

Chapter 1

Adjustment Challenges in Textiles and Clothing

Considerable worldwide restructuring is anticipated following the termination of quantitative restrictions at the end of 2004, as agreed under the WTO Agreement on Textiles and Clothing (ATC). This chapter summarises the key adjustment challenges facing these industries with a view to assist governments in establishing a coherent policy and regulatory framework that facilitates the adjustment of the private sector. This multifaceted process involves: supporting the emergence of qualified pools of expertise and the adaptability of the workforce; improving the regulatory environment for essential business services; stimulating collaborative innovation processes in the fields of dissemination and technology transfer; and negotiating improved market access for textile and clothing products, especially eliminating remaining obstacles to the establishment of retail distribution systems and distorting production measures.

Introduction

The scheduled elimination of quantitative restrictions under the World Trade Organization (WTO) Agreement on Textiles and Clothing (ATC) at the end of 2004 is challenging the global sourcing channels that were formed during decades of trade restrictions and entails considerable adjustments for all stakeholders, especially clothing assemblers in remote, low-wage countries.¹ Given the economic importance of these industries for both developed and developing countries, this study examines the process of adjustment in the textile and clothing industries in the post-ATC period with a view to assisting governments in establishing a coherent policy and regulatory framework to facilitate adjustment in the private sector.

The import quotas initially imposed under the Multi-Fibre Arrangement (MFA) contributed to the international fragmentation of the supply chain by accelerating the diversification of supply. This disadvantaged the more efficient and quota-constrained suppliers, many of which subcontracted clothing assembly to low-wage third countries. Hence, the MFA benefited the least competitive suppliers, most of which were located in small developing countries and in least developed countries (LDCs). Aware of their post-ATC vulnerability, the least competitive countries now seek to improve their access to developed country markets so as to minimise the expected hardships. They are particularly anxious about losing export markets to Chinese exporters and are lobbying for expanded product eligibility under the General System of Preferences (GSP) and other preferential programmes, complemented by more liberal rules of origin to qualify for preferential access.

During the decades of MFA-related quotas, the textile industry did not migrate as fast as the clothing industry to developing country locations. In the post-ATC period, there will be no major obstacles to the emergence of high-quality textile capacity and stronger clusters of expertise in developing countries. Moreover, there will be neither quantitative trade restrictions nor MFA-related guaranteed market access to mask the competitive weaknesses of exporting countries. If countries are to maintain an export-led development strategy in textiles and clothing, these weaknesses must be addressed.

The role now played by textile and clothing production in the industrialisation process of developing countries is far more differentiated than it was a generation ago. While low wages can still give developing countries a competitive edge in world markets, quick turnaround times now play a far more crucial role in determining international competitiveness in the fashion-oriented and ever more time-sensitive textile and clothing markets. The comparative advantage of developing countries in the assembly process, *i.e.* low-wage sewing, does not necessarily translate into a comparative advantage in the management of the entire supply chain when all services-related dimensions are considered. Countries that aspire to maintain an export-led strategy in textiles and clothing need to complement their industrial expertise in manufacturing by developing their expertise in the higher value-added segments of the supply chain. This can be done by upgrading domestic skills in design, material sourcing, quality control, logistics and retail distribution.

For developed countries, the post-ATC environment will have varying effects on different segments of the supply chain. Their textile and clothing suppliers will be exposed to greater competitive pressures. They also host the world's fashion and design hubs. Retail groups in developed countries will have greater liberty to source products globally and to accelerate the expansion of their distribution networks worldwide. Moreover, world exports of textile and clothing machinery originate predominantly in developed countries. On balance, developed countries have multifaceted interests in textile and clothing, and their long-term interests are better served by an open and liberal multilateral trading environment.

Although the prime responsibility for adjustment falls on the firms themselves, governments play a supporting role by establishing a coherent policy and regulatory framework. The objective of such a framework should be to strengthen the private sector's capacity to deal with rapid change and growing competition and to capture the trade opportunities created as a result of improved market access. This involves dismantling trade-distorting production measures, improving the regulatory environment for essential business services, supporting the emergence of qualified pools of expertise and the adaptability of the workforce, negotiating improved market access for textile and clothing products, and eliminating the obstacles to the establishment of retail distribution systems in developing countries.

Liberal trade and investment policies play a key role in this adjustment process. They can help to restrain pressure on the price of imported inputs and thus facilitate the emergence of competitive firms that are able to compete on domestic and international markets. However, liberalisation often encounters serious structural obstacles and imposes temporary hardships on certain segments of the economy. Governments can ease the transition by facilitating the redeployment of affected resources to other productive activities without reverting to costly trade protection and subsidisation measures.

A typology of the textile and clothing supply chain

The textile and clothing industries have distinctive characteristics and involve a large and diversified range of activities that employ a varying mix of labour and capital. For the sake of simplicity, the entire supply chain can be presented as four production segments. The structural adjustment pressures or the drivers of change for each of these segments are discussed below.

Natural fibres. The preparation of natural fibres involves various agricultural activities that are influenced by factor endowments, *i.e.* the quality of land and regional climate and the country's agricultural policies. Various natural fibres are used in the production of textiles, *i.e.* cotton, flax, jute, silk, sisal and wool. Two of them involve animal husbandry, *i.e.* silkworms and sheep herding.

Textiles. The preparation of textile products, from either natural or man-made fibres, involves manufacturing activities in which technological innovations have greatly increased the speed of operations and resulted in huge productivity gains. Non-clothing applications of textiles – the so-called “technical textiles” – are now more important than clothing applications and account for the fastest-growing segment of total textile production in developed countries.

Clothing. The preparation of articles of clothing involves manufacturing activities as well. The clothing sector is also referred to as the “apparel” or “garment” sector. The pre-assembly stage involves designing, grading, marking of patterns and cutting of textiles into individual components. It has been revolutionised through the application of computer-aided design (CAD) and computer-assisted methods (CAM) systems. By contrast, the assembly stage remains highly labour-intensive and involves delicate handling and sewing operations that do not lend themselves to automation. Aside from productivity gains attributable to better needles and more secure fabric-holding techniques, sewing techniques remain basically those of a century ago. This industry is almost unique in its low ratio of capital equipment to labour inputs. However, technological progress in telecommunications and transport networks has made it easier for clothing manufacturers to divide the supply chain on an international basis and to perform the assembly stage in low-wage countries.

Retailing. Retailing activities have changed significantly with the blurring of the traditional boundaries between retailers, brand marketers and manufacturers. Retailers are increasingly involved in global sourcing as lead buyers through a wide variety of organisational channels, such as vertical integration, subcontracting and licensing arrangements. The retail stage has also become increasingly concentrated into large, lean retail organisations that are able to exert considerable influence throughout the supply chain.

Adjustment challenges by production segment

Adjustment in natural fibres

In the post-ATC period, world demand for natural fibres will reflect two opposing consumption trends. In clothing applications, the demand for natural fibres is growing, while in non-clothing applications, the demand for man-made fibres is rising. Hence, the demand for natural fibres is unlikely to exceed the average growth rate of around 2% a year achieved in recent years for the consumption of textiles for clothing applications.

In the post-ATC period, the main drivers of adjustment for natural fibres will be related to the migration of textile capacity to some developing countries and the results of ongoing agricultural negotiations and dispute settlement procedures in the WTO.

Migrating demand for natural fibres

Suppliers of natural fibres will have to accompany the migration of textile capacity to the most competitive developing countries, particularly China and India. These two countries are already strong producers of natural fibres. One implication is that a certain share of world demand for natural fibres that has traditionally gone to developed countries will be redirected to developing countries. Therefore, some production shares of natural fibres in developed countries will have to compete on world markets in terms of quality, delivery and price. It is also expected that access conditions to developing countries will take a more prominent place on the trade policy agenda.

Tariff protection for natural fibres is generally much lower than for finished textiles and clothing products. Moreover, textile-producing countries enforce various duty-remission programmes to improve the cost competitiveness of domestic processing industries. Where high tariffs are levied on natural fibres to protect domestic agricultural producers, the brunt of the costs of protection is ultimately borne by domestic processing industries. In developing countries with predominately labour-intensive agricultural production, the reduction of tariffs on fibres may be difficult to justify for policy makers unless there are clear offsetting labour gains in the processing industries. For least developed countries, like Bangladesh, the prospect of losing employment in clothing manufacturing owing to intensified competition on export markets may worry policy makers and reduce the likelihood of downward tariff adjustment in fibres and/or textiles for fear of exacerbating the employment situation.

WTO agricultural negotiations and dispute settlement

Another challenge for natural fibres relates to the outcome of the ongoing WTO multilateral trade negotiations in agriculture. Under the WTO's Agreement on Agriculture, WTO members have undertaken reduction commitments in respect of market access, domestic support and export subsidy. The negotiations are expected to lead to improved commitments in each of these areas.

Cotton is the principal natural fibre used in clothing applications, and domestic support to cotton production is currently the subject of a formal trade dispute under the WTO dispute settlement procedure. The outcome of this dispute may have a significant impact on the cost competitiveness of fibre producers worldwide. The prospect of a WTO package that may include a meaningful reduction in domestic support and export subsidies could force high-cost producers to rationalise production by adopting more efficient production methods or by shifting production to other crops. As the protracted WTO negotiations in agriculture attest, domestic groups are resisting adjustment towards less protected and distorted markets which would otherwise benefit the processing industries and support economic diversification into higher value-added production segments.

Adjustment in the textile industry

The main drivers of adjustment in the textile industry in the post-ATC period are related to: *i*) the migration of textile capacity to developing countries; *ii*) the adoption of up-to-date equipment by producers; *iii*) the fading attractiveness of outward processing

programmes (OPP); and *iv*) the importance of rules of origin to qualify for preferential trade arrangements.

Migration to developing countries

With the imminent demise of the ATC, there will no longer be any trade obstacles to the development of stronger clusters of textile expertise in the most competitive developing countries. The recent surge in China's imports of up-to-date textile and clothing equipment bears witness to this trend and points to what will be the future sources of textile and clothing production and exports.² With modern equipment, Chinese textile suppliers are improving their productivity and are increasingly producing export-quality textiles. The main beneficiaries are the Chinese clothing suppliers which can procure their textile inputs directly from domestic sources and hence meet shorter turnaround delivery requirements. Access to high-quality textiles is considered one of the most important determinants of the competitiveness of clothing suppliers. As a result, the textile industry in developed countries will face intensified competition in both their export and domestic markets. The migration of textile capacity will nevertheless be influenced by objective competitive factors and will be hampered by the presence of distorting domestic measures and weak domestic infrastructure in several developing and least developed countries.³

The textile industry is also undergoing a major reorientation towards non-clothing applications of textiles, *i.e.* technical textiles, which represent the fastest-growing segment of total textile applications. Technical textiles are often defined as those textile materials and products manufactured primarily for their technical and performance properties rather than for their aesthetic or decorative characteristics. They are used in many applications, including furniture, automotive, health and hygiene, transport, construction and environment. The processes involved in producing technical textiles are human- and physical-capital-intensive and, for the moment, concentrated in developed countries. With the transfer of technology and the expansion of knowledge sharing through global university networks, many developing countries have access to the knowledge base that can allow the technical textiles industries to flourish. Whenever major industries shift to or expand production in developing countries, it is only a matter of time for inputs to be produced there as well.

Shrinking productivity gap

During the twentieth century, improved spinning and weaving equipment led to significant productivity gains. The textile industry has become a capital-intensive industry in which up-to-date equipment plays a crucial role in the competitiveness of firms.⁴ Important productivity gains have historically been driven by the symbiotic relationship between competitive textile and clothing industries and a creative textile and clothing machinery (TCM) industry. However, this symbiotic relationship is weakening, as new materials are developed mainly in the chemical industry and new processes are developed in the machinery industry. As a result, the technological competitiveness of textile and clothing firms largely depends on their ability to adopt new products and processes developed outside the textile and clothing industries. Therefore, the major focus of these industries' innovation activities is on technology transfer. With globalised knowledge networks, technology transfer is rapid, and the productivity gap that has differentiated developed and developing countries is expected to shrink since modern equipment can be operated efficiently in the most competitive developing countries.

Throughout the 1980s and the 1990s, the TCM industry in developed countries nevertheless succeeded in maintaining its high share of the world's exports by accompanying the international shift in the demand for capital equipment. The four main exporting countries are Germany, Italy, Japan and Switzerland; together they account for almost two-thirds of industrial countries' exports of machinery. This is due to various factors, including: *i*) industrial consolidation among firms; *ii*) the development of ties between equipment manufacturers in developed and developing countries; *iii*) concentration of production on the high value-added segments of the equipment market; and *iv*) close contacts with equipment users wherever they are located.

Preferential trade arrangements

Trade policies other than MFA-related quotas have also had a major impact on the development of geographical patterns of trade in textiles and clothing. The elimination of import quotas will reduce the attractiveness of outward processing programmes and, conversely, increase the attractiveness of other preferential trade arrangements, such as regional trade arrangements (RTAs) and GSP regimes. The magnitude of economic benefits accruing under these arrangements varies greatly because of their differences in scope and the specificity of the rules of origin that confer preferential access under various arrangements.

The outward processing programmes, or production-sharing programmes, involve the temporary export of textiles or pre-cut fabrics from the OPP-initiator country to low-wage countries for final assembly. The finished articles are then re-imported under preferential provisions. For low-wage countries, the assembly of imported fabrics into clothing is a simple form of industrial activity. OPP eligibility often acts as a booster for these countries' export-oriented strategies by giving them instant access to high-quality inputs and foreign distribution networks. For developed countries, outward processing transactions strengthen the competitive position of domestic suppliers by enabling them to transfer labour-intensive sewing activities to low-wage countries. To make outward processing transactions worthwhile, the cost savings associated with low-wage assembly in offshore centres and tariff reductions must exceed the inherent additional costs of production fragmentation, namely: two-way shipments; longer and larger inventory; and added co-ordination to manage the fragmented supply chain.

Under the MFA-related quota regime, the inherent cost inefficiencies of outward processing transactions were partly masked by the trade-distorting impact of quota allocations. Moreover, outward processing transactions provided a protected market for textiles made in OPP-initiator countries. In 1995, outward processing trade accounted for 15% of the European Union's external trade in textiles; in 1999, it accounted for 24% of total clothing imports by the United States.⁵ Since then, the importance of outward processing trade has considerably diminished in the EU owing to the entry into force of several free trade agreements (FTAs) with neighbouring countries that made OPP almost redundant. In a less pronounced way, the importance of outward processing trade for the United States diminished with the implementation of the North American Free Trade Agreement (NAFTA), but OPP eligibility was expanded under the Trade Development Act of 2000 and outward processing trade accounted for 10.9% of US clothing imports in 2003.

Without the trade-distorting impact of quota allocations, the inherent vulnerability of business models developed under OPP is exposed. On the one hand, outward processing transactions remain economically attractive only if the margin of preferential duty exceeds the difference between the OPP-related cost and the logistical cost incurred for

competitive suppliers.⁶ With distance and time acting as trade barriers, there are no net cost advantages from outward processing transactions involving offshore assembly centres that are either geographically remote from the OPP-initiator country or nearby with poor transport infrastructure.

On the other hand, in certain instances offshore centres will be able to offer lower prices to buyers of clothing products assembled from third-country textiles. This means that the textile industry in OPP-initiator countries will lose its protected OPP textile export markets and will have to adjust to intensified foreign competition in its domestic markets. Moreover, OPP recipients that have gradually developed their expertise are conscious of their vulnerability and are requesting better trade opportunities from developed countries to help them compete with the most competitive suppliers. Most requests concern the negotiation of FTAs with developed countries and/or improved GSP access. In any of those options, improved access will mean more competitive pressure on the domestic textile industry of developed countries.

Trade opportunities under regional trade arrangements

In the post-ATC period, comprehensive RTAs can provide a useful policy framework to underpin the development of a regionally integrated textile and clothing supply chain and to facilitate economic diversification strategies for their members, but they do not necessarily imply competitiveness. While a comprehensive RTA is necessary, it is insufficient to promote trade flows and a qualitative transformation in textile and clothing production. Although production and trade opportunities are created under comprehensive RTAs, certain domestic factors play an instrumental role in reaping trade opportunities. Among these factors are: the ability to attract the right kind of lead retailers, brand marketers and manufacturers; a pre-existing cluster of expertise; a vibrant entrepreneurial environment; and geographical proximity to minimise the transit time of shipments during transport.⁷

Prior to NAFTA, access of Mexican suppliers to US markets was primarily driven by outward processing transactions in which Mexican suppliers merely assembled components imported from the United States. Under NAFTA, the trade rules have changed and all activities of the supply chain, not only sewing, can be performed in Mexico (and in Canada). In the context of NAFTA, Mexico has been able to promote the consolidation of its regional clusters of textile and clothing expertise and to move beyond the simple assembly of imported components, thereby creating backward and forward linkages in the domestic economy. Similarly, the customs union between Turkey and the European Union has paved the way for further integrating the Turkish textile and clothing markets into the larger European markets. However, despite their growing integration with larger regional markets, both Mexico and Turkey are not shielded from the need to adjust to external competitive pressures, as products originating from countries such as China are increasingly competitive in both the EU and NAFTA markets.

Stringent rules of origin for textiles and clothing

Rules of origin (ROOs) are a necessary part of preferential trade arrangements such as GSP in order to ensure that trade preference is granted to products that effectively originate from the beneficiary countries. Similarly, they are a necessary part of FTAs in order to preserve the preferential treatment accorded to member countries and avoid the problem of trade deflection, *i.e.* the entry of imports into the region through the member country whose import tariff is the lowest. There are considerable disparities in the rules of origin applied under various preferential arrangements and in their utilisation rates.⁸

Specific and more stringent rules of origin are often applied for sensitive products, such as textiles and clothing, and make it more difficult for suppliers to ensure the regional content. This creates an incentive for manufacturers to source inputs from regional suppliers and may act as a trade barrier. By limiting the sourcing of inputs from regional partners, ROOs may encourage a vertical integration of the production chain that may not be competitive outside the regional market. A further problem with specific rules of origin is that the determination of regional content for yarns, fabrics and final products that involve multiple components can be so burdensome and costly that suppliers prefer not to use the preferential arrangements.

Several countries have recently improved their GSP regimes by broadening the scope of eligible textile and clothing products and/or offering comprehensive duty-free and quota-free treatment for products originating from the least developed countries.⁹ While rules of origin are necessary to ensure that preferential trade actually benefits its targeted countries, overly restrictive rules may inhibit meaningful access and lead to under-utilisation of preferential access schemes. By contrast, liberal rules of origin may not benefit the targeted countries as much as intended, and the associated preferential access can invert the tariff structure and create problems for national manufacturers. Moreover, liberal rules of origin do not necessarily confer competitiveness. Inherent competitive factors explain why certain beneficiary countries of preferential arrangements are more likely to gain the most. Both distance between trading partners, which entails long transit periods for shipments, and the size of the cluster of expertise in beneficiary countries seem to matter. Finally, the identity of foreign investors also appears to influence the patterns of input procurement.

The recent modifications to the Canadian GSP regime offer interesting lessons. In 2003, Canada granted duty-free and quota-free entry to all textile and clothing imports originating from LDCs that meet the requirement that 25% of content originates from any LDCs, GSP beneficiaries or Canada. Four main issues are worth noting: *i*) the liberal rules of origin, with the right to group LDC or GSP beneficiaries, have allowed LDCs to drastically boost their clothing exports to Canada within a very short period of time; *ii*) this improved access has enabled many LDCs to expand their exports, although the gains were concentrated in two beneficiary countries, Bangladesh and Cambodia; *iii*) large trade gains also accrued to the largest developing countries, such as China and India, which shipped textiles to LDCs that were subsequently assembled into clothing products and then exported to Canada; and *iv*) duty-free treatment of clothing products inverted the tariff structure and created problems for Canadian manufacturers who claimed unfair competition. Instead of backtracking on its liberal commitments, Canada announced a series of new tariff cuts in early 2004 to address the problems caused by inverted tariff protection and, simultaneously, launched a programme designed to improve production efficiency of Canadian suppliers. One important lesson to draw from the Canadian experience is that the implementation of liberal rules of origin requires a comprehensive approach to ensure that the domestic processing industry also benefits from the trade liberalisation programmes.

With the imminent elimination of the ATC, the small developing countries and LDCs are increasingly vocal about their post-ATC vulnerability and are demanding access to developed country markets on an improved preferential basis as a way to compete more effectively with China and India. Recognising that there is at present virtually no production of high-quality textiles in LDCs, preferential access arrangements in favour of LDCs must take into account that they have to use competitive textiles originating from third countries to compete on export markets. Under these circumstances, it seems

inevitable that in providing LDCs with preferential access, there will be some collateral benefits for suppliers of high-quality textiles. In the post-ATC period, provisions on rules of origin will be at the forefront of the trade policy agenda as demands from vulnerable offshore centres become more insistent. The challenge for policy makers in developed countries is to draft rules of origin for their preferential arrangements that will mainly benefit LDCs and small developing countries, which are most vulnerable to competition from the large and integrated suppliers in China and India. In addition, improvements concerning rules of origin under preferential trade arrangements will increase the competitive pressures on the domestic textile industry of developed countries.

Adjustment in the clothing industry

The main drivers of adjustment in the clothing industry in the post-ATC period are related to: *i*) the importance of time factors as determinants of international competitiveness; and *ii*) the adjustment in trade protection and WTO safeguard measures.

Time factors as determinants of international competitiveness

The role now played by textile and clothing production in the industrialisation process of developing countries is far more differentiated than it was a generation ago. While low wages can still give developing countries a competitive edge in world markets, time factors now play a far more crucial role in determining international competitiveness. With the imminent end of quantitative restrictions, several low-wage countries that had excelled as offshore assembly centres owing to their quota allocations find themselves vulnerable because of the inherent cost disadvantage of their business model based on production fragmentation. Time factors can be an important trade barrier for intermediary inputs involved in an internationally fragmented production process. There are trade-offs between low-wage cost and time factors, since temporal proximity to large consumer markets provides a competitive edge in the highly competitive, time-sensitive and fashion-oriented clothing market.

Moreover, the emergence of more competitive and integrated suppliers in China is exerting considerable pressure on such vulnerable offshore centres to shift domestic capacity towards more advanced processes and to diversify their economic activities. The comparative advantage of developing countries in the assembly process, *i.e.* in low-wage sewing, does not necessarily translate into a comparative advantage in the management of the entire supply chain when all services-related dimensions are taken into consideration. Efficiency in managing the entire supply chain is required, including in design, fabric procurement, logistical skills in transport, quality control, property rights protection, export financing and clearing of trade formalities.

To move beyond the assembly of imported inputs and along the supply chain into more advanced activities, exporting countries need to shift their expertise from manufacturing to services-related activities, such as design, materials sourcing, quality control, logistics and retail distribution. To pursue these avenues, national suppliers need to place greater emphasis on education and training of services-related skills and to encourage the establishment of joint structures through which domestic suppliers can share market knowledge and offer more integrated solutions to prospective buyers.

Efficient port infrastructure, reliable and competitive modes of transport and efficient customs procedures are also extremely important for maintaining an edge in the highly competitive textile and clothing markets. Reliable transport infrastructure and efficient customs procedures complement each other to minimise transit time for shipments involved in international trade and can make geographically remote locations more

internationally competitive. Even if long transit times can be overcome to some extent by preferential market access arrangements, long periods in transit can essentially eliminate from international competition the offshore centres that are either geographically remote from the buyer's markets or nearby but with poor transport infrastructure.

Adjustment in trade protection

As noted earlier, access to high-quality textiles is considered one of the most important determinants of competitiveness for clothing suppliers. Therefore, high tariffs on textile inputs undermine the efforts of clothing suppliers to shift their production mix to goods that require imported high-quality textiles. Policy makers are often confronted with a policy dilemma when deciding which segments of the supply chain should be exposed to greater competition from imports to favour the processing sectors and ultimately consumers. On the one hand, textile suppliers will argue that they need protection to reach critical mass and compete on more equal terms with foreign textile suppliers. On the other hand, clothing suppliers will argue that duty-free access for their inputs is needed if they are to compete with imported clothing products. Various duty-remission programmes can help to reduce the impact of high tariffs on textile inputs, particularly when there is no domestic production of specific textile components. Each country thus needs to assess its competitive strengths and weaknesses along the supply chain, and to balance its tariffs so that tariff protection granted to fibres and textiles does not prevent the emergence of competitive suppliers in the high value-added segments of the supply chain.

India's potential

In India, the textile and clothing industries are based on a system of decentralised production, referred to as "reservation of garment manufacture for small-scale industry (SSI)" which provides certain economic advantages to small-scale labour-intensive firms, with high tariff protection throughout the supply chain, from natural and man-made fibres to textile and clothing products. Policy analysts have argued that the SSI framework has discouraged entrepreneurs from investing in optimal scale production plants and has created strong vested interests that are opposed to reforms. They have also argued that India faces formidable domestic hurdles if it is to meet international quality standards and thus is ill prepared to take advantage of the opportunities created by the elimination of quantitative restrictions. Mindful of all this, the Indian government has recently reduced import duties and is seeking to rationalise the imposition of the value-added tax across the textile and clothing supply chain. India's valuable assets for success in the post-ATC period include the domestic availability of several natural fibres, clusters of expertise in man-made fibres, low wages in manufacturing sectors, an increasingly affluent and educated middle class and a large domestic market. To unleash India's great potential, reforms are needed to remove domestic obstacles to growth and to inject a strong dose of import competition to encourage the modernisation of its production capacity. The case of India underscores the need for all vulnerable countries to assess and address their domestic competitive weaknesses if they want to pursue an export-led strategy in textiles and clothing.

WTO safeguard measures

The post-ATC situation has generated considerable anxiety about the emergence of more competitive suppliers in China. The potential disruption of markets in importing countries is also recognised in the WTO Protocol on the accession of China. The Protocol contains a transitional product-specific safeguard mechanism (Article 16) that enables

WTO members to restrict imports originating in China when such imports cause or threaten to cause market disruption to domestic producers of textile and clothing products. This transitional safeguard provision is valid for a period of 12 years after China's accession (or by December 2013). The WTO Report of the Working Party on the Accession of China (paragraph 242) also contains a textile safeguard provision that enables WTO members to restrict imports from China when they believe that imports of textile and clothing products of Chinese origin are, owing to market disruption, threatening to impede the orderly development of trade in these products. China's textile safeguard provision is valid until the end of December 2008. Otherwise, WTO members can apply temporary protection to products and sectors that are seriously injured by import competition. The implementation of this general safeguard measure is subject to a number of procedural provisions, including the determination of serious injury, consultations with affected trading partners and, potentially, the payment of offsetting compensation to aggrieved partners. Under the WTO Anti-dumping Agreement, members also can take action against dumping and may impose extra import duty on the particular product from the particular country in order to remove the dumping margin and hence the injury to the domestic industry in the importing country.

Whether or not WTO members will frequently invoke the WTO transitional safeguard provision, China's textile safeguard provision, the general safeguard provision or anti-dumping measures in the post-ATC period remains an open question. The United States invoked China's textile safeguard provision in December 2003 and, following consultations with China, restrained Chinese imports of knit fabrics, dressing gowns and brassieres for a period of 12 months. According to the US International Trade Commission (ITC),¹⁰ the WTO transitional safeguard provision creates an element of uncertainty regarding the capacity of Chinese exporters to access foreign markets, and the risk involved in sourcing from a single country will encourage buyers to diversify their sourcing networks among other low-cost alternatives to China. This diversification of imports will be influenced by competitive cost factors in other supplying countries which are themselves affected by market access opportunities offered under regional and preferential trade arrangements.

The potential in emerging economies

The demand for clothing products in developed countries is influenced by underlying changes in demography, disposable income and a growing tendency towards more relaxed and leisure wear, brand-name products and fashion wear. However, consumers in developed countries are spending a declining share of their disposable income on textile and clothing products. With the maturing of markets in developed countries, the opportunities for fastest growth in consumption are likely to be in the emerging and newly industrialised economies (NIEs). This underscores the importance of market access to developing countries in general and large emerging economies in particular.

For the overwhelming majority of developed and developing countries, average applied tariff protection on textiles and clothing remains high compared to average tariffs imposed on manufactured products.¹¹ In developed countries, there are considerable differences in the level of tariffs applied on textiles and clothing and in the recurrence of tariff peaks. In developing and least developed countries, there are similar imbalances. It is worth noting that in 2002 the tariffs imposed on textiles and clothing in China were roughly equivalent to the average tariffs applied by OECD countries and were thus considerably lower than in some OECD countries, such as Mexico, which is a large net exporter of clothing products. In the WTO, all of China's tariffs are bound, and most

bound rates at the end of the implementation period will be much lower than the tariffs applied in 2002. This means that China is effectively reducing its tariff protection over the period. In other developing and least developed countries, high tariff protection remains the norm. Given their concerns about competition from China, they are, for the time being, reluctant to commit to tariff reductions in the ongoing multilateral trade negotiations. Therefore, the prospects of improving south-south trade in textiles and clothing are not promising. In terms of expanding north-south trade, the export interests of developed countries may be better served by seeking improved access to the retail distribution systems of developing countries.

Adjustment in retail distribution

The drivers of adjustment in retail distribution in the post-ATC period are related to: *i)* the leadership role played by large retail groups and brand-name marketers; *ii)* the importance of private codes of conduct and market knowledge; and *iii)* access to retail distribution in emerging economies.

Leadership role of large retail groups and brand-name marketers

Retail distribution is increasingly dominated by large retail organisations in the main consuming countries, where the trend is towards greater product specialisation, brand-name products and market segmentation. The large retail groups and brand-name marketers are also expanding their successful distribution models worldwide. These large retail groups collect market information about the latest trends in styles and tastes, and their integration of this information gives them considerable leverage in dealing with suppliers. Nevertheless, offshore suppliers can benefit from working in close co-operation with large retail groups and brand-name marketers as they learn to: *i)* manufacture quality products; *ii)* apply the buyer's codes of conduct; and *iii)* deliver products in a timely fashion. The development of business relationships between national clusters of expertise and the large retail groups and brand-name marketers plays an instrumental role in facilitating the qualitative transformation of the supply chain by facilitating backward and forward linkages in the local economy. For exporting countries seeking to develop their export-led strategies, nurturing contacts between domestic clusters and the large retail groups and brand-name marketers is a must.

Codes of conduct and market knowledge

Retail groups and brand-name marketers invest handsomely in building distinctive corporate images and in maintaining recognition of brand names. Through fear of tarnishing their reputation or losing the market knowledge that underpins their capacity to sell at premium prices, they are very careful to select suppliers that will protect their market knowledge and will not let their names be associated with exploitative working conditions. Hence, foreign suppliers that guarantee to protect market knowledge and implement the buyer's code of conduct have a competitive edge over other attractive business proposals that do not provide the same level of guarantee, even if they offer lower prices. In this respect, strong enforcement of intellectual property laws and private codes of conduct are considered assets for countries that aspire to maintain an export-led strategy in the upper market segment of clothing products. It also means that non-cost factors are becoming increasingly important in the supply chain, because buying decisions are not based exclusively on price competitiveness, particularly for brand-name and eco-labelled products.

Retail distribution in emerging economies

The large retail groups and brand-name marketers in textiles and clothing are expanding their distribution networks and pursuing business opportunities in countries with attractive growth prospects. In most developed countries, the establishment of retail distribution services is not hindered by restrictions on foreign ownership or obstacles to the right of establishment. Although the large retail groups and brand-name marketers are predominantly headquartered in developed countries and owned by developed countries' interests, some leading manufacturers in Hong Kong (China) have launched their brand names and are entering retail distribution. This strategic move requires services-related expertise in design, marketing, retailing, financing and the gathering of market intelligence on foreign markets. It also requires foreign direct investment (FDI) flows originating from Hong Kong (China) or from other emerging economies that are pursuing similar diversification strategies. In the absence of restrictions on FDI or limitations on access to retail distribution in developed countries, it is only a matter of time before retail distribution chains owned and controlled by Asian interests operate in developed countries and compete head to head with established large or small retail distributors.

In developing countries, access to retail distribution systems is less predictable. In China, as of December 2004, foreign retailing services will have the right to set up distribution networks without geographical and quantitative restrictions through wholly owned foreign enterprises, thereby offering considerable retailing opportunities in this large consumer market. Anecdotal sources estimate that the size of the Chinese affluent middle class is around 80-100 million people, or roughly equivalent to the combined populations of France and the United Kingdom. In India, another country with significant potential, foreign FDI in retailing is not allowed, and India has so far made no commitments under the General Agreement on Trade in Services (GATS) in respect of retail distribution services. Although the commercial presence of some large groups is currently increasing in India, these operations mainly facilitate the sourcing of Indian products for export. In the context of the Doha Development Agenda, countries have an opportunity to improve access for wholly owned foreign distribution services to developing countries that still maintain obstacles to FDI and/or restrict the right to distribute foreign-made goods.

Policy challenges

Trade policy measures have had a major impact on production, trade and investment decisions in the past. Their influence will lessen in the near future with the elimination of the quantitative restrictions that are probably the most restrictive of all trade instruments. As noted throughout this chapter, tariff reductions, preferential access under GSP regimes or regional trade arrangements and access to foreign retail distribution systems will remain on the policy agenda of trade policy makers in the post-ATC environment. To facilitate the process of sound structural adjustment in textile and clothing, governments can play a supporting role by establishing a coherent policy and regulatory framework that complements the competition-enhancing trade policy framework. Labour adjustment policies, technology and innovation policies, and other policy and regulatory dimensions, referred to as business facilitation, can play a complementary role in this process of structural adjustment. The salient points of these policy dimensions are summarised below.

Trade-related labour adjustment policies

It is difficult to isolate the causes of worker displacement. Technological change, productivity gains, increased import competition and shifts in production can all contribute to job losses. The difficulty has led many policy analysts to oppose targeted labour market adjustment policies and programmes for special groups of workers, *e.g.* workers who lose their jobs owing to increased imports, and instead propose broad labour adjustment programmes for all displaced workers. This issue is likely to remain prominent in the foreseeable future with the intensification of international relations among countries.

Available evidence on the impact of globalisation and international trade on labour adjustment suggests that workers who lose their jobs as a result of increased imports or shifts in production do not appear to be different from other dislocated workers. Similarly, their adjustment process does not seem to differ significantly. Trade-related dislocations may suggest the need for labour market adjustment policies and programmes but not necessarily a special response. An analysis of the characteristics of displaced workers from the textile and clothing industries shows that they tend to have a low level of education and low skill levels (thus earn low wages), and are predominantly women and minorities (including minority women). These characteristics make it more difficult for such workers to adjust to changes in the labour market.

In place of the debate over special *versus* general labour market adjustment policies and programmes, more effort needs to be directed towards determining which interventions are more effective. Most developed countries are attempting to improve the co-ordination of their unemployment benefits and employment services.

In most developed countries, unemployment insurance programmes are designed to assist all unemployed workers, regardless of industry, worker demographics or cause of displacement. The most significant exception to this general framework is the targeted Trade Adjustment Assistance (TAA) programme in the United States which provides assistance to workers displaced because of competition from imports and shifts in production. In most other developed countries, more comprehensive and generous labour market adjustment programmes tend to lessen the need for special programmes for workers from a specific industry or whose job loss can be traced to a specific cause.

There has been increasing reliance on training as part of the toolbox of labour market adjustment programmes. Many workers exiting traditional low-wage manufacturing industries lack basic language and mathematics skills, and this prevents them from acquiring the skills needed for the new jobs being created. The shift in the structure of the labour market in developed countries has also resulted in a gap between the skills workers needed in previous jobs and those required by future jobs. Governments are employing various subsidies and tax incentives to encourage training and skill enhancement.

The main goal of any labour adjustment programme should be re-employment: either by returning to one's previous job or finding a new job as soon as possible and with minimal disruption in earnings. With that objective in mind, countries have implemented various programmes to train workers and provide job search assistance. The recent introduction of "wage insurance" in Germany and the United States encourages workers to return to work as soon as possible. Wage insurance is designed for workers whose new wage is lower than their previous wage. By subsidising some portion of the difference between the new and previous wages, it is hoped that workers will be encouraged to take a new job sooner. It is also hoped that new employers will provide the worker with

on-the-job training, which has proven to be more effective and cheaper than government-financed classroom training. These programmes also aim at minimising the economic and social impact of plant closings on communities. At the outset, the overall labour adjustment policy challenge is to devise ways to meet social goals in a cost-efficient and least trade-distorting manner.

Technology and innovation policies

Different countries have different historical backgrounds in terms of their industrial development and thus differ with respect to optimal policy support for industries such as textiles and clothing. Some general lessons are learned from the examination of experiences with technology and innovation in many developed countries.

There seems to be no fundamental lack of invention and innovation. Hence, it does not seem appropriate for governments to launch large-scale basic research projects on textile and clothing technologies beyond the horizontal industrial research schemes based on public-private co-funding mechanisms. Although the textile and clothing industries can be considered mature, they use technological innovations that are largely generated in other industries, above all in chemicals and machinery. These suppliers of technology are well able to provide product and process innovations for textiles and clothing without financial support from public research programmes. While governments may stimulate collaborative innovation processes in the areas of dissemination and technology transfer, such approaches should not distort market-oriented innovation programmes.

Technology transfer between suppliers and users plays a pivotal role in the performance of textile and clothing suppliers. It is therefore appropriate for countries to seek to encourage technology transfer. However, to achieve faster productivity and welfare gains, the process of technology transfer could be strengthened by exploiting more efficiently the opportunities offered by modern information and communication technologies for the dissemination of advanced technological knowledge. Complementary public funding would be needed to give innovators financial incentives to pass proprietary technological knowledge to imitating firms.

Many small and medium-sized enterprises (SMEs) often face substantial difficulties for marketing their products, because they lack a widely recognised reputation for high product quality. Governments could support their marketing activities by promoting certification agencies and common brand names. At present, government activities in this area mainly concentrate on sponsoring fairs and exhibitions.

Governments should keep in mind that, in the long run, innovative capacities basically depend on the availability of suitable human capital. Therefore, a sound education and qualification system seems much more important for sustainable technical progress than public innovation programmes. This applies not only to textiles and clothing, but to any industry.

Business facilitation agenda

In the post-ATC period, there will be neither quantitative restrictions nor MFA-related guaranteed market access to mask the vulnerability of textile and clothing suppliers whose international competitiveness is hampered by inefficient domestic regulatory regimes, obsolete infrastructure in essential business services, cumbersome customs procedures and other distorted market structures. All these dimensions are influenced by the policy and regulatory framework set up by governments. From a trade policy perspective, efficiency in the areas of transport, telecommunications and electricity

infrastructure and in customs services is an important determinant of a country's ability to integrate fully the world economy. Achieving greater synergy among the various policy and regulatory areas that affect the competitive position of national firms is, in essence, the purpose of a business facilitation agenda.

Foster a dynamic macroeconomic environment

Above all, the role of government is to pursue a sound and stable macroeconomic environment able to sustain non-inflationary economic growth. There is strong evidence that real economic growth and, in turn, net employment creation are stimulated in an environment of low inflation. The pursuit of sound macroeconomic policies fosters market adjustment to changes in the competitive environment and facilitates the redeployment of affected resources to other productive sectors. The pursuit of a business facilitation agenda complements other government actions at the macroeconomic and microeconomic levels, *i.e.* in trade, labour adjustment and innovation, and brings benefits that go well beyond the textile and clothing industries.

Minimise transit time for shipments

Reliability of transport infrastructure and efficiency in customs procedures complement each other to minimise transit periods for shipments involved in international trade and can make geographically remote locations more internationally competitive. Recognising that they have different geographical positions relative to large consumer regions and different transport options, countries need to assess the logistical costs involved in export markets with a view to: *i)* setting up an efficiency-enhancing environment in port infrastructure; *ii)* strengthening competition conditions in and between transport modes; *iii)* setting up a competition-enhancing environment in various port services; *iv)* addressing the terrorist risks in transport without losing sight of the benefits of frictionless transport systems; and *v)* better integrating the enforcement of national laws and regulations, *e.g.* customs procedures, taxation, sanitary and environment protection, with other service providers in ports.

Modernise customs procedures

In matters concerning the facilitation of international trade, textile and clothing traders are poised to benefit from streamlined border requirements with the dismantling of MFA export permits and related controls in formerly constrained exporting and importing countries. However, the internationally fragmented supply chain remains vulnerable to cumbersome and outdated customs procedures in countries that are less advanced in the implementation of modern customs systems. Export-led strategies suffer when shipments are held up in customs warehouses owing to inefficiencies in customs procedures, especially in countries that rely on imported inputs for a significant share of their production. In dealing with the added emphasis on security and safety, governments should not lose sight of the benefits of smoothly functioning transport and customs clearance systems.

Ensure reliable telecommunications and electricity infrastructures

Reliable and up-to-date telecommunications and electricity infrastructures give textile and clothing suppliers a competitive edge. Trade flows in differentiated products, such as textiles and clothing, are found to be sensitive to international variations in communication costs. Outdated regulatory frameworks in electricity and telecommunications services act as taxes on textile and clothing suppliers and, more importantly, undermine the capacity of national suppliers to focus production on the

higher value-added segments of the supply chain that depend critically on reliable infrastructure to ensure quick market response. In the post-ATC period, the international competitiveness of textile and clothing suppliers will be enhanced in countries that maintain a competitive environment and spur investment in innovative telecommunications equipment, electricity generation and distribution systems.

Nurture SME-related entrepreneurship

It is important to nurture SME-related entrepreneurship, but when excessive fiscal advantages and labour law exemptions are offered to small-scale operations, there is a danger of creating distorting incentives to invest in sub-optimal productive capacity. Recent work by the OECD in the context of the Bologna Charter on SME Policies has found that education and training are the single most effective means of achieving the objective of fostering entrepreneurship in societies.

Notes

1. The WTO ATC superseded the Multi-Fibre Arrangement (MFA) regime of quantitative trade restrictions when it entered into force in January 1995 and provided the multilateral trade framework applicable for trade in textiles and clothing for all WTO members. The ATC provides for the elimination by 31 December 2004 of all forms of quantitative restrictions applied to trade in textile and clothing products, including those that originated under the MFA regime. The ATC phases itself out of existence at the end of 2004.
2. For more details about textile and clothing machinery trade by country, see Figure 4.3 in Chapter 4.
3. For more details about infrastructure, see the section on business facilitation in Chapter 5.
4. For more details about long-term productivity gains, see Figures 4.4a and 4.4b in Chapter 4.
5. WTO, Trade Policy Review of the United States, 2001, Geneva.
6. For more details about OPP-related logistics cost by country, see Table 2.10 in Chapter 2 and Table 5.2 in Chapter 5.
7. For more details, see Box 2.2 in Chapter 2.
8. For more details about the utilisation rates of preferential arrangements, see Tables 2.12 and 2.13 in Chapter 2.
9. For more details about the GSP regimes, see Box 2.1 in Chapter 2.
10. US International Trade Commission (2004), Textiles and Apparel: Assessments of the Competitiveness of Certain Foreign Suppliers to the U.S. Market, Investigation No. 332-448, Washington, DC, February.
11. For tariff information by country, see Tables 2.8 and 2.9 in Chapter 2.

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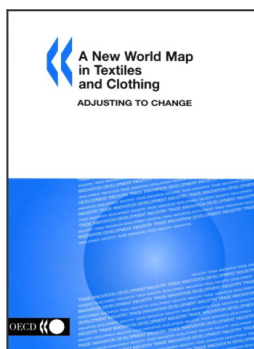
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Acronyms

AGOA	African Growth Opportunity Act (US)
AMS	aggregate measure of support
APEC	Asia-Pacific Economic Cooperation Forum
ASEAN	Association of South-east Asian Nations
ATC	Agreement on Textiles and Clothing (WTO)
ATPDEA	Andean Trade Promotion and Drug Eradication Act (US)
CAD	computer-aided design
CAM	computer-assisted methods
CBTPA	Caribbean Basin Trade Partnership Act (US)
CGE	Computable general equilibrium
CLF	clothing, leather and footwear
CNY	Chinese yuan
CPI	Consumer Price Index (US)
EBA	Everything but Arms (EU)
ECA	European Carpet Association
EFTA	European Free Trade Association
ETAP	European Association for Textile Polyolefins
DDA	Doha Development Agenda
FDI	Foreign Direct Investment
FTA	Free Trade Agreement
FTAA	Free Trade Agreement of the Americas
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GSP	General System of Preferences
GTAP	Global Trade Analysis Project
HS	Harmonised System
IAF	International Apparel Federation
IMO	International Maritime Organisation
IMF	International Monetary Fund
ISPS	International Ship and Port Safety Code

ITC	International Trade Commission
ITMA	International Textile Machinery Association
LDC	least developed countries
LTA	Long-Term Arrangement Regarding International Trade in Cotton Textiles
MFA	Multi-Fibre Arrangement
MFN	Most-favoured nation
NAFTA	North American Free Trade Agreement
NIE	newly industrialised economy
OETH	Observatoire Européen du Textile et de l’Habillement
OPP	outward processing programmes
RCA	revealed comparative advantage
ROOs	Rules of origin
RTA	regional trade arrangement
SAARC	South Asian Association for Regional Cooperation
SMEs	small and medium-sized enterprises
SOE	state-owned enterprise
SOLAS	Convention on the Safety of Life at Sea
SSI	small-scale industry (India)
STA	Short-term Arrangement Regarding International Trade in Textiles
TAA	Trade Adjustment Assistance (US)
TBT	Agreement on Technical Barriers to Trade (WTO)
TCM	textile and clothing machinery
TEU	20 foot equivalent unit
TPL	tariff preference-level provisions
UNCTAD	United Nations Conference on Trade and Development
WIA	Workforce Investment Act (US)
WTO	World Trade Organization



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