Study on China’s Textiles & Clothing Industry and its Market Expansion Strategy

Disclaimer: The views expressed in this study do not represent the views of the European Commission. Its content does not bind the European Commission. The European Commission accepts no liability whatsoever with regard to the information contained in this document.
# Table of Contents

Table of Contents .....................................................................................................................2  
Glossary ........................................................................................................................................3  
Section 1 – Executive Summary..............................................................................................5  
Introduction ................................................................................................................................................8  
Background ...........................................................................................................................................8  
Report Overview ..............................................................................................................................8  
Methodology .......................................................................................................................................9  
Section 2 – Structure of T&C Sector....................................................................................11  
Policy & Regulatory Environment ...................................................................................11  
Industrial Output and Export Performance ...............................................................19  
Ownership of Chinese T&C Exporting Companies ........................................................23  
Political & Economic Significance of the T&C Sector ....................................................25  
Section 3 – Competitiveness Analysis...................................................................................28  
Raw Materials Input ..........................................................................................................30  
Intermediary Inputs ...........................................................................................................35  
Labour and Management ..................................................................................................38  
Clothing Manufacturing ........................................................................................................40  
Infrastructure & Commercial Environment ...................................................................41  
Business Environment ........................................................................................................42  
Section 4 – Analysis of Investment in the T&C Sector........................................................51  
Foreign Investment ............................................................................................................60  
Hong Kong and Taiwan Investment ..............................................................................61  
Involvement of EU Companies in the Sector .................................................................62  
Sourcing from China ...........................................................................................................64  
Section 5 – Analysis of Labour & HSE Issues......................................................................70  
Overview of Legal Requirements & Compliance........................................................70  
Government Attitude & Remit ..........................................................................................71  
Legal Requirements for Health, Safety, and Labour Conditions .....................................73  
Analysis of Labour Conditions .........................................................................................75  
Worker Empowerment ........................................................................................................79  
Environmental Performance ...............................................................................................81  
Section 6 – Analysis of Post-ATC Policy & Investment ......................................................86  
Industrial Policy ..................................................................................................................86  
Upgrading Strategies ...........................................................................................................86
<table>
<thead>
<tr>
<th>Glossary</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>ACFTU</td>
<td>All-China Federation of Trade Unions</td>
</tr>
<tr>
<td>ACWF</td>
<td>All-China Women’s Federation</td>
</tr>
<tr>
<td>ACYF</td>
<td>All-China Youth Federation</td>
</tr>
<tr>
<td>AQSIQ</td>
<td>State Administration for Quality, Supervision, Inspection and Quarantine</td>
</tr>
<tr>
<td>ATC</td>
<td>Agreement on Textiles and Clothing</td>
</tr>
<tr>
<td>CBRC</td>
<td>China Banking Regulatory Commission</td>
</tr>
<tr>
<td>CCCT</td>
<td>China Chamber of Commerce for Import and Export of Textiles</td>
</tr>
<tr>
<td>CEC</td>
<td>Chinese Enterprise Confederation</td>
</tr>
<tr>
<td>CEQ</td>
<td>China Economic Quarterly</td>
</tr>
<tr>
<td>CNTIC</td>
<td>China National Textile Industry Council</td>
</tr>
<tr>
<td>CWTA</td>
<td>China Wool Textile Association</td>
</tr>
<tr>
<td>EPB</td>
<td>Environmental Protection Bureau</td>
</tr>
<tr>
<td>FDI</td>
<td>Foreign Direct Investment</td>
</tr>
<tr>
<td>FHI</td>
<td>Family Health International</td>
</tr>
<tr>
<td>FIE</td>
<td>Foreign Invested Enterprises</td>
</tr>
<tr>
<td>HSE</td>
<td>Health, Safety and Environment</td>
</tr>
<tr>
<td>I/E</td>
<td>Import and Export</td>
</tr>
<tr>
<td>IPR</td>
<td>Intellectual Property Rights</td>
</tr>
<tr>
<td>IWTO</td>
<td>International Wool Textile Organisation</td>
</tr>
<tr>
<td>LDC</td>
<td>Less Developed Countries</td>
</tr>
<tr>
<td>M&amp;A</td>
<td>Mergers and Acquisitions</td>
</tr>
<tr>
<td>MOA</td>
<td>Ministry of Agriculture</td>
</tr>
<tr>
<td>MOF</td>
<td>Ministry of Finance</td>
</tr>
<tr>
<td>MOFCOM</td>
<td>Ministry of Commerce</td>
</tr>
<tr>
<td>Acronym</td>
<td>Full Form</td>
</tr>
<tr>
<td>---------</td>
<td>-----------</td>
</tr>
<tr>
<td>MOLSS</td>
<td>Ministry of Labour and Social Security</td>
</tr>
<tr>
<td>MSI</td>
<td>Marie Stopes International</td>
</tr>
<tr>
<td>NBS</td>
<td>National Bureau of Statistics</td>
</tr>
<tr>
<td>NDRC</td>
<td>National Development and Reform Commission</td>
</tr>
<tr>
<td>NGO</td>
<td>Non-Governmental Organisation</td>
</tr>
<tr>
<td>PRD</td>
<td>Pearl River Delta</td>
</tr>
<tr>
<td>SAIC</td>
<td>State Administration of Industry and Commerce</td>
</tr>
<tr>
<td>SETC</td>
<td>State Economic and Trade Commission</td>
</tr>
<tr>
<td>SEPA</td>
<td>State Environmental Protection Administration</td>
</tr>
<tr>
<td>SEZ</td>
<td>Special Economic Zone</td>
</tr>
<tr>
<td>SAWS</td>
<td>State Administration of Work Safety</td>
</tr>
<tr>
<td>SME</td>
<td>Small and Medium-Sized Enterprises</td>
</tr>
<tr>
<td>SOE</td>
<td>State-Owned Enterprises</td>
</tr>
<tr>
<td>T&amp;C</td>
<td>Textile and Clothing</td>
</tr>
<tr>
<td>USTD</td>
<td>United States Trade Department</td>
</tr>
<tr>
<td>WFOE</td>
<td>Wholly Foreign Owned Enterprises</td>
</tr>
<tr>
<td>YRD</td>
<td>Yangtze River Delta</td>
</tr>
</tbody>
</table>
SECTION 1 – EXECUTIVE SUMMARY

Context
China’s export performance in the products liberalised under the third stage of the Agreement on Textiles and Clothing (ATC) has been characterized by a surge in exports accompanied by a considerable drop in average unit price. The main factors driving this impressive performance include, on the one hand, the liberalisation of the production and export regime and on the other, considerable increases in production capacity.

This research suggests that the sharp decrease in average unit price was partly caused by the elimination of quota price premiums (the share of quota costs as a percentage of the final cost constituted up to 25% of the final price, or even more if quotas were traded on the black market) and the development of cut-throat price competition in the clothing sector, which has created downward price pressure. The export competitiveness of the Chinese clothing sector is underpinned by qualitative and quantitative gains in China’s fibre-processing industries, which underwent major restructuring from 1997-2000 under the framework of the Ninth Five-Year Plan (1996-2000).

The restructuring of the textile industry has had an encouraging effect on the performance of the clothing industry. A vibrant fibre processing industry has further integrated the various links in the supply chain, which is one of China’s key competitive advantages. Nevertheless, even as China’s textile and clothing (T&C) industry makes significant absolute gains in terms of fibre-processing and garment production capacity, the sector’s relative overall export performance as a percentage of total exports has been steadily decreasing.

Increased Capacity
On the upstream side of the sector, Chinese textile companies have been adding new capacity over the last three or four years and have made significant headway in enhancing efficiency and quality of production. There is now a wider variety of fabrics available for the garment manufacturing industry. In the clothing sector, manufacturing companies have been planning to increase production capacity in anticipation of the phase-out of the quota system. Factories have been adding production capacity chiefly by hiring more workers and many have also been purchasing or upgrading equipment in order to improve efficiency and productivity.

On balance, recent investments in China’s T&C sector have a double objective: to upgrade the T&C sector’s industrial infrastructure and to expand production capacity. The bulk of fixed asset investment has focused on the purchase of capital equipment for the domestic textile industry. In 2003, total sales of textile machinery reached US$ 8.6 billion, of which imports of textile machinery accounted for US$ 4.37 billion and sales of domestic machinery accounted for US$ 4.23 billion. China has now become the world’s leading buyer of textile machinery, according to the International Textile Manufacturers’ Federation. Installed capacity in spinning, weaving and knitting equipment has increased substantially since 2000.

Historical Investment & Support
Significant investments were made during the Ninth and Tenth Five Year Plans (1996-2000 and 2001-2005 respectively), which provided funding for the restructuring of China’s textile
industry, particularly in terms of phasing out obsolete equipment and upgrading machinery. This restructuring process was subsidised by the central government and may have facilitated China’s export surge of T&C products. During 2003 the industry again saw increased investment in the sector, but this was due to excessive liquidity in the banking system rather than any direct subsidy from central government.

Since 2003 China’s rates of investment in fixed assets have become so high that some economists caution the inevitable restraints on such investment might yet cause the Chinese economy to suffer a ‘hard-landing’. This cycle of investment is due in part to the absence of sound risk assessment practices in the state-owned banking system. The government has now introduced a series of administrative and macro-economic measures in an attempt to cool investment in the sector.

Given the fact that the government’s direct or indirect subsidies to the T&C sector long pre-date the implementation of the third stage of ATC liberalisation, the sudden drop in unit prices cannot principally be attributed to industry subsidies. Although some government support at the local level is a continuing phenomenon, central government subsidies have been gradually phased out. The real problem is rooted in China’s financial system, which is beset by structural lending and risk management issues, underlining the difficulties that continue to hamper China’s efforts to become a fully-fledged market economy.

Besides domestic investment, foreign direct investment (FDI) has also contributed to the development of China’s T&C sector. Hong Kong remains a major investor in China’s clothing industry and many Hong Kong-based garment suppliers have their own production facilities on the mainland. Recently, Korean and Taiwanese textile producers have also been migrating manufacturing capacity into China in order to address more effectively Chinese buyers’ requirements for higher value-added fabrics.

**Growth Projections**

Textile enterprises will not benefit directly from the phase-out of the quota system in a significant way. But they will stand in a better position to reap the benefits of greater internationalisation thanks to the government’s efforts to rationalise the sector. The Chinese clothing sector will be the biggest market-share winner in the restructuring of the global textile trade system, as buyers strengthen their purchasing activities in China.

Recent economic projections suggest that the share of China’s exports of clothing products in key markets will vastly outstrip its share of textile exports. A recently published WTO report, for instance, projects that China’s share of the combined US/Canada garment market will balloon from 16% to 50%, whereas its share of these countries’ textile market will rise marginally from 11% to 18%\(^1\). In the EU, China’s share of the garment market is projected to reach 29%, up from 18%\(^2\). The projected increase in China’s share of the EU textile imports however is negligible.

Although these projections have been criticised for failing to take into account contingency factors such as the imposition of safeguard measures on Chinese exports, China’s self-imposed export control measures and other key drivers of trade in clothing products such as

---

\(^1\) Figures are based on 1997 and 2005 values estimated by the WTO

\(^2\) Ibid
preferential tariff arrangements and time to market, Chinese exports of clothing products will continue to increase substantially following the total elimination of quotas on 1 January 2005, thanks to increases in China’s installed textile manufacturing capacity and to garment manufacturers’ stated intention to increase production capacity further. Estimates vary, but on average they point to potential increases in garment production capacity from 20% to 50% for key products including men’s trousers, shorts, T-shirts and women’s blouses.

Price competition following the liberalization of the garment export market will probably create further downward price pressure on garment exports, although recent surges in raw material and labour costs may mitigate this pressure. The purchasing pull of large international buyers however may also contribute to downward price competition and the larger the volume of the orders, the more prices are likely to drop. Liberalisation of the sector means that garment manufacturers’ profits will be further squeezed unless they decide to compete on something other than price, for instance on quality and service. As labour prices and raw material costs increase, manufacturers face the choice of passing the burden of rising costs to buyers or absorbing the shortfall themselves.

**Labour & Environmental Standards**

The government is urging enterprises to adhere to domestic labour and environmental standards. Implementation of standards at the local level however remains problematic. By most accounts, including those of central government officials, compliance with labour and workplace HSE standards is far from satisfactory. Large, state-owned enterprises and those owned/operated by EU or North American companies are generally believed to have higher levels of compliance than private or other foreign invested enterprises.

As yet, there are few sources of comprehensive quantifiable analysis on just how poor standards are in the textile and garment industries, though significant anecdotal evidence has been widely documented and the Chinese government has released some indicative statistics. There is general consensus among sources that poor enforcement of existing regulations, which are generally viewed as comprehensive, and the exclusion of migrant workers from the Chinese legal system are the most serious barriers to improved work conditions. These obstacles are closely related to the competition between jurisdictions to facilitate investment and economic growth: the attitude of provincial and local officials is that lax law enforcement that promotes growth is not an abrogation of duties.

Foreign observers have noted recent improvements in enforcement and in the attitude of lower-level officials, especially related to migrant workers’ rights, health and safety. Enforcement is still highly variable and poorly planned. Interviewees have also seen increased interest in standards and corporate social responsibility by factories, but this has primarily been driven by a desire to understand the international market and some managers have openly expressed their disbelief that better labour conditions would benefit their business and their resentment at what they view as multinational hypocrisy.
INTRODUCTION

Background

China’s textiles and clothing industry has achieved remarkable growth and plays an important role in the domestic economy both as a foreign exchange revenue-earner, as well as a key source of employment. The global share of China’s textile and clothing exports has increased from 2.6% in 1970 to approximately 17% today. Accession to the WTO has strengthened China’s textile and clothing sector as key importers of textiles and clothing, including the United States, the European Union and Canada, have begun to phase out quotas on Chinese imports as outlined in the ATC. Indeed, the sector has demonstrated a burgeoning export performance since the implementation of the third stage of ATC came into effect in 2002.

In the EU, China’s textile and clothing products removed from quota restrictions surged by 46% in value and 188% in volume in 2002, while average prices decreased by 50%, according to EU estimates. Indeed, China has become the largest exporter of textile and clothing products to the EU, ahead of the combined top three Mediterranean exporters to the EU (Turkey, Tunisia and Morocco), in spite of the duty- and quota-free import benefits enjoyed by the latter. Furthermore, experts predict that continued export growth in the sector coupled with the coming into effect of the final round of ATC liberalisation will significantly increase imports of Chinese textile and clothing products by the EU.

Report Overview

This report sheds light on the conditions under which China has achieved this extraordinary export performance. It is designed to help the EU Commission gain a clear understanding of the characteristics of the textiles and clothing sector in China and the prevailing regulatory framework. The report covers the following areas:

1 – Analysis of Industry Structure

- Overview of China’s T&C industry and industrial policy, including industry restructuring;
- Analysis of the microeconomic dimensions of China’s textiles and clothing sector; including ownership of textile and clothing companies;
- Analysis of capacity expansion patterns in the T&C sector;
- Evolution of the role of the state and the market in the textile and clothing sector.

2 – Analysis of Competitive Conditions

- Analysis of competitive factors of China’s T&C industry;
- Analysis of export conditions of Chinese T&C products after the third stage of ATC liberalisation;
- Breakdown of production chain in the textile and clothing industries;
- Analysis of raw material prices;
- Analysis of “unfair” competitive advantages, including preferential treatment of T&C companies and other subsidies at the local level.
3 – Analysis of Foreign Investment in the Sector
- Appraisal of developments and trends in foreign investment in the T&C sector;
- Appraisal of investment from Hong Kong in the export-processing T&C sector;
- Role of EU and US investment in the sector;
- Analysis of recent shipments of foreign textile machinery.

4 – Analysis of Labour, Health, Safety and Environmental (HSE) Issues
- Overview of the legislative framework governing labour and HSE issues;
- Outline and assessment of labour conditions in factories;
- Conformity with internationally agreed standards on health and safety issues;
- Overview of environmental problems in the T&C sector.

5 – Analysis of Post-ATC Policy & Investment
- Overview of China’s current industrial policies;
- Analysis of upgrading strategies.

Methodology
This report does not seek to provide a definitive and exhaustive overview of the sector. Rather, it provides qualitative conclusions drawn from available statistics and findings from direct engagement with policy-makers, industry representatives and NGOs. In undertaking this study, initially a research framework was developed and tools were designed to gather quantitative data. The raw data was then analysed systematically to reach conclusions about trends and developments in the sector. This research methodology consisted of:

Desk Research
In the first instance the research team reviewed and analysed a substantial volume of existing information, including statistical information, investment data, growth patterns and export trends. Desk research was based upon materials and secondary sources such as:

- Customs’ data
- National Bureau of Statistics data
- Industry statistics from the China National Textiles Industry Council (CNTIC) and the CCCT
- UN, IMF and World Bank reports
- NGO social accountability audit reports (on labour, health and safety standards)
- Selected media sources

Primary Research
Given the shortcomings of information available from public sources in China, consultations were conducted with the relevant government agencies and industry contacts. Interviews were conducted face-to-face, by telephone and by e-mail.

In order to guide the consultations with stakeholders, a set of preliminary questionnaires was developed. A “sample batch” of interviews was conducted to identify the general issues affecting the industry. The feedback and findings that emerged from these consultations provided the basis for developing another set of targeted questionnaires, designed to gather more in-depth information about specific industry issues.
Introduction

Study on China’s Textiles and Clothing and Market Expansion Strategy
– January 2005
SECTION 2 – STRUCTURE OF T&C SECTOR

Policy & Regulatory Environment
China’s T&C sector is segmented into upstream production sub-sectors (spinning, weaving, knitting and dyeing) and clothing manufacturing (cutting and finishing). Generally speaking, the industry is vertically-integrated. Given the degree of fragmentation however it would be misleading to treat both of these major components of the sector as a coherent whole.

Textile Sector
The textile segments of the T&C sector in China differ from the downstream segments in the degree of state-ownership of key enterprises. This is partly due to the more capital-intensive nature of the industry and the involvement of government agencies in the micro-economic management of the industry. The textile industry in China has experienced a period of gradual consolidation and concentration, thanks to some painful but necessary reorganisation. The government has actively encouraged the industry to implement upgrading strategies, particularly investment in capital equipment such as textile machinery. This research, however, suggests that a significant number of textile manufacturers, particularly textile mills, have been sold off in the last couple of years. If this trend continues, state involvement in the textile sector is likely to be significantly reduced.

Textile Industry – Key Trends
- China used the apparel industry as a focal point of industrial development post-1980 and, through low labour cost advantage, has gained a dominant position
- China is now a leading force in most segments of the textile industry and Chinese goods have increasingly begun to meet international standards
- China’s main weakness in the textile sector is in weaving, where Chinese companies are still reliant on foreign machinery and expertise
- China is still importing a rising volume of fabrics especially from places such as Taiwan and South Korea where there are more modern finishing and fabric weaving facilities
- China’s weakness in the dyeing and finishing segments has come about because of a bottleneck in the finishing industry and continued use of obsolete machinery

Clothing Sector
Garment manufacturing, which is more labour-intensive, has been almost entirely deregulated and is one of the most liberalised sectors in China. Barriers to entry in the sector are low and the state plays only a minor role in directing the industry. However a recent wave of overinvestment and unfettered competition has created serious downward price pressure as international buyers now have a much greater choice of suppliers. This has contributed to further price reductions. Major textile companies have recently voiced their concerns that the cut-throat competition unleashed by the elimination of quotas will harm the industry’s profits as manufacturers slash prices in a bid to stay afloat.
China’s T&C Sector Breakdown
(total sales, 2002)

Manmade fibres
6.5%
Woven garments
31.5%
Knit garments
62%

Source: CNTIC

Regulatory Framework

MOA (general policy)
MOFCOM (import & export policies)
NDRC (general policy, import quota)
SASAC (supervise SOE / associations)
SEPA (environmental standards)

CCCT
CNTIC
CPCIA

Raw materials (cotton, silk, wool)
Yarns
Fabrics
Garments
Textile Machinery
Dyestuff

MOA - Ministry of Agriculture
NDRC - National Development and Reform Commission
MOFCOM - Ministry of Commerce
SASAC - State-owned Assets Supervision and Administration Commission
CCCT - China Chamber of Commerce for Import and Export of Textiles
CNTIC - China National Textile Industry Council
CPCIA - China Petroleum and Chemical Industry Association
SEPA - State Environmental Protection Administration
Industry Production Chain - Regulatory Remit

Raw Material Supply
The Ministry of Agriculture is responsible for key raw material industries including cotton, silk and wool. However, the National Development and Reform Commission (NDRC) is responsible for the importation of raw materials, for which import quotas still apply.

Production and Processing
CNTIC guides the production and processing in the textile industry. CNTIC is the legacy agency of the now defunct Ministry of Textile Industry. Its broad responsibilities include the implementation of industrial development guidelines for the sector.

Export Quota License
The NDRC’s Department of Industry supervises the national textile industry. The Bureau of “Economic Operation” is responsible for formulating policies and controlling the export quota licensing system in the textile industry. However, MOFCOM is in charge of actually issuing export quota licenses.

Standards-Setting
The State Administration for Quality, Supervision, Inspection and Quarantine (AQSIQ) is the government agency responsible for setting technical, safety and environmental protection standards for textile products in China. In the textile sector, AQSIQ functions as a standards-setting coordinator. When setting standards, it seeks technical support from the Textile Industry Standardisation Institute and consults with the CNTIC. AQSIQ is also the agency in charge of enforcing standards and providing certification of products and enterprises. AQSIQ is also involved in drafting laws and regulations governing industrial standardisation in the textile sector.

Textile Sector: Industrial Policy
The textile industry was among the first sectors earmarked for strategic restructuring and was therefore opened to domestic, private and foreign participation at an early stage, particularly in the garment manufacturing industry. Under the centrally planned system, raw materials were allocated with low prices set by the state, production tasks were assigned by administrative orders and state-owned commercial departments monopolised the marketing of finished products. It therefore comes as no surprise that by 1996, losses by state-owned textile companies reached US$ 1 billion. Currently the textile industry in China is in the final stages of strategic restructuring.

Nevertheless, the state continues to exercise control on some segments in the sectoral value chain, and controls the supply of key raw materials. In most other areas, however, central planning mechanisms have been shed, and the sector is now one of the most deregulated industries in China.

Until the late 1990s China’s textile sector was inefficient and loss-making, due mainly to overcapacity, reliance on outdated technology and high overhead costs. In 1997, the Communist Party’s Central Economic Working Committee put together a draft policy to restructure the sector, under the leadership of former State Council Premier Zhu Rongji. The
sector has benefited, from a structural readjustment of its production infrastructure, under the framework of the Ninth and Tenth Five Year Plans. The macro-economic agency in charge of “basic construction projects”, the State Planning Commission (now referred to as the NDRC), and the authority in charge of “technical renovation projects”, the State Economic and Trade Commission (SETC), together committed billions of dollars worth of loans to establish new textile mills and upgrade existing ones with high-tech equipment. Reform has focused on revamping the unprofitable textile sector by increasing efficiency in the production of manmade fibres and transforming cotton spinning and weaving facilities.

<table>
<thead>
<tr>
<th>Year</th>
<th>Regulatory Agency</th>
</tr>
</thead>
<tbody>
<tr>
<td>Before 1993</td>
<td>Ministry of Textile Industry &amp; State Planning Commission³</td>
</tr>
<tr>
<td>1993-1998</td>
<td>National Textile Industry Bureau (reporting to the SETC) &amp; State Development and Planning Commission⁴</td>
</tr>
<tr>
<td>1998-2001</td>
<td>CNTIC; Department of Industry (SETC); State Development and Planning Commission⁵</td>
</tr>
<tr>
<td>2001-2003</td>
<td>CNTIC, Department of Industrial Policy/SETC, Bureau of Economic Operations/SETC, State Development and Planning Commission</td>
</tr>
<tr>
<td>2003-to date</td>
<td>NDRC &amp; CNTIC, CNTIC was committed by the NDRC to research and give advise before key policy be issued</td>
</tr>
</tbody>
</table>

This extensive restructuring programme formed part of the larger process of reform of China’s state sector. The guiding principles of State-Owned Enterprise (SOE) reform, reflected in the official slogan “grasp the large; let go off the small” (zhuanda, fangxiao), applied to the T&C industry. Since 1997, the government has closed down hundreds of smaller, inefficient SOEs in the T&C sector, allowing them to declare bankruptcy and write off debt. To allow for this, significant provisions for bad loans were made. At the same time, the government established a US$ 1.5 billion fund to implement the restructuring of the sector; for example, to provide for the loss of 1.5 million jobs and the scrapping of 10 million obsolete spindles, or a quarter of the national total. By 2000, the textile sector had become profitable. This fund has been added to since 1998 (see Section 3 below).

<table>
<thead>
<tr>
<th>Top 10 Listed Mainland Textile and Clothing Manufacturers, 2003 (RMB million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Company</td>
</tr>
<tr>
<td>Weiqiao Textile</td>
</tr>
<tr>
<td>Shanghai Shenda</td>
</tr>
<tr>
<td>Shanghai Dragon</td>
</tr>
<tr>
<td>Inner Mongolia Erdos Cashmere Products</td>
</tr>
<tr>
<td>China Union Holdings</td>
</tr>
<tr>
<td>Youngor Group</td>
</tr>
<tr>
<td>Shanghai Worldbest Industry Development</td>
</tr>
<tr>
<td>Shanghai Matsuoka</td>
</tr>
<tr>
<td>Wujiang Silk</td>
</tr>
<tr>
<td>Shanghai Kaikai Industrial</td>
</tr>
</tbody>
</table>

Source: Shanghai, Shenzhen and Hong Kong stock exchanges, CEQ

³ The Ministry was degraded as a Bureau and was merged into the SETC
⁴ The State Planning Commission became the State ‘Development’ and Planning Commission
⁵ The National Textile Industry Bureau was eliminated in 2001 and its policy functions were transferred into the SETC. The industry coordination function was transferred to the CNTIC
Tenth Five Year Plan (2001-2005) Goals for Strategic Adjustment

The now defunct State Economic and Trade Commission set industrial policy goals for the T&C sector. The guidelines set for strategic adjustment of the textile industry under the Plan were as follows:

1. The textile industry should centre on the structural adjustment of technology and products, reform traditional industry with new technologies, continue to implement the policy of eliminating backward productivity and of personnel reshuffling, pay great attention to improving the quality, varieties and economic benefits of products and expedite technical reform to realise industrial upgrading.

2. The textile industry should expedite the adjustment of enterprises’ organisational structure, strengthen product R&D and design as well as marketing and service, and enhance the enterprises’ fast-reaction ability to the market.

3. The textile industry should give full play to the regional comparative advantages; encourage trans-regional, inter-trade and trans-ownership combinations between the eastern and western parts of the country to realise the complementarities of different advantages for a common development.

4. The textile industry should further push forward its strategic reorganisation and strengthen the economic-pattern adjustment of state-owned enterprises. Large- and medium-scale state-owned enterprises should speed up the adjustment of capital structure by means of being listed on the stock market, setting up joint ventures, and absorb capital as enterprise shares. For the enterprises whose equity-debt ratios are high but have advanced equipment, potential market and good management, they should lower equity-debt ratios through asset reorganisation to strengthen their vigour. However, for those that have serious losses with debts surpassing assets, bankruptcy is the major way for them to quit the market.

5. The textile industry should positively promote the construction of information networks, aiming to bring structural adjustment and industrial upgrade with advanced information technology, improve the enterprises’ management levels, technical development and marketing and enhance the overall competitiveness of the textile industry in the international market.

Quota Allocation Mechanism for Textile Exports

MOFCOM has been using a direct-allocation plus tendering system in distributing the export quota for textiles. The textile products in this case are categorised into two groups, i.e. ordinary and sensitive categories. MOFCOM does not distribute the quota itself, but allocates the quota for ordinary textile products to the provincial authorities. The provincial MOFCOM surrogates are then authorised to distribute quotas to exporters based on their past export performance.

However, the quota for sensitive textile products is given to the CCCT, which uses a tendering mechanism to allocate it. Only ‘qualified’ companies can bid for the quota. In order to qualify for the tendering process companies need to fulfil the following criteria:

---

6 State Economic and Trade Commission, The Tenth Five-Year Plan for the Textile Industry (June 25, 2001)
1. The company is licensed to import and export;
2. The company is a member of the CCCT;
3. The company exported a certain amount of textile products in the past year.

Response to the End of the Quota System
Although the quota system is soon coming to its end, there has not been any systematic or coordinated preparation by Chinese exporters. The reaction of these enterprises to the end of the quota system is mixed. For most of the textile exporters/producers, elimination of quotas is welcomed. Previously, garment manufacturers had to go through SOEs to export their garments. They had to pay them quota fees. The elimination of quotas – and therefore quota fees – will help reduce prices and make their exports more competitive.

But there will also be negative effects, especially for companies that used to benefit from the quota system. When quotas are gone, these companies stand to lose. Some enterprises (especially trading companies) are proposing that the government use a voluntary quota system to control China’s textile exports. MOFCOM, however, does not want to use such a system, but has asked the CCCT to promote “self-discipline” among its members. The problem, however, is that only a fraction of T&C manufacturers, particularly in the garment manufacturing industry, are CCCT members, thus there is a limit to how much the CCCT can hope to achieve in urging self-regulation.

Meanwhile, officials in Beijing are anxious about the twin threats of protectionist sentiment abroad and an overheating economy at home. Chinese textile organisations have already expressed fears that export prices might drop too far too fast and, according to state-controlled media reports, are urging state intervention to prevent “predatory price competition”. They are concerned that tumbling prices will hurt profits and invite protectionist measures in Europe and America.

A CNTIC official interviewed showed concern that breakneck expansion will also increase costs for materials and labour, thus blunting China’s competitiveness and encouraging buyers to seek cheaper sources of labour and raw materials elsewhere in the region. As will be discussed in more detail in Section 3 below, some clothing factories in coastal areas are finding it difficult to attract workers. Despite having a huge rural population seeking higher-paying work, rural incomes are rising so the incentive to travel to industrial areas for work is declining. And it will continue to decline unless manufacturing wages also begin to rise.

In this context, officials are considering taking steps to limit the industry’s expansion. Sources close to MOFCOM report that Beijing is looking into putting restraints on export growth. However this is easier said than done. China’s T&C sector is no longer subject to central planning controls. In the old days of the planned economy the State Planning Commission or SETC (China’s former microeconomic planning agency) would simply push levers to control the level of investment in the industry. But these days, Beijing can no longer issue orders and expect that they will be followed; instead, according to Wang Yiming, vice-president of the NDRC’s Academy of Macroeconomic Research, it must be content with “trying to convince local governments that the centre’s policies are in their own best interests.”

---

7 Cited from 'The Emperor is not Always Obeyed', The Economist, November 13th 2004
Rationalisation and Concentration

The liberalisation of the sector and the end of the quota system however, has created a “regulatory vacuum”. In the absence of fully-fledged market mechanisms, competition problems have arisen. Particularly after the third stage of liberalisation under the ATC, the sector has experienced increased competition as smaller players compete head-on over prices with their larger rivals in order to gain market share. Currently existing problems of overcapacity and falling profit margins are seriously affecting the sector.

The post-quota environment throws open opportunities for small and medium enterprises to sell directly to buyers. In this environment, entrepreneurs are busy jockeying for position with international customers who cannot fail to notice and take advantage of the price competition that is currently taking place.

Yet the ferocious competition that quota liberalisation has unleashed is embedded in China’s micro-economic conditions, and particularly in corporate pricing policies. Until market mechanisms fully set-in and consolidation creates incentives for companies to compete on service and quality – as opposed to competing solely on price – further downward price pressure is inevitable.

Competition / Free Market Conditions

This pattern of industrial development applies to many manufacturing sectors in China. The problem is that every province has its own key enterprises and the market is highly fragmented. In every industry, there may be anywhere from ten to a hundred different companies competing in the marketplace, with even the biggest players holding less than 20% to 30% of the total market share. To date, few small and medium enterprises pool resources to enhance competitiveness and competition remains fixated on price to the extent that price wars and chronic oversupply amongst domestic manufacturers have become a pervasive phenomenon.

Under normal market conditions, oversupply is typically followed by a series of bankruptcies, which restores the balance between supply and demand. Eventually, the number of players is significantly reduced and the industry consolidates. But in China this self-correcting mechanism does not set in automatically, as the “invisible hand” of the market is restrained by local protectionism or other feature of this transitional market.

This situation arises from the lack of coherent regulatory framework. The regulations governing mergers and acquisitions (M&A) remain underdeveloped. More importantly, China lacks adequate bankruptcy laws. Additionally, microeconomic issues such as the lack of management capacity also adversely affect the situation as many Chinese enterprises do not have a long-term business development or growth strategy.

However trends in other manufacturing sectors suggest that in spite of the lack of adequate self-correcting mechanisms, a sectoral shakeout is likely to take place sooner or later. The sector has already witnessed the beginnings of consolidation, as former state-trading companies, having lost their competitive edge, are now busy acquiring their own manufacturing capacities. Moreover, fluctuating commodity prices and labour wages are already punishing the smaller firms, which rely on informal credit associations for their funding.
As smaller enterprises fall out of business, the onus will be on raising overall business performance to avoid margin-destroying price competition. In the aftermath of this painful process of industrial reorganisation there will be a few winners, and many losers.

The logical evolution of the industry points towards more consolidation. Consolidation is driven partly by buyers, in what can be called a “pull” effect. The size of orders is growing steadily and will grow further, especially for export markets. Buyers are increasingly looking for large suppliers, with larger capacity and efficient operations. Small manufacturers cannot offer these facilities, nor can they offer value-added services, because they do not enjoy the necessary economies of scale. According to Françoise Vappereau from Research-Works, Hong Kong, the consolidation of the industry will ultimately depend on the general health of the industry: “crisis and hard times generally accelerate consolidation as they eliminate the weaker companies.” It will depend also on local vested interests; some cities or provinces might not let textile factories close down for social reasons. Overall, consolidation is not expected to take place quickly. Consolidation is expected to be driven by company closures rather than M&A. Local vested interests will prevent company closures from spreading rapidly. The process is likely to take place gradually, and local government officials are likely to manage the pace of company closures to prevent a domino-effect.

In the textiles sector, the government has taken a more active role in formulating industrial policy goals and directing the restructuring of the state sector. In capital-intensive sub-sectors such as chemical fibre production, cotton spinning and textile machinery manufacturing, the top 50 players account for the bulk of domestic sales. Industrial concentration is particularly noticeable in the polyester production industry. According to CNTIC the top 10 industry players account for 40% of total domestic production.

Trading Rights - State of the Liberalisation Process

With further liberalisation of the textile sector and the gradual elimination of controls in the trading sector, traditional import and export companies no longer have an edge. As a response to these changes, some of them are diversifying their business scope to include more products, and some are acquiring factories to equip themselves with production capabilities.

With the liberalisation of the trading regime, small companies are also allowed to export. MOFCOM issued a new rule prior to the promulgation of the new foreign trade law and further lifted the government’s control on import and export qualifications. Currently, trading companies with registered capital of no less than US$ 121,065 (or US$ 60,532 in central and western areas) are qualified to apply for import and export rights. Under the current regulatory framework, applications are approved automatically unless there is a specific reason to turn them down. For manufacturing enterprises, the minimum registered capital requirement is RMB 500,000 (US$ 60,532). A “registration” certificate is enough for companies to obtain import and export rights. This liberalisation is part of the new Foreign Trade Law, in line with China’s WTO commitment to liberalise trading rights and eliminate the traditional examination and approval procedures for import and export rights. The new regulations will simplify procedures and reduce administrative costs in the textile industry.

---

8 Interview, November 2004
China’s T&C sector is concentrated in the coastal provinces of Guangdong, Zhejiang, Jiangsu, Fujian, Shandong and the Municipality of Shanghai. Together these locations accounted for 82% of China’s exports of T&C products in 2002, measured by value. As the tables below demonstrate, exports accounted for about one-third of the T&C sector’s output.

<table>
<thead>
<tr>
<th>Production Value (Million $)</th>
<th>10,000 - 40,000</th>
<th>4,000 - 10,000</th>
<th>1,000 - 4,000</th>
<th>500 - 1,000</th>
<th>0 - 500</th>
</tr>
</thead>
</table>

Source: CNTIC

### Major Economic Indicators for State-owned Textile Enterprises and Private Enterprises with Annual Sales Revenues above RMB5 Million in 2003

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Annual Total ($ billion)</th>
<th>Growth y-o-y (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross industrial output value (current price)</td>
<td>155.91</td>
<td>22.76</td>
</tr>
<tr>
<td>Gross industrial output value (fixed price)</td>
<td>147.08</td>
<td>20.75</td>
</tr>
<tr>
<td>Product sales revenue</td>
<td>149.42</td>
<td>24.60</td>
</tr>
<tr>
<td>Sales value (current price)</td>
<td>152.48</td>
<td>23.20</td>
</tr>
</tbody>
</table>

In the case of the clothing sector, exports account for more than half of China’s garment production. These statistics in fact cover “statistically significant enterprises”. In other words, all state-owned and non-state owned textile enterprises (private, foreign enterprise or JV) with annual sales value over RMB 5 million (US$ 604,000). In fact, China boasts a large number of small-scale clothing manufacturing enterprises, particularly in Jiangsu, Zhejiang and Fujian provinces (which have traditionally supplied state trading enterprises). If the entire clothing industry were captured in official statistics it is likely that the industrial output to export ratio would be even higher.

<table>
<thead>
<tr>
<th>Year</th>
<th>Textile Products</th>
<th>Clothing Products</th>
</tr>
</thead>
<tbody>
<tr>
<td>1998</td>
<td>12.8</td>
<td>30.0</td>
</tr>
<tr>
<td>1999</td>
<td>13.7</td>
<td>30.0</td>
</tr>
<tr>
<td>2000</td>
<td>17.0</td>
<td>36.0</td>
</tr>
<tr>
<td>2001</td>
<td>17.8</td>
<td>36.5</td>
</tr>
<tr>
<td>2002</td>
<td>21.8</td>
<td>41.2</td>
</tr>
<tr>
<td>2003</td>
<td>28.6</td>
<td>51.9</td>
</tr>
</tbody>
</table>

Source: Customs

Japan and other Asian Pacific markets are currently China’s T&C industry’s top export destinations, closely followed by the EU and the US. Asian countries accounted for 56.5% of all Chinese clothing exports during the first half of 2004.

Main Export Destinations in the T&C Sector 2003

- Japan, 24%
- EU, 22%
- USA, 13%
- South Korea, 5%
- Hong Kong, 16%
- Other countries, 20%

Source: CNTIC

Share of T&C Exports by Region

A) Pearl River Delta Region (PRD)

The PRD region has absorbed the majority of foreign direct investment (FDI) from Hong Kong. The success of Guangdong in attracting FDI and developing a thriving, export-oriented economy can be attributed in part to political circumstances. Guangdong was an enthusiastic supporter of the central leadership’s economic reform policies throughout the 1980s and early 1990s, and was chosen by Deng Xiaoping to re-launch economic reform in what became known as his “Southern Tour”. This sparked a phenomenal investment boom. Perhaps the single most celebrated success story was the development of Guangdong’s Special Economic Zones (SEZs) – Shenzhen, Zhuhai and Shantou – which since 1980 have contributed significantly to the growth of the T&C sector.
Guangdong’s rapid industrialisation has however created a new set of challenges, including increased costs associated with labour, land, utility tariffs and taxes, which have gradually weakened Guangdong’s competitiveness in traditional manufacturing sectors. As costs increased, foreign investors began to move first from Shenzhen and Guangzhou’s Economic and Technological Development Zone to other cities along the PRD and subsequently to other coastal provinces such as Fujian and Jiangsu, which offer cheaper costs of production. Inevitably, this trend is slowly eroding Guangdong’s privileged position as the country’s leading exporter in the T&C sector.

Jiangsu and Zhejiang provinces have therefore become attractive alternative investment destinations in recent years. Spearheaded by Shanghai, the Yangtze River Delta’s (YRD) economy is now increasingly integrated, thanks to rapidly growing networks of suppliers that provide a wide range of products for export markets. The introduction of policies to encourage foreign investment in the YRD means that the preferential access policies offered by Guangdong’s SEZs have partly lost their significance.

**Share of Garment Exports by Province**

- **Guangdong**: 21%
- **Jiangsu**: 15%
- **Zhejiang**: 20%
- **Shanghai**: 13%
- **Shandong**: 8%
- **Fujian**: 10%
- **Other**: 13%

*Source: China Customs’ Statistics*

B) Yangtze River Delta (YRD) Region

The majority of T&C manufacturing enterprises in Fujian and Zhejiang developed organically, unlike in other regions of China, such as Guangdong, where the main industry drivers have been Hong Kong entrepreneurs, and Jiangsu, where state-owned trading companies have played a major role in developing the sector. Another differentiating factor characterising Zhejiang and Fujian enterprises is the way in which they typically secure funding.

Small and medium enterprises, key building blocks of the industrial fabric in the two provinces, have avoided state-owned banks which tend to shun small private businesses or individuals in need of funds. Instead they have sought funding from informal credit associations, known as *biaohui*. *Biaohui* are part of a larger phenomenon of small and medium industry clusters prevalent in certain parts of eastern China and can offer quick credit solutions when capital is required. They provide the lifeblood for the increasingly competitive small, informal industrial networks found across Zhejiang and Fujian.
This is particularly relevant in the context of Zhejiang’s rise as China’s largest T&C exporting province.

Ownership of Chinese T&C Exporting Companies

From State-Ownership to Private Ownership

Generally speaking, the state in China has gradually disinvested from the clothing sector, although it remains an important shareholder in certain segments of the textile sector. Until recently, China’s textile industry consisted mainly of SOEs which exhibited excess capacity and employment and used outdated technology. This research also indicated that a significant number of SOEs do not run on full capacity, although this is changing with the pace of restructuring and market-oriented policies gaining momentum. Currently SOEs account for less than a quarter of total gross output value of China’s T&C production. SOEs are reputedly less productive and efficient than domestic private and foreign-invested enterprises.

The Ninth and Tenth Five Year Plans for the textile industry formulated by the SETC focused on the restructuring of the state-owned sector. The main objectives of the strategic restructuring plan involved the increase of production efficiency through the reduction of redundant and obsolete spindles and the reduction of redundant costs. This is captured by the slogan “reduce capacity, reduce personnel and cut losses”. Inevitably, this has involved the elimination of over 1.5 million jobs and the sale of state-owned assets. Even so, redundant capacity still besets the industry.

In the clothing manufacturing segment, there are three different kinds of enterprises:

1. Foreign-invested enterprises, including joint ventures and wholly foreign-owned enterprises (WFOEs) managed mainly by Hong Kong and Taiwan-based enterprises;
2. SOEs, which are largely focused on domestic sales;
3. So-called collective enterprises, which are effectively, privatised SOEs at the village and township levels.
Analysis of Private Sector Development

It is difficult to find authoritative statistics on the level of private involvement in the T&C industry, not least because official categories of state-owned and non-state owned are blurred and there is no commonly agreed definition of what is a “private enterprise”. According to the CNTIC, in 2003, 84% of China’s T&C enterprises with sales of US$ 604,000 and above are either partly or wholly-owned by non-government enterprises, in other words, domestic private or foreign investors. In any event, according to SETC data at the time of formulating the Tenth Five Year Plan (2001-2005), 30% of all enterprises in the textile sector were state-owned enterprises and 26.5% were collective enterprises, or in other words, companies with mixed capital (many of which are ‘closet’ private companies).

Management and local government officials often buy out smaller firms owned by local governments. Local managers, often the same managers that used to manage the plants under government ownership, typically run privatised companies in the T&C sector. These enterprises do not carry heavy overhead expenses and are typically managed relatively efficiently.

In the textile sector there are still many SOEs although privatisation schemes have taken place at the local level. As a result there are a number of semi-private companies where the local government owns a certain percentage. Many of them are quite large, with 3000-5000 employees, and they are thus achieving the necessary economies of scale.

Profitability of Textile & Clothing Companies

According to official sources, the overall profit margin of T&C enterprises in 2003 was up 0.18%. The combined profits of state-owned and privately owned T&C enterprises reached US$ 5.37 billion, up 30.36% from the previous year. Profitability is stronger in the textile industry than in the low-margin clothing manufacturing industry. Profit margins in the clothing manufacturing sector averaged 2.85% during 2000-2003. The hike in cotton prices...
during 2003, however, hit profit margins in the textile industry harder than in the clothing industry.

| Return on Equity (%) of SOE T&C Manufacturers, 1997-2003 |
|---------------------------------|-----|-----|-----|-----|-----|
| Year  | 1997 | 2000 | 2001 | 2002 | 2003 |
| Textiles | -15.4 | 4.7 | 5.0 | 8.1 | 0.1 |
| Clothing  | -3.4 | 2.9 | 3.4 | 4.9 | 0.2 |

According to CNTIC statistics, the profit margin of private and collective enterprises in the T&C sector increased by 0.05% in 2003.

Political & Economic Significance of the T&C Sector

The T&C industry represents around 10% of the Chinese economy in terms of GDP and generates about 20% of exports of goods in value. The labour-intensive textile and clothing industry remains a key source of employment, particularly on the export manufacturing regions of the eastern seaboard.

Share of Total Employment in the T&C Value Chain

Some 18 million workers are directly employed in the Chinese T&C sector, in addition to some 13 million more employed in natural fibre processing. Farmers also depend on the development of the textiles industry as they supply raw materials for upstream textile industry processes. China’s textiles industry consumes over 6.2 million tons of domestically-produced natural fibres, which provides employment for an estimated 100 million farmers (or 10 million households).⁹

| Employment in the T&C Sector (Source: CNTIC) |
|---------------------------------|-----|-----|-----|-----|-----|
| Number of Employees              | 6,130,000 | 9,160,000 | 11,730,000 | 14,710,000 | 18,000,000 |

T&C Share of Total Exports

Since 1994 China’s exports of textiles and clothing have experienced an average annual growth rate of 13%, although it is interesting to note that this rate of growth actually lags behind the rate of growth for Chinese exports as a whole. Trends also suggest that the share of textiles and clothing as a percentage of China’s total exports is steadily decreasing, from 28% in 1994 to 18% in 2003.

In contrast, imports of textiles and clothing have grown at a much slower pace, from US$ 12.8 billion in 1994 to US$ 15.6 billion in 2003. This represents a meagre year-on-year increase of 2.2%. The share of textiles and clothing in China's total imports of goods has dropped from 11% to 3.8%. The trade surplus generated by the textiles and clothing industry during the last decade has almost doubled, climbing up from US$ 21.3 billion to US$ 63.2 billion.

The clothing sector represents about two-thirds of the industry’s exports. Principal markets are Japan (38% of exports), the EU (17%) and the US (17%). Textile exports make up the remaining one-third of exports. ASEAN countries are the major recipients of China’s textile exports.
Foreign currency earnings derived from the T&C sector make a significant contribution to China’s foreign currency reserves and the balance of payments.

In 2003 the total import and export value of textile and clothing products increased 24% year-on-year, reaching US$ 94.5 billion with US$ 78.8 billion in exports and US$ 15.6 billion in imports. This represented increases of 27.7% and 8.5% respectively, resulting in a surplus of US$ 63.2 billion, up 33.4%.
SECTION 3 – COMPETITIVENESS ANALYSIS

The following section analyses the competitiveness of China’s T&C sector throughout the value chain. It examines the competitive advantages that have helped the Chinese T&C industry obtain an extraordinary performance in the third stage of ATC and draws attention to competitiveness factors that in some instance are construed as “unfair practices”.

As highlighted in the Executive Summary, given the fact that the Chinese government’s support for the T&C industry long pre-dates the implementation of the third stage of ATC, the sudden and recent drop in unit price cannot be attributed directly to government subsidies. Indeed, in recent years China’s T&C sector has been moving steadily away from state control and the support mechanisms of the planned economy. Instead, this research suggests that the sharp decrease in average unit price was caused principally by the elimination of quota constraints and the development of vigorous competition, with concomitant downward pressure on prices.

Nevertheless, it is true to say that China’s T&C sector today has been the beneficiary of government initiated restructuring and investment over the course of the Ninth and Tenth Five Year Plans. Part of this restructuring process involved the provision of funds for the overhaul of China’s textile industry infrastructure, particularly in terms of phasing out obsolete equipment and debt-laden plants (and dealing with the associated social costs), and upgrading to more modern machinery.

Elimination of Quota Rents

Export quotas have constituted a significant share of T&C products’ prices, but the share varies for different products. In some cases it amounted to up to 25% of the price of the final product. And if quotas were traded on the black market, the share of quota costs as a percentage of the final cost was sometimes even higher. In a quota environment, a firm that wants to export has to obtain a quota from MOFCOM, the CCCT, or from another firm on the black market, and so the existence of the quotas adds a cost that is analogous to an export tax, or an “export tax equivalent”.

The estimated average export tax equivalents of the quotas for T&C for four major suppliers to the USA and the EU are presented in the summary table below. These estimates, prepared by the Centre for Management and Economic Research, are based on the latest available data with adjustments made for particular features of the quota allocation system in the different countries compared. Note the high export tax equivalents on China’s exports to the US for textiles and clothing and on exports of clothing to the European Union, compared to its rivals. When quotas are binding, as it is the case with many of the T&C products under quota restrictions, quota licenses naturally command a premium.

Quota utilisation rates in three of the four group limits imposed by the US on Chinese imports of textiles and clothing were filled by more than 90%, which suggest that China’s exports on products under quota restrictions are severely restricted. The difference between the export tax rates for China and other suppliers, such as Bangladesh whose quotas (to the US) are also binding, seems to be explicable largely in terms of the much lower growth rates allowed for China’s quotas relative to its production capacity. The EU for its part had 42 quotas on
imports of Chinese T&C products, mostly on clothing products, of which 25 were filled by over 90%.

<table>
<thead>
<tr>
<th>Export Tax Equivalents Of Textile And Clothing Quotas On Key Suppliers</th>
</tr>
</thead>
<tbody>
<tr>
<td>To the USA</td>
</tr>
<tr>
<td>Textiles</td>
</tr>
<tr>
<td>Clothing</td>
</tr>
<tr>
<td>To the EU</td>
</tr>
<tr>
<td>Textiles</td>
</tr>
<tr>
<td>Clothing</td>
</tr>
</tbody>
</table>

Source: Centre for Management and Economic Research

The elimination of export quotas which used to account for a significant proportion of the costs partly explains the export price fall. A US Trade Development (USTD) report shows that “in 2002 the estimated export tax equivalent on the quota for Chinese knit cotton shirts was about 27% ad valorem and for cotton trousers it was 64% ad valorem.” Lower prices in a post-quota environment therefore reflect the absence of quota fees. This also explains how some manufacturers still enjoy higher profit margins even though they are selling their products at lower prices. So, firms that are competitive in producing high-quality products are expected to still be able to make profits by selling cheaper products after the end of quotas.

**Fierce Price Competition**

The elimination of quotas also depressed the price of China’s T&C products in another way: a greater number of companies and factories can now export directly to foreign markets, and this has led to fierce competition. Production capacity actually has not increased so rapidly, but competition has reduced exporters’ profit margins dramatically. In the most extreme cases, the price of some textile products has fallen by nearly 70% since 2001. However, even though prices will drop on average as a result of the elimination of quota fees, this research suggests that a combination of inflationary factors including rising wages, commodity prices and utility costs, will gradually push up costs of Chinese T&C goods. Prices have been falling for the last five or six years but as the new cost structure begins to make itself felt, this trend should be reversed. One reason why prices have not yet started to rise, as is argued in Section 4 below, is because large international buyers have enough purchasing leverage to continue to keep prices down, even as underlying costs are rising.

---

China’s T&C Sector – Main Competitive Factors

- **Price** – greater competition enables buyers to squeeze suppliers who are willing to sell at razor thin margins (and even bear losses) in order to gain market share and survive
- **Quality** – the quality of China’s textile products is comparatively high, and represents good value for buyers
- **Costs** – labour costs are still low, and have not risen for the last five years. Factory and land are cheap and in some places the government offers attractive land use fees if T&C enterprises provide employment and contribute to local economic development
- **A Complete Industry Chain** – China is a one-stop shop. Chinese producers have great flexibility in meeting buyers’ requirements on product specifications, quality and quantity. Infrastructure and logistics are competitive, enabling suppliers to cut delivery times

### Raw Materials Input

China enjoys a competitive domestic supply of raw materials including fibres, yarns, fabrics and trim. Moreover, China enjoys abundant supplies of natural fibres such as ramie and silk. In spite of China’s abundant supplies of raw materials, however, the security and reliability of fibre supply remains a concern for the government. To satisfy China’s growing demand for natural and manmade fibres, the Chinese government has put in place programmes to encourage the production of key fibres. The total volume of fibres processed by China’s textile industry in 2003 was just over 20 million tons, a year-on-year increase of 14%. This represented 30% of the world’s total.

<table>
<thead>
<tr>
<th>Fibres Processed by China in 2003 (Source: CNTIC)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Item</strong></td>
</tr>
<tr>
<td>Total</td>
</tr>
<tr>
<td>Raw Cotton</td>
</tr>
<tr>
<td>Chemical Fibres</td>
</tr>
<tr>
<td>Wool</td>
</tr>
<tr>
<td>Flax</td>
</tr>
<tr>
<td>Silk</td>
</tr>
</tbody>
</table>

### Self Sufficiency / Imports

Even though China has become one of the world’s largest producers of key fibres such as cotton and chemical fibres, it is currently also importing cotton, wool and manmade fibres as its domestic supply is insufficient to meet demand. Indeed China is already a net importer of cotton as well as synthetic fibres and will need to increase its imports even more in the future as it receives more orders from Western retailers and buyers after the quotas are removed.
China's Imports of Raw Materials

<table>
<thead>
<tr>
<th>Products</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>03/02 change (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>All Raw Materials</td>
<td>2,666</td>
<td>2,852</td>
<td>4,047</td>
<td>41.9</td>
</tr>
<tr>
<td>Cotton</td>
<td>84</td>
<td>191</td>
<td>1,187</td>
<td>521.5</td>
</tr>
<tr>
<td>Silk</td>
<td>10</td>
<td>7</td>
<td>10</td>
<td>35.8</td>
</tr>
<tr>
<td>Wool</td>
<td>1,104</td>
<td>1,063</td>
<td>957</td>
<td>-10.0</td>
</tr>
<tr>
<td>Synthetic Fibres</td>
<td>1,351</td>
<td>1,462</td>
<td>1,683</td>
<td>15.1</td>
</tr>
<tr>
<td>Other</td>
<td>116</td>
<td>129</td>
<td>210</td>
<td>63.0</td>
</tr>
</tbody>
</table>

The supply of raw materials to the industry is still partly controlled by the state through MOFCOM and the NDRC, which continues to play a major role in textile raw material importation. The NDRC controls textile raw material imports through tariff rate quotas. Historic data in recent years shows that the quota is generally lower than demand, and there have been additional quotas allocated each year in order to meet demand.

**Import Quotas**

Except for cotton and wool, which are subject to an import tariff rate quota regime, other textile products can be freely imported into China. Quotas are obtained via the NDRC system. Sources consulted noted the opacity of the quota allocation system and the market distortions that it tends to create. These distortions affect both foreign exporters who do not have a clear understanding of the regulatory process for the import quota regime, as well as domestic businesses, which bear the burden of higher raw material costs generated by inefficiencies in the supply and distribution system for key raw materials. Some commentators have alleged that the tariff rate quota (TRQ) system is being manipulated at the expense of international textile exporters, with imports of raw materials being condoned for re-export purposes only, and then the TRQ used to block market access for other imports.
Cotton
The supply of cotton remains crucial for the textile industry. Although the government has restructured the cotton market through widening the distribution channels and relaxing price controls, supply is still subject to government controls. In the absence of market mechanisms, the following government bodies are involved in setting prices:

- NDRC: price, qualification of cotton purchasing station/company; import quota;
- Ministry of Finance (MOF): the state subsidy for procurement;
- Ministry of Agriculture (MOA): cotton plantation;
- State Administration of Industry and Commerce (SAIC): market distribution supervision;
- AQSIQ: cotton quality and grading;
- All China Federation of Supply and Market Cooperation: purchasing and distribution station of agricultural products;
- Agricultural Development Bank of China: a policy bank that provides loans for agriculture;

<table>
<thead>
<tr>
<th>Tariff Structure - Natural and Man-Made Fibres</th>
<th>Tariff in 2003 (%)</th>
<th>Within TRQ</th>
<th>Outside TRQ</th>
</tr>
</thead>
<tbody>
<tr>
<td>Silk</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Raw silk</td>
<td>9</td>
<td></td>
<td></td>
</tr>
<tr>
<td>others</td>
<td>9</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Wool</td>
<td></td>
<td>1 or 3</td>
<td>38</td>
</tr>
<tr>
<td>Fin or coarse animal hair</td>
<td>9</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cotton</td>
<td></td>
<td>1</td>
<td>47.2</td>
</tr>
<tr>
<td>Other natural textile fibres</td>
<td>5-7.8</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Man-made filaments</td>
<td>6.8-8.2</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Man-made staple fibres</td>
<td>5-7.8</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>


Source: Ministry of Agriculture

Study on China’s Textiles and Clothing and Market Expansion Strategy
– January 2005
Experts from the cotton sector at the Agriculture Ministry’s Economic Research Centre, estimate that in 2004-2005 China’s domestic cotton output will be around 6.1 million tons (more than 25% of the world’s total), while total demand reaches 7.33 million tons. In other words, about a quarter of China’s cotton supply is now imported.


In 2003 China’s domestic cotton prices increased significantly once again – in spite of the fact that world supplies of cotton exceeded demand – as suppliers could not meet growing domestic demand due partly to a poor harvest. The gap between supply and demand was closed through imports. However, cotton vendors took advantage of the lack of market mechanisms to regulate the supply and distribution of imported cotton to speculate on prices. At the end of 2003, the price of cotton reached US$ 2,179/t, more than US$ 205.8 higher than average international prices.

Currently, China’s Cotton Textiles Association estimates that raw materials take 70% of overall production costs for manufacturing cotton fabrics.

Another surge in production volume in the post-quota context will create a huge demand for cotton, driving up the costs of cotton imports. It is expected that this will diminish China’s advantage as a producer of cheap textiles.

Silkworm Cocoon
This product is strictly regulated by the government in the areas of production, purchasing, distribution and pricing. MOFCOM and NDRC control the supply.

![Silk Production in China (1999 - 2003)](chart.png)
It is worth noting that although the government does not officially set dual pricing of fibres and raw materials, especially cotton and silk, when they are in short supply, private distributors offer higher prices than state-owned enterprises. It is likely that the government will use its strategic reserves to reverse any significant price hikes, for instance by supplying subsidised raw materials to producers for government procurement. Other than in this scenario, there is no dual pricing for raw materials.

**Wool**

China is a major importer of wool, which is subject to import quotas regulated by the NDRC. Currently, wool represents less than 5% of the total textile output from China, and is therefore less significant than the manmade fibre and cotton industries.

Recent investments in the Chinese wool-processing sector are focused mainly on weaving, dyeing and finishing machinery, e.g. later-stage processing equipment. Until recently, domestic industry purchased a large amount of second-hand equipment from international textile machinery manufacturers. Recent imports of foreign wool processing machinery have been underpinned by strong growth in wool textile processing in the last year or so.

There are large numbers of small foreign direct investments in Chinese wool processing mills. However, larger foreign companies such as Suedwolle, Chargeurs and Shnalder have become WFOEs. Technology levels have been upgraded throughout. In the last five years, most of the SOEs in this segment have been privatised and today there are few SOEs left in the wool textile industry.

The wool industry is concentrated along the eastern coastline: namely Shandong, Jiangsu, Zhejiang and Guangdong provinces. This research suggests that there is no more government support to the wool processing industry in terms of investment from the central government level. However, for political reasons, China does subsidise wool procurement from South America (this is common knowledge but the government will not acknowledge it officially) to gain support from South American countries for political purposes (e.g. to gain diplomatic leverage vis-à-vis Taiwan, which traditionally has had close political links with South American countries). In addition, the government is providing support for the China Wool Textile Association (CWTA) to join the International Wool Textile Organisation (IWTO) – with the government paying the membership fee.

**Manmade Fibres**

China has become the world’s largest producer of manmade fibres. Production capacity has increased at an average annual rate of 18.3% in the past five years according to China’s Chemical Fibre Association. In 2003, the output of chemical fibres reached 11.8 million tons, accounting for one third of the world total and 65% of the total output of domestically-produced fibres, according to the CNTIC. Exports of T&C products made of chemical fibres reached 35.4% of total T&C exports in the same year.

A combination of state-led efforts to restructure the industry with the opening up of the fibre-processing sector to domestic private and foreign investment has led to a significant technology upgrade in manmade fibre production. China is rapidly becoming a competitive fabric supplier, and will catch-up with Taiwan and Korea shortly. Consultations with firms in the sector suggest that a number of Taiwanese and Korean fabric manufacturers have shifted production to wholly-owned subsidiaries in mainland China, thereby benefiting from lower
labour costs and proximity to buyers and suppliers. China’s manmade fibre production sector also benefited from the surge in domestic cotton prices in 2003, which caused a diversion of supplies from cotton to manmade fibres.

![Production Volume of Man-made Fabric Products (2000-2003)](image)

Industry sources, however, complain that the supply of key chemical fibre inputs are subject to volatile market changes and often need to be imported. Prices of synthetic and chemical fibres are, to a certain extent, linked to oil prices and naphtha prices and therefore fluctuate accordingly.

This research indicates, however, that the quality and efficiency of China’s manmade fibre production is inconsistent, and operates using obsolete equipment. As a result, productivity and efficiency levels are lower than in South Korea and Taiwan. The use of old equipment also poses a serious environmental issue. As the sectoral restructuring programme laid out in the Tenth Five Year Plan unfolds, however, China is rapidly upgrading its manmade fibre production capacity through investments in new equipment. Production of manmade fibres is still concentrated in top SOEs. According to the China Chemical Fibre Association, the proportion of loss-making SOEs is being reduced but still accounts for 23% of the whole industry.11

**Intermediary Inputs**

China’s domestic production of processed fibres is increasing rapidly. Domestic production of cotton yarn grew at an annual average of 8.8% to 8.5 million tons between 1990 and 2002. Production of cotton and manmade fabrics grew at a slower pace, averaging 4.6% to 32.2 billion metres during the same period.

---

### China's Imports of Textile Products - In Million US$ (Source: CCCT)

<table>
<thead>
<tr>
<th>Products</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>03 / 02 %</th>
</tr>
</thead>
<tbody>
<tr>
<td>All Textiles</td>
<td>12,579</td>
<td>13,066</td>
<td>14,225</td>
<td>8.9</td>
</tr>
<tr>
<td>Yarns</td>
<td>3,036</td>
<td>3,463</td>
<td>3,934</td>
<td>13.6</td>
</tr>
<tr>
<td>Cotton</td>
<td>1,123</td>
<td>1,322</td>
<td>1,504</td>
<td>13.7</td>
</tr>
<tr>
<td>Silk</td>
<td>9</td>
<td>5</td>
<td>6</td>
<td>28.3</td>
</tr>
<tr>
<td>Wool</td>
<td>223</td>
<td>233</td>
<td>208</td>
<td>-10.9</td>
</tr>
<tr>
<td>Synthetic</td>
<td>1,539</td>
<td>1,753</td>
<td>2,048</td>
<td>16.8</td>
</tr>
<tr>
<td>Other</td>
<td>142</td>
<td>149</td>
<td>168</td>
<td>12.9</td>
</tr>
<tr>
<td>Fabrics</td>
<td>7,708</td>
<td>7,667</td>
<td>8,184</td>
<td>6.7</td>
</tr>
<tr>
<td>Cotton</td>
<td>1,734</td>
<td>1,814</td>
<td>1,960</td>
<td>8.0</td>
</tr>
<tr>
<td>Silk</td>
<td>92</td>
<td>84</td>
<td>94</td>
<td>11.8</td>
</tr>
<tr>
<td>Wool</td>
<td>570</td>
<td>536</td>
<td>519</td>
<td>-3.2</td>
</tr>
<tr>
<td>Synthetic</td>
<td>3,372</td>
<td>3,113</td>
<td>3,133</td>
<td>0.6</td>
</tr>
<tr>
<td>Other</td>
<td>1,939</td>
<td>2,120</td>
<td>2,478</td>
<td>16.9</td>
</tr>
<tr>
<td>Made-up articles</td>
<td>1,835</td>
<td>1,937</td>
<td>2,107</td>
<td>8.8</td>
</tr>
<tr>
<td>Home Textiles</td>
<td>13</td>
<td>16</td>
<td>26</td>
<td>63.8</td>
</tr>
<tr>
<td>Carpets</td>
<td>33</td>
<td>35</td>
<td>47</td>
<td>34.7</td>
</tr>
<tr>
<td>Industrial Textiles</td>
<td>1,151</td>
<td>1,196</td>
<td>1,226</td>
<td>2.5</td>
</tr>
<tr>
<td>Non-Wovens</td>
<td>401</td>
<td>434</td>
<td>525</td>
<td>20.9</td>
</tr>
<tr>
<td>Other</td>
<td>237</td>
<td>256</td>
<td>283</td>
<td>10.7</td>
</tr>
</tbody>
</table>

### Spinning Activities

China has invested heavily in spinning and weaving equipment in the last five years. Its installed short-staple spindle capacity, for instance, has almost doubled since 1999.
Fabric Production – Weaving and Knitting
China has a large weaving industry which until recently has suffered from low fabric quality and limited fabric variety, design and innovation. This research suggests that China continues to import large amounts of fabric, mainly from South Korea, Taiwan and Hong Kong, although the share of domestic input is rising. This is partly due to investment from suppliers from Taiwan, Japan and South Korea principally into WFOE plants in China. But this phenomenon also reflects China’s increased capacity to produce higher quality fabrics, using state-of-the art textile machinery.

China’s knitting sub-sector is dominated by SOEs. Smaller companies supply the lower-end of the market, typically consisting of domestic-oriented manufacturing companies, whereas larger knitting firms with more advanced machinery and management systems supply the export-processing sector. Until recently the industry suffered from low-levels of technical advancement and weak managerial skills, although since 2000, the sector has invested heavily in new machinery, which has helped improve production quality and efficiency. According to International Textile Manufacturers Federation (ITMF) statistics, during 2000-2002, China accounted for 27% of world purchases of circular knitting equipment.

Dyeing, Printing and Finishing
According to both official and industry sources, China’s dyeing and printing industry also suffered from low standards and quality; although in recent years imports of dyestuffs and dyeing and printing equipment have brought about an improvement in quality. According to China’s Dyeing and Printing Association, the quality of domestically-produced dyed and printed materials has improved significantly and the import of materials from South Korea, Hong Kong and Taiwan have decreased somewhat.

The dyeing and printing industry is almost entirely in private hands and is concentrated in coastal provinces, particularly Zhejiang, which accounted for 50% of production of dyed and printed cloth in 2003. According to China’s Dyeing and Printing Association, 18.3% of enterprises in the sector are making losses, a 12% increase from the previous year. It is estimated that 41.3% of the remaining SOEs in the sector are incurring losses.
Labour and Management

Labour Costs
A key factor affecting price competition in the more labour-intensive segments of the T&C industry (e.g. garment manufacturing) is labour costs. While it is clear that one of China’s key competitive advantages is the availability of a vast pool of cheap labour, this issue needs to be analysed in more detail because China’s labour market structure is quite complex and can be misleading.

To be sure, China enjoys some of the world’s lowest cost structures in the textile and clothing sector, reflecting not only “raw labour” costs but also high rates of efficiency and productivity. In fact wage rates in China’s garment manufacturing sector are actually higher than in countries such as India, Pakistan and Bangladesh, where average wages per hour are less than US$ 0.50.

Other associated costs, such as social security and insurance liabilities are also low in China, although this is gradually changing with more stringent requirements placed on factories to comply with compulsory worker insurance schemes.

<table>
<thead>
<tr>
<th>China’s Dyeing and Printing Industry – Production &amp; Sales</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Year</strong></td>
</tr>
<tr>
<td>Production (million meters)</td>
</tr>
<tr>
<td>Industrial output (US$ million)</td>
</tr>
<tr>
<td>Sales income (US$ million)</td>
</tr>
<tr>
<td>Export value (US$ million)</td>
</tr>
</tbody>
</table>

(Source: China Dyeing and Printing Association)

<table>
<thead>
<tr>
<th>Labour Cost Comparisons</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Estimated Manufacturing Wage Rate Comparison</strong></td>
</tr>
<tr>
<td><strong>Country</strong></td>
</tr>
<tr>
<td>Bulgaria</td>
</tr>
<tr>
<td>China</td>
</tr>
<tr>
<td>Mexico</td>
</tr>
<tr>
<td>Brazil</td>
</tr>
<tr>
<td>Taiwan</td>
</tr>
<tr>
<td>Hong Kong</td>
</tr>
<tr>
<td>Singapore</td>
</tr>
<tr>
<td>United Kingdom</td>
</tr>
<tr>
<td>United States</td>
</tr>
<tr>
<td>Germany</td>
</tr>
</tbody>
</table>

(Source: Deutsche Bank Securities)
China’s wage advantage in the textile sector, however, is pronounced when compared with other competitors. Hourly rates in China average US$ 0.69 compared to US$ 5.73 in South Korea and US$ 7.15 in Taiwan, China’s main suppliers of fabric.

Labour Availability Trends
In fact, China does not enjoy access to an “unlimited supply of cheap labour”, as conventional wisdom has it. True, China does have a large potential pool of unskilled and semi-skilled labour thanks to its massive, and mobile, rural population. However, the common conception that China has a “surplus” reserve of labour of around 150m to 200m unemployed farmers is misconceived. The real picture is more complex.

This research suggests that patterns in China’s labour market have evolved significantly over the last 3-4 years. Three key factors (which are closely linked with the competitiveness in the T&C sector) characterise China’s market for unskilled and semi-skilled workers: 1) shifting urban-rural terms of trade; 2) changing demographic patterns; and 3) fragmented labour supply routes.

First, China suffered during the 1990s from erratic government policies that provided artificial incentives to farmers to produce grain, encouraged by the government’s promises to subsidise grain production. This policy gradually led to overproduction of staple crops and consequently plummeting prices, which coupled with the government’s failure to pay subsidies in cash, actually caused farmers’ incomes to stagnate, particularly in relation to rapidly raising incomes in urban areas. Since 1998, however, this policy has been abandoned and farmers have diversified production into higher value-added crops which yield higher economic returns. As a result, the urban-rural terms of trade have improved considerably over the last three years, with a marked jumped in 2003 owing to rising food prices. In other words, farm prices have been rising while prices for manufactured goods have been falling steadily, which means that some farmers are now better off than urban workers were three years ago.

Second, Chinese factories, particularly in low-tech, export-oriented light industry sectors such as garment manufacturing, rely on a very specific group of workers. Factories rely overwhelmingly on young girls between 18 to 26 years of age. Migrant workers outside this demographic bracket will find it difficult to find employment in export-oriented garment factories. However, the pool of labour in this age/gender bracket is now contracting significantly given the declining proportion of births as a result of the one-child policy (implemented in 1979). Note also the declining proportion of female births which have
contributed to a male to female ratio of 118 to 100, one of the world’s highest gender inequalities.

Third, migrant labour flows are multi-tiered and highly fragmented. The majority of the estimated 100 million migrant workers travel within inland areas, typically from rural counties to nearby cities. This is partly a product of the government’s drive to urbanise China’s interior. Migration flows from the rural hinterland to industry clusters along coastal regions, where the bulk of China’s textiles and clothing manufacturing factories are located, are less pronounced. These manufacturing regions moreover, rely on specific networks of migrants from particular inland regions. Factories in Guangdong for instance rely heavily on migrant labour from particular counties in Sichuan and Hunan provinces.

These trends affect the supply of labour in two ways. On the one hand, raising relative agricultural prices increases the purchasing power of farmers and reduces the incentive for migrant work. On the other, the continued fall in manufacturing prices, driven by chronic overcapacity and rising raw material prices puts a squeeze on manufacturers, many of whom are consequently unwilling to raise wages. The point is that these trends will eventually force garment manufacturers either to raise wages, and therefore lose part of their competitive advantage, or relocate production to alternative locations with greater availability of cheap labour. Whether manufacturers relocate to China’s interior provinces or they move production to less developed countries such as Vietnam remains to be seen.

Cost however is not the only source of competitiveness of China’s labour force. And indeed China’s cost advantages are already lower than competitors such as India, Pakistan, Bangladesh and Vietnam, where unit labour costs are cheaper. Research carried out by the Institut Francais de la Mode identify overall labour skills and know-how throughout the T&C value chain as a key source of competitive advantage. The Institut rates China’s labour competitiveness above that of other key T&C manufacturing countries such as India, Pakistan, Bangladesh, Turkey, Romania and Morocco.

China’s manufacturers are also perceived to be quick and responsive to buyers’ needs and have more flexibility to meet tight deadlines than counterparts in countries such as India and Pakistan. In the case of the US, this is in part due to shorter lead times from Chinese ports, but it is also a reflection of leaner, less bureaucratic management structures.

**Clothing Manufacturing**

China’s clothing manufacturing sector comprises about 15,000 export suppliers generating annual sales of US$ 50 billion. Official statistics show that a Chinese clothing manufacturing firm on average employs 300 workers, although these statistics exclude smaller manufacturing firms, which have a significant manufacturing presence in T&C clusters around Jiangsu, Zhejiang and Fujian provinces. According to some industry forecasts, in a non-quota environment China’s annual exports of clothing products could reach US$ 128 billion by 2008.

---

13 Global Sources Market Intelligence: Summer Garments, China Supplier Survey: Summer 2005 Buying Season
14 Ibid
Industry analysts agree that the end of the quota system will divert trade in clothing products away from other Asian markets to more profitable markets in the EU and North America (e.g. the US and Canada). China’s exports of T-shirts, casual and dress shirts, suits, dresses, cotton trousers and shorts are extremely competitive. These products are supplied in a range of materials including cotton, polyester, lace, ramie, organza, silk and denim. Key production hubs include Zhejiang with 23% of exports of clothing products and Guangdong, with 22% of exports.

<table>
<thead>
<tr>
<th>China’s Imports of Clothing Products - In Million US$ (Source: CCCT)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Products</strong></td>
</tr>
<tr>
<td>All Clothing Products</td>
</tr>
<tr>
<td>Knit Clothing</td>
</tr>
<tr>
<td>Cotton Clothing</td>
</tr>
<tr>
<td>Silk Clothing</td>
</tr>
<tr>
<td>Wool Clothing</td>
</tr>
<tr>
<td>Synthetic Clothing</td>
</tr>
<tr>
<td>Other Clothing</td>
</tr>
<tr>
<td>Woven Clothing</td>
</tr>
<tr>
<td>Cotton Clothing</td>
</tr>
<tr>
<td>Silk Clothing</td>
</tr>
<tr>
<td>Wool Clothing</td>
</tr>
<tr>
<td>Synthetic Clothing</td>
</tr>
<tr>
<td>Other Clothing</td>
</tr>
<tr>
<td>Leather &amp; Fur Clothing</td>
</tr>
<tr>
<td>Leather Clothing</td>
</tr>
<tr>
<td>Fur Clothing</td>
</tr>
<tr>
<td>Other Clothing</td>
</tr>
<tr>
<td>Clothing Accessories</td>
</tr>
<tr>
<td>Headgear</td>
</tr>
</tbody>
</table>

**Infrastructure & Commercial Environment**

**Infrastructure**

China is well ahead of competitors such as India, Pakistan and Bangladesh in terms of investment in basic infrastructure. China currently boasts a major highway system and good connections with modern, deepwater port facilities. In Guangdong, Chinese shipments of T&C goods can be sent either through the Shenzhen ports (Yantian, Shekou & Chiwan), or through Hong Kong.

**Commercial Factors**

Many European textile buyers prefer China to its competitors because of the dependability of its supply chain, from ordering to shipping. Buyers generally consider China to be business friendly and firms are increasingly working directly with producers in the mainland rather than working through Hong Kong or mainland state-owned agents. This reduces the costs of
intermediary services and allows domestic manufacturers to gain experience in dealing directly with customers. Manufacturers are therefore increasingly capable of meeting buyers’ demands, in conformity with product quality specifications. Indeed, many T&C manufacturers in more developed industrial areas such as Shanghai hold ISO certifications.

**Business Environment**

This section examines China’s business environment as a competitive factor. The focus of this section centres on conditions that arise from government intervention in the industry. Other non-conventional sources of competitive advantage such as lack of compliance/enforcement with international sustainable development standards are addressed in more detail in the following section.

**Price Wars**

As stated in Section 2 above, China still lacks the mechanisms to provide the necessary incentives and disincentives to enterprises seeking to compete in the marketplace. These basic market inefficiencies have triggered cut-throat price wars which in turn have created downward price pressure, leading to a steady fall in the prices of manufactured goods. For reasons that are peculiar to China’s transitional economy, Chinese companies often continue to boost production in an effort to expand market share long after their profit margins have been squeezed. In some cases, even when domestic demand is fully satisfied and inventories are filling up with unsold goods, production lines run are kept running.

This phenomenon, in evidence at several factories in the PRD and other parts of China, has important implications for the country’s emergence as a manufacturing power. First, it means that without reforms to eradicate the causes of oversupply, the price wars and anaemic corporate profits that have characterised industrial development in the past five years could continue. And deflationary risks, which China stands accused of exporting to the world, remain a concern. As shall be seen in the section below, the reason why Chinese producers lack the capacity to refrain from producing more at lower costs when they face excessive competition and price depression is rooted in structural inefficiencies connected with a partially reformed banking system and a system of political and economic incentives biased towards boosting growth at all costs.

Although deflation diminishes the profits of companies that compete within China, it raises the competitiveness of those that export to the world. Hence the strong motivation for China-based companies to export, contributing to trade surpluses in some key trading relationships.15

The overall impact of price wars is considerable. Profit margins take a beating, affecting the ability to spend on research and development and to repay bank debt. In this scenario most companies are forced to seek alternative markets. Diversification of domestic sales into higher margin segments and exporting to less saturated markets remain the main choices. And for the majority of enterprises in the T&C sector, the abolition of the quota system provides an incentive to expand their exports.

---

Preferential Financing / Loans

China’s central government authorities do not condone preferential financing terms for the T&C industry. However, in practice preferential financing does take place at the local level. This is not an isolated phenomenon affecting the T&C industry alone. Rather it is a systemic problem typical of a transitional economy, which enables enterprises to secure the funding required to run their factories.

At the heart of the problem lies an ‘iron triangle’ of companies, bank managers and local government officials who are driven to push production and investment to excessive levels by a mixture of administrative and political incentives.

“The answer revolves around the prevalent culture in China’s half-reformed state banks. Chinese banks rarely conduct research on market conditions, nor do they perform techniques such as cash-flow analysis. Instead, they lend mainly on the basis of collateral: If a company is big [...] it is considered creditworthy. This attitude reinforces a desire among Chinese companies to expand market share at all costs.”16

Such inefficiencies in ressource allocation are rooted in lending decisions made at the local level. The performance of local branch managers at state-owned banks has until now been based on asset growth: “Lending lots and attracting deposits quickly have been all that counted: risk return and capital adequacy have meant nothing.”17 In some cases local managers are egged on by local government officials eager to seek funding for local investment projects.

Indeed, for local officials GDP growth is a political-performance target by which they are measured, and this creates incentives to attract investments that can boost local economic growth and create jobs. Investments therefore are often made where there is no sound economic rationale. Yet in a highly fragmented and localised market, a “band-wagon” effect of unsound investments often follows. “The outcome tends to be waves of overcapacity, as investments are made up to – and sometimes way beyond – the point where it is patently obvious that the economics cannot justify them.”18 In spite of the administrative measures taken by the Hu/Wen leadership to cool down the economy, boom-and-bust cycles remain an enduring feature of the Chinese economy.

According to some estimates, local governments in China have illegally underwritten US$ 100 billion in loans to bankroll favoured investment projects.19

These problems underlie the gap China needs to close to become a fully-fledged market economy. In a market economy, market forces eventually correct capital misallocation and oversupply, punishing those firms that placed too many eggs in the same basket. Ultimately bankruptcy is the price companies have to pay for making unsound investments in sectors suffering from overcapacity.

However, the proportion of companies that go bankrupt in China relative to gross domestic product, for example, is less than a tenth that of the US. Beijing is aware of the economic

17 ‘China’s Banks, Root and Branch’, The Economist, November 6th 2004
19 ‘China’s Banks, Root and Branch’, The Economist, November 6th 2004
rationale for accelerating reform of the bankruptcy regime. Yet the lack of progress in this area is not so much technical in nature as political. The Chinese government and the Communist Party in which it is embedded need to maintain social stability and avoid industrial unrest as a precondition for sustaining their rule. As a result, China does not have an effective bankruptcy law, making creditor banks wary of seeking liquidation for fear they will lose most of their assets. A draft bankruptcy law has apparently been drafted, yet legislators in China’s National People’s Congress have dragged their feet on this issue for almost 10 years.

Without recourse to liquidation, local banks are often predisposed to extending credit, not least because corporations often keep several sets of accounts, which they use to persuade banks to lend to them. In addition, banks seldom take any action if one of their debtor companies starts expanding production into an oversupplied market. It is no wonder that the price of industrial products as they leave the factory gates has fallen by up to 5% year on year from 1998 to 2003, apart from in 2000 when higher oil prices inflated the average. For banks, the price to pay for this excess is a swelling portfolio of non-performing loans that run at around 40% of total assets according to independent analysts’ estimates.

Lending malpractice, however, may ease in the following years as Beijing unfolds an ambitious plan to modernise the banking system. The reform, led by the China Banking Regulatory Commission (CBRC) is intended to make local bank managers responsible for risk assessment and maintaining capital-adequacy ratios of 8%.

**Tax Exemptions & Exchange Rate**

Chinese authorities have thus far resisted pressure from the US and the EU to revalue the Yuan. China, has however taken alternative measures to curb export growth, notably the cut in the rate of VAT rebates for exporting enterprises, as a way to ‘appease’ China’s main trade partners, and to encourage Chinese enterprises to export products of higher added value. For textile and clothing products, the rate for VAT refund was reduced from 17% down to 13% at the end of 2003.

VAT in China is levied at each link of the production chain, at a rate of 17%, before the final product is manufactured. However, part of the taxation on the producer at each link is deducted because that portion has been paid and is included in the supply the producer buys from the previous link. Because the deduction is made at each link, the final taxpayer appears to pay a much lower rate of tax (i.e. the so-called ‘tax burden’ which is different from the actual ‘tax rate’). So the final producer has paid a full VAT of 17% covering the process. In other words, the end user picks up the total tax liabilities. It would appear that this tax rebate policy does not violate Article III, Part II of the GATT, which outlines national treatment on internal taxation and regulation, since it is applied to all exporting enterprises irrespective of their legal status (i.e. whether they are domestic or foreign-invested).

The rebate cut is expected to put pressure on clothing companies, many of which relied on this export rebate to make up for losses. The cut will therefore raise costs significantly for garment enterprises, it is estimated that every percentage point drop will push up production costs by RMB 5 million annually. It is expected that the export rebate cut will have a negative effect on growth momentum, although in view of the fierce competition in the garment manufacturing sector in particular, it is likely companies will be prepared to bear losses to continue to export.
The rebate adjustment will place new pressure on the overall cost structure. Many companies will depend on timely payment of the full cost of the rebate to keep their balance sheets in the black. If the rebate is made in time, the pressure brought about by the rebate cut will be offset to some extent by reducing the enterprises’ interest burden.20

Note also that prior to the policy adjustment, VAT refund was entirely funded by the central government. Under the new system the rebate will be shared by both central and local government.

In order to reduce costs, enterprises may engage in more processing trade, in particular with supplied materials, which may slow down the growth rate of normal trade. This research suggests that the larger companies, particularly in the Shanghai area, plan to adjust the product structure to produce higher-value garments.

Claims from some quarters about the application of different exchange rates, higher for imports and lower for exports, would appear in fact to refer to the dual exchange rate, which was abolished in 1994. Since 1994, one single exchange rate has been applied uniformly.

Given the pressure that the US in particular has applied on China to revalue the Yuan, it is sometimes assumed that the currency valuation issue is the root of all problems in the bilateral trade relationship. However, this research does not support the view that currency valuation is the decisive factor in explaining China’s surge in T&C exports or the drop in unit price of those exports. Although the Yuan is pegged to the US dollar, Chinese T&C exports to the US have also surged and at a lower unit price. In summary, while the currency valuation issue cannot be discounted, it would appear that other factors, such as the competitive environment, flexibility of the labour market and the elimination of costs associated with export quotas are more directly responsible for recent trends in Chinese T&C exports.

### Preferential Treatment of Foreign-Invested Enterprises

Since about one third of export-oriented garment manufacturing companies are foreign-invested, it is worth looking at the tax and investment environment under which they operate. Note, however, that many foreign invested companies operating in the T&C sector in China are in fact domestic companies using a Hong Kong shell company to re-invest on the mainland (a practice referred to as “round-tripping”). This practice is quite common across most sectors in China.

It is impossible to calculate accurately the share of round tripping from China’s total FDI inflows, as Hong Kong and other free markets keep no official statistics on free capital flows entering and leaving their territory. A 2002 report by Guy Pfeffermann, Chief Economist of the International Finance Corporation (IFC), estimates that round-tripping stands at 30-50% of total FDI, based on 1999 and 2000 figures.21 It is expected that the system of incentives to foreign investors will be harmonised in 2006 as China implements its tax reform programme. This will reduce the incentives for round-tripping. Yet, the problem will not be completely eliminated, as preferential measures to attract foreign investment are likely to remain a key

---

20 China Garment Association, quoted in CNTIC, Report on China’s Textile Industry Development

21 Quoted in Ryan, P, Marubeni Research Institute, 2002
tactic among local governments eager to attract FDI inflows to stimulate growth and employment in their own regions.

The sectoral options for foreign investment in China are governed by the Catalogue for the Guidance of Foreign Investment. The latest version of this Catalogue, issued in 2004, superseded previous versions, promulgated in 1995 and 1997. In addition to the Catalogue, the Chinese government has issued a range of accompanying laws defining tax concessions, special investment incentives, foreign exchange controls, etc.

The Catalogue and associated regulations provide guidance to government at central and local levels and to potential investors regarding:

- Which foreign investment projects can be approved at the local level;
- The preferential treatment that such projects will receive;
- Whether foreign investment in a sector is restricted or prohibited.

Note that in China there are often significant discrepancies between legislation and the manner of its implementation. Many local governments, either with central government in ignorance or turning a blind eye, cut special deals with foreign investors. The same is, of course, often true in the case of domestic enterprises, many of which are kept afloat by a combination of tax rebates and bank loans, granted more on social/political grounds than on any rational assessment of credit risk.

Investment categories:

The Catalogue divides sectors into four categories according to their degree of openness to foreign investment: ‘encouraged’, ‘permitted’, ‘restricted’ and ‘prohibited’. Generally speaking, the main difference between these categories is the level of access afforded to investors:

1. Encouraged:
   - Projects for new agro-technology and comprehensive development as well as for construction in energy, transportation and key raw materials;
   - Projects using high-tech conducive to performance improvements and energy savings;
   - Projects enhancing product quality to satisfy domestic market demand, and to increase exports;
   - Projects adopting new technologies and equipment for comprehensive utilisation of resources;
   - Projects in the mid-west region for the full use of human and natural resources and in line with the industrial policy.

2. Permitted: any projects that do not fall into any of the other three categories.

3. Restricted:
   - Projects using outdated technology;
   - Projects non-conducive to the environment and resources saving;
   - Projects for the mining of specified minerals;
Projects in sectors gradually open to foreign investment such as the tertiary sector.

4. Prohibited:
- Projects endangering the state security or damaging the public interests;
- Projects causing pollution and impairment of human health;
- Projects taking a large amount of farm land;
- Projects threatening military installations and facilities;
- Projects utilising Chinese traditional craftsmanship or technology, which are unique in China.

**Tax Exemptions for Encouraged Projects**

In the new Catalogue the number of encouraged industries has increased from 186 to 262 and the number of restricted sectors has reduced from 112 to 75. Some industries previously closed to foreign investors, such as design of integrated circuits, development and production of software, production of certain computer systems and peripherals, automobile manufacturing and wholesale and retail of “ordinary goods”, have now been included in the permitted category.

Only projects in the encouraged category are eligible for exemption of customs duty for imported capital goods. VAT rebates are also available for the purchase of domestically made equipment. Enterprises in the permitted category that export 100% of their finished products are also considered ‘encouraged’ and therefore are eligible for the above tax concessions. It is arguable, that tax concessions for ‘encouraged’ sectors is contrary to the WTO Agreement on Subsidies and Countervailing Measures that restrict export subsidies.

At the national level, corporate tax concessions are granted to foreign investors in manufacturing and production sectors, which enjoy a two year tax exemption, commencing on the first profit-making year, as well as a 50% reduction on corporate income tax during the next three years if the operating term is more than ten years.

However, only two categories of textiles and clothing projects are encouraged by central government policy:

- Production of special textiles for engineering use, and;
- Dyeing and printing as well as post processing of high emulation fabric.

**Local Government Deals**

In addition, local governments offer foreign-invested enterprises (FIEs) *ad hoc* reductions on land use fees and utility charges. FIEs can also be exempted from City Maintenance Fees and Construction Tax. This is because in China, tax is collected and shared between the central and the local governments. Local governments may decide how the share of local tax revenue is spent. Therefore local governments can also provide incentives for foreign invested projects at their own expense, though this varies from region to region. Subject to the nature of the projects, the benefits may include:

- Complete waiver of the land use fee for a specified period or preferential rate;
- Extension of the tax holiday;
• Low interest credit arrangements;
• The same utility charges as domestic companies;
• Other benefits negotiable within the local government’s mandate.

The tax incentive system, however, is complex and haphazard in its implementation. It is not uncommon for different government levels to apply tax regulations inconsistently. However, tax collection is being increasingly centralised and the responsibility for assessment and filing of returns was transferred to enterprises in 1999.

**Power Costs**

Preferential conditions to foreign investors – and indeed domestic investors – looking to invest in the textiles and clothing sectors are no longer offered in key provinces such as Guangdong, which in fact has some of the highest power costs in the region. Subsidies for utility payments however are still found at the county and township level where local authorities are eager to attract investment.

**Land Lease Costs**

Special land deals in SEZs are offered to enterprises in encouraged sectors. There are of course special land deals offered to foreign investors, particularly in less developed provinces where local governments are eager to attract investment. During this research, at least two companies were identified that claim to have received free land from local government authorities. Both cases involved wool manufacturing plants in Hebei province and Inner Mongolia. However, this research suggests that few, if any, such incentives are offered to T&C companies in key manufacturing regions such as Guangdong, Zhejiang and Shanghai.

This research suggests that local authorities in key T&C manufacturing regions such as Guangdong are no longer offering special deals to T&C enterprises. In manufacturing industry clusters in Guangdong province, such as Dongguan, land has become more expensive and harder to come by. Beijing is also cracking down on illegal land deals being made by local officials, in an effort to cool down the economy. Harry Lee, Managing Director at TAL apparel (one of Hong Kong’s largest apparel manufacturers, with annual revenues of US$ 600 million), advised that his company had to cancel plans to build a second plant in Guangdong after local government officials blocked a deal it had to buy land for the factory.22

**Export-Oriented Industries**

Export-oriented industries enjoy concessionary tax rates under the following conditions:

- Enterprises in the permitted category that export 100% of the finished products are also considered encouraged projects and therefore are eligible to the above tax concessions;
- Following expiry of the ordinary tax holiday, FIEs exporting at least 70% of their output in a given year are eligible for a 40% reduction in enterprise income tax in that year (subject to a minimum reduced rate of 10%).

---

22 No Rush into China, Far Eastern Economic Review, November 4th, 2004
Additional tax and other incentives are available to foreign investors in designated SEZs, coastal cities (in particular their Economic and Technology Development Zones) and other special investment zones (including Pudong New Area, New and High-Technology Development Zones, Bonded Zones and Export Processing Areas).

Incentives include:

- Corporate tax reductions;
- VAT exemptions;
- Tariff exemptions;
- Others (reduced land use fees, utility charges, etc.).

The incentives available vary from zone to zone, but the following gives a flavour of the incentives that may be offered:

**Corporate Income Tax**

- A flat corporate profit tax rate of 15% (compared with 33% in other regions);
- Waiver of corporate tax for production industries for the first two years of profitable operation, then 50% of full rate for the next three years (i.e. 7.5% in SEZs);
- Preferential tax rates beyond the two to five year tax reduction period subject to certification or industry-specific exemptions or reductions;
- A one-year tax exemption followed by a two year 50% tax reduction for certain service industries and financial institutions starting from the first profitable year.

**VAT and Tariffs**

SEZs and Development Areas do not offer any special incentives in the T&C sector, although projects that incorporate “high-technology” content can be eligible to receive preferential treatment. Therefore foreign investors in the T&C sector may enjoy access to investment incentives provided they can bring a significant technology component into the project.

Part of the attraction of investing in certain Chinese regions is the deals that can be secured from special status zones. For example, Tianjin Economic Development Area cut Motorola’s VAT rate from 17% to 6% and exempted the firm from paying enterprise income tax for five years, with the rate cut by half for a further five years. Imports of parts and raw materials are exempted from Customs duties, and profits generated can be converted into US dollars.

As explained above, China does not offer any preferential treatment to foreign investors in the T&C sector as a matter of policy, with the exception of two specific technical categories of products in the textiles segment.

The situation is in fact similar in key manufacturing regions such as the PRD area (in Guangdong province), where local governments actively encourage foreign investment in high-tech industries.

However, China is in the process of amending its corporate tax law, which will unify the separate tax codes that govern foreign and domestic enterprises. The State Tax Administration and the MOF have completed a draft that is now circulating within the National People’s Congress. The government has not indicated whether it will grandfather
the preferential tax treatments already approved, and this is likely to emerge as a point of contention.

Some government officials have unofficially indicated that the government will gradually phase out preferential treatment applied to foreign investors. Currently this proposal remains unclear, although unofficial sources close to MOFCOM claim that incentives offered to foreign investors in priority investment areas will remain in place at least throughout 2005.

This research suggests that no local content requirements are mandated for foreign investors in the T&C sector in Guangdong province.

FIEs established in bonded zones can be exempted from import tariffs and VAT upon imported equipment, materials and goods to be used for manufacturing, construction, and administration within the bonded zones. Additionally, manufacturing companies that export 100% of their products may enjoy a duty exemption on imported capital equipment, which is typically refunded on a yearly basis over a five year period.

Domestic export processing companies can apply for import duty rebates on imported raw materials provided they export 100% of their products. To qualify as a processing company, domestic firms have to obtain an import/export licence.

**Protectionism**

Protectionism does occur at the local level – in Beijing this is usually referred to as “regional protectionism”. The principal driver of regional protectionism is the desire of local officials to keep jobs and maintain social stability. Shutting down factories is a thankless task and the fear of creating social disruptions is real. In many instances local governments prefer to keep loss-making enterprises afloat through a combination of subsidies and soft loans. This is, however, illegal and Beijing is currently putting administrative measures in place to curb illegal lending and subsidies to loss-making industries, particularly, but not restricted to, the state sector.

It is arguable that allowing a loss-making company to continue to operate and sell products is a hidden form of subsidy. Loss-making companies that are protected by the government receive an unfair advantage in comparison to others which have to be profitable to survive or to provide a legitimate return to their shareholders.

From the Chinese perspective, this can be seen as an analogue with Chapter Eleven type bankruptcy arrangements in the US, or indeed as comparable to efforts to prop up loss-making ‘national champions’ in other jurisdictions.
SECTION 4 – ANALYSIS OF INVESTMENT IN THE T&C SECTOR

It would be misleading to assess the preparations of China’s textile and clothing industries prior to the elimination of the quota system as if the two industries were a coherent whole. In fact, the bulk of the investment poured into China’s T&C industry has gone to the textile sector, whether through subsidies or through domestic private and foreign investment, and was initially conducted within the framework a wider state sector reform programme. The revamping of the textile industry in this sense was not conducted only in direct anticipation of the removal of quotas; it was done as part of a 3-year SOE “shock-therapy” plan designed to allow inefficient, loss-making enterprises to go bankrupt and to bring the more promising enterprises back to the black through a strategic upgrading process.

Since the completion of the restructuring programme in 2000, however, the textile industry has once again started to add manufacturing capacity and investment, driven partly by the surge in demand for textile products from clothing manufacturers.

China’s textile industry will no doubt benefit from a quota-free environment in terms of market access. But the largest single beneficiary from the phase-out of the quota system will be the Chinese clothing industry. To be sure, the strengthening of the textile industry will have an encouraging effect on the performance of the clothing industry. A vibrant fibre processing industry will strengthen the integration of the supply chain, which is one of China’s key competitive advantages.

<table>
<thead>
<tr>
<th>EU Sources of Clothing % of Total</th>
<th>Before Quota Phase-Out*</th>
<th>After Quota Phase-Out</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>18</td>
<td>29</td>
</tr>
<tr>
<td>India</td>
<td>6</td>
<td>9</td>
</tr>
<tr>
<td>Turkey</td>
<td>9</td>
<td>6</td>
</tr>
<tr>
<td>Central and Eastern Europe**</td>
<td>9</td>
<td>6</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>6</td>
<td>6</td>
</tr>
<tr>
<td>North Africa***</td>
<td>6</td>
<td>5</td>
</tr>
<tr>
<td>Other</td>
<td>46</td>
<td>39</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>EU Sources of Textiles % of Total</th>
<th>Before Quota Phase-Out</th>
<th>After Quota Phase-Out</th>
</tr>
</thead>
<tbody>
<tr>
<td>Turkey</td>
<td>13</td>
<td>12</td>
</tr>
<tr>
<td>China</td>
<td>10</td>
<td>12</td>
</tr>
<tr>
<td>India</td>
<td>9</td>
<td>11</td>
</tr>
<tr>
<td>USA, Canada</td>
<td>8</td>
<td>7</td>
</tr>
<tr>
<td>Central and Eastern Europe*</td>
<td>6</td>
<td>6</td>
</tr>
<tr>
<td>Other</td>
<td>54</td>
<td>52</td>
</tr>
</tbody>
</table>

* Based on 1997 values
** Excluding Hungary and Poland
*** Excluding Morocco
Source: WTO

Yet recent economic projections suggest that the share of China’s exports of clothing products in key markets will vastly outstrip its share of textile exports. A recently published WTO report, for instance, projects that China’s share of the combined US/Canada garment market will balloon to from 16% to 50%, whereas its share of these countries’ textile market
will rise marginally to from 11% to 18%. In the EU, China’s share of the garment market is projected to reach 29% in 2005, up from 20% in 2002\(^{23}\). The projected increase of China’s share of the EU’s textile imports is negligible, as shown in the table above.

These projections, however, have been criticised for failing to take into account contingency factors such as the imposition of safeguard measures on Chinese exports, or China’s self-imposed export control measures. Nor do they consider other key drivers of trade in clothing products such as preferential tariff arrangements and time to market. Nevertheless, in light of recent increases in China’s textile manufacturing capacity, thanks in part to investment in textile machinery, and of garment manufacturers’ intentions to increase production capacity (see page 57 below), it would be logical to conclude that Chinese exports of clothing products will increase substantially over the next few years. *Estimates vary, but on average they point to potential increases in garment production capacity of about 40% for key products including men’s trousers, shorts, T-shirts and blouses.*

**Investment & Industry Upgrading**

On the upstream side of the sector, Chinese textile companies have been adding new capacity over the last 2-3 years and have made headway in enhancing efficiency and quality of production. There is now a wider variety of fabrics available for the garment manufacturing industry.

In the clothing sector, garment manufacturing companies have been planning to increase production capacity in anticipation of the phase-out of the quota system. As shall be seen below, expanding production capacity in the clothing sector is achieved chiefly by hiring more factory staff. Purchasing or upgrading equipment can also lead to efficiency and production increases among garment manufacturers.

Recent investments in China’s T&C sector have a double objective: to upgrade the T&C industrial infrastructure and to expand production capacity. In the first instance, upgrading is driven by purchases of high-tech textiles machinery equipment. In 2003, total sales of textile machinery reached US$ 8.6 billion, of which imports of textile machinery accounted for US$ 4.37 billion and sales of domestic machinery accounted for US$ 4.23 billion.

---

\(^{23}\) The Global Textile and Clothing Industry Post the Agreement on Textiles and Clothing, Hildegunn Kyvik Nordas, WTO 2004
In 1999, the SETC began to coordinate the issuing of bonds to provide soft loans for technological renovation projects in certain targeted sectors. Loans were mainly used to support 520 key companies and 120 test companies in seven key industries: metal smelting and processing, ferrous metals, petrochemicals, textile machinery, electronics and information and paper products. By 2001, 880 projects had been approved, 141 of them in the textile industry. These bonds were intended to stimulate investments by supplying a form of seed capital to be augmented through other channels.

The CNTIC (former State Textile Bureau) stated that China committed US$ 2.4 billion in grants to the industry’s top 200 textile enterprises and US$ 1.7 billion in soft loans to fund the upgrading of the industry – mainly through the replacement of obsolete equipment. The funds were made available by the Ministry of Finance. According to this research, enterprises were eligible for grants worth US$ 363,196 and soft loans worth US$ 242,130 for every ten thousand spindles scrapped.

These subsidies were categorised as a spindle-scraping plan and were mainly to be used for the reemployment of those workers who were laid-off as a result of the modernisation of the industry. Fixed investment growth statistics in the sector during that period would suggest that some funds were also used to replace and upgrade equipment. More recently, the CNTIC has launched a programme to encourage the consolidation of the top 600 textile mills in China in an effort to enhance quality, efficiency and develop economies of scale. However, few subsidies have been available to the textile industry since 2002.
In the textile sector, companies have been upgrading machinery under the framework of the Tenth Five Year Plan, which makes provisions for grants and soft loans to the industry. This is not fundamentally linked to the end of the quota regime, but rather is a programme designed to restructure the sector strategically by enhancing, for instance, China’s capacity to supply high quality, locally-produced fabrics. This research suggests that rather than increasing capacity, Chinese textile enterprises have been mostly involved in upgrading their machinery, with emphasis on improving efficiency through technology upgrades.

However there has been a slowdown in growth recently, following the government’s measures to restrain investments in ‘overheated’ sectors. Following these measures Chinese banks are beginning to hold back on loans to private domestic enterprises, although specific figures on the effects of recent restraints on investment are not yet available. One consequence of tighter lending policies has been a cutback on the amount of sales to China by foreign textile machinery manufacturers.

**Imports of Textile Machinery**

Chinese textile manufacturers are eager to replace outdated machinery with fast and flexible models to produce for export. EU companies are actively selling to China, and in some projects, provide soft loans to facilitate the purchase of more equipment. According to this research, in 2001 about 90% of China’s installed capacity in the cotton sector (excluding open-end rotors) was more than ten years old.\(^{24}\) As the table below shows, imports of textile machinery grew by 32.1% on average during 2001-2003. At US$ 1.3 billion in 2003, Japan leads China’s market for imports of textile machinery, followed closely by Germany with US$ 1 billion and Italy, with US$ 494 million.

\(^{24}\) ITMF, International Machinery Shipment Statistics, 2002
According to the ITMF, in 2003, shipments of short-staple cotton spindles reached 8.2 million, a 133% year-on-year increase. The surge in orders from China was the main factor driving the massive growth of cotton-spindle shipments worldwide. Asia received 88% of all spindles shipped in 2003. China was the main market with 4,951,000 spindles. Shipments to India (933,000), Pakistan (632,000) and Turkey (595,000) also contributed to the growth in cotton-spindle shipments.

<table>
<thead>
<tr>
<th>China’s Imports of Textile Machinery Products (million US$)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Product type</strong></td>
</tr>
<tr>
<td>Printing, Dyeing, and finishing</td>
</tr>
<tr>
<td>Looms</td>
</tr>
<tr>
<td>Spinning machinery</td>
</tr>
<tr>
<td>Chemical textile machinery</td>
</tr>
<tr>
<td>Knitting</td>
</tr>
<tr>
<td>Other equipments and facilities</td>
</tr>
<tr>
<td><strong>Total Textile Machinery Imports</strong></td>
</tr>
<tr>
<td><strong>Source:</strong> China Customs</td>
</tr>
</tbody>
</table>
According to the ITMF, “240,000 long-staple (wool) spindles were delivered in 2003, a
decline of 32% compared with 2002, as Chinese and Turkish investment in the sector
weakened. The most important investors in wool spinning were China (82,000 spindles),
Turkey (63,000) and Iran (25,000). Shipments of open-end rotors also declined by 5% from
2002 levels. Open-end rotors shipped in 2003 totalled 346,000 worldwide. Rotor shipments
were concentrated in China (248,000 rotors) and Turkey (32,000), which together accounted
for 81% of global shipments in 2003 (up from 78% in 2002).”

Nevertheless, even as imports of foreign textile machinery have increased over the last couple
of years, domestic production of machinery has also improved significantly.

<table>
<thead>
<tr>
<th>Textile Machinery Imports 2001-2003, By Major Suppliers</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Million US$) Ranked by import value 2003</td>
</tr>
<tr>
<td>Supplying Country</td>
</tr>
<tr>
<td>Total</td>
</tr>
<tr>
<td>Japan</td>
</tr>
<tr>
<td>Germany</td>
</tr>
<tr>
<td>Italy</td>
</tr>
<tr>
<td>Switzerland</td>
</tr>
<tr>
<td>Taiwan</td>
</tr>
<tr>
<td>South Korea</td>
</tr>
<tr>
<td>Belgium</td>
</tr>
<tr>
<td>France</td>
</tr>
<tr>
<td>Hong Kong</td>
</tr>
<tr>
<td>United States</td>
</tr>
<tr>
<td>United Kingdom</td>
</tr>
<tr>
<td>Czech Republic</td>
</tr>
<tr>
<td>Sweden</td>
</tr>
<tr>
<td>Austria</td>
</tr>
<tr>
<td>Australia</td>
</tr>
<tr>
<td>Netherlands</td>
</tr>
<tr>
<td>Spain</td>
</tr>
<tr>
<td>India</td>
</tr>
<tr>
<td>Singapore</td>
</tr>
<tr>
<td>Mexico</td>
</tr>
</tbody>
</table>

Textile machinery manufacturers are investing in China to produce for the domestic market
and to export to less developed markets. Foreign enterprises typically establish WFOEs or
joint ventures although the trends suggest that WFOEs have become the preferred vehicle for
entering the Chinese market. Intellectual property rights (IPR) violations within the industry
are an issue, and European companies claim that many Chinese machinery makers are
copying foreign technology.

Despite this concern, this research suggests that currently the technology being transferred to China includes state-of-the-art equipment because of rapidly rising textile standards requirements. Foreign manufacturers are protecting their investments mainly by establishing WFOE, thereby reducing the risk of possible leaks of proprietary technology to domestic competitors.

The competitiveness of China’s domestic textile machinery industry varies. For example, in the case of rapier weaving machines, China is only importing 10% and manufacturing the rest locally. But for advanced air-jet weaving, Chinese companies are importing 92% and only manufacturing 8% locally.

This research suggests that Japan is a major provider of weaving and spinning equipment, whereas Italy focuses mostly on sales of spinning and weaving machinery. German and Swiss companies have shown strong sales in China for their spinning machinery.

In 2003 the export value of textile machinery from Italy to China reached over US$ 494 million, taking a market share of 12.5%. The export of Italian weaving machinery decreased compared to 2002, however exports of knitting machines and spinning machines increased.

Of Italy’s total machinery exports to China, yarn preparation and spinning machinery accounts for 32% of exports, weaving machinery for 34%, knitting machines for 23% and finishing machines for 11%. Germany and Belgium are also major exporters of textile machinery to China.
### Statistical Profile of the Textile and Clothing Sector 1997-2003

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Textile and clothing share of manufacturing value added (percent)</td>
<td>12.2</td>
<td>11.9</td>
<td>11.5</td>
<td>9.6</td>
<td>N/A</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Number of textile and clothing establishments</td>
<td>45,600</td>
<td>19,300</td>
<td>18,900</td>
<td>18,900</td>
<td>21,144</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Number of textile and clothing workers (1,000)</td>
<td>10,649</td>
<td>8,590</td>
<td>7,772</td>
<td>7,592</td>
<td>7,890</td>
<td>18,000</td>
<td></td>
</tr>
<tr>
<td>Installed spinning capacities:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Short-staple spindles (1,000)</td>
<td>42,456.0</td>
<td>42,456.0</td>
<td>33,826.0</td>
<td>34,435.0</td>
<td>35,483.9</td>
<td>49,069,100</td>
<td>59,420,950</td>
</tr>
<tr>
<td>Long-staple spindles (1,000)</td>
<td>3,871.0</td>
<td>3,871.0</td>
<td>3,878.0</td>
<td>3,600.0</td>
<td>3,600.0</td>
<td>3,600.0</td>
<td></td>
</tr>
<tr>
<td>Open-end rotors (1,000)</td>
<td>578.2</td>
<td>578.2</td>
<td>593.6</td>
<td>623.8</td>
<td>711.5</td>
<td>837.6</td>
<td>1,006.10</td>
</tr>
<tr>
<td>Installed weaving capacities for the cotton system:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Shuttle-less looms (number)</td>
<td>45,800</td>
<td>45,800</td>
<td>58,700</td>
<td>60,930</td>
<td>82,900</td>
<td>113,600</td>
<td>211,900</td>
</tr>
<tr>
<td>Shuttle looms (number)</td>
<td>687,500</td>
<td>687,500</td>
<td>637,500</td>
<td>594,500</td>
<td>578,400</td>
<td>633,650</td>
<td>668,100</td>
</tr>
<tr>
<td>Purchase of large circular knitting machines</td>
<td>N/A</td>
<td>1,007</td>
<td>1,675</td>
<td>3,600</td>
<td>2,587</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Average total labour cost per operating hour</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Coastal China</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>$0.69</td>
<td>$0.69</td>
<td>$0.69</td>
<td>$0.69</td>
</tr>
<tr>
<td>China, other than in coastal areas</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>$0.41</td>
<td>$0.41</td>
<td>$0.41</td>
</tr>
<tr>
<td>Mill fibre consumption</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cotton (1,000 metric tons)</td>
<td>5,118.2</td>
<td>4,704.2</td>
<td>4,766.1</td>
<td>4,804.0</td>
<td>5,210.6</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Wool (1,000 metric tons)</td>
<td>262.7</td>
<td>267.0</td>
<td>271.1</td>
<td>304.2</td>
<td>314.4</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Manmade fibres (1,000 metric tons)</td>
<td>5,935.2</td>
<td>7,056.2</td>
<td>8,121.9</td>
<td>9,316.4</td>
<td>10,211.2</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total (1,000 metric tons)</td>
<td>11,316.1</td>
<td>12,027.4</td>
<td>13,159.1</td>
<td>14,424.6</td>
<td>15,736.2</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Capacity Expansion in the Clothing Sector

Given the labour-intensive nature of the clothing sector, plans to expand production capacity are focused chiefly on hiring additional staff and expanding factory space. Investment in capital equipment also plays a significant role, although clearly this is not as crucial as it is for the textile sector.

An estimated 91% of suppliers of clothing products in China intend to expand production capacity in anticipation of the end of quotas. Clothing manufacturers intend to expand capacity by 92%, whereas trading companies plan to increase capacity by 88%.26

![Pie chart showing the percentage of suppliers planning to expand production capacity](source)

More than half of China’s suppliers of manufactured clothing products intend to boost capacity by 20-50%. However, only 16% of suppliers intend to increase capacity by more than 50%.27 Garment manufacturing companies plan to increase capacity mainly by adding to their headcount. The problem facing clothing manufacturing enterprises as is discussed in Section 3 is that although factory managers prefer to hire young female workers in their late teens or early twenties, this particular pool of labour is shrinking. Labour costs are therefore expected to rise, as are raw materials and overhead costs, including land and utility charges.

---

26 Global Sources Market Intelligence: Summer Garments, China Supplier Survey, Buying Season 2005
27 Ibid
Other ways of increasing capacity, include the purchase or upgrading of manufacturing equipment and the extension or construction of factory space.

<table>
<thead>
<tr>
<th>How do you intend to expand your production capacity?</th>
<th>% of total respondents</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hire more staff</td>
<td>68.3%</td>
</tr>
<tr>
<td>Purchase additional equipment</td>
<td>61.7%</td>
</tr>
<tr>
<td>Upgrade existing equipment</td>
<td>35.0%</td>
</tr>
<tr>
<td>Build or move to new factory</td>
<td>31.7%</td>
</tr>
<tr>
<td>Extend existing factory space</td>
<td>33.9%</td>
</tr>
</tbody>
</table>

Source: Global Sources Market Intelligence

Aside from manufacturers, trading companies are increasing capacity in an effort to reinvent their business. In a non-quota environment, trading companies will no longer be the bridge between suppliers and buyers. These companies may continue to provide value-added services as middlemen, but only if they can compete effectively against manufacturers, which are developing their own international marketing capabilities. Trading companies are therefore setting up their own manufacturing capabilities. This will also enable them to manage the production process more efficiently, improving design innovation, production efficiency and quality control.

**Foreign Investment**

This research suggests that large garment makers and sourcing companies are still reluctant to expand production significantly in China due to the possibility that safeguard quotas may be placed on China-made garments. Interestingly, it would seem that the uncertainty surrounding the transition to a quota-free environment may in itself place certain restraints, albeit as an indirect effect, on the growth of orders for Chinese T&C products.

Most international garment makers and traders active in China in fact continue to source from factories in other countries within the region. The other reason why companies are not significantly expanding capacity in China is because new entrants in the garment sector are, by and large, rushing into the lower-end of the market. This may cause a surge in exports of bulk garments. Yet international buyers are not yet willing to sacrifice quality by switching to lower-cost upstarts.
CNTIC data on FDI in the T&C sector indicates that as of 2003 there were over 22,727 FIEs in the sector, of which 11,777 were garment companies and 10,950 were textile companies, including manmade fibre manufacturing companies. In 2003, FIEs accounted for US$ 43.19 billion in gross output, US$ 41.49 billion in sales and US$ 1.64 billion in profit. Hong Kong accounts for the bulk of FDI in the sector with 70% of total investment. Taiwan trails in second position with about 10% of total FDI according to 2000 statistics.

**Hong Kong and Taiwan Investment**

**Development of the PRD Region**

Hong Kong has played a significant role in the development of China’s T&C. During the 1950s and 60s, when Mao Zedong severed mainland China’s links with the outer world, Hong Kong emerged as a global T&C manufacturing powerhouse. In the wake of China’s Open Door Policy, however, Hong Kong’s entrepreneurs began migrating manufacturing capacity across the border into Guangdong province, taking advantage of their giant neighbour’s cheap and disciplined labour. Hong Kong enterprises have particularly favoured the PRD region, which during the period 1985-1999 attracted US$ 80.5 billion in FDI from Hong Kong and Macao companies.

Interestingly, quotas imposed on mainland China’s exports of T&C products have halted the wholesale migration of Hong Kong’s T&C manufacturing sector across the border. Indeed the combined T&C manufacturing sector continues to account for 25% of manufacturing employment in the territory and a similar proportion of gross output.\(^2\) Yet in spite of the migration of manufacturing to the mainland, T&C products still constitute Hong Kong’s second-largest industry. T&C exports totalled US$ 23.1 billion in 2003.

**Integration of Manufacturing and High Value-Added Activities**

Hong Kong’s T&C manufacturing industry however is inextricably connected through tight supply chains with its factories across the border. This is possible through outward processing arrangements in which parts of the supply chain are carried out on the Mainland (cutting and parts), but the final product is assembled in Hong Kong. A significant number of products finished in Hong Kong are exported under the “Made in Hong Kong” label (whether legally or illegally). Products under the “Made in Hong Kong” label have been able to enjoy less restrictive quotas and therefore better access to quota-bound markets.

In a post-quota environment, it is likely that much of Hong Kong’s remaining T&C production capacity will move gradually to China. However, most Hong Kong companies expect the US, and possibly also the EU, to place safeguard quotas on China-made garments. As a result Hong Kong’s T&C companies will continue to retain existing manufacturing capacity in the territory in order to get around the system by dividing production processes between Hong Kong and the mainland.

\(^2\) ‘Leaping Dragon, Trailing Tigers? Taiwan, Hong Kong and the Challenge of Mainland China’, Economist Intelligence Unit, May 2003
Shift to Services

The migration of manufacturing capacity to the mainland, however, has not decreased the importance of the T&C sector for the Hong Kong economy. The deindustrialisation process has been accompanied by a rapid development of a dedicated service industry catering to the commercial needs of T&C manufacturers. According to the Hong Kong Trade Development Council (TDC), by 2002 more than 15,000 companies in Hong Kong were involved in garment import-export trade and employing over 90,000 workers.\textsuperscript{29} Indeed, most Hong Kong T&C companies are engaged in supply chain management, from product design and factory sourcing to transport and logistics services.

Involvement of EU Companies in the Sector

There is scant data available on the level of European direct investment in China’s T&C sector. Consultations with the commercial delegations of EU member states, however, suggest that the level of EU investment is shallow, and is focused on small garment manufacturing plants in the South, as well as textile machinery manufacturing plants. The focus of European businesses in China’s T&C sector is on the sale of textile machinery and the sourcing of finished T&C products.

An overview of Chinese imports of EU T&C products is reproduced below:

\textsuperscript{29} Ibid
<table>
<thead>
<tr>
<th>Countries/areas</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>03/02 change%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>12,579</td>
<td>13,066</td>
<td>14,225</td>
<td>8.9</td>
</tr>
<tr>
<td>Asia</td>
<td>11,938</td>
<td>12,317</td>
<td>13,319</td>
<td>8.1</td>
</tr>
<tr>
<td><strong>Europe</strong></td>
<td>436</td>
<td>497</td>
<td>572</td>
<td>15.2</td>
</tr>
<tr>
<td>North America</td>
<td>174</td>
<td>211</td>
<td>275</td>
<td>30.5</td>
</tr>
<tr>
<td>Taiwan</td>
<td>2,879</td>
<td>3,095</td>
<td>3,178</td>
<td>2.7</td>
</tr>
<tr>
<td>Japan</td>
<td>2,735</td>
<td>2,561</td>
<td>2,896</td>
<td>13.1</td>
</tr>
<tr>
<td>South Korea</td>
<td>2,499</td>
<td>2,328</td>
<td>2,439</td>
<td>-4.8</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>1,285</td>
<td>1,340</td>
<td>1,336</td>
<td>-0.3</td>
</tr>
<tr>
<td>Pakistan</td>
<td>475</td>
<td>474</td>
<td>460</td>
<td>-2.8</td>
</tr>
<tr>
<td>United States</td>
<td>169</td>
<td>204</td>
<td>264</td>
<td>29.4</td>
</tr>
<tr>
<td><strong>Italy</strong></td>
<td>210</td>
<td>233</td>
<td>236</td>
<td>1.5</td>
</tr>
<tr>
<td>Indonesia</td>
<td>215</td>
<td>224</td>
<td>216</td>
<td>-3.7</td>
</tr>
<tr>
<td>Thailand</td>
<td>92</td>
<td>97</td>
<td>139</td>
<td>44</td>
</tr>
<tr>
<td>India</td>
<td>197</td>
<td>169</td>
<td>138</td>
<td>-18.3</td>
</tr>
<tr>
<td>Germany</td>
<td>54</td>
<td>79</td>
<td>107</td>
<td>36</td>
</tr>
<tr>
<td>Macao</td>
<td>59</td>
<td>54</td>
<td>65</td>
<td>19.9</td>
</tr>
<tr>
<td>Malaysia</td>
<td>62</td>
<td>65</td>
<td>62</td>
<td>-3.8</td>
</tr>
<tr>
<td>Singapore</td>
<td>28</td>
<td>50</td>
<td>59</td>
<td>16.1</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>38</td>
<td>44</td>
<td>48</td>
<td>7.4</td>
</tr>
<tr>
<td>France</td>
<td>29</td>
<td>30</td>
<td>32</td>
<td>7.6</td>
</tr>
<tr>
<td>Belgium</td>
<td>15</td>
<td>21</td>
<td>28</td>
<td>37.4</td>
</tr>
<tr>
<td>Vietnam</td>
<td>12</td>
<td>16</td>
<td>24</td>
<td>50.3</td>
</tr>
<tr>
<td>Australia</td>
<td>16</td>
<td>20</td>
<td>24</td>
<td>20.9</td>
</tr>
<tr>
<td>Luxemburg</td>
<td>13</td>
<td>18</td>
<td>21</td>
<td>16.4</td>
</tr>
</tbody>
</table>
Sourcing from China

Concentration of Purchasing

The global consolidation of the supply-chain, thanks to a more liberal trade regime and technological improvements in transportation and logistics, has had a visible effect on buyer-supplier relations. Large-scale international retailers have established global sourcing systems and consolidated direct buying centres on the mainland. This trend has created a bandwagon effect in which suppliers follow their customers to China. In a post-quota environment this trend can be expected to intensify. According to a recent Goldman Sachs survey of major global buyers, China’s share of sourcing will increase by as much 20-40% from 2005-2007 and by 40-60% thereafter.30

---

30 Goldman Sachs 2005 Quota Elimination Impact Survey
Competition & Bargaining Capacity

Direct sub-contracting of production in China by international buyers eliminates the need to pay commissions to Chinese trading companies, which until recently acted as middlemen. International operators are also taking full advantage of the current over-supply by flexing their purchasing muscle. This in turn contributes to further downward price pressure as suppliers, in particular small and medium ones, make heavy investments in order to expand production capacity, or to enhance operational efficiency, in order to fulfil increasingly large customer orders.

Production Structures

Big players, such as Wal-Mart, are continually raising the bar, forcing both retailers and suppliers to “chase a moving target”. In 2003 Wal-Mart, the US retailing giant, sourced US$ 15 billion worth of goods in China and mainland products made up about 80% of imports sold by Wal-Mart at its more than 3,200 outlets in the US. The company, which is the single largest importer of manufactured goods from China into the US, works with its suppliers to lower prices (Wal-Mart’s global purchasing headquarters is located in Shenzhen in Southern China). As a result, companies like Wal-Mart are driving prices down, thanks partly to consolidation of supply chains in China, thereby achieving the economies of scale needed to provide Wal-Mart with its low-price mandate. However, as large corporations like Wal-Mart create competition by selling at lower prices, retailers will also cut prices but will not necessarily sell more. One result may be deflation in the clothing industry.

---

31 Deloitte Research, *Global Consumer Business, Strategies for a Challenging World*
32 Deloitte & Touche USA LLP, *The Wal-Mart Effect*
Impact of Potential Measures on EU Industry

The consolidation of sourcing operations in China, fuelled by the need to develop efficient supply chains, is one of the most powerful drivers of lower prices in the industry.

Yet the necessity of maintaining low costs is also an imperative driven by consumers in developed markets in the EU, the US and Japan. The balance of power in global supply chains has already tipped towards the consumers in developed economies. Already, decisions in the global supply chain are taken in the higher value-added segments of the T&C value-added chain, such as in design, fashion, brand and retailing. These decisions, including pricing policies, are ultimately driven by consumer behaviour.

In the current economic environment, consumers face serious constraints on spending. This means that retailers in developed markets seeking to retain their market share will be unwilling to pass on cost increases to consumers. Rising commodity prices, exchange rate volatility, shortages created by sudden surges in demand or the application of trade defence measures could generate such cost increases.

Downward price pressure and reduced profit margins are the most obvious examples of the “pull” effect as power shifts to stakeholders who call the shots in the global supply chain: the retailers, and ultimately, the consumers. The consequences are felt throughout the value chain. In developing countries like China, where suppliers face a market of fewer, larger buyers, their bargaining power is significantly reduced. In the end they have to compete on price, as well as on service and quality differentiation.

European retailers and suppliers interviewed for this study corroborate the “pull” effect of consumer-driven price pressure in their pricing policies. Most of Europe’s leading retailers have a significant sourcing presence in China because it offers low-cost products of reasonably good quality. Although few of them source exclusively from China, and indeed
most plan to continue sourcing from other countries after 2005, they expressed serious concern about the possibility of measures being put in place in the EU. Interestingly, this research also revealed that a number of apparel manufacturers from leading EU T&C manufacturing regions deliberately keep a low profile in their China operations to avoid criticism from labour unions and other interest groups in Europe. Many of these traditional European enterprises have developed a strong buying presence in China, and in some cases have invested directly into domestic manufacturing plants to offset high production costs in Europe.

**Market Dependency**
China’s market share of Australia and Japan’s combined imports of textile and clothing products (69% in 2002 and 77% in 2001) demonstrate its ability to compete effectively in a non-quota environment. These figures may appear to corroborate the results of a recent WTO report which projects that China’s share of garment exports to the US will rise to 50% after 2005, up from 16% after the third stage of ATC liberalisation in 2002[^34].

However a number of obstacles may attenuate the expansion of Chinese exports of T&C goods to the EU and the US, including the potential imposition of safeguard measures. Consultations with wholesalers and manufacturers suggest that buyers, including leading sourcing giants such as Wal Mart, do not want to rely too heavily on China due to uncertainty about the use of safeguard quotas by the US and the EU.

Given that the buying cycle for T&C products is often longer than the length of time required to process petitions for the application of safeguard measures, buyers do not want to be [^34]: The Global Textile and Clothing Industry Post the Agreement on Textiles and Clothing, Hildegunn Kyvik Nordas, WTO 2004

---

**Do you expect to increase sourcing in any other countries? If so which?**

<table>
<thead>
<tr>
<th>Country</th>
<th>% of responses</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cambodia</td>
<td>18.2%</td>
</tr>
<tr>
<td>Pakistan</td>
<td>27.3%</td>
</tr>
<tr>
<td>Bangladesh</td>
<td>36.4%</td>
</tr>
<tr>
<td>India</td>
<td>63.6%</td>
</tr>
<tr>
<td>No</td>
<td></td>
</tr>
<tr>
<td>Yes</td>
<td></td>
</tr>
</tbody>
</table>

Source: Goldman Sachs 2005 Quota Elimination Impact Study
caught having ordered products that will be barred from entering into US or EU ports. Buyers and retailers, in other words, are afraid of placing their supply chains at risk by “putting all their eggs in the same basket”. They want to avoid excess market dependency on China in case the US and the EU take trade defence action against imports of Chinese goods. Therefore many of them are diversifying their production to other key supplying countries such as India, Vietnam, Bangladesh and Pakistan.

A recent McKinsey report suggests that the value of the global trade in T&C goods is likely to reach US$ 248 billion by 2008, with China and South Asian countries gaining the lion’s share. The report forecasts that India may increase its share from the current 4% to 6.5% valued at US$ 16 billion by 2008 and notes that by 2013, exports from India could grow 15% to 18% annually amounting to over US$ 30 billion.35

Other obstacles including concerns about working and environmental conditions in factories are explored in more detail below.

**Impact of China’s T&C Export Measures**

An initial analysis of the recent measures announced by the Chinese authorities on exports of T&C products indicates that efforts to discourage Chinese enterprises from focusing on export quantity are unlikely to lead to a sharp fall in the volume of garments exported36.

Thus far, some details are available concerning the proposed duties on exports of T&C products37. Duties levied will be based upon the quantity of garments exported instead of their value. The Chinese authorities hope that this measure will encourage Chinese enterprises to export products with a higher added value, as the duty will be comparatively lower. Duties will be imposed at the symbolic levels of between 0.2 and 0.3 Yuan (US$0.025 and 0.04) per item and of 0.5 Yuan (US$ 0.06) per kg.

In practice export duties are unlikely to become an effective deterrent unless exporters share a clear understanding of what constitutes a ‘risk zone’, which may not become apparent unless real safeguard measures are put in place. Otherwise the duties will restrain surge in exports in so far as they pose an administrative burden. This research however indicates that large-scale Chinese exporters do not actually perceive the export duties to be a real burden (although industry analysts suggest that they may have a negative impact on small exporters). As the measure has only recently come into force, however, it will take some time to see the effect on the different types of exporting enterprises.

On balance, the absence of a strong reaction from Chinese exporters would seem to corroborate the view that the measures are largely symbolic and are unlikely to lead to a fall in garment exports, particularly in light of the expected reduction in average unit prices which is likely to accompany the end of quota-bound product categories under the final stage of ATC liberalization.

---

35 DHL-McKinsey Apparel and Textile Trade Report
36 This analysis is shared by the CCCT.
37 In December 2004, the General Administration of Customs announced that from January 1 this year export duties will be levied on some garment products and this should apply to products exported under general trade, process trade and border small trade. This measure covers a total of 148 garment products according to customs classification.
Specifications concerning the remaining (seven) measures announced by the Chinese government unfortunately remain vaguely worded and open-ended, and therefore it is difficult to assess their impact.\(^\text{38}\)

The measures concerning the restraint on investment in particular may only affect production and exports in the medium term. In any event they are likely to have a limited impact, as there are many indications that a large amount of investment projects have already been carried out so the capacity is already there. Questions also arise regarding the implementation of investment restraint measures at the local level.

Potentially the most significant measure is the call for self-discipline in the industry, including the publication of data on exports (which would in a way mirror the EU monitoring system), but of course the feasibility of this approach depends on how it is implemented. There have been press notices that some groups of exporters are introducing price controls for certain products, but they cover only a relatively small part of exporters (in the case of the CCCT, less than 20\%) and only for some products.

If on the whole the measures appear toothless, they nevertheless reveal that the Chinese authorities are interested in avoiding potential safeguard measures, and that they want to be perceived as ‘good citizens’ committed to ensuring a smooth transition to a quota-free trade regime.

\(^\text{38}\) The promised lowering of import duties (when, how much, for which products), duty-free treatment of imports of “parts of products” imported from 25 African countries (which products, when), intensification of IPR protection, encouragement to Chinese companies to invest overseas, “dialogue and cooperation” in textiles.
SECTION 5 – ANALYSIS OF LABOUR & HSE ISSUES

Overview of Legal Requirements & Compliance

This research suggests that the central government is actively encouraging textile and garment companies to develop quality control mechanisms and ensure that environmental and labour standards are adhered to. However, even officials from the CNTIC admit that as of now there is no effective system in place to ensure that such standards are met. The point to note is that the central government is keen to develop a more organised approach to ensure compliance in the future, although admittedly this will take time (partly due to the lack of enforcement capacity).

By most accounts, including those of Chinese central government officials, compliance with labour and workplace HSE standards is far from satisfactory. Large, state-owned enterprises and Western-invested operations are generally believed to have higher levels of compliance than private or other foreign invested enterprises. As yet, there are few sources of comprehensive quantifiable analysis on just how poor standards are in the textile and garment industries, though significant anecdotal evidence has been widely documented and some indicative statistics have been released by the Chinese government.39

There is general consensus among sources that poor enforcement of existing regulations, which are generally viewed as comprehensive, and the exclusion of migrant workers from the Chinese legal system are the most serious barriers to improved work conditions. These obstacles are closely related to the competition between jurisdictions to facilitate investment and economic growth: the attitude of provincial and local officials is that lax law enforcement that promotes growth is not an abrogation of duties.

Foreign observers have noted recent improvements in enforcement and in the attitudes of lower-level officials, especially related to migrant workers’ rights, health and safety (including HIV/AIDS). Enforcement is still highly variable and poorly planned. Interviewees have also seen increased interest in standards and corporate social responsibility by factories, but this has primarily been driven by a desire to understand the international market and some managers have openly expressed their disbelief that better labour conditions would benefit their business, and their resentment at what they view as multinational hypocrisy.

This section begins by focusing on labour, health and safety issues, providing an overview of the political environment, relevant government and semi-government actors, key pieces of legislation, actual labour conditions, wages and remuneration, and worker empowerment. Environmental issues are treated separately, though many of the systemic enforcement problems and reasons for non-compliance are similar.

39 This section and the section on environmental compliance draws from 18 interviews with foreign government officials, compliance and communication officers from foreign textile buyers, NGO and multilateral organisation representatives, Chinese factory owners, and representatives of Chinese government-organised NGOs, as well as reports published by the Chinese government, international NGOs, the international media, and the domestic media.
Government Attitude & Remit

Relevant agencies at the central government level, namely the State Council, the Ministry of Labour and Social Security (MOLSS), and the semi-government All-China Federation of Trade Unions (ACFTU) have not taken an open and definitive stand on labour rights. On December 7, 2004, MOLSS abruptly cancelled an international meeting to discuss labour rights in Beijing, illustrating that the issue remains sensitive. At a meeting the day before, a cadre from the Chinese Enterprise Confederation (CEC), a government-organised NGO representing Chinese employers, argued during a heated public discussion of corporate social responsibility that legal compliance is difficult, if not unachievable for many companies and that there should be flexibility regarding enforcement, an opinion that may be representative of how many officials view this problem.

Despite the government’s reticence concerning “labour rights,” the State Council, MOLSS, the ACFTU, CEC, and the progressive State Administration of Work Safety (SAWS) openly acknowledge health and safety problems and the lack of protection for migrant workers and have initiated efforts aimed at providing access to legal protection and representation, as well as limited social services for migrant workers. The state media is also increasingly covering these issues. However, not only are these initiatives too recent to have produced widespread improvements, but the central government is compelled to rely on often uncooperative lower-level branches to lead enforcement efforts.

Government resources are limited at each level, and incentives for enforcement are usually weak. The central government lacks the capacity to oversee effectively the efforts of provincial and local governments, and lower-level governments are motivated to overlook employer transgressions as they compete to attract investment and orders. Furthermore, health and safety problems in the textile and garment industries are dwarfed by the number of deaths and injuries in the mining and transportation industries, prompting SAWS to focus more resources on those sectors.

Nonetheless, foreign interviewees from NGOs and multinationals have noted a marked improvement in the attitudes of some local government officials towards health and safety issues and migrant workers, and in some cases labour conditions. One interviewee reported that local labour bureau and union officials were very willing to participate in projects related to both migrants and health issues (including the previously taboo HIV/AIDS), but continued to resist efforts to improve working conditions or introduce anything related to freedom of association.

Relevant Government Agencies

State Council

The State Council is the highest executive body in the Chinese government, led by Premier Wen Jiabao. The State Council spearheaded the ongoing campaign against delayed wage payment for migrant workers (discussed below) and issued the “Notice on Properly Carrying Out the Work of Management and Services for Rural Migrant Workers in Urban Areas,”

dealing with payment in arrears, schooling for the children of migrant workers and working conditions. The involvement of the State Council in migrant workers and health issues, such as HIV/AIDS, is a signal to the rest of the government to take those issues seriously.

**Ministry of Labour and Social Security (MOLSS)**

At the national level, MOLSS is aware of the critical need to protect the rights of migrant workers in the textile industry, but lacks the ability to enforce regulations directly or force provincial and local branches to do so. Instead, central-level MOLSS officials are reportedly making serious efforts to educate migrant labourers about their rights through their branches and through quasi-government organisations, such as the ACFTU, the CEC, and the All-China Women’s Federation (ACWF).42

Over the past few years, MOLSS has become increasingly forthright about problems with labour conditions; a report released in September this year partially blames inadequate wages and sweatshop conditions for the recent labour shortage.43 In 2003, MOLSS launched a campaign to assist migrant workers by distributing the *Manual of Protection of Labourers’ Rights* and establishing hotlines for complaints. On December 1, 2004, they announced a two-month inspection drive to combat wage defaults.44

The active participation of local labour bureaux in central MOLSS initiatives is doubted by many. However, according to an expert from the Guangdong Textile Association, the stricter requirements for production required by international buyers are having an effect on the behaviour of some local labour officials. He described the previous method of inspection as “one eye open and one eye shut” as officials would give advance notice to factory management. He claims that Guangdong officials have now begun “cross-district” inspections, in which officials inspect factories in districts other than their own without prior notification.45 Such improved practices are still rare.

**State Administration of Work Safety (SAWS)**

According to one Western observer of labour issues, SAWS is “very forward thinking”, “open”, “responsive”, “interested in new ideas”, and “highly praised”. Another observer focusing on Southern China noted a stark improvement in HSE enforcement, possibly because work safety problems are more difficult to hide and can be monitored with a “checklist”.

The statements of SAWS officials in the media and their interaction with NGOs do indicate that SAWS is comparatively open about the problems it faces. At a conference on work safety for migrant workers co-hosted by SAWS, Beijing-based NGOs, and Hong Kong Oxfam, Mr. Zhao Tiechui, a deputy director at SAWS, said that mainland China had more

42 An example of the relationships between government branches is a ‘pact’ that was signed between the Beijing municipal Bureau of Labour and Social Security, Construction Commission, Judicial Department, Trade Union, and Women’s Federation and their counterparts from Heilongjiang Province in October 2004. The agreement created a framework for protecting “the legal rights of migrant workers from the province in order to tackle the capital’s labour shortage.” This example illustrates increasing efforts at protecting migrant workers; the independence of departments at administrative levels (the pact was signed by individual departments); the lack of a nationwide framework for protecting migrants and the inability of the central MOLSS to institute one. “Beijing, Heilongjiang sign labour pact,” *China Daily*, 14 October 2004.


incidences of workplace-induced illness than any other country. More specifically, he stated that 50,000 cases of workplace poisonings are recorded annually and migrant workers are particularly prone to accidents due to long working hours and lack of education on work safety: “the awareness is not low—there is no awareness at all.” He also conceded that law enforcement was weak and that the “intertwined” relationships between local governments and enterprises complicate the problem. 46

The young agency, created in 2001, is tasked with improving occupational safety and reducing workplace accidents, which their statistics estimate resulted in 98,809 deaths during the first nine months of 2004. 47 Despite SAWS’ apparent activism, it is limited by its status in the government hierarchy: its lead administrator was recently promoted to full ministerial rank, but its authority is still weaker than other ministries. Although workplace safety in the textile and garment industries falls under their purview, SAWS is much more focused on coal mining and traffic accidents, as they respectively accounted for well over three-quarters of those deaths. Consequently, one Chinese interviewee felt that they have very little relevance for the textile industry.

Relevant Quasi-Governmental Organisations

There are a number of quasi-governmental organisations that were founded by the state and which rely on the government to varying degrees for their status and budget. The ACFTU, the ACWF, the All-China Youth Federation (ACYF), and the CEC are all increasingly focusing on issues such as corporate social responsibility, labour conditions, and the rights of migrant workers. Each of these organisations is involved in related pilot projects with international donors, NGOs, and/or multinational corporations, in addition to some of their own initiatives that have been carried out through their broad networks.

When set against the scale of the labour issues across China, it is unlikely that their projects have made significant impacts on workplace conditions; however, as their experience grows and projects expand, this may change. More importantly at this time, their status as quasi-governmental institutions reflects both a greater political openness and commitment towards labour issues and represents a source of pressure on other government agencies to act that is recognised as legitimate by the central government.

Of particular importance to labour conditions is the ACFTU, which is described in more detail below.

Legal Requirements for Health, Safety, and Labour Conditions

National Legislation

National legislation pertaining to labour conditions and HSE is straightforward and promises a relatively high level of standards. 48 The most important pieces of national legislation include the National Labour Law, covering labour standards, and the 2002 Production Safety

48 Some actors have asserted that standards are unrealistic for many enterprises to attain at current levels of development and are therefore not taken seriously.
Law, which deals with work safety issues. There are also a number of other national laws, regulations and rules, as well as provincial and local regulations.

The National Labour Law is a comprehensive piece of legislation created in 1994 as the government faced increasing levels of employment outside of the state sector and the dismantling of the “iron rice bowl” system. Among other things, it places clear and reasonable limits on working hours and mandates health coverage and leave for situations such as maternity and marriage. MOLSS is primarily tasked with enforcing the Labour Law, but its ability to do so is weak. Key problems include:

- Flaws in the *hukou* system of residential permits effectively force migrant workers to remain outside of the legal system at the mercy of their employers (see below), and therefore unprotected under this law. Although this situation is now improving in some areas, migrant workers are still frequently unaware of their entitlements under the law and lack the capacity to seek enforcement. Most do not seek labour contracts with employers and are left without recourse to hold employers accountable.

- Article 39 of the Labour Law states that if an enterprise “cannot follow [the hour restrictions stipulated] in Article 36 and Article 38 of this Law due to its special production nature, it may adopt other rules on working hours and rest with the approval of the labour administrative department.” Local government approval is apparently not difficult to obtain.

- Factory managers are often inexperienced and poorly educated; many lack awareness of their obligations under the law.

- According to a Beijing-based MOLSS official, there are many “gaps”, especially related to social security and HSE that were intended to be addressed by provincial and/or local “rules”. Local administrations often do not have the resources to provide social services to the large numbers of migrants entering their territories, do not feel that it is their responsibility to do so, and/or deliberately favour employers.

- The Labour Law allows for “probation” periods of up to six months, after which workers can be dismissed without having a fixed term contract.

- Minimum wages can vary across large municipalities and within provinces. According to Articles 48 and 49, they are determined by provincial or municipal governments taking into account “The lowest living expenses of labourers themselves and the average family members they support; the average wage level of the society as a whole; labour productivity; the situation of employment; and the different levels of economic development between regions.”

The Work Safety Law broadly covers a number of aspects of work safety, including mandating that the appropriate administrative body under the State Council, SAWS, develop specific standards for work safety and monitor their implementation. The law also declares that the state will strengthen related propaganda, encourage and support research, and reward “remarkable success in improving work safety conditions.” Production units are required to
provide education and training courses and all units should have occupational injury and social insurance for employees.

According to Article 19, production units not dealing with dangerous materials that have over 300 employees must set up a work safety control organ or assign full-time work safety controllers. If a production unit has fewer than 300 employees it should hire full- or part-time work safety controllers or hire appropriate technologists. Article 7 stipulates that trade unions should “organise employees to participate in production and operation units’ democratic management and supervision over work safety, and maintain employees’ lawful rights and interests in work safety.” According to a study by Impactt, a social consultancy, some factories have had difficulty with implementation due to lack of experience. It is also likely that many are simply not bothering to implement it or are half-heartedly appointing committees or personnel that are then not held accountable for performance.49

Social Insurance Regulations
In China, there are considered to be five basic types of social insurance: pension, unemployment, maternity, medical, and work injury. Only one—work injury insurance—has been included in a nationwide law: the 2002 Law of Occupational Disease Prevention and Treatment. This law stipulates that all employers are required to pay an insurance premium on all employees, regardless of whether they are on long- or short-term contracts. It was an immense step towards mandating improved protection for migrants, but currently many employers collude with inspectors or falsify documents to pay premiums covering only a percentage of their workforce.

Analysis of Labour Conditions
There have been a number of well-researched and thorough descriptions of labour conditions in the Chinese garment industry, relying on extensive interviews, on-site investigations and programmatic experience.50 Although the anecdotal evidence they cite is widely accepted by Western buyers and government officials, NGO representatives, and the media, reliable statistical figures and estimates of the financial impact of these factors are lacking.

The major labour conditions described below tend to apply most to foreign invested factories (especially Taiwanese, Korean, and Japanese) and private Chinese SMEs. According to a Shanghai-based Chinese textile factory manager, roughly 80 percent of the companies in the textile and clothing industry near Shanghai are SMEs, and most of these are privately owned or county-level collectives. The industry is therefore difficult to monitor, with competition pushing down margins along with labour conditions.

Officials from local labour bureaux are frequently more concerned with attracting investors or buyers and often offer exemptions from social insurance requirements and other regulations as explicit incentives to potential investors. Lax enforcement also follows as factory managers actively cultivate friendly relationships with labour officials.

50 In addition to interviews, media reports, and other reports, the Impactt study cited above and “Labour Standards in China, the Business and Investment Challenge,” published by the Association for Sustainable & Responsible Investment in Asia, December 2002, were particularly helpful.
Labour Conditions

The following key labour issues are widely acknowledged as being the most serious. According to one NGO interviewee, the issues workers care most about are, in order of importance, excessive overtime, payment in arrears, and dormitory/canteen quality. One interviewee from a multinational felt that workers care most about compensation, as their suppliers experienced much higher turnover when hours were reduced to limit overtime.

- **Excessively Long Hours:** Factories often illegally force migrant workers to work additional unpaid hours either directly or indirectly through production quotas and “per-piece” payment. In other instances, excessive hours may be sanctioned by local governments through Article 39 in the National Labour Law as described above. The state media and SAWS have admitted that this is a serious problem. According to SAWS, 46 percent of workers in the PRD work 14 hours per day, while only 30 percent work eight hours per day.\(^{51}\)

- **Compensation Issues:** The guidelines for determining minimum wages, as described in the National Labour Law section above, are open to interpretation and abuse. They are effectively determined by local government officials and are therefore subject to variation and corruption. Furthermore, these wages are not considered to have kept pace with economic growth: in September 2004, the Guangdong Provincial Federation of Trade Unions released a study revealing that the average monthly salaries of migrant workers in Guangdong have only increased by RMB 68 over the past 12 years.\(^{52}\) Dr. Liu Kaiming, of the Shenzhen-based Institute of Contemporary Observation, has pointed out that during the same period, the price index increased by 300 percent.

In many cases, migrant workers are paid legal and fair wages “on the books” that are then in effect diluted by unpaid overtime and convoluted fine systems that dock pay for minor errors or “offences” such as leaving production to use the toilet. Migrant workers often do not understand the complicated company formulas for determining their wages and typically do not receive other forms of compensation or entitlements, such as holiday, sick leave, or health insurance.

Another important compensation issue is payment in arrears. Migrant workers in every industry are subject to this method of control: they are often owed back pay, which they would be unable to collect if they were to leave their positions. According to the Guangdong Provincial Trade Union survey cited above, workers in 73 of 100 factories investigated did not receive payment on time. Payment in arrears is recognised as a serious issue by the highest level of the central government: Vice Premier Zeng Peiyan announced in August 2004 that over US$ 43 billion in unpaid wages were owed to migrant workers. The central government announced a three-year campaign to combat this problem in 2004, though officials admit that its success depends on the development of reliable legal mechanisms for enforcement, which has yet to occur.\(^{53}\)

---

\(^{51}\) It is unclear how SAWS produced this figure and it is likely that it is not accurate. However, the fact that the government is openly admitting to such a high proportion of overtime workers is significant. Josephine Ma, “Despite a decline in job-related deaths, many labourers face grave dangers,” *South China Morning Post*, 19 June 2004.

\(^{52}\) People’s Daily, 19 September 2004.

• **Dormitory and Canteen Issues:** Major complaints among workers relate to poor food and cramped living conditions. Employers frequently charge workers for room and board at rates above fair market prices, provide low quality fare, and subtract fees directly from their pay.

• **Poor Health and Safety:** As discussed in the section describing SAWS above, poor standards for health and safety are widely acknowledged. The financial savings for employers resulting from lax enforcement is unclear. They are cutting costs by not purchasing or maintaining adequate safety equipment, neglecting training for workers or managers, and saving in management hours. One representative from a major Western buyer noted that their inspectors have observed that even when factories have invested in appropriate equipment it is often simply not used. This points to low levels of training and awareness that may or may not be translating to a cost advantage.

• **Restrictions on Freedom of Movement and Abusive Treatment:** Migrant workers are frequently abused and various methods are used to control their freedom of movement, resulting in longer hours on the job. Typical methods include housing workers in monitored dormitories, threatening dismissal, holding identity papers and monetary deposits, and holding payment in arrears.

• **Poor Communication between Workers and Management, Discrimination:** Managers often do not know how to communicate with workers due to lack of education and management skills or low Mandarin language levels among migrant workers. Factories normally lack systems for facilitating such communication. Pervasive discrimination and condescension against workers from rural areas further complicates the relationship between managers and workers.

• **Lack of Freedom of Association:** This is a key issue of contention often cited by foreign actors as a major barrier to improved labour standards. It is discussed in detail below.

**Migrant Workers / Hukou Issues**

Migrant workers face significant social and systemic discrimination that has effectively kept the majority of them outside of the official employment system, thus denying them government protection and access to social services. They are often looked down upon by people raised in urban environments, who view them as inferior and blame them for crime.

The hukou system requires all residents of China to hold a hukou, or residential permit, and people are only legally permitted to work or entitled to social services in areas for the location of their hukou. This is a barrier to migration from rural to urban areas and an added hardship for workers seeking employment. Upon arrival in some cities, migrants were forced to pay exorbitant fees for temporary hukous—often this money is paid by the factories and then withheld from the workers’ salaries. Alternatively, some workers are unable to obtain permits and, living in fear that they will be arrested and/or abused by the authorities, cannot

---

54 The majority of garment workers are young, female migrant workers.
seek legal protection against their employers. The extent to which this is still the case is unclear.

Since at least 2001, the central government has been issuing directives to lower-level governments to take measures to protect the rights of migrant workers and integrate them into the official employment system. Central government messages were intensified after the transfer of power to Hu Jintao and Wen Jiabao in 2002 and following the much publicised beating to death of a student mistaken for a migrant worker in Guangzhou in 2003. The central government, including the State Council and the Beijing, Shanghai, and Guangdong branches of MOLSS, ACFTU, and ACWF have been attempting to protect migrants and provide them with healthcare and education for their children; however, the situation outside of major municipalities remain uncertain. Although these efforts are either newly implemented or in development, growing numbers of complaints by migrant workers to authorities concerning abuse may indicate that the atmosphere is changing for the better in some areas: in the first half of 2004, the Shenzhen government received over 41,000 petitions concerning poor labour conditions, an increase of 13.6 percent from the same period in 2003.

Factory Management

Often underestimated in the media, the lack of management capacity negatively impacts working conditions and HSE. Local management are often poorly educated and have not had training on appropriate working conditions, HSE issues, and management skills that would improve their capacity to manage a workforce without labour violations. Representatives of multinationals working with suppliers or contractors often complain that local management simply do not understand the need for HSE standards. Management training projects such as the China Training Initiative by Business for Social Responsibility, a US-based NGO, have been operating in garment factories, but impact so far has been inconclusive. One challenge that they have noted is the relatively high-rate of turnover among factory managers themselves.

Factory management also faces intense pressure from buyers to produce on tight deadlines at the lowest possible cost. Foreign efforts to force them to improve labour standards are often viewed as trade barriers, creating resistance to compliance. Many also do not believe the “business case” for improved conditions and social responsibility, and accuse advocates of hypocrisy. Competition makes compliance exceptionally painful for the countless small companies, so many of them feel justified in not complying.

---


57 Chow Chung-yan, “Shenzhen struggles to deal with rising labour disputes: Migrant workers continue to suffer long hours and non-payment by employers,” South China Morning Post, 14 August 2004.
Worker Empowerment

Collective actions by workers, including protests, strikes, and petitions to the government, are growing in number. Although the official media rarely covers worker protests, state media coverage of labour abuses is increasing, undoubtedly raising awareness among the general public and migrant workers themselves. The ACFTU and the ACWF claim to be making efforts to educate workers about their rights and support their entry into the official employment system. However, protesting workers still risk retribution from their employers and/or the local government and officials repeatedly demonstrate their lack of tolerance for collective action.58

All-China Federation of Trade Unions (ACFTU)

Internationally, the Chinese trade union system is much criticised: only trade unions under the official umbrella of the ACFTU are legal. Critics rightfully claim that this is a restriction on association and that workers are not permitted to organise themselves outside of the auspices of the Communist Party. The mandate of the ACFTU leaves its mission unclear as it is dually tasked with representing workers and ensuring that they contribute to development. In the event of a “work stoppage”, the trade union is tasked with being an intermediary, required to “assist the enterprise or institution to restore the normal order of production as soon as possible.”59

There have been some attempts to set up “Health & Safety” committees in lieu of independent unions, but according to the Work Safety Law, worker representation related to work safety is still under the purview of the ACFTU. Some committees have reportedly been successful, but in others the union has asserted its control.

Union representatives are usually appointed and foreign buyers report that factory managers often hire relatives or retired employees to run the union branch, though in some areas they are more closely affiliated with the Communist Party than with management. For these reasons, unions are often corrupt, inept, or not taken seriously. Opinions concerning their intentions and utility among Western multinational and NGO representatives are generally not high.

Despite much corruption within its system, there are ACFTU officials who are genuinely trying to protect the rights of workers, so local trade union chapters could theoretically play an important role despite their lack of independence. At this time, however, these cadres often take care to speak about labour issues as individuals and not as representatives of the trade union. As an institution, the ACFTU has begun to place greater emphasis on protecting the rights of workers through corporate social responsibility and SA8000, despite public comments that corporate social responsibility is partially driven by trader barriers. They have generally increased their rhetoric about workers rights and have even taken the lead—

59 Article 27 of the Trade Union Law of the People’s Republic of China (amended in 2001) reads, “In case of a work stoppage or a go-slow in an enterprise, the trade union shall represent staff and workers in consultation with the enterprise, institution or relevant party, and shall reflect the opinions and demands of staff and workers as well as raise solutions. The enterprise or institution shall strive for a settlement with the reasonable demands made by the staff and workers. The trade union shall strive hard in its task to assist the enterprise or institution to restore the normal order of production as soon as possible.”
possibly reluctantly—in a joint workplace campaign to combat HIV/AIDS in the workplace.\footnote{In November 2004, the ACFTU was the lead organiser to launch a Red Ribbon workplace campaign to combat HIV/AIDS and will be using its network to educate workers about the disease.}

In a purported effort to protect the rights of abused workers, the ACFTU launched a “Million Branch Campaign” a few years ago to increase its reach into private and foreign-invested enterprises, which are required by law to have a workers committee if the workers desire one.\footnote{Under the Trade Union Law of the People’s Republic of China (1950), all trade unions must belong to the ACFTU and “a basic-level trade union committee shall be set up in an enterprise, and institution or a government department with a membership of twenty-five or more.”} Although trade union membership increased, the ACFTU was unable to establish branches in a large number of factories, so in late 2004, its leadership announced that it would blacklist foreign-invested enterprises that refuse to set up unions.\footnote{“Wal-Mart Says It Would Support Unionisation Efforts in Chinese Stores,” \textit{BSR News Monitor}, 24 November 2004.} If local-level union branches take the initiative to protect workers rights, the ACFTU could make a significant difference; however, most interviewees were sceptical.

**Increasing Number of Strikes**

The growing number of strikes and labour unrest is an important concern for the government. Although some of these collective actions affect the textile industry, they should not be mistaken for a sign that local or provincial officials and factory owners are more tolerant to collective action. Protesters are often arrested and convicted in local courts; if courts were to begin ruling in favour of the workers rather than the management, this trend could lead to significant change. Independent lawyers and NGOs are increasingly providing legal aid to workers, including a pending appeal by a Beijing-based lawyer on behalf of five workers imprisoned for their role in a riot at a shoe factory in Guangdong.\footnote{Edward Cody, “In China, Workers Turn Tough,” \textit{Washington Post Foreign Service}, 27 November 2004.} In the immediate term, however, these strikes are unlikely to lead to improved conditions across the industry.

**Civil Society Involvement**

The environment for local and international NGOs has drastically improved over the last few years, but is still far from perfect. The central and some local governments have begun to recognise the value of civil society organisations, especially when they collaborate with the government-organised NGOs, such as the Women’s Federation or the ACFTU. In many localities however, acceptance of NGO involvement is still hampered by local protectionism and fear.

There are three main areas where the government has permitted international and local NGOs to be particularly active in support of migrant workers: health, legal rights, and general support. Marie Stopes International (MSI) and Family Health International (FHI) have been working with suppliers of Nike and Adidas to provide workers with training on health issues such as HIV/AIDS. A number of NGOs, government-organised NGOs and individuals have begun to provide legal assistance to migrant workers, including the Hubei Provincial Legal Aid Centre for Migrant Workers, the Beijing-based Law Maintenance Group for Migrant Women, the Guangdong Women’s Federation Legal Aid Group and Gao Zhisheng.\footnote{Gao Zhisheng, a lawyer from Beijing, is currently representing five migrant workers appealing a conviction for labour-related riots in the Stella International Shoe Factory in Guangdong.} NGOs...
registered under the Women’s Federation and run by female cadres who gained experience and status through the ACWF have set up support programmes for female migrant workers, most notably the Cultural Development Centre for Rural Women in Beijing.

Other organisations, such as Business for Social Responsibility, Hong Kong-based NGOs and the Ethical Trading Initiative, are working on labour rights issues. Such work is often done without the express approval of the government, through multinational sponsors, and/or in conjunction with more “desirable” programmes from the local government point-of-view.

Environmental Performance

The environmental performance of manufacturers includes many of the same issues as labour standards, although there are some differences:

- The implementing body, the State Environmental Protection Administration and its lower level Environmental Protection Bureaux, is admittedly weak and lacks capacity. The central government has come out more forcefully on environmental issues, but was embarrassed when it was revealed that billions of dollars spent to combat pollution in major rivers was wasted through poor local enforcement.
- Environmental laws are generally acknowledged to be comparable to international best practice—in some industries they are believed to be too stringent to be realistic. The Chinese lack quality enforcement, not quality legislation.
- Labour and environmental issues balance economic development with social concerns and state security. With labour issues, the government aims to manage unrest through suppression, rhetoric and improvement to avoid rebellion. With environmental issues, especially related to water scarcity, the government must also balance development and potential social unrest. The desire for economic development encourages lax enforcement to attract investment at the same time as it necessitates the careful maintenance of natural resources. Both severe pollution and the actions that could curtail it—increased prices for resources and the closing of offending facilities—could spark social unrest.
- Production is dispersed among too many small factories. According to the China Chemical Reporter, the lack of consolidation in the dyeing and printing sector, in which most textile-related pollution is concentrated, has resulted in poor environmental performance and outdated production processes.65
- The state media is increasingly exposing environmental malpractice, though there are still limits to what the press can disclose.66
- Domestic and international non-governmental organisations are extremely active in Chinese environmental issues, but they rarely adopt confrontational tactics. With few exceptions, they have not begun to tackle industrial pollution.

State Environmental Protection Administration (SEPA)

Tasked with enforcing all environmental regulations, SEPA was elevated to ministerial rank in 1998, but remains exceptionally weak. SEPA has only 300 central staff and must

66 Kenji Otsuka, from the Institute of Developing Economies, Japan External Trade Organisation, wrote in a draft paper from 2003: “A notification by Propaganda Department of [the Chinese Communist Party] has declared to praise typical successful cases first, and keep secret uneasy solved problems arising from fiscal and technical constraints secret.” [sic] “Critical Review for Multidimensional Governance of Environmental Policy in China.”
coordinate with and support other members of the bureaucracy that may have different objectives.67

An outspoken vice director, Pan Yue, openly describes his agency’s major weakness: local environmental officials often report to the local authorities instead of the central level SEPA and therefore prioritise economic growth over the environment.68 In some cases, local environmental protection bureaux (EPBs) are funded by local governments and must adhere to their policies. Fines collected from polluters are sometimes refunded by the local government through tax breaks.69 In other cases, EPBs depend on the income from fines paid by polluters, creating a perverse incentive for EPBs to keep polluting factories open. Such fines are frequently less than the cost of investing in appropriate solutions, so there is no incentive for factories to improve.70

Disregard of central SEPA mandates can sometimes be exceptionally blatant: environmental disasters are developing along the Yangtze River upstream from the Three Gorges Dam because of lower-level resistance. SEPA revealed in May 2004 that local officials had refused to shut down 206 or 304 small and medium-sized factories that it had been targeted. Of 242 large factories that were ordered to improve their pollution-control facilities, 227 had not complied. The central government promised to spend US$ 4.8 billion to build wastewater-treatment plants and garbage disposal sites in that area, but some of the first facilities completed have been idle as municipal governments and larger factories refuse to bear the cost of operating them.71

Some EPBs are genuinely interested in enforcing regulations; however, one interviewee who works closely with an EPB overseeing the Tianjin Economic Development Area described them as “forward thinking but clueless.” They had some positive initiatives in place, such as incentives to recycle water and an environmental fund in which offenders were given a percentage of their fines back to invest in a solution. She found that they lacked systemised data and analysis necessary for proper environmental management. Data is generally collected only annually to fulfil central level reporting requirements and is unconnected with risk management. Inspections were ad hoc and limited by extreme staff shortages.

SEPA is also leading a new initiative known as “Green GDP”: officials are reportedly developing a method of calculating economic growth that would account for environmental costs. Pilot programmes are slated to begin in 2005.72 There is also some speculation that environmental measures could soon be included in performance indicators for government officials. The results of Green GDP are far from certain, but it could be an indication that SEPA will be leading more progressive policymaking in the future.

Other Relevant Agencies

Although SEPA is the lead agency for environmental issues, much stronger bodies are also supposed to bear some responsibility:

67 The Shanghai EPB has only 300 staff to monitor 20,000 factories. “A Great Wall of Waste,” The Economist, 19 August 2004.
70 An official from the Shanghai EPB stated that it is only permitted to fine a polluting company a maximum of RMB 100,000. “A Great Wall of Waste,” The Economist, 19 August 2004.
• The State Council sets overall policy direction;
• The Ministry of Construction is supposed to oversee water and sewage treatment;
• The Ministry of Water Resources monitors pollution in rivers and lakes and sets the total quotas for pollutants;
• The NDRC can take action such as banning the construction of outdated, uncompetitive, and polluting factories. The NDRC is also responsible for issuing guidance catalogues of cleaner production technologies, techniques, and equipment, according to the Promotion of Cleaner Production Law listed below.

Environmental Legislation
There is a significant amount of legislation covering environmental issues, including national laws, administrative rules and standards, and provincial/local regulations. Because the most significant and controversial aspect of these laws is the lack of enforcement, this analysis does not discuss the laws and regulations in detail. The following is a list of the most relevant pieces of national legislation and applicable rules:

• Discharge Standard of Water Pollutants for Dyeing and Finishing in the Textile Industry (1992) – These standards were set by the National Environmental Protection Bureau (predecessor to SEPA) to “prevent and solve water pollution and promote technical advancement of manufacturing techniques and pollution abatement.”
• Law of the People’s Republic of China on the Prevention and Control of Water Pollution (1984, amended in 1996);
• Notice of Issuance of Technology Measures of Prevention of Waste Water Pollution for Dyeing Industry (2001) – These measures were issued to apply the Law on Water Pollution Prevention and Control to the dyeing industry;
• Environmental Protection Law of the People’s Republic of China (1989);
• Law of the People’s Republic of China on Prevention of Environmental Pollution Caused by Solid Waste (1995);
• Rules on Environmental Administrative Penalty (1999);
• Law of the People’s Republic of China on the Prevention and Control of Atmospheric Pollution (1995, amended in 2000);
• The Water Law of the People’s Republic of China (2002);
• Law of the People’s Republic of China on the Promotion of Cleaner Production (2002).

Power & Energy
The dominant form of energy is coal, contributing to poor air quality in many parts of China. Power prices for industry are fixed by provincial power bureaux above the cost of production (approximately RMB 0.3 per kilowatt-hour) at roughly RMB 0.6-0.7 per kilowatt-hour. This is slightly higher than for consumers (RMB 0.5-0.6 per kilowatt-hour) and significantly lower than for commercial enterprises (around RMB 1 per kilowatt-hour). Although industrial prices are somewhat subsidised by commercial prices, industries are bearing the economic cost of production.\(^\text{73}\)

---

\(^\text{73}\) This is based on interviews with four people in the energy industry and the website of the State Energy Regulatory Commission: www.serc.gov.cn.
They are not, however, bearing the full social or environmental cost of coal use. In an article penned for China Coal Outlook 2004, the Director of the Board of the Shandong Xinwen Coal Field Group Corporation, Lang Qingtian, indicated that coal was undervalued and pollution and mining accidents could be reduced if the costs of compensation, safety equipment, and pollution were factored into the overall price and the additional funds invested in safety precautions.74

Frequent power shortages beginning in the summer of 2002 have impacted production, as well as labour standards. In some cases, power shortages may have hurt labour conditions, as workers are forced to work 24 hours/day to make up for lost production time. In other cases, some observers have suggested that power shortages may have improved conditions by forcing factories to shut down for part of the week.

**Water Pollution and Scarcity**

China is facing a water crisis that some have asserted “threatens global prosperity and social stability.”75 Mainland China has only 2,200 m$^3$ per capita of fresh water resources—less than one quarter of the world’s average. The usable water supply is continuously being depleted by waste and the daily production of approximately 3.7 billion tonnes of sewage, most of which goes untreated into rivers and lakes. Market analysts Frost & Sullivan estimated that treating just half of this waste would require 10,000 new plants costing around US$ 48 billion.76

Despite the water scarcity, the prices of water do not generally reflect the real cost of pumping or the depletion of non-renewable sources. Although prices and amounts of available water vary regionally, prices tend to be 80-90 percent lower than countries with four times more water per capita.77 The actual market value of water is difficult to determine and would vary in areas like Guangdong, rich in water but heavily polluted, and Beijing or Shandong, which have less than half of the level of water availability that the United Nations Environment Programme classifies as “danger level.”78

With little economic incentive to develop waste-water treatment industries or conserve water, most smaller cities do not charge for water treatment services and a majority of cities charge below cost.79 Although unlikely due entirely to pricing, the Chinese Ministry of Water

### Water Prices in December 2003

<table>
<thead>
<tr>
<th>CITY</th>
<th>Industry (¥/m$^3$)</th>
<th>Municipal (¥/m$^3$)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beijing</td>
<td>2.90</td>
<td>2.00</td>
</tr>
<tr>
<td>Shanghai</td>
<td>1.30</td>
<td>1.03</td>
</tr>
<tr>
<td>Jiangsu</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Nanjing</td>
<td>1.80</td>
<td>1.45</td>
</tr>
<tr>
<td>Wuxi</td>
<td>1.70</td>
<td>1.40</td>
</tr>
<tr>
<td>Jiangyin</td>
<td>1.45</td>
<td>1.05</td>
</tr>
<tr>
<td>Yangzhou</td>
<td>1.68</td>
<td>1.40</td>
</tr>
<tr>
<td>Zhejiang</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hangzhou</td>
<td>1.75</td>
<td>1.55</td>
</tr>
<tr>
<td>Ningbo</td>
<td>1.15</td>
<td>1.20</td>
</tr>
<tr>
<td>Shandong</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Jinan</td>
<td>2.10</td>
<td>1.75</td>
</tr>
<tr>
<td>Qingdao</td>
<td>1.35</td>
<td>1.30</td>
</tr>
<tr>
<td>Zibo</td>
<td>0.60</td>
<td>0.60</td>
</tr>
<tr>
<td>Guangdong</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Guangzhou</td>
<td>1.37</td>
<td>0.90</td>
</tr>
<tr>
<td>Shenzhen</td>
<td>1.90</td>
<td>1.50</td>
</tr>
<tr>
<td>Shantou</td>
<td>0.89</td>
<td>1.25</td>
</tr>
<tr>
<td>Foshan</td>
<td>0.96</td>
<td>0.79</td>
</tr>
</tbody>
</table>

Source: Aqua BioTronic.

75 Interview with John McAlister, CEO of Aqua Biotronic, 6 December 2004.
77 Interview with John McAlister.
78 “China Water vision,” and John McAlister
Resources estimates that industrial enterprises in China consume five to ten times more water to produce an equal unit of goods as developed countries consume.\textsuperscript{80}

Having recognised the threat posed to economic development by water scarcity, the central government has begun instructing local water bureaux nationwide to gradually raise prices. The current challenge is to raise the price enough to encourage conservation and foreign investment in facilities, but to keep it low enough to avoid fuelling inflation and a public outcry.\textsuperscript{81} The government did not charge for water at all until 1985, and some observers have suggested that many Chinese still strongly believe that water should be publicly subsidised.\textsuperscript{82} Criticisms of the Beijing government for increasing prices in 2004 do indicated that some academics feel that the cost of water should not be born by consumers.\textsuperscript{83} It is likely that subsidies will continue for some time, despite being unsustainable.

\textsuperscript{83} “Payments for water spout higher,” \textit{Business Daily Update}, 10 June 2004.
SECTION 6 - ANALYSIS OF POST-ATC POLICY & INVESTMENT

Industrial Policy

Adjustment to Post-Quota Environment
The government officials interviewed expressed serious concerns on trade developments after 2005. It seems clear that MOFCOM is eager to end unfair competition practices within the industry in order to avoid trade friction with key trade partners. To this end it has sought to work through the sectoral chambers of commerce to urge the industry to self-regulate. However, the chambers have not been successful in negotiating an agreement on export practices. Partly this is a result of the degree of sectoral liberalisation.

But it is also a reflection of the extent to which the chambers can co-opt only the major industry players in this fragmented market.

The government is considering taking active measures to change the situation, but thus far has not made any concrete progress. MOFCOM is planning to introduce a “Foreign Trade Agent System”, as a way to reduce the increasingly hostile competition amongst Chinese exporters (not only for textiles).

Growth of Domestic Markets as Outlet for Domestic Production
China’s domestic sales of T&C products are often overlooked. However China enjoys a huge and rapidly growing domestic market. Total annual retail sales of clothing products increased by 9.2% in 2003, reaching US$ 63.4 billion. Domestic consumption volumes for home and industrial textiles grew by 10% and 13% respectively in the same year.

Overall the domestic T&C sector accounts for about two thirds of total production. Chinese industry expects this share to increase, even in a quota free environment.

Outward Investment in Less Developed Countries
China is currently a significant outward investor in the textiles and clothing sector in LDC. China’s foreign direct investment in the sector is clearly driven by a desire to access quota-bound markets such as the EU and the US by outsourcing manufacturing to countries that enjoy quota-free or low-tariff access to these markets. If safeguard measures are placed on Chinese products it is likely that Chinese companies will continue to expand capacity in overseas factories.

Upgrading Strategies
Although the government is trying to encourage the adoption of industry upgrading strategies, attempts to move to the high-end of the sector will not be easy. Some garment manufacturers are already attempting to upgrade by developing brands. But brand-building is a difficult and time-consuming process. Thus far, Chinese T&C enterprises have proven themselves effective at producing cheap textiles in bulk, but the fashion segment of the trade is a different ball game. And it is simply not enough for the government to order companies to move up the value chain, particularly in the more competitive market segments such as garments and home textiles.
In innovation and design Chinese T&C enterprises are weak. Therefore, in the short term, the focus of the textile sector in China will continue to be on low-price, high-volume manufacturing.

**Textiles vs. Clothing**

Another development is the migration towards more technology-intensive fabric production such as industrial and other technical fabrics.

Textiles for the home is another segment that will see a surge in domestic sales, due to the increasing levels of home ownership in urban areas, and increased spending on furniture and fittings.

**Fashion, Branding & Design**

China’s wool processing industry is export-oriented. However, until recently, Chinese-made products have captured the lower-end of the market. This will change in the next few years as companies are increasingly concentrating on developing branding strategies, quality improvement and intensive product development.