future flow of goods, the political consequences, and the political power of competing interests. Consequently, risk exists and market participants must plan accordingly.

In this brief paper, we will examine global trade in apparel and textiles, the evolution of the trading regime, some likely scenarios for the future of global trade and protection, the impact of ending quotas on China and other emerging countries, and the strategic choices that market participants must make in the coming years.

Although risk exists and future patterns of trade and protection cannot be accurately predicted, there are a few conclusions that can reasonably be made:

- There will be consolidation of apparel and textile exports. A small group of countries will account for a much larger share of trade. That means that some countries will experience a significant loss of market share with potentially serious economic consequences.
- There will be more vertical integration of apparel production within countries. Those countries that gain share of exports will offer multiple processes such as cotton production, textile production, dying, knitting, and distribution.
- There will be consolidation among apparel and textile importers, with a smaller number of large retailers and branded apparel suppliers dictating the flow of imports into developed countries. These companies will play a big role in determining the structure of global trade in apparel.
- Even if importing countries impose new forms of protection (and they may), average apparel and textile prices will fall resulting in stronger volume demand. The fall in prices will, in part, stem from the efficiency gains of consolidation.
- Apparel and textile producers will seek to diversify risk. As such, they will not put all their eggs in the China basket.

# Global trade in apparel and textiles

China has become the world's largest single exporter of textile and apparel products. In 2002, China accounted for 20.6% of global apparel exports, up from just 9% in 1990. China also accounted for 13.5% of global textile exports, up from 6.9% in 1990. No other single country accounted for more than 5% of such trade in 2002.

**Figure 1. Leading Exporters of Textiles and Apparel**
**(% Share of Total World Exports)**

| | Textiles | | Apparel | |
|---|---|---|---|---|
| | 1990 | 2002 | 1990 | 2002 |
| EU15 | 48.7 | 34.2 | 37.7 | 25.1 |
| EU15 (extra EU) | 14.5 | 15.2 | 10.5 | 8.3 |
| China | 6.9 | 13.5 | 9.0 | 20.6 |
| Hong Kong | 2.1 | 0.6 | 8.5 | 4.1 |
| Turkey | 1.4 | 2.8 | 3.1 | 4.0 |
| Mexico | 0.7 | 1.5 | 0.6 | 3.9 |
| US | 4.8 | 7.0 | 2.4 | 3.0 |
| India | 2.1 | 3.7 | 2.3 | 2.8 |
| Bangladesh | NA | NA | 0.6 | 2.1 |
| Indonesia | 1.2 | 1.9 | 1.6 | 2.0 |
| Korea | 5.8 | 7.0 | 7.2 | 1.8 |
| Thailand | 0.9 | 1.3 | 2.6 | 1.7 |
| Pakistan | 2.6 | 3.1 | NA | NA |
| Taiwan | 5.9 | 6.3 | NA | NA |
| Other | 16.9 | 17.1 | 24.4 | 28.9 |

Source: OECD

China's growing strength in this industry was the result of massive investment in capacity, relatively low labor costs, and very high labor productivity leading to very low unit labor costs. In 2002, China's imports of apparel and textile machinery accounted for 15.2% of global imports of such capital goods. This was up from 4.5% in 1998. As a result of capital intensity, China's apparel workers are highly productive. For example, although India's apparel wage rates are roughly 10% lower than in China, unit labor costs are 40% higher than in China due to much lower productivity. India's lower efficiency is the result of less capital intensity, poorer transportation and utility infrastructure, fewer economies of scale, and distorting government regulations (such as tariffs on imported textiles, restrictions on foreign investment, and restrictions on the ability to dismiss workers).

**Figure 2. Textile and Clothing Machinery Imports**
(US Millions of Dollars)

| | Turkey | Mexico | China | World | China share of world |
|---|---|---|---|---|---|
| 1994 | 586 | 506 | 1,887 | 21,514 | 8.8% |
| 1995 | 1,503 | 349 | 2,146 | 24,240 | 8.9% |
| 1996 | 2,240 | 522 | 2,042 | 23,335 | 8.8% |
| 1997 | 1,823 | 778 | 1,645 | 22,888 | 7.2% |
| 1998 | 1,226 | 791 | 906 | 20,163 | 4.5% |
| 1999 | 498 | 782 | 958 | 17,399 | 5.5% |
| 2000 | 869 | 835 | 1,444 | 19,242 | 7.5% |
| 2001 | 594 | 508 | 2,051 | 17,948 | 11.4% |
| 2002 | 1,361 | 414 | 2,693 | 17,671 | 15.2% |

Source: UNCTAD

Interestingly, China's employment in textile and apparel manufacturing has been stagnant. From 1995 to 2001, textile employment declined by nearly two million while apparel employment rose a modest 277,000. This represented a smaller percentage gain in apparel employment than took place in India and Mexico. Yet despite these employment numbers China's output increased rapidly, the result of sizable gains in productivity. That, in turn, was due to the massive investment in capital goods.

**Figure 3. Employment in Textiles and Clothing**
(thousands workers)

**Textiles**

| Country | 1995 | 2001 | Chg | % Chg |
|---|---|---|---|---|
| China | 6,730 | 4,775 | (1,955) | -29.0% |
| Mexico | 187 | 317 | 130 | 69.5% |
| India | 1,579 | 1,289* | (290) | -18.4% |

**Apparel**

| Country | 1995 | 2001 | Chg | % Chg |
|---|---|---|---|---|
| China | 1,750 | 2,027 | 277 | 15.8% |
| Mexico | 476 | 681 | 205 | 43.1% |
| India | 264 | 331* | 67 | 25.4% |

*Note: India data is for 2000, not 2001
Source: OECD

Despite China's strength in this industry, its exports have been limited by the existence of quotas. For example, China's share of US apparel imports has been steady for the past decade. Indeed the quota system, by limiting China's exports and creating a relatively inefficient system of apparel trade, has increased the prices global consumers pay for apparel and textile products. The WTO has estimated the amount by which the prices of apparel and textile exports are elevated due to the existence of quotas. It found that, in the case of China's apparel exports to the US, the quotas were equivalent to an export tax of 33%. In the case of Bangladesh, on the other hand, its quotas were equivalent to a tax of just 8.1%. Therefore, eliminating the quotas should result in a sizable reduction in China's export prices relative to those of Bangladesh and other countries as well. This assumes, of course, that no other forms of protection are implemented. Given that consumers face a drop in apparel prices, it is reasonable to expect an increase in overall apparel volume.

**Figure 4. Export Tax Equivalent of Quotas**
(Percent)

| | US/Canada | | EU | |
|---|---|---|---|---|
| | Textiles | Clothing | Textiles | Clothing |
| Bangladesh | 15.3 | 8.1 | 8.4 | 7.3 |
| China | 20.0 | 33.0 | 12.0 | 15.0 |
| Hong Kong | 1.0 | 10.0 | 1.0 | 5.0 |
| Hungary | 6.9 | 5.0 | 0.0 | 0.0 |
| India | 9.8 | 34.2 | 12.0 | 15.2 |
| Indonesia | 8.1 | 7.8 | 6.3 | 6.0 |
| Philippines | 6.5 | 7.8 | 5.7 | 6.0 |
| Poland | 6.9 | 5.0 | 0.0 | 0.0 |
| Sri Lanka | 15.3 | 8.3 | 5.5 | 6.6 |
| Thailand | 8.3 | 13.2 | 6.4 | 7.8 |
| Turkey | 7.0 | 4.9 | 1.5 | 0.0 |
| Vietnam | 6.9 | 7.1 | 7.5 | 7.2 |

Note: This shows the tax that would have to be imposed on exports in order to have the same pricing effect as the existing quotas.
Source: IMF Estimates

Although China's share of the US apparel market has remained steady, its share of other important markets has grown. For example, from 1995 to 2002, China's share of Japan's apparel imports rose from 59.1% to 77.5%. This partly reflected the greater willingness of Japanese retailers to source their apparel from China. In addition, China's share of European Union (EU) apparel imports rose from 14% in 1995 to 20% in 2002.

Although China casts a giant shadow of the global apparel and textile trade, there are other countries that play a significant role. For example, Mexico accounted for 12% of US apparel imports in 2002, up from 7% in 1995. For the EU, Turkey, Morocco, and Central Europe jointly accounted for over one quarter of apparel imports in 2002. It is expected that the end of quotas will create turmoil for each of these countries.

# Evolution of the trade regime

### MFA

The quota regime came about as a way to offset the impact on developed countries of rising apparel and textile imports from emerging countries. The Multi-Fiber Arrangement (MFA) was codified in 1974. It provided that importing rich countries could impose specific quotas on imports of textiles and apparel from exporting developing countries. As a result, importing companies embarked on a process of quota chasing. That is, they sought to take advantage of the low labor costs in many emerging nations by utilizing the quota rights of those countries. Consequently, many small emerging nations developed significant apparel and textile exporting industries. Often, one country would engage in one process, export to another country for the next stage of production, and so on. Many countries developed these industries with no other comparative advantage than quota rights and low wages. The result was a highly inefficient system by which countries imported most raw materials and components, added labor value, and re-exported to the next country. For many of these countries, this industry became a significant economic force, accounting for a large share of manufacturing employment and exports.

Consider, for example, the extreme case of Bangladesh. During the past thirty years, this poor country developed a significant apparel exporting industry, accounting for 77% of merchandise exports in 2002. Yet although Bangladesh has very low wages, it is not considered well situated to compete absent quotas. That is because its workers are not very productive, the result of minimal capital investment, poor transportation and utility infrastructure, and the necessity of importing most raw materials. Other countries with large quota-induced apparel and textile industries include Cambodia, Sri Lanka, Tunisia, Morocco, Egypt, and Jamaica – to name a few.

### ATC

Under the WTO's Agreement on Textiles and Clothing (ATC) implemented in 1995, MFA quotas were to be gradually phased out over a 10 year period ending in January 2005. It was expected that political opposition to the ATC would principally come from rich importing countries. That is because their remaining textile and apparel industries would be threatened by a flood of cheaper imports once quotas were eliminated. Indeed, such opposition has emerged. Yet great opposition also came from many of the countries that have benefited from the quota system. Their concern was that China would take market share from them resulting in huge losses of employment. In Bangladesh, for example, it has been estimated that between 10 million and 15 million jobs are directly or indirectly affected by the apparel exporting industry. Consequently, in 2004 50 apparel exporting countries petitioned the WTO to postpone the elimination of the quota regime. This request was denied.

### What happens next?

The quotas have been eliminated. The WTO has made estimates of the likely impact on flows of trade (see Figure 5). Its estimates are solely based on the sensitivity of demand to changes in prices. The WTO assumes no other changes in the trading regime or in exchange rates. The results indicate that the ATC could have a profound effect.

First, the WTO predicts that imports will rise as a share of demand in both the US and Europe. In the case of the US, imports are expected to increase from 33.8% of demand to 45%. In Europe, the impact is smaller, with an increase from 48.5% to 51%. The smaller increase in Europe reflects the fact that the EU gradually eliminated quotas while the US waited until the end to eliminate most of the quotas.

Second, the WTO expects that China will gain substantially at the expense of most other countries. In the case of the EU, China's share of apparel imports will rise from 18% to 29%. India's share is also expected to increase while those of Turkey, Central Europe, and Morocco are expected to decline. For the US, the WTO expects a similar pattern. China's share of imports will rise from 16% to 50% while Mexico's share will drop from 10% to 3%.

**Figure 5. Imports of Clothing to the US:**
**(% of total apparel imports)**

| Country of Origin | 1995 | 2002 | WTO Projection |
|---|---|---|---|
| China | 15 | 16 | 50 |
| Hong Kong | 10 | 6 | 6 |
| India | 4 | 4 | 15 |
| Mexico | 7 | 12 | 3 |
| Bangladesh | 3 | 4 | 2 |
| Philippines | 5 | 3 | 2 |
| Other | 56 | 55 | 22 |
| **TOTAL** | **100** | **100** | **100** |

Projection based on impact of ending quotas without any offsetting change in trade barriers or currency movement.
Source: WTO

Again, it is important to note that these estimates, while reasonably robust, assume no new protectionist measures or exchange rate changes. Either assumption could very well be incorrect. Therefore, predicting the true impact of ATC is fraught with risk.

One thing that is reasonable to expect is that apparel purchasers will end the process of quota chasing. That is, they will now make sourcing decisions on the basis of true costs and supply chain efficiency. This fact alone should lead to an overall reduction in costs and, therefore, prices.

# The importance of China

Most discussions about the end of trade quotas revolve around China. Not only is China already the biggest apparel and textile exporter, it is expected to become much more important.

## Advantages of China

The WTO's well publicized predictions about the impact of quota removal on China and other countries are worth noting again. Specifically, the WTO has estimated the impact of quotas on apparel and textile prices and the sensitivity of demand for these products to changes in prices. The result is an estimate of the impact on exports from China and elsewhere. The WTO estimates assume that all other things remain constant (including exchange rates, trade barriers, and consumer price sensitivity). The results are stark. The WTO predicts that China's share of US apparel imports, having remained steady since 1995, will increase from 16% in 2002 to 50% following the end of quotas. That increase is expected to be at the expense of a large number of smaller exporters including Mexico, Bangladesh, and the Philippines.

Such a large increase is indicative of the cost of the quota system. Yet the impact could even be greater. After all, the WTO estimate is based simply on the sensitivity of demand to changes in prices. There are supply-side factors to consider as well. Apparel buyers will increase their manufacturing capacity in China not only because of low wages but because of other factors. These include favorable infrastructure, quality of the workforce, availability of skilled managers, access to raw materials, and the ability to create a more efficient, vertically integrated supply chain. Taking account of these factors, the IMF estimates that China's apparel exports could double within three years.

The latter is important because the quota regime involved performing various stages of production in different locations. The result was inefficiency, higher transport costs, and slower production cycles. China has the advantage of being able to offer all stages of production including harvesting raw materials, transforming them into textiles, processing the textiles, sewing and knitting, packaging, and distribution. In fact, 63% of fabric used to make apparel in China is domestically produced.

Given China's attractiveness, it is not surprising that, prior to the end of quotas, many apparel companies were actively developing new production capacity in China in anticipation of the new era. In 2003 foreign direct investment in China's textile and apparel industry was $4.4 billion. Taiwanese investment in the sector, which accounts for a large share of such investment, rose 261% from 2000 to 2002.

## Risks of doing business in China

*Protectionisim*

Although China holds the promise of great riches, it also involves many risks. The greatest risk (discussed in detail later) is protectionism on the part of importing countries, especially the US. Political support for freer trade has diminished in the US and Europe. Governments on both sides of the Atlantic have not been shy about imposing trade restrictions in order to assuage the concerns of domestic industries. This has certainly been the case in the US when it comes to apparel. Moreover, the terms by which China entered the WTO allow the US to impose severe limits on Chinese apparel imports. Clearly concerned about the potential for protection, the Chinese government has even offered modest constraints on exports in order to fend off protectionist action.

*Exchange rate*

One factor that is contributing to protectionist sentiment is China's exchange rate. Widely regarded as overvalued, the renminbi (China's currency) has been the bane of protectionists in the US. Some members of the US Congress have offered legislation that would impose punitive tariffs on China if it fails to revalue the renminbi. They reason that China's leaders are holding down the renminbi's value in order to keep China's exports cheap. They regard this as a form of dumping and believe that it has contributed to America's current account deficit.

It is true that China's government has maintained a fixed exchange rate. It is also true that China's leaders are concerned that revaluation would adversely affect the price competitiveness of China's exports. Yet China's exchange rate policy has not been the cause of the US current account deficit. A large gap between saving and investment is the proximate cause. Nor would revaluation have a big impact on that deficit.

Still, there are reasons to expect China to revalue. First, maintaining the fixed exchange rate requires China to purchase foreign currency reserves in exchange for renminbi. This leads to excessive money supply growth in China which can be inflationary (although inflation has lately declined after an initially large increase). Second, rapid money supply growth feeds China's inefficient banking system and exacerbates the problem of excessive lending to loss-making state-owned enterprises. Third, a revaluation would lower import prices and effectively increase the purchasing power of Chinese consumers. This would have the salutary effect of shifting growth away from reliance on exports and toward domestic demand.

Therefore, there is a not insignificant probability that China will revalue its currency in the near future. If it does, the effect would be to increase the cost of exporting from China. This would especially matter to companies with highly labor intensive processes. A large revaluation might encourage some apparel producers to shift capacity to other lower-wage countries.

*Intellectual property*

One of the biggest headaches for branded apparel and textile companies sourcing their product in China is protection of intellectual property (IP). China has had a problem in enforcing such protection. The biggest IP problem comes from the actual contract manufacturers, some of whom produce extra output for their own distribution channels. The result is that the brand value is diminished by the availability of identical product at much lower prices. For branded companies doing business in China, the challenge then is to find reliable contract manufacturers and to properly police them.

*Rising costs*

Another risk of doing business in China is the fact that costs might rise significantly in the near future. Why? The reason is that China's economy is booming, thereby creating bottlenecks and shortages which affect the cost of production. In the past year the availability of electric power has been limited, often forcing factories to temporarily shut down at the behest of arbitrary government officials. Although massive investment in transport infrastructure is taking place, the system is not yet sufficient to handle the current growing volume of trade. Thus there are frequent bottlenecks on roads and at ports. Finally, as the economy overheats, wages are rising rapidly in the big coastal cities where most apparel and textile manufacturing takes place. Some producers are moving further inland where wages are substantially lower. Yet this often involves costlier and more time-consuming transportation.

## China's apparel and textile industry

The Chinese government is interested in taking advantage of the end of quotas to solidify China's position as the world's leading apparel and textile supplier. The government wants apparel and textile exports to rise from roughly $60 billion in 2003 to over $100 billion in 2010. Consider the fact that China's apparel and textile exports to the US rose 25% in 2004 alone. Although a disproportionate share of China's export growth recently has been driven by high technology products, the labor intensive nature of apparel and textiles is attractive to China's leadership. After all, they are concerned about absorbing many new workers into the market economy. With privatization of state-owned enterprises accelerating, and with a huge migration of rural workers to the big cities, the apparel and textile industry offers a social safety valve.

On the other hand, the government is clearly mindful of the political impact its success is having in other countries. Consequently, just prior to the end of quotas the government announced the imposition of export duties of 2% to 4% on some textile and apparel products. Unfortunately for China, this move was viewed cynically by importing governments. The duty was seen as insignificant and purely symbolic. With new protectionist measures threatened by the US and EU, China is now considering setting minimum prices on six categories of apparel products.

One of the salutary aspects of China's apparel and textile industry is that it is relatively privatized and efficient. For example, in 2001 state-owned enterprises (SOEs) accounted for only 10.6% of apparel employment, 8.1% of apparel enterprises, and 6.7% of apparel output. The remainder was mostly accounted for by foreign invested factories. On the other hand, the textile industry had more state involvement with SOEs accounting for 49.4% of textile employment, 21.3% of textile enterprises, and 35.7% of textile output.

**Figure 6. State owned enterprises in China 2001**

| | SOE employment as % of total | SOEs as % of enterprises | SOEs as % of output | % of SOEs operating at loss |
|---|---|---|---|---|
| Textiles | 49.4 | 21.3 | 35.7 | 41.1 |
| Clothing | 10.6 | 8.2 | 6.7 | 35.6 |
| – Knitwear | 21.0 | 14.4 | 13.0 | 41.2 |
| – Garments | 8.4 | 6.7 | 5.2 | 32.6 |
| Equipment | 48.6 | 29.6 | 32.8 | 39.0 |

Source: OECD

In the cases of both apparel and textiles, SOEs were much less efficient than the private sector. In 2004, foreign and overseas Chinese invested textile and apparel factories produced 31,250 renminbi of output per worker while SOEs produced 14,800 renminbi of output per worker. Moreover, the private firms had, on average, a 5.9% return on assets while SOEs had a loss.

**Figure 7. Data on textile and apparel industry in China**

| | State owned | Collective owned | Foreign and Overseas Chinese funded |
|---|---|---|---|
| Number of firms | 190 | 687 | 3,754 |
| Avg number of employees | 395 | 292 | 337 |
| Avg revenue (000 RMB) | 18,755 | 32,452 | 37,298 |
| Return on assets (%) | (0.76) | 4.92 | 5.87 |
| Return on equity (%) | (3.32) | 15.42 | 12.99 |
| Labor productivity (000 RMB per worker) | 14.80 | 35.41 | 31.25 |

Note: similar results obtain for other industries within the textile and clothing umbrella

Source: China Markets Yearbook 2005

Going forward, the Chinese apparel and textile industry is likely to change in some important ways. First, the end of quotas will drive consolidation and vertical integration in the industry. Nowhere will this be more important than in China. Consequently, the industry will experience greater economies of scale and further investment in technology. In addition, the government will encourage the industry to move up the value chain by producing higher technology and higher value added products. It will also encourage locally owned companies to take greater control over distribution and, ultimately, develop brand names that can be exported.

# The impact on other countries

While China will undoubtedly gain from the end of quotas, the impact on other countries will vary, depending on their mix of competitive advantages and also depending on the actions of importing governments.

## India

When the WTO did its analysis of the impact of the ATC on export volumes, India was the only country other than China that figured prominently as a beneficiary of the ending of quotas. Specifically, the WTO predicted that India's share of US apparel imports would increase from 4% in 2002 to 15% after quotas are eliminated. This analysis was based on the fact that India has a relatively efficient industry with low wages yet onerous quotas. The IMF estimates that India's apparel quotas were equivalent to an export tax of 34%, similar to their estimate for China (33%). Thus ending quotas should allow export prices to come down considerably.

India's apparel and textile industry is already quite large. Exports were roughly $12 billion in 2002 and producers are responsible for millions of employees. The industry is more vertically integrated than most given that India is the world's third largest producer of cotton. Although productivity is lower than in China, wages are low enough that, if China's costs should rise precipitously, India could become a far more attractive place to produce. India certainly benefits from the great availability of cheap, skilled, English speaking managers. Finally, India has the advantage of being a good place to protect intellectual property given its strong courts and cultural respect for the rule of law.

**Figure 8. China and India: A Brief Comparison**

| | China | India |
|---|---|---|
| Total Cumulative Foreign Direct Investment, $US Bills | 500 | 35 |
| Textile Exports 2002, $US Bill | 20.6 | 6.2 |
| Textile Exports as % of Global Total | 13.5% | 4.1% |
| Apparel Exports 2002, $US Bill | 41.3 | 6.3 |
| Apparel Exports as % of Global Total | 20.6% | 3.1% |
| Spending on Power and Transport Infrastructure 2002, $US Bill | 128 | 18 |
| Infrastructure Spending as % of GDP | 9% | 3% |
| Highway Network (1,000 km) | 1,400 | 200 |
| Freight handled by major ports 2002, millions tons | 1,666 | 288 |

Sources: EIU, UNDP, US Int'l Trade Commission, China National Statistics Bureau, The Economist, Morgan Stanley

On the other hand, India has some serious disadvantages it must overcome:

- First, the apparel and textile industry has had a much smaller volume of investment than China. It is, therefore, less technologically sophisticated and its workers are thus less efficient.
- Second, the transport and utility infrastructure is poor and the level of investment insufficient. Such investment accounts for 9% of China's GDP but only 3% of India's. Moreover, India has far fewer highways than China and much less port capacity (see Figure 8). The result is that the transportation lead time for apparel produced in India is much greater than in China.
- Third, India has onerous labor laws. It can be difficult to dismiss workers. Therefore, some producers are reluctant to hire new workers unless they perceive a permanent rather than temporary increase in the demand for their output.
- Fourth, India's government has encouraged small-scale industry (SSI) as part of a larger policy to maintain a fragmented rather than concentrated industrial system. The goal is to develop many small, family owned enterprises. This policy has entailed trade barriers to imported raw materials and capital equipment. The result has been to discourage entrepreneurs from investing in large-scale, capital-intensive production which might benefit from the ending of quotas. On the other hand, tariffs have lately been reduced. The current government is cognizant of the requirements of a world-class industry. However, it faces political obstacles to enacting needed reforms.

## Bangladesh

As mentioned earlier, Bangladesh is the most extreme example of a country where the apparel industry came about purely due to quotas. As such, it stands to suffer a dramatic loss in employment following the end of quotas. The WTO estimates that, all other things being equal, the removal of quotas will lead to an 18% decline in Bangladesh's apparel exports within three years. The problem is that the country has a number of impediments to competitiveness. These include an unreliable and expensive transportation, telecommunications, and electricity infrastructure; poor ports; widespread corruption; and an uninviting investment climate. If these supply-side problems were to be addressed, the country might salvage some of the anticipated loss.

## Others

*Pakistan*

Pakistan has also benefited from the quota system. Yet unlike Bangladesh, it is perceived as a strong player. This is due, in part, to a large cotton producing industry which enables a degree of vertical integration. Today, Pakistani producers are optimistic that the ATC will do more good than harm. Consequently, Pakistan's exports of apparel and textile products to the US rose 12.5% in 2004.

*Mexico, Central America, and the Caribbean*

Mexico and its neighbors have the advantage of being adjacent to the US, the world's largest apparel purchaser. There are two reasons why this is important. First, the cost of transporting apparel to the US is substantially lower than in the case of China (see Figure 9). This fact partially offsets the labor cost advantage of China. Second, apparel can be transported to the US much more quickly than sea-based goods sent from China. This is important for fashion oriented retailers seeking a quick and frequent turnaround of merchandise.

**Figure 9. Transit costs of US imports of textiles and clothing (% of import value)**

| | Transit in days | Total cost of freight |
|---|---|---|
| Mexico | 2 | 1.6% |
| China sea | 12 | 24.1% |
| China air | 2 | 27.8% |

Note: Cost of freight includes custom duty, actual freight cost, and time factor
For China, additional cost of air is related to higher cost of air transport partially offset by lesser time factorMexico's cost advantage can be offset by China's cheaper production costs.

Source: OECD

Mexico also has the advantage of being a member of NAFTA (North American Free Trade Area!fi Free trade with the US means that, unlike China, Mexico is relatively immune to new forms of protection. The same could eventually be true of Central America if CAFTA (Central America Free Trade Area) is passed by the US Congress.

*Central and Eastern Europe, North Africa*

These countries benefit from close geographic proximity to the EU. That fact should partly offset the gains for China. Also, several Central European countries have recently joined the EU and thus have completely free access to the European market. This should stimulate some investment in the apparel and textile manufacturing sector in these countries. Moreover, now that the EU has committed to membership negotiations with Turkey, there could be greater investor confidence there as well.

# Possible protection by the US

The biggest risk to the new trade regime is the possibility that the US will offset the benefits of the ATC by implementing new protectionist measures. Indeed, such measures have already been implemented in some categories. Moreover, there is a huge gap between what the WTO predicts will happen to Chinese apparel exports to the US and the potential limits that the US government can impose under WTO rules. For apparel purchasers and producers, this creates a very uncertain environment in which to make plans.

## Safeguards

There has been plenty written about the details of trade rules. Instead, let us consider here a summary of the rights of the US government under the WTO. First, under the so-called "safeguards" rules, the US may impose quantitative limits on imports of apparel from China if they "disrupt" the pattern of trade. Under most traditional rules, such limits may only be imposed if imports "damage" domestic producers. The difference is more than semantic. Disruption can entail simply a drop in imports from Mexico replaced by a surge from China. This can involve no damage to any US producer at all. Yet under such circumstances, the US has the right to limit Chinese imports.

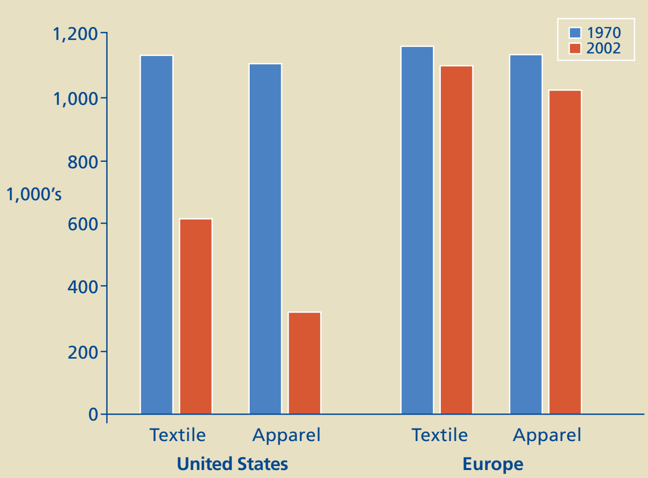
Moreover, under the rules the US can implement restrictions on China while ignoring the role of any other country. In other words, the US may discriminate against China, something that is not usually the case in international trade agreements.

The US has already implemented quantitative restrictions under these rules in the case of several apparel categories. The restrictions generally entail a limit on import growth of 7.5% per year. Some members of Congress have called for further restrictions, including increased tariffs, if China fails to revalue its currency. In addition, US apparel and textile producers have petitioned the US government to impose new limitations on the basis of anticipated or potential disruption to trade. China claims that such a move would be a violation of the spirit of the WTO.

It is difficult to predict what the US government will do next. Yet it is reasonable to expect that protectionist sentiment will diminish if China revalues its currency. On the other hand, the protectionist lobby has been powerful and effective, especially given that industry employment is relatively concentrated geographically. Still, it should be noted that, as of February 2005, the outstanding petitions for safeguard protection cover 60% of apparel and textile imports from China. Consequently, even if all petitions are accepted by the government, 40% of imports would experience an end to quotas with no offsetting protection. Thus the prices of many products will decline substantially. Moreover, the quotas will still be eliminated for all other countries.

It is surprising that the anti-liberalization movement is so powerful given the relatively small number of apparel and textile jobs remaining in the US. Consider the fact that, from 1970 to 2002, the number of apparel manufacturing jobs in the US fell from 1.1 million to roughly 300,000. The number of textile jobs fell from 1.1 million to roughly 600,000. Thus there are today fewer than one million industry jobs remaining. Yet the magnitude of the US job losses to date clearly demonstrates why the issue is so sensitive. In Europe, on the other hand, there have not been such large losses of apparel and textile jobs (see Figure 10). Hence European politicians are not as vexed over this issue. Moreover, the ascent of several Central European countries into the EU will probably entail a shift of employment within Europe rather than toward Asia.

**Figure 10. Textile and Apparel Employment in the U.S. and Europe**




Source: OECD

Given the fact that protection can be imposed when no damage to the US industry takes place, it becomes clear that the issue in the US is really part of a larger debate about the role of trade and manufacturing in the US economy. Efforts to limit Chinese apparel imports are, therefore, necessary for opponents of trade to demonstrate their political effectiveness.

## Dumping

Aside from the "safeguards," the other significant way that apparel and textile imports into the US can be limited is through traditional anti-dumping lawsuits. Specifically, dumping is considered to take place when products made in one country are sold in another at a below-cost price. The real issue is how to measure the cost of production. This depends on whether the exporting country is considered a "market" or "non-market" economy.

If a country is a market economy, then production costs in that country are sufficient for determining if dumping has taken place. If, on the other hand, the country is considered a non-market economy, then domestic costs are considered potentially distorted. Therefore, costs in a third country are used to determine if dumping has taken place. Given that there will usually be a third country with high production costs, proving the existence of dumping becomes quite easy – and quite politically driven.

The US considers China a "non-market" economy. Thus, demonstrating dumping is not difficult. China wants to be considered a "market" economy. Yet under US law China must meet several requirements before its categorization can be changed. Among these is a currency revaluation.

Recently, Chinese exporters have found a loophole in US law that enables them to avoid serious penalties from dumping. Specifically, several exporters have claimed in US court that, although China is a non-market economy, these privately owned companies operate in the market-oriented part of the Chinese economy. Therefore, these company's own production costs should be used in determining dumping. The result has been that several exporters have avoided draconian fines. For example, in a recent case against Chinese wood furniture manufacturers, duties of 8.6% were imposed on imports as punishment for dumping. Yet if the non-market method of determining costs had been used, the duty would have been in the range of 150-200%. Now the US government is considering eliminating this loophole

The bottom line is that political decisions of the US government will determine much of what transpires in the near future. Again, this creates a great deal of uncertainty for market participants.

# Impact of ATC on global apparel trade

The end of quotas is not the end of the story. Many unknown variables remain, not the least of which is the response of importing governments. Yet while industry players await disparate protectionist moves by the US and other governments, they will not sit still. Instead, they have already begun a process that will lead to a very different industry.

## Consolidation

The most important effect of the ATC on the structure of global apparel trade will be consolidation on both sides of the supply chain. First, there will be fewer countries accounting for a larger share of total apparel and textile exports. The countries that will gain share will surely include China and India. These exporters will offer not only low costs but vertical integration, strong management, and better infrastructure. As for others, winners will be those that have some kind of niche competitive advantage. For example, countries within close geographic proximity to the final market will be favored for fast fashion. Countries that can offer some degree of vertical integration will be better positioned than those whose industries developed purely on the basis of quota rights. Naturally, some countries will suffer grievous losses.

Second, there will be fewer buyers of apparel and textile products. Unrelated to the end of quotas, a process of global retail consolidation has been under way for quite some time and is likely to accelerate. In the past, the leading buyers of apparel in the US, Europe, and Japan were department stores, leading vertically integrated specialty players, and major fashion houses. Yet in recent years, large food and mass merchandise retailers have dramatically increased their share of total retail sales. As they have achieved maturity and, in some cases, market saturation they have shifted their focus from food and packaged goods toward apparel and home related products. Their goal is to obtain a greater share of wallet from existing customers by becoming a destination for fashion. Among the retailers doing or trying to do this are Wal-Mart and Target in the US, Tesco in the UK, and Carrefour in France. These retailers seek low cost products and efficient supply chains. With their vast purchasing power and global reach, they will be influential in dictating the structure of the industry.

Moreover, other buyers will not sit still. In response to the rise of mass merchants, other retail channels will experience more consolidation. Witness the recent merger of Sears and Kmart. Witness the industry talk of further department store consolidation. There will also be consolidation among fashion houses in order to reduce supply chain costs and to have greater leverage with their retail customers.

The overall result will be fewer buyers each with greater power. The result will also be a greater focus on reduced costs in order to compete with mass merchants. This will mean consolidated purchasing in a handful of low cost countries. Yet there will also be a focus on differentiation in order to compete on the basis of something other than price. Non-value retailers will seek to avoid becoming commodity sellers by creating exciting fashions with clear brand identities. Such a focus on differentiation will be beneficial to those countries other than China and India that offer faster turnaround. These include Mexico and the Caribbean for US retailers and Turkey, Morocco, and Central Europe for European retailers.

Within exporting countries, there will be consolidation of sellers. The leading retailers and fashion houses will seek to employ the services of large companies that can offer a fully integrated, low cost, and rapid supply chain. This will likely entail consolidation and rationalization among the Hong Kong and Taiwan owned factories in southern China. In India it will mean that, provided the government cooperates, there will be massive consolidation resulting in very large operations—comparable to what exists in China.

## Risk management

Although the major players in the global apparel and textile trade will seek to optimize efficiency, they will also be mindful of risk. Among the risks they face are protectionism, exchange rate movements, changes in the regulatory environment in both exporting and importing countries, and changes in the tax environment to name a few.

To deal with this, buyers will undertake strategies aimed at reducing risk. Principally, this will mean maintaining the ability to source apparel and textile products in multiple locations. Countries other than China and India that benefit from such risk management will have one or more of the following characteristics:

- Close geographic proximity to the final market
- Political and economic stability
- Close economic ties with importing countries (ie; membership in EU or NAFTA)
- The ability to offer vertical integration
- Strong physical infrastructure (roads, electricity, ports)
- Strong managerial skills

# Strategic implications for companies in the apparel and textile industry

For companies involved in the design, production, or distribution of apparel and textile products, the new trading environment offers some great opportunities as well as greater uncertainty. The trick will be to take advantage of the opportunities while planning for the risks. The good news is that, for any given company, many competitors will be in the same boat.

The principal impact of the ATC will be lower apparel and textile costs for retailers. Given the various risks discussed, it is difficult to know by how much costs will fall. Yet any drop in costs will have different implications for different kinds of retailers.

For those retailers for whom low prices are their principal competitive advantage, the ATC will be beneficial. Discount oriented retailers will either pass on the cost reduction to consumers in the form of lower prices, or they will maintain prices and obtain an improvement in their margins—or some combination thereof. What they decide to do will depend on the price sensitivity of demand and the intensity of competition. If demand is highly price sensitive, they will lower prices thereby spurring increased volume. If not, they will witness margin improvement. Or they may choose to maintain prices but improve product quality. The latter strategy would enable discounters like Wal-Mart to improve the brand equity of their apparel selection and thus become more significant destinations for apparel shoppers.

For other less value-oriented retailers, the ATC may be more problematic. Department stores and high-end specialty retailers depend on high margins and relatively low volume. Given the highly competitive environment in which these retailers operate, it is unlikely that any one of them will attempt to maintain prices. Instead, there will be a general price decline. Yet these retailers do not compete principally on the basis of price. Thus demand is not highly price sensitive. The result will probably not be a strong increase in volume. Instead, there will be a hit to margins. For these retailers, the challenge will be to redouble their efforts at clear differentiation and branding. Only by engendering greater customer loyalty will they be able to resist price cuts.

In summary, for retailers as well as textile and apparel brand managers, the ATC creates several imperatives that are worth noting:

- **Make a big bet on China.** Even though there are substantial risks to doing business in China, on balance China is a very appealing place to source apparel and textile products. Any significant player on the global stage ought to be there.

- **Make a few other big bets.** With the end of quota chasing, retailers and brand managers needn't source goods in a multitude of places. Yet they should source in a few strategic locations if only as a risk avoidance strategy.

- **Focus on quality.** Costs will surely come down regardless of what importing countries do. It is simply a question of how much. Yet at the end of the day, most branded companies will best their competitors not simply through pricing but through quality and product differentiation. Therefore, sourcing decisions ought to be made on this basis as well as cost considerations.

- **Participate in consolidation.** The most successful companies in this industry will possess economies of scale. Even if a producing or importing organization lacks critical scale, it can participate in scalar efficiency by contracting with large, vertically integrated organizations that can assist with all aspects of sourcing.

- **Take note of emerging market brands.** As China and other emerging countries move up the value chain, some of their indigenous brands will emerge as world-class sellers with global reach. For global retailers, these could be part of a differentiated portfolio of brands. They could offer the ability to provide consumers with low prices as well as innovative fashion. For branded apparel managers, these new brands could represent competition – or perhaps acquisition targets.

# About the Author

**Ira Kalish**
Deloitte Services LP
Tel: +1 213 688 4765
e-mail: ikalish@deloitte.com

Ira Kalish is Global Director, Consumer Business at Deloitte Research. He is an expert on global economic issues as well as the effects of economic, demographic, and social trends on the global retailing and consumer products industries. Mr. Kalish conducts research on global economic issues and has authored in-depth reports on economic and consumer issues in many of the world's major countries. In addition, Mr. Kalish has been widely quoted in the news media. His remarks have been published by The Wall Street Journal, Business Week, The Economist, The Financial Times, and USA Today to name a few. Mr. Kalish holds a bachelor's degree in economics from Vassar College and a Ph.D. in international economics from Johns Hopkins University.

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For more information about Deloitte Research, please contact Ajit Kambil, Global Director, Deloitte Research, part of Deloitte Services LP, at +1 617 437 3636 or via e-mail: akambil@deloitte.com.

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# For Further Information, Please Contact

## Consumer Business Leaders

### Global

**Ed Carey**
Deloitte Consulting
Tel: +1 312 374 3048
Email: ecarey@deloitte.com

### Americas

**Tara Weiner**
Deloitte & Touche LLP
Tel: +1 215 246 2326
Email: tweiner@deloitte.com

### LACRO

**Francisco Perez Cisneros**
Deloitte
Tel: +52 55 5080 67 20
Email: fperezcisneros@dttmx.com

### Europe

**Gilles Goldenberg**
Deloitte S.A.
Tel: +33 1 40 88 28 16
Email: ggoldenberg@deloitte.com

### Asia Pacific

**Yoshiaki Kitamura**
Deloitte Touche Tohmatsu
Tel: +81 3 6213 1307
Email: yoshiaki.kitamura@tohmatsu.co.jp

## Global Chinese Service Group

**John Jeffrey**
Deloitte & Touche LLP
United States of America
Tel: +1 212 436 3061
Email: jjeffrey@deloitte.com

**Clarence Kwan**
Deloitte & Touche LLP
Tel: +1 212 436 4732
Email: clkwan@deloitte.com

**Peter Bowie**
Deloitte Touche Tohmatsu
Email: pbowie@deloitte.com.hk
Tel: +852 2852 6789

**Chris Lu**
Deloitte Touche Tohmatsu CPA Ltd.
Tel: +86 21 6335 0202 ext. 1003
Email: chrislu@deloitte.com.cn

**Chris Fitzgibbon**
Deloitte & Touche
Tel: +44 20 7007 1827
Email: cfitzgibbon@deloitte.co.uk