



## Textiles and clothing industry in Eastern Europe: pressure following expiry of the quota system

The textiles and clothing industry has a long tradition in the countries of Central and Eastern Europe. German companies in particular began transferring labour-intensive activities to these countries some decades ago to exploit cost advantages. Often this was in the form of so-called outward processing trade, with semi-finished textiles being exported at favourable tariffs from Western to Eastern Europe, where they were made up into finished garments and then re-exported to Western Europe. This led to intensive trade relations between the old EU member states and the new EU entrants and candidate states. As a result, the countries of Eastern Europe as well as North Africa and Turkey are therefore not only among the top suppliers of clothing to Western Europe but also among the top markets for textiles produced in Western Europe (see charts on the right).

These trade relations face tough strains in the coming years. The clothing industry not only in Eastern Europe but also in Turkey and North Africa will come under increasing pressure. Obviously, this holds for a number of countries in Southern Europe, too, where garment manufacture especially still plays an important role today (e.g. Italy, Portugal, Greece). This is due to the expiry of the Agreement on Textiles and Clothing (ATC) at the end of 2004. This liberalisation of world trade has hugely intensified competition on the world market for textiles and clothing. Unlike before, the big Asian producers – especially China – are no longer subject to any volume restrictions on their textiles and clothing exports to the EU (or the US).<sup>1</sup> In future, Eastern Europe's textiles and clothing industry will need to focus more strongly on its specific advantages over the competition from China.

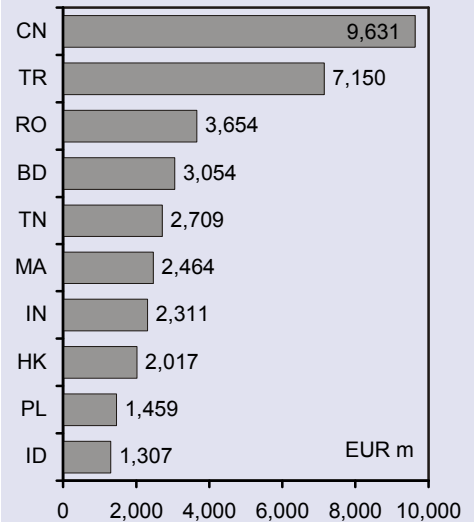
### 1. Importance of the textiles and clothing trade in Eastern Europe

The importance of the textiles and clothing industry in Eastern Europe varies widely from country to country. This depends in the main on how successfully each nation has managed to diversify its industrial structure in the past. Local wage levels are another key factor for the importance of the textiles and clothing sector.

Generally, the whole industry plays a much greater role in Eastern Europe than in Western Europe, and this holds particularly for the clothing industry. This sector has far greater importance especially for the labour market in the countries of Central and Eastern Europe (CEE) than in the old EU member states. According to statistics published by Eurostat the textiles and clothing industry (T&C sector) accounted for a good 7% of total manufacturing employment in the EU-25 (2002, more recent figures are not yet available). The three biggest new EU members were above the EU-25 average: Hungary 12%, Poland 11% and the Czech Republic 9%. But the figures for the Baltic states (between 17% and 24%), Bulgaria (28%) and Romania (24%) are much higher.

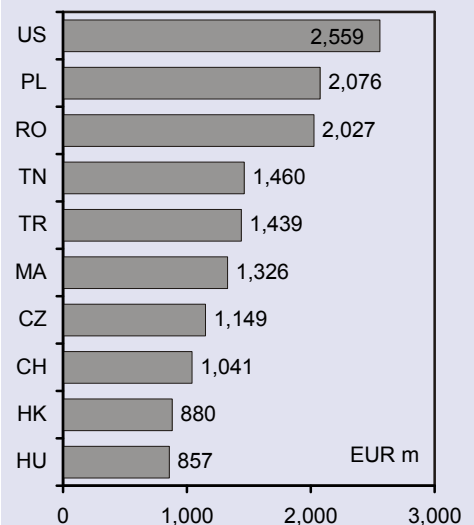
Looking at the T&C sector's share of manufacturing turnover in the CEE countries the differences (in absolute terms) are less pronounced but still significant. The EU-25 average in 2002 was less

TOP 10 EU-15 suppliers in clothing, 2003



Source: Eurostat

TOP-10 EU-15 markets in textiles, 2003



Source: Eurostat

<sup>1</sup> See Heymann, Eric (2005). WTO textile agreement now expired: China maturing into the world's tailor. Deutsche Bank Research, Current Issues, February 14, 2005, Frankfurt am Main.

than 4%. While the core states of Poland, the Czech Republic and Hungary had already converged more or less into line with this level, the figures for Romania, Bulgaria and the Baltic states were still around 9% to 10%. This is largely due to the fact that in recent years Western European firms have been shifting their sourcing more strongly from Poland, Hungary and the Czech Republic into Romania and Bulgaria owing to the lower wage costs there.

Despite the industry's importance in Eastern Europe, the new EU states plus Romania and Bulgaria still accounted for less than 10% of total T&C sector turnover of the (hypothetical) EU-27 in 2002. As is to be expected, the share is higher for clothing than for textiles. The biggest producers of textiles and clothing in Eastern Europe are Poland followed by the Czech Republic, Romania and Hungary. This ranking is also based on the statistics for 2002. In the meantime Romania has rapidly gained ground, however. For some time it has been Western Europe's biggest supplier of clothing in the CEE. Common to all these countries is their high export ratios with a pronounced bias towards Western Europe. Up to 90% of domestic production is exported. According to WTO statistics, textiles and clothing accounted for roughly one-fourth of Romania's and Bulgaria's total exports in 2003. Their relative weight has increased significantly since the mid-1990s. These two countries are far more dependent on the T&C sector than Poland, the Czech Republic or Hungary, where the industry's share of total exports is around 5% and has been steadily declining in recent years. This reflects the broader diversification of the industrial landscape in the big three new EU member states.

**Sharp falls in production at the beginning of 2005**

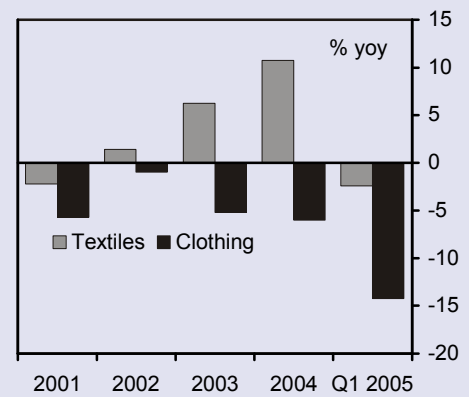
The development of production in the T&C sector clearly reflects the greater importance the industry has acquired in the two EU candidate states compared with the big three new EU states. While clothing production declined, in some cases quite considerably, between 2000 and 2004 in Poland (-17%), the Czech Republic (-12%) and Hungary (-3%), it has expanded strongly in Romania (+18%) and especially in Bulgaria (+91%). In the textile trade, too, the established CEE producers – with the exception of Poland – have suffered setbacks. Over the same period production fell by 23% in Hungary and stagnated in the Czech Republic. Output in Poland rose by 16%. But even this is low by comparison with the growth in production in Romania (+51%) and Bulgaria (+120%).

Currently, there are signs of a trend reversal. In Q1 2005 production in both the textiles and clothing sectors was below year-earlier levels in almost all countries. Textiles production in Bulgaria was the one exception, with a modest year-on-year rise but well below the growth witnessed in previous years. Although the figures need to be viewed with some caution since they are partly based on provisional figures and Eurostat estimates, they do suggest nonetheless that the expiry of the ATC at the end of 2004 may be an important factor behind this downturn.

**2. End of the ATC: challenges for the Eastern European textiles and clothing industry**

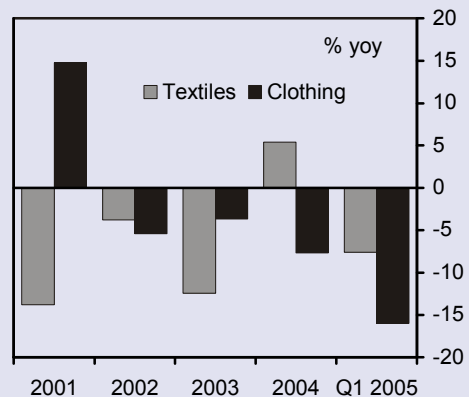
The end of the ATC ushers in a new era for the global textiles and clothing industry. Regardless of the current trade disputes between the US and China and the cap on EU imports from China in ten product categories recently agreed between the EU and China one thing is clear: the balance of global trade in textiles and clothing will shift massively in China's favour in the next few years. Besides China, India and Pakistan should also benefit from the phasing out

**Development of output in Poland**



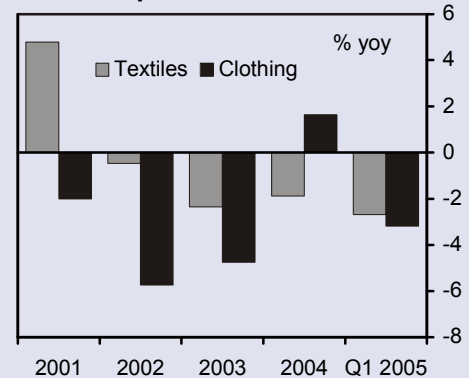
Source: Eurostat, based partly on provisional figures and estimates

**Development of output in Hungary**



Source: Eurostat, based partly on provisional figures and estimates

**Development of output in the Czech Republic**



Source: Eurostat, based partly on provisional figures and estimates



of the quota system. All other countries are affected negatively in varying degree.

The main upshot of the liberalisation of the world textiles market is that Asian producer countries now have free access to the markets in Western Europe, which is by far the most important market for T&C firms in Central and Eastern Europe. This has hugely intensified the competition for market share in Western Europe where the market for textiles and clothing is likely to see little, if any, growth. The EU import figures for Q1 2005 already reflect the new situation: in some product categories EU imports from China have soared (see table on right). At the same time, EU imports from other countries have fallen sharply in some cases.

### Limited production advantages in Eastern Europe

Broadly speaking, the locational advantages for the production of textiles and clothing in the individual CEE countries are similar. In the main this is the proximity to the Western European market. In contrast to Asia, this allows much quicker delivery, which is a critical factor above all in the fashion-sensitive clothing sector. Another argument in Eastern Europe's favour is the longstanding good relationships with companies in the old EU member states. At the same time, wage levels are much lower than in Western Europe.

However, wage levels, which are a key factor in labour-intensive garment production, are also the decisive drawback for the CEE countries. Wage costs in Eastern Europe are, after all, much higher than in Asia. This is true especially of the Czech Republic, Poland and Hungary, while wages in Romania, Bulgaria and the Baltic states are lower but, nonetheless, are still higher than in Asia. However, since it is not only the wage levels that are higher than in China, the prospective wage increases in the CEE countries are likely to be higher, too, the divergence versus China will tend to widen. Given the abundant supply of labour wage levels in China are likely to remain low for some time. A problem at the production locations in Eastern Europe is not only the fact that wage costs are higher than in Asia but also the industry's low productivity. It is only around 20% to 40% of the EU-15 level and, for a great many product categories, is below productivity levels in the industry in China.

Furthermore, for the new EU states EU membership entails a higher cost burden to bring environmental, health and safety standards into line with EU standards. In addition, they can now only impose the lower EU tariffs on non-EU countries, resulting in stiffer competition on their home markets.

Another drawback for the T&C industry in Eastern Europe is its strong dependence on Western Europe as its principal market. At the last count the EU-15 accounted for around 90% of Romania's and Poland's clothing exports. This concentration on Western Europe is unlikely to change much in the coming years since the US will probably remain relatively insignificant as an export market. It is likely to turn even more strongly than Western Europe to Asia for its supplies. Moreover, the structure of the textiles and clothing industry in Eastern Europe is still highly fragmented. The companies' capital base and hence their financial strength is comparatively weak. This limits their ability to modernize partly obsolescent facilities and catch up on the productivity levels of their Chinese counterparts. Most companies do not have the financial clout to establish their own labels and improve their competitive positioning in this way. This option is only open to the few companies that are already well positioned and have sufficient capital.

### EU textile imports

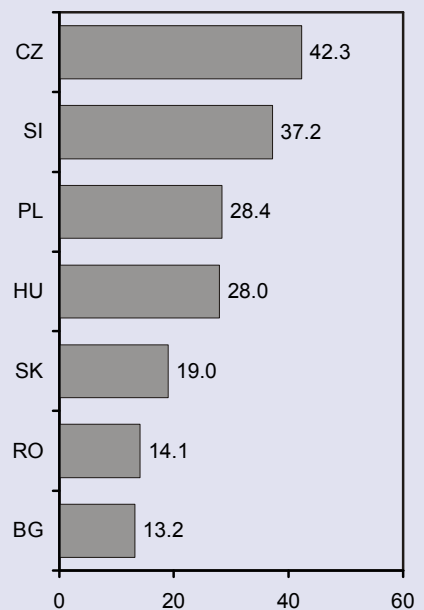
%-change Q1 2005 vs. Q1 2004

	Volumes imported		Ø Average import prices, total
	from China	from other traditional textile produc- ing nations	
Pullovers	534.3	-30.7	-21.7
Trousers	412.6	-27.0	-20.1
Flax fabric	257.3	-33.5	-23.3
Women's blouses	186.0	-25.6	-10.9
Socks and hosiery	183.5	47.4	-74.7
Shirts and tee- shirts	164.1	0.8	-20.1
Women's overcoats	139.4	-3.8	-28.4
Brassieres	63.0	-46.2	-12.4
Flax yarn	50.7	2.0	-7.1

Source: European Commission

### Productivity levels in the Eastern European T&C industry

relative to the EU-15 average, %



Source: WIIW

The lack of feedstocks (such as cotton or high-quality textiles from domestic production) is another drawback versus China with its vertically integrated textile value chain. Only Turkey is similarly well positioned in this respect.

### Strategies for Eastern European companies

The textiles and clothing industry in Eastern Europe must endeavour to intensify its research and development efforts in future, and tend to focus on niche markets. This includes supplying local industrial customers. In this way companies specialising in textiles for the automobile industry (such as air bags, safety belts, seat upholstery) for instance can profit from the large number of new car plants being set up in CEE countries. Given the importance of the furniture industry in Poland for instance, the needs of this customer ought to be another focus. Industrial textiles, with their ever broader range of applications, are an area where companies in Eastern Europe could shield themselves from the competition from Asia. In Germany, industrial textiles meanwhile account for over 40% of the textile industry's total output value. The Czech Republic and Slovakia are well placed to succeed in this market segment as their textiles industries are already better positioned than those of their Eastern European neighbours.

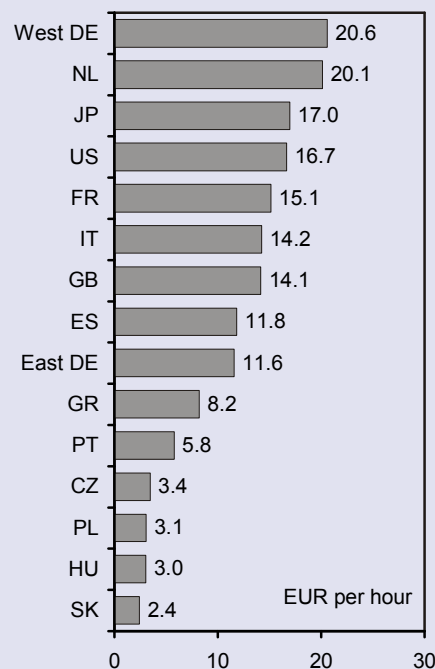
For the future it will also be increasingly important to emphasise the geographical advantages. For instance, short distances and speed of delivery are an advantage that Chinese competitors cannot match since the clothing products normally are shipped to Western Europe by sea. Consequently, manufacturers in Eastern Europe should specialise in fashion garments. Ever shorter fashion cycles demand a high degree of flexibility and speed from suppliers. It also entails a focus on small-lot production. At the same time the industry's own fashion design expertise needs to be improved. So far it has relied on its Western European customers in this regard. By contrast, companies in Eastern Europe have few advantages in the production of commodity goods where fashion aspects, and thus time, are not important (such as white tee-shirts, simple underwear bathrobes, hosiery). Here, China clearly has all the trump cards.

### Lower employment and loss of market share inevitable

These strategies to improve market positioning will probably not be feasible for many textile and clothing companies in Eastern Europe as they do not have the capital, technological know-how (for instance for developing industrial textiles) and management capacities. Companies backed by financially strong partners in Western Europe are likely to be in the best position.

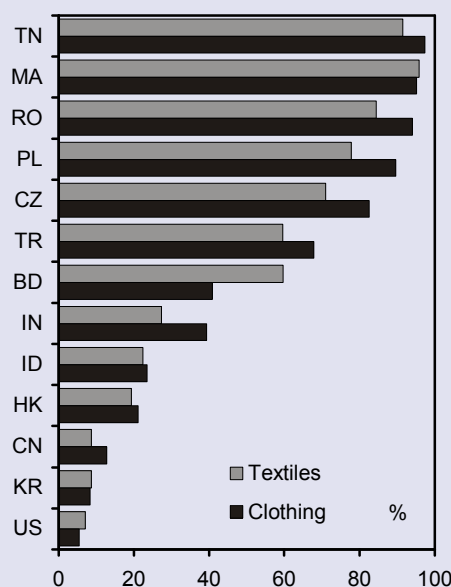
In a few years from now it can probably be said in retrospect that the turn of the year 2004/05 marked the start of a steady decline in Eastern Europe's share of the world market for textiles and clothing, triggering or, as the case may be, accelerating a process that began much earlier in Western Europe (especially in Germany). Massive declines in employment appear inevitable. This can lead to problems for the labour market in regions where the textiles and clothing industry is particularly dominant. Many small companies will have to close down. The speed at which this process takes place will depend primarily on how quickly customers in Western Europe start sourcing from Asian countries or downsizing their own production capacities in the CEE countries. Indications are that the new competitive situation will force them to act sooner rather than later. The process is likely to be faster in Poland, the Czech Republic and Hungary than in Bulgaria, Romania or Ukraine where wages are lower. Turkey still appears the one country in the region that is best

**Labour costs in the textile industry in selected countries, 2002**



Sources: ILO, IW Cologne

**Exports to the EU-15 as a percentage of total exports, 2002**



Source: WTO



equipped for the future. Turkish companies have the added advantage that their home market is quite large.

Romania, Bulgaria and Turkey, and North Africa as well, are currently the most dependent on the textile and especially the clothing industry. Negative employment effects will have a stronger impact on these countries' economies than, say, in Poland, the Czech Republic or Hungary whose dependence on textile and clothing exports has been sharply reduced in recent years. One hope for Eastern European firms is that the big textile and garment buyers in Western Europe will want to diversify their sourcing structure to some extent so that they do not become dependent on just a few suppliers or countries. All in all, many of the least developed countries are affected much more by the phasing out of the ATC than the CEE countries. Countries such as Cambodia, Bangladesh or Sri Lanka are far more dependent, with textile and clothing exports accounting for more than 70% of total exports in some cases. This holds for many smaller countries in the Caribbean basin as well.

### 3. Return to textile quotas makes little sense – press for reciprocal liberalisation

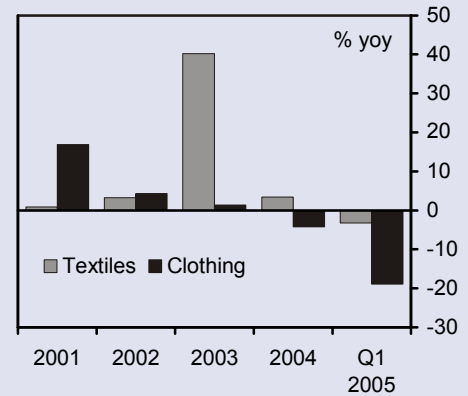
Although the outlook for the textiles and clothing industry in Eastern Europe is not rosy, a re-introduction of textile quotas to protect the industry in Europe makes little sense, in our view. In the negotiations on China's admission to the WTO it was stipulated that the US and the EU can still impose quotas on textile and clothing imports from China after the ATC is phased out if excessive imports cause disruptions to the domestic markets. The US has already resorted to this possibility. However, after prolonged trade conflicts with China the EU recently agreed not to reintroduce quotas. Instead, in ten product categories where imports have risen particularly sharply since the beginning of 2005 the growth in EU imports from China is to be capped at 12.5% per year until 2008. This is a much better solution than reintroducing quotas like the US has done.

#### Protection afforded by new quotas is overrated

Those who call for a re-introduction of quotas should bear in mind that this can provide only temporary protection. They have to be finally abolished at the latest by the end of 2008. Moreover, there are a host of other producer countries in Asia that can manufacture commodity products more cheaply than most countries in Europe. So if imports from China were restricted by quotas, garment buyers would very likely source more of their supplies from countries such as India, Pakistan or Bangladesh which are no longer subject to any quotas. The protection would therefore be limited. While the ATC was in force and also before that, quotas were circumvented by spreading garment production over many small countries. In this way the ATC and the regime in force before that already contributed towards the globalisation of textile and clothing production.

Moreover, it should be remembered that the ATC was conceived as a solution for the transition from a regulated to a liberalised world textile market over a ten-year period. The removal of quotas as from the end of 2004 therefore came as no surprise. If some countries are less well prepared for the new situation than others (such as Germany) they only have themselves to blame. Among the countries that have undertaken less stringent adjustments and had therefore come out more strongly in favour of quotas are Italy, Portugal and Spain.

Development of output in Romania



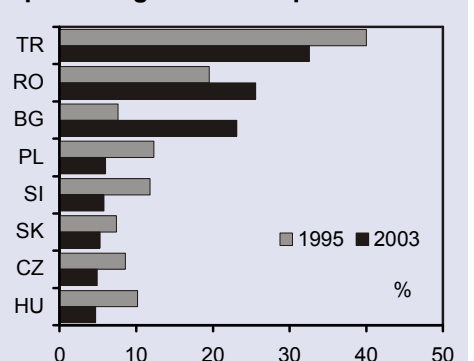
Source: Eurostat, based partly on provisional figures and estimates

Development of output in Bulgaria



Source: Eurostat, based partly on provisional figures and estimates

Textile and clothing exports as a percentage of total exports



Source: WTO

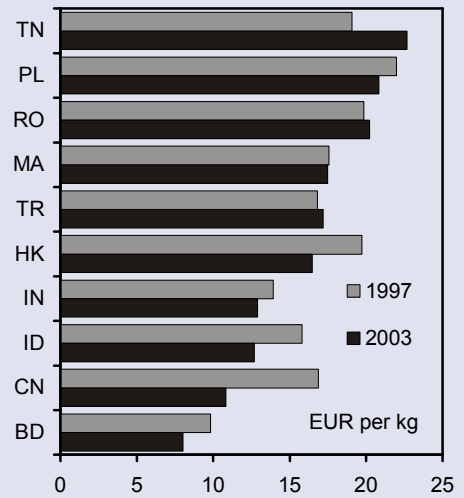
Ultimately, consumers benefit from the removal of quotas through lower prices for textiles and clothing. In the first months since market liberalisation import prices have fallen far more strongly in some cases than retail prices in the stores. However, given the fierce competition in the retail trade, it is likely to be only a matter of time before the end consumer comes to enjoy the benefit of falling clothing prices. All the same, the cap on the growth in EU imports from China for selected product categories will reduce the pressure on prices in these segments.

**EU should press for market liberalisation in Asia**

The EU should step up its efforts in another trade policy area. On the subject of (import) tariffs for textiles and clothing it should press more strongly for a reciprocal liberalisation of the markets in Asia. Given import tariffs of 30% or more in Asia they are still well above EU levels (less than 10% on average). The EU should also press for a faster dismantling of non-tariff trade restrictions in Asia. This should significantly improve European companies' sales prospects in Asia. European clothing labels have a strong reputation in these markets and the share of the population in Asia that can afford and wants upmarket European fashion is on the rise.

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**Average price of EU-15 clothing imports by country of origin**



Source: Textiles Intelligence