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**China's textile and
clothing exports:
changing international
comparative advantage
and its policy implications**

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Abbreviations

ASEAN	Association of Southeast Asian Nations
ATC	Uruguay Round Agreement on Textiles and Clothing
EU	European Union
FTC	foreign trade corporation
GATT	General Agreement on Tariffs and Trade
ITCB	International Bureau of Textiles and Clothing
NAFTA	North American Free Trade Area
NIE	newly industrialising economy
MFA	Multifibre Arrangement
PRC	People's Republic of China
SOE	state-owned enterprise
TVE	township and village enterprise
UNCTAD	United Nations Conference on Trade and Development
US	United States
VER	voluntary export restraint
WTO	World Trade Organisation

Remarkable changes have occurred in world textile and clothing markets in the last two decades. Japan lost its comparative advantage in labour-intensive textiles and clothing in the 1970s, and the Asian newly industrialising economies (NIEs) of Hong Kong, the Republic of Korea, Singapore and Taiwan have also been rapidly shifting away from these products. At the same time, China and several other low-wage economies have emerged as major textile and clothing exporters. China has, in particular, overtaken the NIEs as the world's largest clothing exporter.

In the past few years, China itself has shown signs of export diversification, at the expense of textiles and clothing. Such a rapid structural change raises several questions. Is China losing comparative advantage in textiles and clothing? Does the diversification result from domestic structural change, competition from other exporting economies or import restrictions overseas? What is the proper policy response to the declining importance of textiles and clothing in China's manufactured exports?

This paper examines these questions. In the following section, China's labour-intensive exports are placed in a broad context of the world market and historical trends are analysed. In Section 3, domestic structural change is examined and its effects on China's competitiveness in textiles and clothing are analysed. Demand side issues are discussed in Section 4, with particular attention to the implications for China's textile and clothing exports of the changing trade environment after the conclusion of the Uruguay Round. The potential impact of China's entry into the World Trade Organisation (WTO) will also be discussed. In Section 5, China's textile and clothing quota allocation regime is analysed. The paper concludes with a brief summary of policy implications.

Changing international comparative advantage

China's resurgence as a major textile and clothing exporter has changed the landscape of world textile and clothing trade.¹ In 1950, China was a significant textile exporter, but inward-looking policies under central planning led to gradual erosion of China's market share. China was unable to exploit its vast labour resources by specialising in labour-intensive exports. By 1970, China accounted for less than 14 per cent of total textile exports originating in developing economies, and less than 5 per cent of total clothing exports from developing economies (Table 1). Economic reforms beginning in the late 1970s provided a strong impetus to the sustained growth of textile and clothing exports. By 1988, China's share in the world textile market had peaked, having increased to 22 per cent of total textile exports originating in developing countries, or 7 per cent of world textile exports. As for clothing exports, China's market share has continued to increase. In 1994, China became the world's largest clothing exporter.

As China's exports surged, the dominance of the NIEs in the world textile and clothing markets began to decline. While the growth of the NIEs' share in the world textile market has continued to increase, their share in the world clothing market has dropped sharply. The NIEs accounted for more than 70 per cent of clothing exports originating in developing economies up to the mid-1970s. By 1996, however, this market share had fallen to 18 per cent.

The dramatic decline in the importance of the NIEs in the world clothing market reflects the fact that clothing is more labour-intensive than textiles. As real wages increase and labour skills upgrade, the NIEs have therefore lost much of their comparative advantage in clothing while maintaining it in textiles. Accelerating the process of structural adjustment in the NIEs is the opening up of the Chinese economy which has become attractive to export-oriented foreign direct investment from the NIEs. A large part of the NIEs' clothing production activities has recently moved to China. Rapid expansion of the clothing sector in China and ASEAN has in turn put further pressure on structural adjustment in the NIEs. While clothing exports by Chinese firms funded by foreign investment compete directly with clothing produced in the NIEs, they also generate increased demand for textiles from the NIEs. This induced demand has helped maintain the growth of NIEs' textile exports. In addition, a large proportion of China's textiles and clothing exports continues to be re-exported (some after processing) via Hong Kong. This has facilitated China's access to overseas markets and has benefited Hong Kong's services industries.²

Table 1 Textile and clothing exports by developing economies, 1970–96
(percentage of developing economy total)

	1970	1980	1985	1990	1996
Textiles					
China	13.7	17.1	21.9	21.5	19.4
NIEs ^a	22.5	34.7	35.9	38.8	42.2
ASEAN ^b	3.4	6.9	7.3	9.5	11.5
South Asia ^c	35.8	17.4	14.4	13.6	12.7
Latin America	8.2	9.7	7.9	5.2	5.9
Developing economies (US\$ bn.)	2.2	14.1	16.7	37.0	62.7
World (US\$ bn.)	12.1	53.9	52.3	104.0	142.1
Clothing					
China	4.8	10.1	15.0	26.6	27.8
NIEs ^a	75.8	60.9	55.1	34.1	18.2
ASEAN ^b	2.5	7.4	8.2	13.0	14.5
South Asia ^c	2.9	4.9	6.6	8.3	12.6
Latin America	4.8	6.5	3.6	4.0	9.3
Developing economies (US\$ bn.)	1.5	16.5	24.8	62.1	89.8
World (US\$ bn.)	5.7	38.2	46.5	109.7	157.4

Notes: Data before 1988 are not strictly comparable with those from 1988 onward. This is because pre-1988 export data for China are calculated as the sum of imports from its trade partners, whereas from 1988 onward the data are based on official Chinese statistics. Because of China's large re-exports via Hong Kong, the pre-1988 data presented in the table involve double counting of China's re-exports and include value added to re-exports in Hong Kong.

^a Includes Hong Kong, Republic of Korea and Taiwan.

^b Includes Indonesia, Malaysia, Thailand, Singapore and the Philippines.

^c Includes Bangladesh, India, Nepal, Sri Lanka and Pakistan.

Sources: United Nations COMTRADE and the Chinese Customs statistics, International Economic Databank, The Australian National University.

China is not the only economy which has exerted adjustment pressure on the NIEs. With the help of FDI from the NIEs and other regions, textile and clothing exports from ASEAN and South Asia have also surged in recent years. Between 1970 and 1996, ASEAN's share in textile exports from developing economies more than tripled, while its share in clothing increased nearly five fold (Table 1). South Asia was a significant exporter of textiles in the 1950s. In fact, India was such a significant exporter that it became one of the few developing economies whose exports were targeted by import restrictions in industrial economies (Keesing and Wolf 1980). In contrast with the NIEs, however, India and other South Asian economies were unable to expand or maintain their market share, largely due to inward-looking policies in the past. With economic reform in recent years, however, South Asia has recaptured part of its lost market. By 1996, South Asia had already overtaken ASEAN as the world's third largest textile exporter, with its clothing exports catching up to those from the ASEAN economies (Table 1). At the current rate of growth, South Asian exports are poised to overtake ASEAN clothing exports in the near future.³

It is clear that the world textile and clothing sector is relocating itself rapidly. In the 1950s and 1960s, the sector was mainly shifting from developed economies to developing economies. In the last two decades or so, the most remarkable relocation seems to have occurred among developing economies, especially in Asia. The market share lost by the NIEs has been entirely captured by China, ASEAN and South Asia. This occurred in a period of about two decades, but most of the shift occurred from the mid-1980s when China's exports began to surge dramatically. China is clearly ahead of South Asia in textile and clothing exports and is at a similar stage of development to some of the less developed ASEAN economies, namely Indonesia and the Philippines. It is, however, slightly behind the more developed members of ASEAN—Malaysia and Thailand. Vietnam, one of the newest members of ASEAN, is at a similar stage to South Asia.

With more developing economies entering world textile and clothing markets, the division of labour among them seems to have deepened as competition becomes more intense. The income gaps between China and the NIEs were much larger when China began to replace the NIEs in the world clothing market than the current gaps between China and the South Asian economies. This means that economies at similar stages of development and with similar resource endowments will have to produce more differentiated products than was the case two decades ago. As a result, an economy may have strong comparative advantage in textiles but not in clothing, or *vice versa*. Similarly, an economy may be competitive in products made of certain fibres but not of others. China has in the past been very competitive in cotton textiles, but that may soon change as the domestic cotton prices go up and the relative prices of synthetic fibres decline as tariffs begin to fall. The South Asian economies have become China's strongest competitor for cotton textiles. China's export specialisation in textiles has fallen significantly since the early 1980s, while South Asia's concentration on textile exports, especially those made of cotton, has increased steadily since the early 1990s (Table 2).

With trade barriers falling in many developing economies, trade among them is expanding rapidly, especially in East Asia. A decade ago, there was hardly any trade between China, on the one hand, and the Republic of Korea and Taiwan on the other. Now, however, they are major trading partners. These developments will certainly accelerate structural adjustment in Asia, and China in particular, as its dominance in the world textile and clothing market is being challenged.

Managing such structural adjustment is a major task for China. Unlike the Asian NIEs, China has a much greater problem with unemployment than the NIEs had when they moved from textiles and clothing to other exports. China needs strong growth of labour-intensive industries to absorb its massive labour surplus in rural areas and unemployment in urban areas. This is made particularly difficult, however, by the rigidities and underdevelopment of labour markets and the current financial difficulties facing state-owned enterprises (SOEs). These issues will be discussed further in the following section.

Table 2 Indices of export specialisation^a, 1965–96

	1965	1970	1975	1980	1985	1990	1996
Textiles							
China	3.9	4.1	4.3	4.8	4.5	3.7	2.8
NIEs ^b	3.1	2.8	3.7	3.5	2.7	2.8	3.4
ASEAN ^c	0.3	0.3	0.4	0.5	0.6	0.8	0.8
South Asia ^d	6.0	6.2	5.8	7.5	5.9	5.9	6.1
Latin America	0.1	0.2	0.4	0.5	0.5	0.5	0.5
Developing countries	0.9	0.9	0.8	0.9	1.3	1.6	1.7
Clothing							
China	2.0	2.0	2.4	4.7	5.2	5.8	5.2
NIEs ^b	15.2	13.3	14.2	10.1	6.8	4.0	1.9
ASEAN ^c	0.3	0.3	0.6	0.9	1.1	1.7	1.2
South Asia ^d	0.4	0.7	1.9	3.5	4.6	5.7	7.7
Latin America	0.1	0.2	0.3	0.5	0.3	0.6	1.0
Developing countries	0.9	1.3	1.4	1.5	2.2	2.5	2.2

Notes: Data before 1988 are not strictly comparable with those from 1988 onward. This is because pre-1988 export data for China are calculated as the sum of imports from its trade partners, whereas from 1988 onward the data are based on official Chinese statistics. Because of China's large re-exports via Hong Kong, the pre-1988 data presented in the table involve double counting of China's re-exports and include value added to re-exports in Hong Kong.

^a Defined as the ratio of the share of a commodity (in this case textile or clothing) in an economy's total exports to the share of that economy's total exports in global exports. This index is also known as 'revealed comparative advantage' from Balassa (1965).

^b Includes Hong Kong, Republic of Korea and Taiwan.

^c Includes Indonesia, Malaysia, Thailand, Singapore and the Philippines.

^d Includes Bangladesh, India, Nepal, Sri Lanka and Pakistan.

Source: United Nations COMTRADE and the Chinese Customs statistics, International Economic Databank, The Australian National University.

Changing structure of production and exports

Textiles and clothing have been the spearhead of China's industrialisation. China's modern textile industry already had a considerable capacity before the Communists took power in 1949. Although the industry was not given any priority in development under central planning, like all other light industries, it grew quite rapidly. Nevertheless, its importance in the industrial sector was declining (Table 3). Its share in industrial output has continued to decline after the reform even though light industry has since been given greater development priority. This is primarily because textiles are relatively income-inelastic in the domestic market and import restrictions in industrial economies have curtailed China's export expansion. These restrictions may have even greater impact on China's textile and clothing sector in the near future as the MFA quotas for WTO members are being phased out as part of the Uruguay Round Agreement (Zhong and Yang 1999).

According to official statistics, the share of clothing in industrial output has increased in recent years. The increase between 1992 and 1994 was especially marked. However, this may be due to a statistical error in the *Statistical Yearbook of China 1995* or to an increase in the statistical coverage of output. China's clothing output was 68.2 billion yuan in 1992, and it increased to 144.2 billion yuan in 1994, a 111 per cent increase in nominal terms in two years. Even taking into account considerable inflation during the period (ex-factory prices for clothing increased by 18 per cent and 16 per cent in 1993 and 1994, respectively), the increase still seems to be too large to be true. This is also inconsistent with the data presented in Tables 4 and 7 below. Between 1992–94, township and village enterprises (TVEs) accounted for about half of China's total clothing production, but the share of clothing in TVE industrial output was falling. This implies that the clothing output of state and other enterprises would have increased enormously given the increase in the share of clothing in national industrial output from 1992 to 1994.

Table 3 Textiles and clothing in industrial output^a and manufactured exports, 1986–94 (per cent)

	1986	1988	1990	1992	1994	1996
Output						
Textiles	12.3	11.8	12.3	10.5	9.6	7.5
Clothing	2.0	2.0	2.2	2.5	2.8	2.8
Textiles and Clothing	14.3	13.8	14.5	12.9	12.4	10.3
Manufactured exports						
Textiles	23.8	20.4	15.8	12.6	11.7	9.5
Clothing	29.1	20.5	21.1	24.9	23.8	19.6
Textiles and Clothing	52.9	40.9	36.9	37.5	34.5	29.1

Notes: ^a Independent accounting enterprises only.

Source: China Statistical Yearbook, various volumes, and United Nations COMTRADE, International Economic Databank, The Australian National University.

Whether the share of clothing in industrial output has increased or not, it is unambiguous that the combined importance of textiles and clothing in China's total manufactured exports has declined significantly since the mid-1980s (Table 3). In the eight years from 1986-96, the combined share of textiles and clothing in manufactured exports fell by 45 per cent. It should be noted that not only did the share of textiles fall, but also that of clothing, even though the latter declined more slowly. This is a strong indication that China's exports are diversifying and its reliance on textiles and clothing is diminishing rapidly.

Until recently, China's textile and clothing industries had been dominated by the state sector. With the freeing up of the rural economy, township and village enterprises⁴ began to play an increasingly important role in the textile and clothing industries (Table 4). In the eight years from 1986 to 1994, their share in national textile and clothing output more than tripled. By 1996, TVEs accounted for 61 per cent of total textile output and 98 per cent of clothing output. As TVEs grew more rapidly than other sectors on average, they contributed the bulk of incremental output during the period 1986-94 (Table 4).

There are several reasons why TVEs have grown more rapidly than SOEs. First, wage costs in rural China are generally considerably lower than in urban China where most SOEs are located. Given the labour-intensive nature of textiles and clothing, this gives TVEs a considerable cost advantage. TVEs are more flexible in their wage policies. In the past they have attracted a large number of skilled workers at salaries higher than the SOEs would pay. Upon retiring from SOEs, a lot of skilled workers have taken up employment with TVEs. Second, TVEs are more accountable for their own management. In contrast, their state counterparts often face a 'soft budget' and tend to lack incentives to improve efficiency. Finally, TVEs are more responsive to market conditions. They are more adaptive and innovative in meeting market demand.⁵

Table 4 Town and village enterprises in national industrial output (per cent)

Share of township and village industry in total output						
Year	1986	1988	1990	1992	1994	1996
Industry	17.7	21.9	23.4	28.6	36.5	56.6
Textiles	18.6	24.3	26.2	35.2	42.1	60.8
Clothing	27.9	35.4	40.8	49.6	53.9	98.3
Share of township and village industry in total incremental output						
Year	1988-86	1988-90	1990-92	1992-94	1994-96	
Industry	37.4	52.9	43.4	60.7	87.9	
Textiles	64.7	130.2	66.9	76.1	n.a.	
Clothing	67.3	75.3	65.2	61.0	161.2	

Note: n.a.: not applicable. From 1994 to 1996, national output of textiles fell, while TVE output rose. This makes it impossible to calculate the contribution of TVEs to incremental output during the period.

Source: *China Statistical Yearbook*, various volumes.

Because of these qualities, TVEs have become dominant in China's labour-intensive manufactured exports (Table 5). For example, 90 per cent of China's clothing exports in 1992 were produced by TVEs. The share of TVEs in textile and clothing exports is likely to have increased in the past four years, but comparable statistics are not available. Overall, TVEs produced more than one-third of China's total exports in 1992. By 1997, this share had increased to 36.4 per cent (Editorial Board of ACTE 1998).

China's experience of export expansion by small enterprises is not unique. In the Asian NIEs and ASEAN economies, small and medium-sized enterprises have all played an important role in their export-oriented growth. What is more unique about China is that rural enterprises dominate China's small enterprises. There is a large number of collective enterprises in urban China, but they are heavily influenced by the structure of SOEs and are often less flexible than rural enterprises. Nevertheless, they are also concentrated in the clothing industry and are normally more competitive than SOEs.

Rural and urban collectives are likely to provide even greater competition for SOEs in the future, especially in the clothing industry. The high labour intensity and simple technology of this industry is well suited to small and medium-sized enterprises. The textile industry is more capital-intensive, exhibits economies of scale and requires more sophisticated technology, and, consequently, large enterprises have certain cost advantages in this industry. These cost advantages, however, can easily be outweighed by inefficiencies in management. In particular, large SOEs tend to be over-staffed and have low rates of capital utilisation. This has led to the recent wave of plant closures and massive lay-offs in the textile industry. Protests against these lay-offs by textile workers are widespread.⁶

The policy challenge for China is to level the playing field for all types of enterprises. At present, small enterprises enjoy some tax benefits partly because they often face lower tax rates or greater opportunities for tax evasion. However, they often receive lower priority in

Table 5 Rural industry exports, 1988–92 (percentage of national exports)

Commodity	1988	1989	1990	1991	1992
Clothing	49.6	65.2	72.0	77.5	89.7
Handcrafts	39.0	43.1	45.0	52.0	63.7
Chemicals	23.6	36.3	27.3	31.5	53.2
Silk	21.4	25.1	24.3	33.7	54.0
Other light manufactures	19.3	22.8	28.5	38.7	53.9
Textiles	16.4	19.2	21.9	25.0	–
Machinery	16.2	19.6	21.8	23.8	–
Minerals	13.6	15.9	15.8	–	–
Food	27.1	19.3	15.5	–	–
Other farm products	16.3	9.2	10.4	–	–
Others	32.7	61.1	24.5	–	–
Total	–	–	–	29.7	32.4

Source: Editorial Board of ACTE, *Almanac of China's Township Enterprises*, various years, Agriculture Press, Beijing.

government policy, have more restricted access to the state-controlled banking sector and to the supply of raw materials. The SOEs, on the other hand, have a greater social security burden, often having to provide housing, medicare and pension to their current and former employees. Greater efficiency can be achieved if policy incentives become non-discriminatory. Both factor and commodity markets need to be further integrated to allow all types of enterprises to have equal access to capital, labour and raw materials. Tax and other policies should apply across the board. In fact, the traditional practice of treating TVEs differently from SOEs should be abolished. As the rural and urban economies become increasingly integrated, such a practice is out of date and creates costly distortions in economic incentives.

With further reform, China will probably see substantial structural adjustment in its textile and clothing industries among different types of enterprises. Small and medium-sized clothing enterprises, both in rural and urban areas should expand relative to large enterprises. Textile industries will be consolidated to allow economies of scale to be exploited. If the program of state enterprise reform succeeds, China's large textile enterprises may gain competitiveness vis-à-vis TVEs. However, the timing of state enterprise reform will also be important. Continued delays in reform may see SOEs being replaced by more competitive forms of enterprises before they are reformed.

China's textile and clothing production is heavily concentrated in the coastal regions. Exports are even more concentrated (Table 6). Jiangsu, Zhejiang and Guangdong take the lead in the export drive. The top 8 provinces together accounted for about 90 per cent of total TVE textile and clothing exports. The geographical concentration of textile and clothing exports is higher than the average for all commodities, but follows a similar pattern.

With rapid economic growth over the past two decades wages have risen considerably in some of these provinces, drawing large migration from inland areas despite government restrictions on migration. At the same time, rental costs for land are also increasing and exerting pressure for production facilities to move west. The soaring costs have led to diversification of production activities. The share of textiles in total TVE exports has declined sharply since the early 1990s (Table 7). The slowing down of the growth of textile exports in the TVE sector is consistent with the overall decline in the share of these commodities in national manufactured exports, as shown earlier. In contrast, the more labour-intensive clothing exports continue to increase their share in total TVE exports. Whether the trend can be maintained in the future depends critically on labour market policy.

Labour and land costs vary greatly across regions in China. They have increased most rapidly in the coastal regions and are much higher there than in inland regions. Given the large pools of the unemployed and underemployed in most coastal regions it will take a considerable time before an overall shortage of unskilled labour emerges in these regions. However, there are some areas where industrialisation has proceeded so rapidly that labour shortages have already appeared. To protect local wages, some local governments have been trying to prevent immigration from other regions. This is not in the interests of the country, nor is it in the interests of the regions which restrict immigration, especially in the long run.

Household registration has been a major constraint on migration, although the system now has less sway over the rural population. A number of other policies have also hindered effective use of migrant resources in urban area; migrants are seldom eligible for public housing, medicare, and education;⁷ there are still restrictions on employment of rural migrants in SOEs, regulations are also imposed on where migrants may live in urban areas, and some cities collect tolls on migrants.

China should further relax migration control and reduce the costs of migration from the west to the east. This will keep production costs low for both agriculture and industry in the coastal regions. Migrants from inland regions often replace local farmers in agricultural activities. Local farmers have been reluctant to relinquish their right to arable land because they want to keep land as their last resort in case of any policy backlash against reform. This has resulted in declines in

Table 6 Share of the top eight provinces in total exports of township enterprises, 1987–94 (per cent)

	1987	1990	1992	1994	1997
Textiles					
Jiangsu	43	40	53	57	41
Zhejiang	17	20	18	18	15
Guangdong	2	4	5	7	6
Shandong	7	4	3	6	15
Fujian	1	1	1	2	3
Shanghai	14	18	11	0	8
Liaoning	1	1	1	1	1
Hebei	1	0	0	0	3
Share of top 8	86	88	91	92	92
Clothing					
Jiangsu	16	17	23	25	16
Zhejiang	4	12	15	22	18
Guangdong	1	3	3	5	4
Shandong	16	12	11	17	24
Fujian	3	7	8	9	8
Shanghai	32	19	14	0	14
Liaoning	4	5	5	4	3
Hebei	3	2	2	2	2
Share of top 8	79	77	81	84	89
All commodities					
Jiangsu	20	22	31	31	23
Zhejiang	10	13	13	15	15
Guangdong	7	9	8	12	11
Shandong	15	10	9	14	10
Fujian	4	6	8	9	9
Shanghai	14	11	9	0	8
Liaoning	4	5	4	4	4
Hebei	5	4	3	3	3
Share of top 8	78	81	85	87	84

Source: Editorial Board of ACTE, *Almanac of China's Township Enterprises*, various years, Agriculture Press, Beijing.

sown areas and land productivity in many coastal areas as the opportunity costs of farming increases (Tian 1999). Migrant workers are willing to accept lower wages as their opportunity costs are much lower. Once migrants are allowed to work on coastal farms, more skilled local workers are able to concentrate on more productive, non-agricultural activities.

An alternative policy for tapping China's vast labour resources is to further improve infrastructure in inland areas. This will not only reduce migration costs if farmers choose to migrate east, but also provide the necessary conditions for indigenous industries to thrive should would-be migrants decide to remain in the west. This may also attract entrepreneurs inland. This trickle-down effect is likely to reduce east-west income inequality which has been growing since the beginning of reforms in the late 1970s. Recent government initiatives seem to move in this direction. However, more than just improvement of physical infrastructure in inland provinces is involved. Since the reform of the late 1970s, inland provinces have had less autonomy in economic management and economic reforms are often first experimented with in the coastal regions. Such reforms often include preferential policies. To accelerate the development of inland provinces, policy biases against them must be removed so that they can compete with coastal regions on an equal footing.

Table 7 Share of textiles and clothing in total township exports, 1987-94 (per cent)

	1987	1990	1992	1994	1997
Output ^a					
Textiles	12.7	13.4	12.8	10.4	8.1
Clothing	3.3	4.2	4.7	4.5	5.3
Textiles and Clothing	16.0	17.6	17.5	14.8	13.4
Exports					
Textiles	19.7	22.7	20.5	18.1	13.1
Clothing	11.0	13.1	15.6	16.2	17.1
Textiles and Clothing	30.7	35.8	36.1	34.3	30.2

Notes: ^aOutput data are from *China Statistical Yearbooks*, except for 1997, for which data are from the *Almanac of China's Township Enterprises*, 1998. The State Statistical Bureau ceased to publish TVE output by industry in the *China Statistical Yearbook* after 1995. The definitions of various industries in the almanac seem to be somewhat broader than those in the yearbook. After examining data for the years prior to 1995 for which both sets of data are available, it appears that the two sets of data are broadly consistent as far as the shares of textiles and clothing in industrial output is concerned.

Source: State Statistical Bureau, *China Statistical Yearbook*, various volumes, China Statistical Publishing House, Beijing, and Editorial Board of ACTE, *Almanac of China's Township Enterprises*, various years, Agriculture Press, Beijing.

MFA quota allocation

Reform of the current regime of MFA quota allocation will greatly increase competition among different regions and enterprises.⁸ China's textile and clothing quota allocation regime has favoured large SOEs in the coastal regions. Normally, only those enterprises which are designated exporters are eligible for quotas. Foreign enterprises and joint ventures were not eligible for quotas until recently (1996), and even this newly acquired eligibility is limited to a very small number of quotas. Township enterprises are allocated quotas only if they are included in state export plans. Despite the abolition of the export plan at the beginning of 1994, most quotas continue to be allocated to the formerly designated exporters.

In contrast to most other countries, quotas are normally not allocated directly to export enterprises, as most enterprises do not have the right to export their products directly. Instead, most quotas are allocated to the China Textile Import and Export Corporation and its provincial counterparts via regional commissions of economic and trade affairs. Foreign trade corporations (FTCs) purchase export products from these enterprises according to the export task and quotas assigned to them. This system enables the FTCs to capture the quota rents.

China's quota allocation is essentially based on past performance with some incentives for product upgrading and diversification and the use of domestic inputs. The question arises whether the quota allocation regime promotes export efficiency. Clearly, administrative discretion plays an important role in China's quota allocation regime. It is likely that this quota allocation process favours large enterprises and SOEs which have greater access to the government departments which are in charge of quota allocation and have traditionally been assigned the task of exporting. It is not clear how other enterprises, especially joint ventures and township enterprises, obtain access to quotas beyond the few limited categories if they have never been assigned the task of exporting. Presumably, with increased autonomy, FTCs with quotas could purchase export supplies from these enterprises as long as they are competitive. Another way of accessing quotas would be subcontracting to enterprises with quotas. Although trading in quotas is illegal, interviews in Chinese factories revealed that it is not uncommon (Lu 1995).

With rapid change in the structure of textile and clothing industry, such a regime seems to be out of date. The relative competitiveness of different types of enterprises has changed fundamentally in the past decade. The competitiveness of different regions is also likely to change. The allocation regime based on past performance disadvantages small and often efficient exporting enterprises. In addition, as more enterprises obtain the right for direct export, such a quota allocation regime will only serve to subsidise FTCs by giving them quotas free of charge.

It is conceivable that the administrative allocation of quotas may result in less than optimal utilisation of quotas even if full utilisation is achieved. 'Picking winners' based on past export performance does not guarantee that the most efficient exporters get sufficient quotas, as large volumes of exports may not mean high value added. Also, high export prices may not be the result of high value added in the process of production. They may be the result of inefficiency so that the producing enterprises have to charge high prices. A better method of allocation would be to auction quotas. If auctions are properly conducted, the most efficient enterprises would obtain

sufficient quotas, whether they were state-owned enterprises or TVEs. If auctions are competitive, marginal returns to a unit of a quota will be equalised across exporters. MOFTEC has been conducting quota auctions on a trial basis since the mid-1980s, but only a tiny fraction of quotas has been auctioned, and those auctioned tend to be the less restricted ones.

Free trade in quotas will further increase export efficiency and quota utilisation. The conditions facing individual enterprises will change over time. In some circumstances, profits will be maximised by selling the quotas instead of using them. This will increase both export efficiency and quota utilisation, because there are incentives to quota holders to sell their quotas if the value of the quotas to them is lower than the market price.

With free trade in quotas, export efficiency can be increased even if quotas are allocated administratively in the first place. To achieve this, the quota market must be competitive so that quota premiums are reflected in the marginal prices of quotas. The legalisation of trade in quotas will increase competition by facilitating transaction transparency and reducing market fragmentation. The government could, in fact, establish a nationwide market for quotas.

Quota rents represent windfall gains to quota holders who obtain them free of charge. The administrative discretion involved in quota allocation encourages rent-seeking activities and can lead to corruption. In addition, FTCs which are allocated quotas may have to share quota rents with overseas importers. Typically, importers will bargain for lower import prices if they know that the exporters have not paid for their quotas (Krishna, Erzan and Tan 1994). Under China's quota allocation regime, quota premiums are not obviously separable from production costs and the United States regards them as part of sellers' prices which form the basis of US tariff collection. In contrast, import duties on Hong Kong exports are collected on the basis of quota premium-exclusive prices as the United States regards quota premiums in Hong Kong as clearly separable from production costs because of free trade in quotas there.⁹

As far as product upgrading is concerned, empirical analyses show that China has succeeded in upgrading its exports to the US market (Yang 1992, Cline 1987, Pelzman 1986). It is difficult, however, to assess to what extent this was due to the quality criterion in quota allocation. Generally, it would be most efficient to auction the quotas and let the enterprises themselves decide on the quality of products they export. If high quality products are indeed more profitable than low quality products, enterprises will move up market, and if they cannot do this because of technical constraints they will have an incentive to sell their quotas to enterprises which can produce higher quality products efficiently. China's own experiments have shown that auctioning quotas tends to accelerate product upgrading. An increase in export prices of more than 20 per cent was achieved when quotas were auctioned during the Guangzhou Trade Fair in 1987. It was reported that the price increases occurred because exporting enterprises had greater incentives to upgrade their products when they had to pay for quotas instead of having them free of charge (Wang 1987). Forced upgrading through quota allocation will likely result in low efficiency and a reduction in national welfare.

The only justification for promoting upgrading and the use of domestically produced fabrics is that there are sufficient externalities in doing so. The regional contribution to the volume of national exports and market diversification to non-restricted products as criteria for rewarding quotas may only be justified if the large exporters are more efficient and there are externalities arising from diversification, such as reduced market risks and long-term expansion of unrestricted products and accumulated market knowledge. If externalities do exist, the more efficient way to promote product upgrading and diversification is not through quota allocation, but through more direct economic incentives, such as government assistance with market information in order to reduce private sector costs. It is self-defeating to reward market diversification with quotas as increases in quotas will reduce the incentive to export to unrestricted markets.

The new international environment

World textile and clothing markets have been the most distorted among manufactured commodities. They have been regulated by consecutive international agreements which contravene GATT principles. These agreements include the Short Term Arrangement regarding Cotton Textiles, the Long Term Arrangement regarding Cotton Textiles and the Arrangement regarding International Trade in Textiles, better known as the Multifibre Arrangement (MFA). They were all aimed at curbing exports of textiles and clothing from developing to developed economies. Although these agreements have not prevented export-oriented economies from exploiting their comparative advantage, as discussed earlier, they did slow down structural adjustment in various industrial economies (Cline 1987).

Phasing out the MFA is a major step towards free trade in textiles and clothing. There are, however, major weaknesses in the Uruguay Round Agreement on Textiles and Clothing (ATC). The long transition time for the phasing out of MFA restrictions over a 10-year period (1 January 1995 – 1 January 2005) has created several problems.

The process of phasing out the MFA is heavily end-loaded, with nearly half of textile and clothing products remaining under quota restrictions until 2004. If importing countries choose first to liberalise products which are not restricted by the MFA, there will be little substantive liberalisation before 2005 (Bagchi 1994, Blokker and Deelstra 1995). In the transition process, a special safeguard mechanism similar to the MFA is available for importing countries to impose quantitative restrictions on products yet to be integrated. In the first few months after the WTO agreements were effected, the United States made 20 'calls' for consultation by invoking the special safeguard provision (UNCTAD 1995a). There is also a fear that when the special safeguard mechanism becomes unavailable after the transition period, importing economies will use other protectionist measures as a substitute for the MFA. Anti-dumping and countervailing are likely to be the favoured instruments.

As quota acceleration is based on the quota growth rates effective on 31 December 1994, initial rates of quota growth are critical in determining the extent of quota enlargement. Existing differences in quota growth rates will lead to greater disparities among exporting economies as

well as to increases in the variations in quota volumes for different products. As sensitive products have lower quota growth rates under bilateral agreements, their relative quota volumes in the transitional period will slip further, creating greater distortions in resource allocation. Yang (1998) reported that the standard deviation of quota volumes across exporters increases by 50 per cent in North America and 57 per cent in the European Union as a result of quota acceleration.

Tariffs on the textile and clothing sector have been much higher than those in other sectors and have been characterised by tariff peaks (above 15 per cent) in industrial markets. Tariffs in developing markets are even higher. Tariffs on textiles and clothing will be reduced as a result of the Uruguay Round, but the extent of the reduction in major industrial markets (except Japan) will be much lower than in other manufactured commodities. For example, the average tariff reduction by the Quad countries is only 22 per cent, making textiles and clothing the only sector that did not fulfil the target of one-third reduction (UNCTAD 1995b).

China has been one of the most severely restricted exporters and its competitiveness in textiles and clothing should improve once the MFA is phased out.¹⁰ There are, however, uncertainties about improved market access as the removal of MFA quotas on China depends on China's status in the WTO. According to the legislation implementing the Uruguay Round in the US and EU, non-WTO members may not be able to benefit from the ATC even if they were members of the former MFA (UNCTAD 1995b). After 13 years of negotiations on China's WTO membership, it is still uncertain when China is to be admitted to the WTO. If it is not a member of the WTO, China may face increasingly discriminatory measures against its exports. Mexico, for example, imposed anti-dumping duties of 54–500 per cent on Chinese textiles and clothing (Moore 1995). China will be forced to rely entirely on bilateral efforts to deal with such trade restrictions so long as it is not a WTO member. Empirical estimates show that China would lose substantially if it is excluded from MFA reform (Zhong and Yang 1999).

Recent changes in the rules of origin concerning textile and clothing imports in the United States are likely to have an adverse effect on China's exports. In accordance with Section 334 of the US Uruguay Round Agreement Act (implementation legislation), changes in the rules of origin (effective on 1 July 1996) will affect a broad range of products (T-shirts, pants, and dresses). The new rules will, in most cases, consider the country of assembly to be the country of origin, and quotas will be charged against this country. Since China relies heavily on processing trade it will be greatly affected by such a change. While WTO members may have access to compensation in accordance with the WTO agreements (including the ATC), it is unlikely that China will be compensated.

Even if China gained WTO membership in the near future, it is possible that China's exports would be subject to discriminatory restrictions under a special safeguard provision which is most likely to be included in the Protocol of Accession of China. As China is considered to be a planned economy with broad government interventions in production and trade, the United States and the EU have insisted on the inclusion in China's Protocol of Accession of a special safeguard provision that would allow other WTO members to impose quantitative restrictions

specifically against China upon the determination of a surge of Chinese imports and serious damage, or threat thereof, to industries in destination markets. Such a mechanism is similar to the safeguard mechanism based on the concept of market disruption contained in the MFA. The proposals by the United States and the EU on the special safeguard provision also contains a mechanism for third countries to have recourse to such measures on the basis that the imposition of restrictions by other countries has resulted in a diversion and surge of China's exports to their markets.

It is likely that such a mechanism would be applied mostly against China's most dynamic exports—labour-intensive products, including textiles and clothing. Furthermore, such a mechanism would be open to use by any member of the WTO, whether developed or developing. Therefore, there is a real possibility that even if China gains early accession to the WTO, it may, nonetheless, continue to face discriminatory restrictions.

Anti-dumping actions are another source of concern for China. By using a third country or reference price in the determination of dumping margins, the actual costs of China's exports are virtually disregarded. Between the late 1980s and 1994, the EU alone has brought at least 179 anti-dumping measures or proceedings against China (Zhong and Yang 1999).

Regionalism and the spread of preferential trade agreements is another concern for China. In the textile sector, several recent developments will further affect China: the formation of the North American Free Trade Area (NAFTA); the enlargement of the EU to include Austria, Sweden and Norway; the EU's preferential agreement with Turkey (a rapidly expanding exporter of textiles and clothing) eliminating all the quota restrictions on Turkey effective on 1 January 1996; and the EU's preferential agreements with Central and Eastern European economies eliminating all quota restrictions on them by 1 January 1998 (ITCB 1995). Sweden abolished MFA quotas in 1991, but its accession to the EU means that this market is under quota restriction again.

Another important recent development is Japan's intention to impose quantitative restrictions on China's textile and clothing exports. Increasing restrictions in the US and EU markets have led to rapid diversification and diversion of Chinese exports to the Japanese market. China's shares in Japan's total imports of textiles and clothing have risen dramatically in recent years, increasing for textiles from 25 per cent in 1992 to 32 per cent in 1994, and for clothing, from 43 per cent in 1992 to 54 per cent in 1994 (WTO 1995). As a result, Japan became China's largest industrial market for textile and clothing exports in 1994.

Rising import competition has aroused increasing calls from Japan's textile industry for import restrictions. Starting October 1994, at the request of the Japanese Government, several rounds of consultations were held between China and Japan on possible 'voluntary export restraints' on a range of textile products by China. On 9 November 1995, the Japanese Government decided that restrictions would not be imposed *for the time being* due to a decline in China's exports of these products to Japan during the period under investigation. Calls for protection of Japanese textile industry have since continued unabated.

This development could have far-reaching implications for China. It means that new grey area agreements against China could spread. South Africa has been negotiating a voluntary export restraint (VER) agreement with China, and both Korea and Taiwan have attempted to

enter into negotiations with China on voluntary restraints on Chinese exports (Reuters Electronic News, 29 January 1996). The WTO is yet to deal with such arrangements involving non-WTO members.

Maintaining the competitive edge

The resurgence of China's textile and clothing exports since its economic reforms of the late 1970s was the result of exploiting its comparative advantage in labour-intensive manufactured exports. After two decades of rapid export expansion, China is now facing the strongest competition ever, resulting largely from evolving international comparative advantage. With rapid capital accumulation, capital-intensive exports are expected to expand rapidly. In addition, a large number of low-wage economies have undertaken reforms and have emerged as dynamic textile and clothing exporters. Less developed ASEAN economies, such as Indonesia and Vietnam and the South Asian economies are likely to pose the strongest challenge to China's current dominance in world textile and clothing markets.

The Chinese economy has shown a strong ability to adapt to market conditions, but this is largely due to thriving TVEs and also enterprises funded by foreign investment. State-owned enterprises have experienced great difficulties in the past, and these difficulties are likely to continue unless profound reforms are undertaken. With increasing competition from township enterprises and foreign exporters, SOEs will require even greater structural adjustment in the future. Without a viable social security system to assist the potentially unemployed, China will face a formidable task in reforming its SOEs. SOEs need to be liberated from their state welfare functions, such as discharging housing, medicare, pension, childcare and many other responsibilities.

The outcome of reforms in the SOEs will also have a profound effect on the export performance of non-state enterprises. In the past, China's macroeconomic policies have been influenced by its policies towards SOEs. China's macroeconomic environment has been plagued by instability created by attempts to ensure the survival of SOEs. As the state sector shrinks, the welfare of the Chinese people will be increasingly determined by the non-state sectors. Government policy should be based not just on the welfare of the state sector, but on all sectors of the economy.

Despite recent diversification, China's exports are dominated by labour-intensive manufactures. Competitive wages are essential for continued export expansion. This is especially true for the coastal regions where both wages and land prices are on the rise. Given the existence of vast surplus labour in inland provinces, it is in China's national interest to allow migration from the inland to coastal regions. Recent government initiatives to level the playing field for the inland provinces are moving in the right direction and should have favourable effects on the inland region. However, as the sources of most of China's labour-intensive manufactured exports are concentrated in coastal regions, it is important to allow west-east migration in order to maintain China's export momentum while the inland provinces are developing into major exporters.

The reform of the current quota allocation system is particularly important for increased competition among different enterprises and regions. The present system allows too much room for administrative discretion and rent-seeking. An auction system would increase the efficiency of quota use and enable the Government to obtain quota rents and reduce the chances of quota transfer to overseas importers. Thus, free trade in quotas will bring further economic benefits.

The structural adjustment of China's textile and clothing industries will have to occur in a changing external environment. The phasing out of the MFA will not increase China's price competitiveness if China is unable to join the WTO. If China's MFA quotas are removed, it will largely benefit the non-state sectors. The state sector, however, will lose the protection of quotas and hence face greater competition. Furthermore, China is likely to face a daunting task if it has to fight anti-dumping and countervailing charges in industrial economies, yet such restrictions may well substitute for MFA quotas, if demands for protection in these economies continue.

Whatever happens in the world market, China must press ahead with its own reforms in order to improve the efficiency of its textile and clothing industries. Past experience shows that Chinese exporters, like those in the NIEs, have been able to penetrate the industrial market, despite severe restrictions. In addition, the Asian region itself will provide an expanding market in the long run, despite the current economic difficulties in the regions. The challenge for China is to remain competitive and to maximise market access through early accession to the WTO.

Notes

1 See Anderson (1992) for a broader review of changing comparative advantage in world fibre, textile and clothing markets.

2 See Sung (1991) for an comprehensive analysis of Hong Kong's role in China's export drive.

3 It is not clear yet how the Asian Crisis, which began in mid 1997, will affect textile and clothing exports from various Asian developing economies. While overall production has suffered enormously in the worst-affected economies, exports from these economies will have to expand rapidly when recovery is under way, in order to repay the expanded foreign debt resulting from currency depreciations. Given the large falls in real wages in these economies following the Crisis, exports of labour-intensive commodities, such as textiles and clothing, may regain some of the growth momentum that was lost in the years immediately prior to the Crisis. This, however, is likely to be transitory.

4 These enterprises probably include those with foreign investment, although this is not clear from the *Almanacs of China's Township Enterprises* or *China Statistical Yearbooks*.

5 Recent press reports suggest that the output of the TVE sector are considerably overstated. It remains valid, however, that TVEs as a whole have preformed better than state-owned enterprises.

6 There were several demonstrations by textile workers in Nanchong, Sichuan Province, Taiyuan, Shanxi Province, and Hefei, Anhui Province earlier in 1997 despite tight restrictions on such activities. In January 1999, hundreds of workers from the Changde Textile Mill in Hunan Province protested against the laying-off of 30 per cent of the mill's workers. The protest caused a three kilometre long traffic jam on a national highway. See *Huaxia Wenzhai (China News Digest)*, No. 408, 22 January 1999.

7 With the ongoing housing reform, it may become less difficult for migrants to find accommodation in urban areas in the future.

8 For more elaborate discussions of China's quota allocation system, see Yang (1995).

9 I am grateful to Roy Delbyck for this piece of information.

10 See Trela and Whalley (1990) and Yang (1994) for assessments of the effect of MFA abolition on China and other economies. Also see Zhong and Yang (1999) for an analysis of the demand side issues facing China in the post-Uruguay Round.

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