

**ANALYSIS OF CHINESE GARMENT EXPORT SECTOR**

**By**

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**PROJECT SUBMITTED IN PARTIAL FULFILLMENT OF  
THE REQUIREMENTS FOR THE DEGREE OF**

**MASTER OF BUSINESS ADMINISTRATION**

**In the  
Faculty  
of  
Business Administration**

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**SIMON FRASER UNIVERSITY**

**Summer 2009**

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## **Abstract**

This paper analyzes the Chinese garment export sector. The Chinese garment industry has been an economic pillar ever since the open-door policy and economic reforms of the country took effect in 1979. Earnings from apparel exports have been a major source of foreign revenue. The industry has thus developed and played a vital role in the growth of China's foreign trade and economic development although some signs of slackened vigour have been revealed recently. To assess the threats and opportunities China's export clothing industry is facing, this paper identifies and analyzes the drivers of demand, key sources of advantage for exporting apparel manufacturers, and the strength of key industry forces. Based on this analysis, the paper offers several recommendations for Chinese exporting enterprises to enhance their competitive position against not only international competitors, but also domestic competitors. Specifically, these recommendations include increasing the added-value of the products, relocating the production base and exploring domestic and new markets.

**Keywords:** Lost Cost, WTO, Labour Cost, Government Policy

## **Dedication:**

This thesis is dedicated to my parents and my daughter with my gratitude for their support, encouragement and inspiration throughout my study. I would like to thank my husband for the original impetus from which this essay came, and for his unwavering support in gathering statistics.

## **Acknowledgements**

I would like to express my sincere gratitude and respect to Andrew von Nordenflycht for his insightful, constructive, and enlightening guidance and feedback during the writing of this paper.

Next, I would also like to express my appreciation to the dedicated group of scholars and professors at Simon Fraser University who inspired me to view the business climate with curiosity.

Finally, I would like to thank my lovely classmates who contributed to the memorable and pleasant learning environment.

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# **1. Introduction**

Since China opened its door to the World in 1978, it has not only been the world's fastest growing major economy, but also an outstanding exporter and a large recipient of foreign direct investment (FDI) —it has emerged as a world “workshop”.

According to figures from the World Trade Organization (WTO), the United States has remained the world's largest importer of wearing apparel in recent years. The global retail sale market has steadily lost confidence amid the US subprime mortgage crisis, preventing distributors from placing orders and developing plans for new products. To control stocks efficiently and to focus more on their own products, many distributors either cut or delay orders, which take a toll on orders and prices of wearing apparel worldwide. China remains the world's largest exporter of wearing apparel. However, economic fundamentals in China and in the United States combine with trade regulations to affect the wearing apparel industry worldwide. China has unveiled various economic and trade policies such as the New Labour Law and the Guaranteed Fund Mechanism, which have hurt Chinese apparel mills. Additionally, the steady appreciation of the Yuan has prompted Chinese garment exporters to raise prices, and to restore discipline and market principles needed for a recovery in the global apparel trade. Exporting enterprises in China are struggling during the economic downturn and are seeking further development.

The purpose of this paper is to analyze China's garment export sector and propose strategic recommendations for the industry. I first discuss 30 year's development of the industry, the

industry structure, and sources of advantages, then I use Porter's Five Forces Model to analyze the industry and major challenges enterprises are facing. Finally, I propose strategic recommendations and implementations for the industry and enterprises.

## **2. Industry Overview**

This chapter will briefly introduce the Chinese Garment Exporting Sector and the four stages of development, and will analyze and summarize the characteristics of each stage.

### **2.1 Industry Definition**

The term 'Garment Exporting Sector in China' (which I will also refer to as the “Chinese Apparel Exporting Industry”) refers to the activity of manufacturing and exporting men's, women's, and children's cut and sewn apparel, with fabrics being the primary raw material. It is an important segment of China's entire textile and apparel industry. The industry includes manufacturers who purchase fabrics and those who manufacture the fabrics themselves. It also includes enterprises that have fixed operational facilities and companies that export garment products. The industry is comprised of 41,855 enterprises of various sizes; the majority of which are privately owned small or medium size enterprises. The total revenue of the Chinese Apparel Exporting Industry in 2008 was \$119.81 billion US dollars.<sup>1</sup>

### **2.2 Development of China's Garment Exporting Industry**

Since the introduction of the Open-door Policy, China's apparel exporting industry has experienced four stages of development. The industry's development is not only influenced by worldwide demand but is also closely associated with the overall development of China's textile and apparel industry. During the past 30 years (1978-2008), China's textile and apparel industry

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<sup>1</sup> Sourced from Industry Statistics Report 2008, China Chamber of Commerce for Import and Export of Textiles

has grown very quickly; so has the apparel exporting industry. The total revenue from the apparel exporting industry in 1978 was 1.13 Billion US dollars, compared to the 2008 figure of 119.81 Billion US dollars (Sheng, 2008) - a growth rate of 4.1%.

A clear understanding of the four stages of the development of the apparel exporting industry, one which defines the strengths and characteristics of each stage, can lead to conclusions about what has been achieved so far and to recommendations for the strategic transformation of the exporting industry.

### **2.2.1 The Early Stage of the Apparel Exporting Industry (1978 – 1985)**

Before the open-door policy, the Chinese economy was a planned economy, and the government controlled all commodities including garment products. People required special coupons to buy clothing. After 1978, the government supported the development of the textile industry and the apparel industry. The manufacturers' capacity and sales volume both increased quickly.

On December 1<sup>st</sup> 1983, the government declared a country-wide stop to the use of the special clothing coupon, which meant Chinese people could freely buy clothes without any restriction. Meanwhile, the cancelling of coupons, which had a 30 year history, indicated that following five years of rapid growth, production volumes in the textile and apparel industry by the end of 1983 were already able to meet the demands of the domestic market. The government supported the development of the textile and apparel industry as the country's leading industry.

### **2.2.2 Second stage of Apparel Exporting Industry (1986 – 1993)**

During this period, developed countries were experiencing industry upgrading and the transformation to more capital-intensive industries. The low-cost strength of the Four Little

Dragons in Asia (South Korea, Taiwan, Singapore and Hong Kong) was decreasing. Many clothing manufacturers from Taiwan and Hong Kong began to set up new factories in Mainland China, and with the saturation of the domestic market, Chinese companies looked for more opportunities to export. The capacity of the apparel exporting industry increased considerably. The volume of exported apparel products surpassed the volume of textile products. In 1991, China's total revenue from textile products was 7.7 billion US dollars while the total apparel exporting revenue was 8.9 Billion US dollars (Sheng, 2008). The Garment Exporting Sector consisted of 53.98% of the total for textile and apparel exporting, exceeding textile products for the first time and changed the pattern for exportation.

### **2.2.3 Third Stage of the Apparel Exporting Industry (1994 - 2004)**

In 1994, China's total textile and apparel exporting revenue reached 35.5 billion US dollars, occupying 13.2 % of the world's production, and becoming the biggest textile and apparel exporting country in the world. On January 1<sup>st</sup>, 1995 during this stage, the World Trade Organization (WTO) came into being. It is an international organization designed by its founders to supervise and liberalize international trade. Since January 1995, the international textile and clothing trades have been undergoing fundamental change as a result of the 10-year transitional program of the WTO's Agreement on Textiles and Clothing (ATC). Before the Agreement took effect, a large portion of textile and clothing exports from developing countries to industrial countries was subject to quotas under special provisions outside of normal GAAT<sup>2</sup> rules.

From 1995 to 2004 (Sheng, 2008), China grasped the opportunity to liberalize the trade of world textile products and to expand the exportation of textile and apparel products. In 1997, and

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<sup>2</sup> General Agreement on Tariffs and Trade: Treaty organization affiliated with the United Nations whose purpose is to facilitate international trade. GATT was superseded by WTO

1998, due to the Asian Financial Crisis, total exporting volume decreased. However, during the next 8 years, the numbers all increased, especially from 2002 to 2004. Every year the increase exceeded 10 billion US dollars: 60 billion 80 billion and 90 billion respectively. The average annual increase in the third stage was 15.8%.

In 2004, China's total textile and apparel exporting revenue was 97.83 billion US dollars, occupying 21 % of the world's production.

#### **2.2.4 Fourth Stage Development of the Apparel Exporting Industry (2005 to now)**

The Agreement on Textiles and Clothing (ATC) and all restrictions there under terminated on January 1, 2005. The expiry of the ten-year transition period of ATC implementation meant that trade in textile and clothing products was no longer subject to quotas under special provisions outside of normal WTO/GATT rules but was now governed by the general rules and disciplines embodied in the multilateral trading system. China's apparel productivity exploded in face of the huge world market. In 2005, textile and apparel exporting broke a record of 100 billion US dollars. In 2007, the annual growth rate of the Chinese garment export sector reached 20.9%. The scale of the garment export industry kept expanding. By 2008, domestic economic regulations and the world financial environment were having a stronger impact on the industry which led to an annual growth rate drop of 4.1% resulting in the closure of many enterprises.

### **3. Industry Structure**

Now that a clear understanding of the development of the Chinese apparel export section has been established, this section will explore the industry's structure, especially the transparent business model, and ownership structures.

#### **3.1 Business Models**

The participants in the Chinese apparel export section consisted of two groups - exporting trading companies and other is manufacturing exporters. Export trading companies are corporations organized for the principal purpose of exporting goods and services. These companies connect buyers and sellers in different countries but do not get involved in the owning or storing merchandise. Generally, these companies do not have any manufacturing base but possess an authorized exporting license. Manufacturing exporters are manufacturing enterprises that have an independent exporting license and a production base.

It was difficult to get an exporting license from the Chinese government until late 20<sup>th</sup> century. In 1978, there were only 14 companies that had an authorized exporting license - all of them were state-owned enterprises (SOEs). Garment manufacturing enterprises had to sell products to authorized exporters if they wanted to export products outside of China. During the quota period that followed, the federal government controlled all the quotas and assigned them to provincial governments based on the planned market system. The provincial governments



reassigned quotas to state-owned exporters. Those exporters had authorized export licenses and quotas. They dominated the industry and took the biggest part of the profit.

In 1999, the Ministry of Commerce of the People's Republic of China issued Regulations for Authorized Exporting Private Companies and Research Institutes. In July 2001, China enacted legislation (Foreign Trade and Economic Cooperation Gazette Issue No.38, 2001)<sup>3</sup>, and in September 2003, approved the individual export licensing of companies (China Foreign Trade and Economic Cooperation Gazette Issue No.31 2003)

As more and more manufacturers received authorized exporting licences, they could conduct business with foreign customers directly and could export products by themselves. After the expiry of the ATC in 2005, the world textile and apparel trade entered a free trade period. Export trading companies lost the key factor of their success and their profit margin declined. Some exporters foresaw the decline and 'backward integrated' by acquiring manufacturing companies or by building new plants. Although the state-owned trading companies lost their key success factor, they still had solid connections with foreign retailers and distribution channels. Most of the small to medium sized enterprises still exported garment products through state-owned trading enterprises.

### **3.2 Ownership Structure**

From the perspective of investment capital source, there are three categories in the garment exporting industry. One is the state-owned company, one is the private owned company, and another is the foreign owned enterprise which includes wholly owned foreign companies and joint ventures. Table 1 shows the various ownership segments within the garment exporting

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<sup>3</sup> Sourced from Ministry of Commerce of People's Republic of China

sector for 2008. Generally, private owned enterprises consist of over half of the total number of enterprises; foreign investment enterprises are the second and state-owned companies are the third. The garment export sector is a private enterprises oriented industry.

**Table 1 Different Ownership of Garment Export Enterprises**

Types of Ownership	State-owned	Foreign Investment	Private
Numbers of Enterprises	2511	12432	27268
Percentage	6%	29.7%	64.3%

Data Source: China Apparel Industry Development Report 2008/2009

### **3.2.1 State-owned Company**

First off, it should be noted that the Chinese government plays a relatively small role in the country's garment industry. This is in sharp contrast to China's textile industry, in which the government controls the buying and selling of cotton, wool and silkworms, and is heavily involved in spinning and weaving.

Industry Statistics Report 2008 from China Chamber of Commerce for the Import and Export of Textiles showed the following breakdown of overall sales:

- \* 20 percent of sales were attributable to state-owned enterprises;

- \* 47.6 percent of sales could be traced back to private enterprises and urban collective.

- \* 32.4 percent of sales were made by enterprises with foreign investments

In 2008, a total of 99 enterprises have annual exporting volume over \$100 million US dollars. Among them, 44 were state-owned enterprises, 51 privately-owned enterprises and four

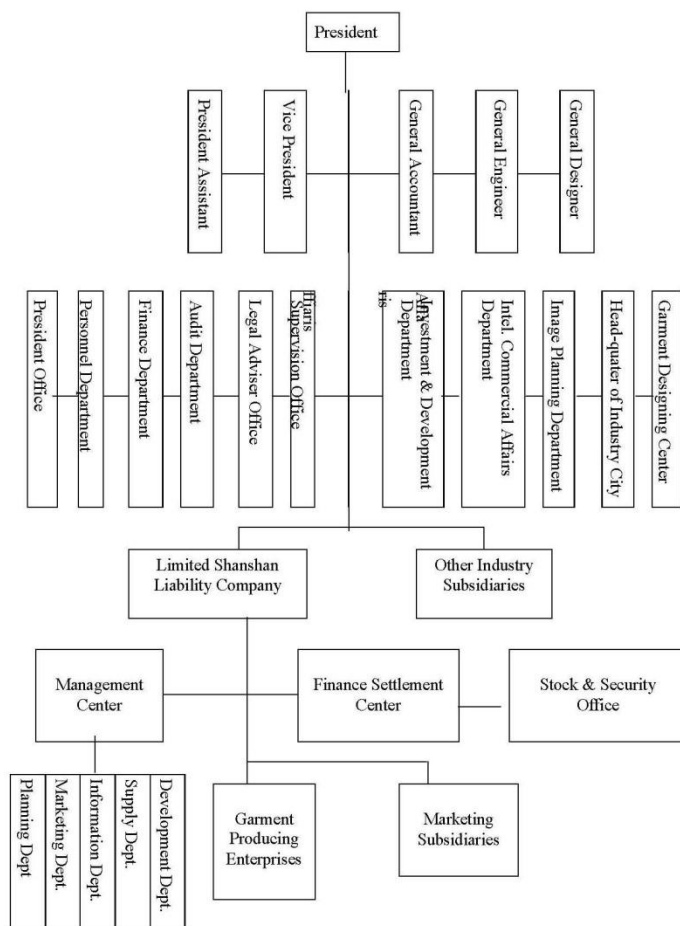
were foreign investment enterprises. Though state-owned enterprises represented only 6% of all garment export enterprises, the average enterprise's exporting volume is bigger than that of private sector and foreign investment enterprises. In fact, many small to medium sized private manufacturers still export products through state-owned companies.

State-owned enterprises are widely viewed as slow and inefficient -- not characteristics well suited for the fickle fashion industry. The bureaucratic structure of these companies gets in the way of efficiency and flexibility, and there is often petty interference from government officials. The management team of state-owned companies is not as motivated as that of private enterprises and foreign investment enterprises. SOEs used to offer their workers lifetime employment and paid pensions to workers following retirement. In the early 1990s, SOEs in the apparel industry started to set up contract relationships with their workers while the contract period in SOEs typically is longer than for enterprises with other forms of ownership. SOEs typically have more complicated organizational structures than joint ventures and private enterprises of the same size. This is, in part, because of the heavy historical and social burdens that they bear such as support of retired workers. Figure 1 shows the organizational structure of an SOE.

On the other hand, SOEs usually can get more support from the government compared to privately owned enterprises, especially during the economic downturn. The banks, also owned by the state, implement different monetary measures with regard to the type of enterprise ownership. Before 1992, under the planned economic system, SOEs enjoyed preferential treatment by the Chinese government. However, with the transition to a market economy, most state-owned enterprises have not only lost government protection, but are facing a

huge financial burden: the obligation to support an increasing number of retired and laid-off employees. However, many state-owned enterprises have a solid foundation in technology and equipment, enabling them to offer quality products. At the same time, their managerial systems and market adaptability tend to be dated. After 2000, many State-owned exporting enterprises began to reorganize and carry out the new commission system intended to inspire employees. Shanshan Enterprise is a typical garment SOE enterprise in China with over a 20 years history.

**Figure 1: Organizational Structure of a typical SOE**



Data Source: Shanshan Enterprise China

### 3.2.2 Privately Owned Companies

The Chinese Garment Exporting Sector consists of a large portion of small and medium sized enterprises and this category includes private companies and urban collectives. It is a truism that economic reform in China has meant a substantial expansion in the role of private initiative in economic activity. The dismantling of communes and collectives as well as the recognition of the private sector was initially viewed as a "supplement to the state-owned economy" and subsequently as an "important component of the socialist market economy". The opening of the Communist Party of China (CPC) membership to entrepreneurs and businesspersons also contributed to a substantial expansion in the role of the private sector, and continues to do so.

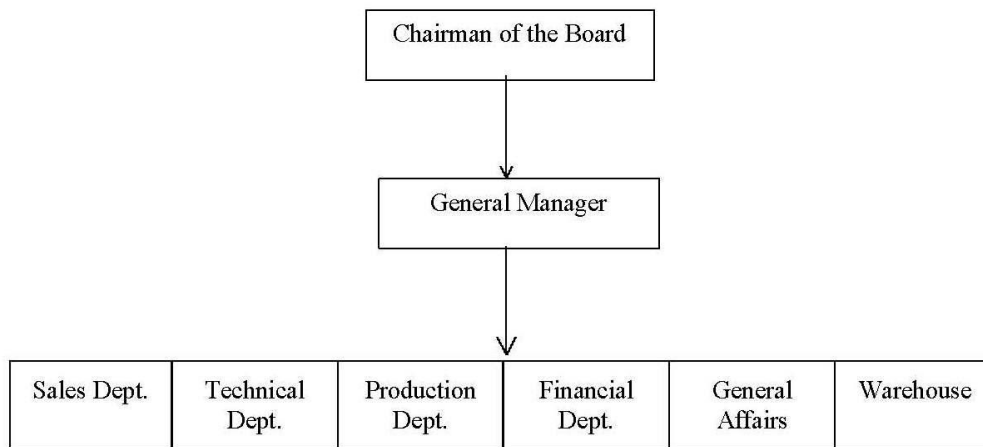
In the garment export sector, as table 1 shows, privately owned companies occupy almost half of the total enterprises. The organizational structure of privately owned companies is comparatively simpler than of state-owned companies which also contribute to the productivity of privately owned companies. Small and medium sized enterprises are very active in the garment export sector as they have better efficiency, flexibility and adaptability. An OECD report "Fast-falling barriers and growing concentration" shows that Chinese private firms are twice as productive as state-owned firms.<sup>4</sup>

Hangzhou Wintime Clothing Co.Ltd is a typical small and medium size private garment exporting enterprise established in 2001.

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<sup>4</sup> OECD: Organization for Economic Co-operation and Development

**Figure 2: Organizational Structure of a Privately Owned Company**  
**Hangzhou Wintime Clothing Co. Ltd.**



Data Source: Hangzhou Wintime Clothing Co. Ltd.

### 3.2.3 Foreign Investment Companies

Foreign Direct Investment companies are those companies funded by foreign capital including foreign investor owned companies and joint ventures. China's Foreign Direct Investment Companies followed the third migration of a worldwide trend. Since the 1950s, the world textile and apparel industry has gone through several production migrations. Understandably, companies were following cheaper sources of labour as sophistication and openness of the developing economies increased. The first was from North America and Western Europe to Japan in the 1950s and early 1960s, when western textile and clothing production was displaced by a sharp rise in imports from Japan. The second migration happened from Japan to Hong Kong, Taiwan and the Republic of Korea, which dominated global textile and clothing exports in the 1970s and early 1980s. In the late 1980s and the 1990s there was a third migration, from the Asian "Big Three" (Hong Kong Special Administration Regime, Taiwan and the

Republic of Korea) to other developing economies. In the 1980s, production moved to mainland China, but also to several Southeast Asian countries like Indonesia, Thailand, Malaysia, Philippines and Sri Lanka. In the 1990s, new suppliers included South Asian and Latin American apparel exporters who were driven by special economic zones and proximity to the USA (Gereffi et al, 2003). There is no reason to believe that the third migration is exclusive.

Joint-venture enterprises were the first group of enterprises to emerge after economic reform in China. Originally, most of these companies were state-owned enterprises. When these companies changed ownership from state-owned to joint venture with incoming foreign investment, money was paid to the government by the foreign investor to settle their obligations (e.g., provide support for retired and laid-off employees). By doing so, joint-venture companies were able to have a fresh start without any long-term financial burden related to their formerly state-owned enterprises. As a result, joint-venture companies are in a more advantageous situation than state-owned enterprises because they possess a good technical and production foundation developed when they were state-owned companies. At the same time, more capital and support from their more recent foreign investors allows them to be more flexible, efficient, and competitive.

As table 1 show, in the apparel exporting industry, FDI companies occupy over one fourth of the industry. According to the 2007 statistics from the National Bureau of Statistics of China, the use of foreign capital investment in China's apparel industry dropped from 15.64 percent to 13.83 percent. Taiwan-funded enterprises and foreign investment declined from 31.24 percent to 25.19 percent in 2006 - a six percentage point- drop. Foreign investment in the industry is obviously cooling.

Foreign direct investment plays a pivotal role in China's economy. FDI companies ensure a huge amount of capital, high production levels, advanced management knowledge, and employment opportunities. In order to attract FDI, the Chinese government offers some special tax rules for FDI companies as specified in the Income Tax Law (Tseng and Zebregs, 2003) of The People's Republic of China for enterprises with foreign investment and foreign enterprises. The policy is simplified as "the preferential tax policy of two free and three half free", meaning that any enterprise with foreign investment of a production nature scheduled to operate for a period of not less than 10 years shall, from the year it begins to make profit, be exempted from income tax in the 1st and 2nd years and allowed a 50% reduction in the 3rd to 5th years.

The policy was enacted in 1991, but as privately-owned companies developed and more and more business owners became the members of Chinese Communist Party, domestic companies protested the unfair competitive environment. In 2007, PRC legislators passed the new, long-awaited Enterprise Income Tax Law at the full National People's Congress meeting in March. Most significantly, China's new Enterprise Income Tax law will unify the income tax rate for all enterprises in China at 25 percent and adjust preferential tax policies to reflect the government's focus on technological development, environmental protection, and balanced socio-economic and regional development. Of particular importance to foreign investors, the new law will eliminate the tax reductions and exemptions for manufacturing foreign-invested enterprises (FIEs), including the "2+3" tax holiday under which eligible FIEs did not have to pay income tax for two years following the first profitable year and pay only half of the income tax for the third through fifth years after the first profitable year. The new law took effect on January 1, 2008.



### **3.3 The Geographic Distribution of China's Apparel Export Sector**

The majority of the Chinese apparel exporting enterprises is located in coastal areas. The next largest number of firms is located in the midland provinces, and the smallest number, in the western provinces. The Coastal area also known as the Eastern Region includes Beijing, Fujian, Guangdong, Hainan, Jiangsu, Liaoning, Shandong, Hebei, Shanghai, Tianjin and Zhejiang (11 provinces and municipalities in total). The Midlands, also known as the Central area includes Anhui, Henan, Heilongjiang, Hunan, Jilin, Jiangxi, Shanxi and Hubei (8 provinces in total). West area includes Chongqing, Gansu, Guizhou, Ningxia, Qinghai, Shanxi, Sichuan, Xizang and Xinjiang, Nei Mongol, Yuannan, and Guizhou (12 provinces and municipalities in total).

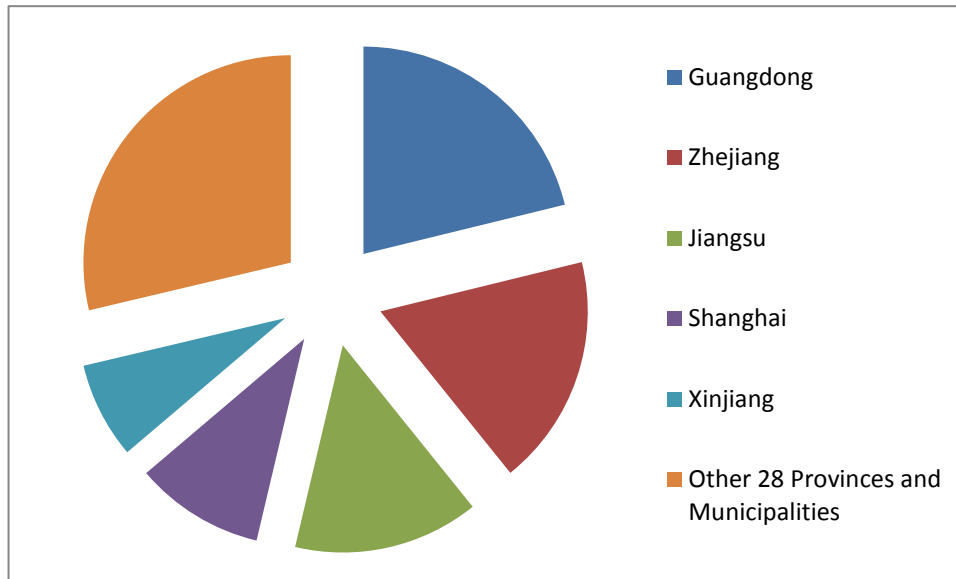
This geographic distribution of China's apparel industry is driven by the following factors:

1. The coastal area is China's traditional location for its apparel industry as well as for upstream industries such as the textile industry and the synthetic fibre industry. In addition, there are more qualified workers in the coastal areas than the rest.
2. The open door policy first applied in the coastal areas and the main Economic Development Zones. Shenzhen, Zhuhai, Haikou, Ningbo, Shanghai, Dalian, Qingdao, Xiamen are all located in coastal areas.
3. This area is of high population density and the people there have a higher income, better education and are more conscious of fashion than in other areas. This leads to better market potential.
4. There are relatively well-equipped infrastructures in the area - a logistics system that is attractive to exporting enterprises.

The sharp increase in labour cost, especially in the coastal areas, has increased the wage gap among the coastal, middle, and western provinces. This wage gap puts coastal apparel factories

under pressure to cut down their production, move the plants to the middle or west, or employ workers from the inland provinces.

**Figure 3: Top 5 Garment Exporting Provinces in 2008**



Data Source: China Apparel Industry Development Report 2008/2009

## **4. Sources of Advantage**

This chapter will analyze the sources of advantage for China's garment export enterprises and will offer reasons why China can maintain itself as the biggest garment exporting country in the world.

### **4.1 Labour Cost Drivers in the Garment Export Sector**

'Cost drivers' are factors that determine the cost of an activity. They are a component of activity based costing which is used in continuous improvement programs. Cost drivers usually work together as multiple drivers rather than singly. There are two main types of cost driver: the first is a resource driver, which refers to the contribution of the quantity of resources used, to the cost of an activity; the second is an activity driver, which refers to the costs incurred by the activities required to complete a particular task or project (Susan Chan Egan 1999).

Several drivers impel the development of the Apparel Exporting Industry in China. Some have changed; some are still very crucial to the industry. Generally, low labour cost is the main driver of the Chinese exporting apparel sector and its key success factor.

#### **4.1.1 Low Labour Cost**

The garment manufacturing industry, as an traditional industry, is a labour intensive one that requires very little capital investment with respect to industrialization. China accounts for one fourth of the World's total population and it has a massive supply of cheap labour. As the European Union, the United States, Japan and Hong Kong are the key players in both China's

trade and FDI; the discussion will highlight the way in which China's huge labour supply and, thus, cheap labour cost, makes China relatively competitive in comparison with that of its key economic partners. In fact, comparing China's endowment of labour (agricultural, unskilled and skilled) and capital with that of its top trading partners reveals that China is labour abundant, and the percentage of labour cost in the garment manufacturing sector is one of the least expensive for all countries and regions.

**Table 2: Percentage Share in World Aggregate Factor Resources (2000)**

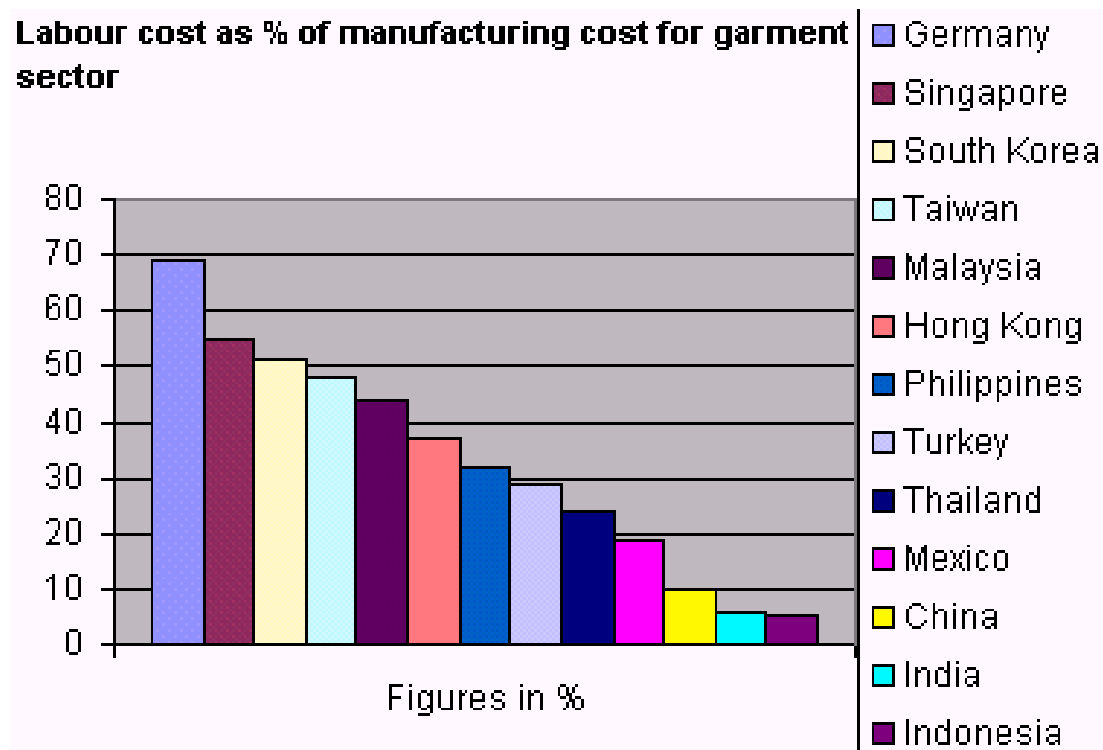
	USA	EU	JAPAN	CHINA	Rest of World
Agricultural Labour	0.3	0.7	0.3	40	52.3
Unskilled Labour	7.9	10.4	4.5	13.7	57.3
Skilled Labour	14.5	15.6	3.6	17.5	45.8
Capital	19.3	30.7	22.7	2	23.3

Data Source: Gasgupta (2000) On Population and Resources

Table 2 shows that China has a huge agricultural, unskilled and skilled labour force (40%, 13.7% and 17.5% respectively of the world labour force in each category). Although hourly compensation costs in China's manufacturing sector increased relatively rapidly between 2002 and 2006 compared with those of other economies, (Lett and Banister 2009), the percentage of

labour cost in garment manufacturing is still lower than in most of the garment exporting countries, although slightly higher than in India and Indonesia.

**Figure 4: Labour Cost as % of manufacturing cost for garment Sector 2004**



Data Source: Textile Outlook International 2004

As figure 4 shows, Labour cost is about 10% of the total manufacturing cost in China's garment manufacturing sector for 2004, while its main competitors in Asia and North America have labour costs that are mostly above 20% of total manufacturing cost.

#### **4.1.2 The Current Trend of Increasing Labour Cost**

According to Textiles Intelligence, Werner International data shows the average annual increase in Chinese labour costs over 2004-2007 was 11.8% in the coastal region and 9.6% inland.

In 2008, Chinese labour costs were expected to have risen by 20-25%. Stringent labour laws introduced in January 2008 stipulate a minimum wage and fixed overtime, severance pay, health and accident care and a pension plan for workers.

Credit Suisse estimates that these laws alone add 15-20% to the cost of running a labour-intensive industry, and for small and medium-sized apparel exporters they come at a rough time.

### **4.2 Clusters**

‘Cluster’, in a modern sense, refers to a strategic alliance among prevailing enterprises and other related enterprises along with those situations that contribute to the value chain which has the strong ability for sustainable development. Over 70 percent of China’s present exporting apparel production (Elsayed, Kulich 2006) is concentrated in three coastal provinces (Guangdong, Zhejiang, Jiangsu) and two river deltas (Pearl River and Yangtze River). Clusters have been a significant component of the provincial economies of coastal China. Literature cites them as a new source of growth for non-metropolitan areas, enabling them to attract investment and resources that would otherwise be concentrated in major cities (Zhang et. al, 2004)

The development of the garment exporting industry cluster in China follows the pattern in which industrial clusters tend to form in regions where barriers to entry in terms of capital and technology are very low. Also, in the specific provinces mentioned above, there was initially an abundant supply of cheap labor and open access to information and technology due to knowledge

spill-over generated and circulated within the clusters, thus making rapid market development possible. Most importantly, these coastal regions provided the opportunity for international trade in order for clusters to grow and develop in an international context (Zhang, 2004).

#### **4.2.1 Guangdong**

Guangdong has ranked first in China for national apparel exporting since the 1990s. In 2008, its revenue from exported apparel was \$25.35 Billion US dollars, about 21.16% of China's total apparel export revenue. (Statistics Report of Garment Products 2008) Among Hong Kong, the United States, and the European Union, the three biggest traditional markets for Guangdong apparel exporting firms, Hong Kong plays an important role in the Guangdong cluster due to its status as a Specialized Administration Zone and its close geographic location. It provides "management know-how, technology, equipment, design and research, marketing skills, procedure service and quality assurance." (Enright et al, 2005)

#### **4.2.2 Zhejiang**

Zhejiang is the fourth industrial base in China after Guangdong, Jiangsu and Shandong Provinces. It is also the second largest textile and apparel exporter of China. The province has a number of apparel production bases including Pinghu, Tiantai, Ningbo, and Fenqiao that specialize in certain products. The rate of exportation accounts for 95% of total garment production. In addition, Yiwu is the biggest garment accessories supply centre in China or even worldwide. The provincial government recently announced that Pinghu City was listed by the China Garment Association as the first pilot zone of 'the Chinese garment transnational procurement base', after the Chinese Textile Industry Association and the China Garment Association awarded Pinghu city the title of 'China's export garment manufacturing city' in 2002

(Ruth, 2009). The move will promote Pinghu's construction of related industries cluster docking the supply chain system of transactional procurement.

#### **4.2.3 Jiangsu**

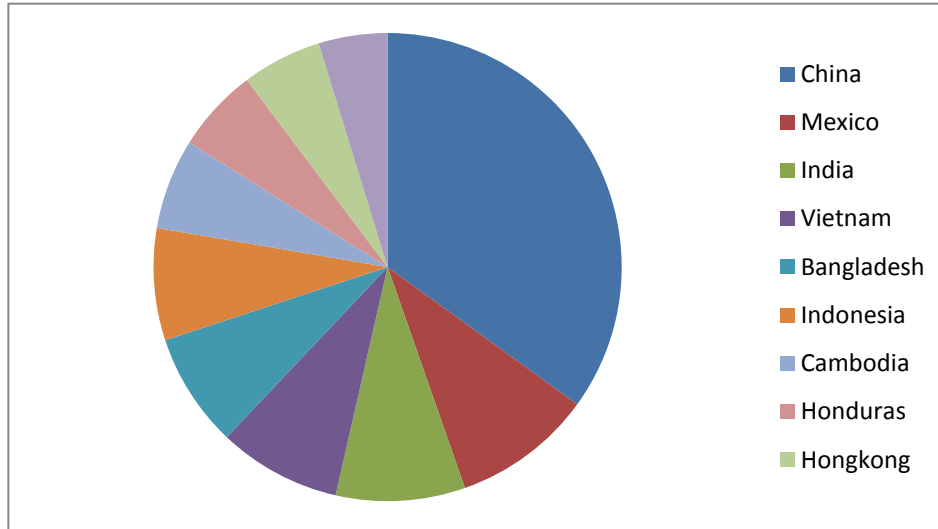
Jiangsu Province is a traditional textile production base in China, and the biggest fabric exporter. There are a number of fabric manufacturers and dyeing plants making up the supply chain for the garment sector. In 2008, its garment exporting revenue was \$ 17.34 billion US dollars, about 14.5 % of China's total garment exporting revenue. The European Union is the biggest market for Jiangsu Province.

### **4.3 Economies of Scale**

Overall, China's apparel exporting enterprises employ around 10 million people directly, along with workers in a large number in support activities. From 2000 to 2007, the annual growth rate of China's garment exporting sector was 18%, and in 2007, the growth rate was 20.8%. Figure 5 shows the top ten exporters to the US market in 2008, indicating that China contributed to over one quarter of total US apparel imports. No other country has the production capacity to compete.



**Figure 5: Top Ten Apparel Exporters to US 2008**



Data Source: China Apparel Industry Development Report 2008/2009

In 2008, the annual reported revenue from 99 Chinese garment export enterprises exceeded \$ 100 million US dollars. These 99 enterprises represented 16.9% of the total garment exporting revenue – a percentage increase of 5% compared to the previous year. This illustrates that the economies of scale for individual Chinese garment enterprises keeps increasing. Although small and medium-sized enterprises are active in the exporting sector, given the number of players, in the long term, these companies are facing the challenge of profitability. The growth of China's apparel exporting industry has been accompanied by declining profitability (Ruth, 2009). The control of profitability relates to economies of scale, which in microeconomics represents the cost advantage that a business obtains due to expansion.

#### **4.4 Production Time**

One of key criteria for overseas retailers to measure the merit of sourcing enterprises is production time. As garments are seasonal products, time is crucial. It usually takes more than

three months before the products are ready for sale in retailers' warehouse centres. The whole process begins with the buyer placing an order. Manufacturers then order raw material, such as fabric, zippers and accessories, and send a sample to the customer for approval. Once the sample is approved, plants begin to produce. Next, buyers will send quality controllers to the plants on several occasions until the products are finished. Afterwards, the products are sent to centralized locations before shipping. For some small to medium sized plants that enter subcontracts with export trading companies, the process is more complicated. To lower the cost, most customers choose to ship products by sea and this usually takes an extra 20 to 30 days for shipping from China to North America or Europe. Therefore, production time is vital. Compared to other low-cost competitors, the production time of China's garment enterprises is shorter. China has minimized production times due to its enormous capacity and domestic textile industry. Using fabric made at home, Chinese factories can churn out huge quantities of garments in a relatively short period. Because China has three mature clusters which include all supply chains for plants, from fabric to accessories, the productivity of Chinese factories is generally higher than for other low-cost competitors such as Vietnam and Indonesia. "One of our factories in China can produce 100,000 pants in one week," said a U.S. buyer who spoke on condition of anonymity because of corporate policy. "It would take a Vietnamese factory four weeks."

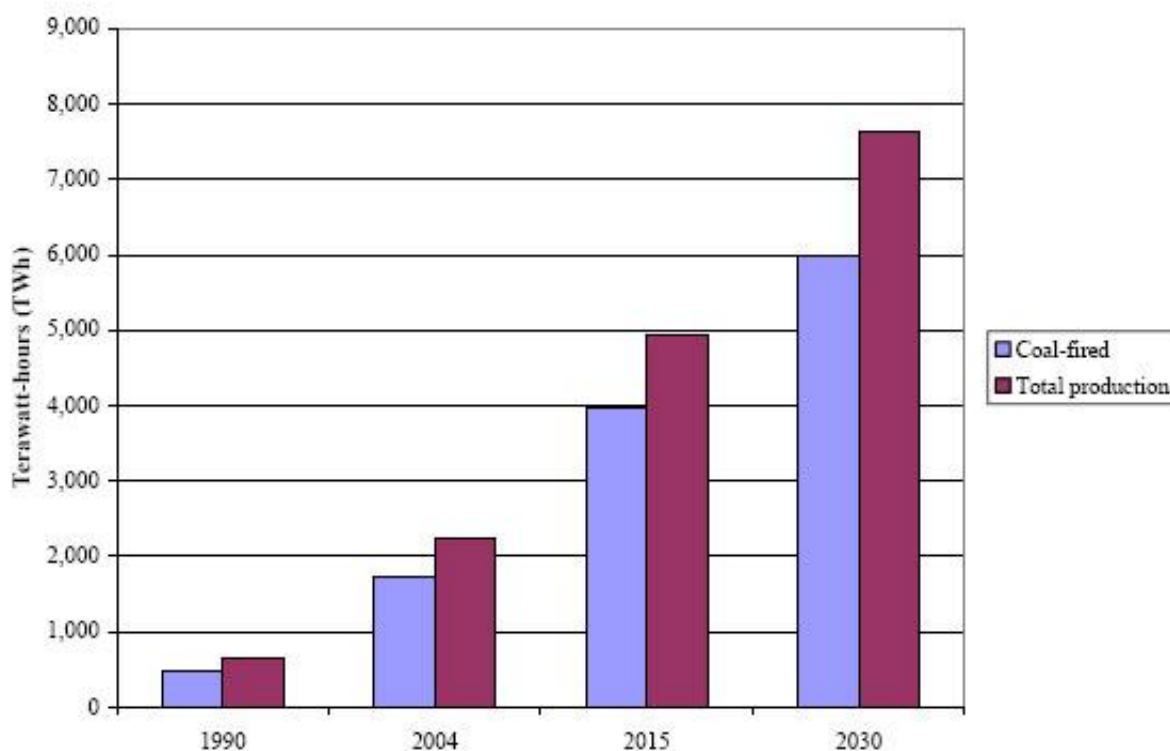
## **4.5 Infrastructure**

The Chinese government has invested heavily in infrastructure, especially in coastal areas where most of the garment enterprises are located. A large number of ports and harbours handle export trade, and are served by most international shippers. Over two hundred airports are located in coastal areas and service is available from both local carriers and most international

airlines. Railway is another major means of transportation within China and there are over 62,500 kilometres of track - mostly standard gage.

According to the reference scenario of the International Energy Agency (IEA), China's electricity productions will more than double in the next 15 years

**Figure 6: China's Electricity Power Production and Estimation**



Data Source: Data obtained from the International Energy Agency, *World Energy Outlook 2006*. Figure prepared by Frédéric Beauregard-Tellier, Parliamentary Information and Research Service, Library of Parliament

China's total electricity production was 3,510 billion Kilo-watt hours in 2008. The Three River Gorges Project is a major endeavor that involved the construction of a dam and which now produces tremendous amounts of electricity to feed the growing demand for energy. Fabric

manufacturers and dyeing plants both consume large amounts of energy and are vitally important in the garment supply chain. The stable energy supply adds value to the Chinese garment export sector.

## **4.6 Other Success Factors for Apparel Exporting Enterprises**

There are several key success factors in apparel exporting enterprises. They are also customer decision-drivers. Generally, it is thought that price is the key success factor in China's apparel exporting sector. This is true, but within the industry, there are other factors that will influence the customer's decision. More frequently, enterprises are realizing that, to some extent, low price is equal to low profit, and that there are other criteria that influence the customer's decision.

### **4.6.1 Reliable Production Workers**

Quality is a key factor for any enterprise. Because product within the apparel industry is mainly made by workers, much even by hand, consistency of quality is very hard to achieve. Complicating this is the fact that within China, a large portion of the labour force in this industry is made up of migrant workers who have the tradition of going back to their hometown during the Chinese New Year. The rate of drop-out is usually high after Chinese New Year and the unskilled or semi-skilled workers who replace them, lack training.

### **4.6.2 Good Fashion Design**

The garment exporting sector is part of the fashion industry and world fashion trends start in Europe and the US and later move to Asian Countries. Although, China's local enterprises

usually have OEM orders to produce garment products for customer-owned brands, customers like to choose enterprises that have good fashion design and can offer them stylish samples. Therefore, the enterprise's fashion design sense, especially the merchandiser's understanding of fashion in western countries, is another key success factor for an apparel enterprise as merchandisers need to source samples for customers.

#### **4.6.3 Ethical Standards**

China's 'sweatshops' are a sensitive issue criticized by foreign human resource organizations as well as foreign purchasers. In apparel exporting sectors, it is usual for manufacturers to demand long hours working time and without overtime pay. Even worse, child labour is common and is lower paid. Many big companies have their own sustainable criteria considering those ethical issues that are frequently emphasized in developed countries. Foreign customers send third party auditors to exporting enterprises to make sure that the enterprise obeys the labour law of China, and uses Codes of Conduct at the factory level, ones in which worker representatives participate.

Generally, comparatively low labour costs, solid infrastructure, economies of scale and short production times are the main advantages of China's garment sector. As individual enterprises strive for efficiency, flexibility and adaptability, the garment export enterprise should provide the stable quality, fashion ability and ethical standards to satisfy overseas customers.

## **5. Analysis of Porter's Five Forces**

Porter's Five Forces Model is used to assist in identifying and working with the broad competitive forces that must be considered in building and implementing strategic planning in China's garment export sector.

### **5.1 Barriers to Entry**

The apparel export industry has low barriers to new entrants. Clothing manufacturing is traditionally low-level manufacturing with small economies of scale. Trading companies need to have a minimum investment to meet the requirements of government. According to the policies (Xinhua Net, 2003) of the Ministry of Commerce of the People's Republic of China established on September 1<sup>st</sup> 2003, any company with registered capital of over \$146,412 USD ( equal to 1 Million CNY )<sup>5</sup> could apply for an exporting license (in Inland China and Western China, the requirement is even lower - about \$ 73,206 ), one-fifth of what it was previously. In addition, manufacturers could apply for an independent exporting license with a minimum registered capital of \$73,206 US dollars, one-third of what it had been previously, about \$219,618 US dollars. Meanwhile the government cancelled the requirement of company's existing time and promised that the process time is about 10 workdays.

Property, plant and equipment (PPE), also called Fixed Assets, is a term used in accounting for assets and property that cannot easily convert into cash (Easton, 2008). In the apparel

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<sup>5</sup> Currency Rate 1 USD = 6.83 CNY July.16<sup>th</sup> 2009

industry, PPE investment is lower compared to other industries like telecoms and the auto industry. Companies which entering the apparel export industry need educated merchandisers who are fluent in foreign language (mainly is English) to communicate with overseas buyers. Some buyers from Hong Kong can speak Mandarin. Due to the recent severe competition in the personnel market, it is not difficult to find staff who learned English in the University or who studied abroad. According to 2008 statistics from the Ministry of Education of the People's Republic of China, 5.6 million new undergraduate students entered the job market This, added to the 0.7 million unemployed undergraduates from the previous year, meant that over 6 million undergraduates competed for new jobs.

## **5.2 Bargaining Power of Suppliers**

Suppliers to apparel exporting manufactures are textile and fabric manufacturers, accessories manufacturers, and also semi-skilled workers or unskilled country workers. There are a large number of suppliers available in the market from state- owned, foreign investor owned and privately owned businesses. According to the Chinese National Bureau of Statistics (Statistics Report of Garment Products 2008), in 2008, there were a total of 48,952 textiles and fabric manufacturers countrywide, including 28,155 stated-owned companies, 15,481 private companies, and 5306 foreign investor owned companies. The Pearl River Delta and the Yangzi River Delta are the two main manufacturing bases and clusters. And they assemble two- thirds of exported apparel. Apparel export manufacturers have better access to suppliers through these two clusters, because firms in the same sector or related areas are close competitors or value chain members.

Suppliers in rural area like Inland China and Western China maintain low price strength by keeping wages down and overhead expenses low in comparison to the two clusters. However, sourcing expenses are higher for apparel exporting companies, as are expenses for quality control and logistics. Furthermore, the technology in Inland China and Western China is comparatively low and suppliers can only produce low added-value products.

Semi-skilled labourers and unskilled labourers are also suppliers to garment companies. The labourers bargaining power has been increasing for many years as the industry grows. Garment manufacturers competed for semi-skilled labours to increase their productivity. Other manufacturing industries also tried to attract unskilled labours along with the garment export sector - industries such as the semi-conductor and electronics industries. Due to the economic recession which began in 2008, about 20 million country labours were unemployed after the Chinese Lunar Year of 2009. The bargaining power of labourers is comparatively low at present, but as the economy starts bouncing back, labourers' power will increase.

For garment trading companies, suppliers are garment export manufacturers. At a level above manufacturers, they usually have their own overseas customers and export through their own companies. Trading companies' main suppliers are small to medium sized manufacturers. The competition among these manufacturers is very high as there are over 20,000 players in this sector. The majority of these small-medium manufacturers do not have direct connection with overseas buyers.

Overall, the bargaining power of suppliers is medium.



### **5.3 Bargaining Power of Buyers**

Importers from outside of China are all the buyers of China's apparel export companies while the market today is still dominated by the EU, Japan, the United States and Hong Kong. Overseas buyers attend China's Import and Export Fair (Canton Fair) twice a year, and the East China Fair (Shanghai Fair) once a year looking for manufacturers and exporting companies.

Some multinational buyers have buying offices in metropolises like Shanghai, Guangzhou and Beijing etc., which hire local merchandisers to look for good suppliers as regards manufacturers' production capacity and product categories. The apparel value chain is a good example of a buyer-driven value chain in which retailers and marketers like Wal-Mart, Sears, Nike, Gap or Liz Claiborne are "manufacturers without factories" with the physical production of goods separated from design and marketing. In contrast to producer-driven value chains where profits come from scale, volume and technological advances, the profits from buyer-driven chains come from superior design, sales, and marketing. This allows the retailers, designers and marketers to act as strategic brokers in linking overseas factories with product niches in their consumer markets. In these cases, buyers have fundamental control over the whole value chain without capital investment or the hassle of physically owning and operating the factories.

Apparel exporting companies would like to choose companies having larger number of orders as their ideal customers. As a labour intensive industry, productivity is hard to increase. The most effective way to increase labour's productivity is through quantity. If the average number of per order is low, the productivity of labour is low. Therefore, all the manufacturers compete for big buyers. So buyers like Wal-Mart and other big department stores have very high bargaining power due to the size of their orders. Even the piece price is low.

Some buyers own famous brands like Zara, Gap, and Nike and H&M also outsource their products in China, moreover, as those companies sell high added-value products, the purchasing price is better than that of Wal-Mart and department stores. Apparel exporting companies have to meet the buying companies' sustainability standards before becoming their local suppliers. Licensed brand products can sell in the domestic market if the order is cancelled by accident. The risk is lower for exporting companies doing business with famous brand companies.

There are also some small overseas retailers who out-source their products in China, especially from European countries like France, Italy, and Germany. The size of European orders is usually smaller than orders from the US. For instance, the average order of an American retailer is about 10,000 pieces, whereas the average order size for a Europe retailer is only 1,000 pieces. Small retailers with branded products usually have more power as their products have high value-added and the profit margin for manufacturers is high. Some unbranded retailers from European countries do not have high bargaining power as their orders are either not big enough or the price is not good enough. Overall, the bargaining power of buyers is high.

#### **5.4 Availability of Substitutes**

Generally, there are no substitutes for the apparel industry. The only alternative to Chinese exported apparel products in the world market are products from local manufacturers and products from other developing countries.

**Table 3: Leading Exporters of Clothing in World Trade, 2007**

Billion Dollars and Percentage

Countries	Value in 2007	Share in 2000	Share in 2006	Share in 2007
China excluding Hong Kong	115.2	18.2	30.6	33.4
Turkey	14	3.3	3.8	4.1
Bangladesh	10.1	2.1	2.8	2.9
India	9.7	3.1	2.7	2.8
Vietnam	7.2	0.9	1.7	2.1
Indonesia	5.9	2.4	1.9	1.7
Mexico	5.1	4.4	1.8	1.5
Sri Lanka	3.3	1.4	1.0	1.0

Data Source: International Trade Statistics, World Trade Organization 2008

Under the Agreement on Textile and Clothing (ATC), world trade in textile and clothing has become very free (without quotas) and integrated with the World Trade Organization. There has been a sense of optimism in the Chinese clothing industry in the post-quota period revealed by the statistics (Table 3). Yet it is perceived that countries like Turkey, Bangladesh, India and Vietnam will emerge as major sourcing centres. Turkey managed to garner a share of 4.1% in 2007 as compared to 3.3% in 2000. Bangladesh has been able to increase its export share from

2.1% in 2000 to 2.9% in 2007 and Bangladesh clothing exports for the financial year 2007-June 2008 rose by 16.2%. (International Trade Statistics, 2008)

Vietnam's market share has been able to gain marginal growth in its export share as its share in world clothing trade increased from only 0.9% in 2000 to 2.1% in 2007. In 2007, the Vietnamese industry grew by 33.4% to become, in 2008, the USA's second largest foreign supplier of textiles and clothing. China still maintains its position as the largest exporter to America. Exports from Vietnam to the European Union have also grown. In the first six months of 2008, Vietnam's exports to the EU grew by 8.4%. Chinese exports to the EU during the same period increased by 5.1%. (International Trade Statistics 2008)

The Indonesian market saw a moderate increase in exports during the first six months of 2008, with domestic demand growing. The Malaysian textile and clothing industry saw a 3.2% decrease in 2007, while the Philippines faced heavy competition from China. Thailand's industry grew during the same period of 2008 in comparison to the same period for 2007. (International Trade Statistics)

Due to many preferential trade agreements like the North American Free Trade Agreement (NAFTA), Caribbean Basin Initiative (CBI), and African Growth and Opportunity Act (AGOA), the beneficiary countries have strong growth potential compared with China.

With respect to local manufacturers, companies like American Apparel are growing very fast. Started from 1997, the company bases manufacturing in downtown Los Angeles, California and has over 182 retail stores in 13 countries. It also owns and operates its own fabric dye house, garment dye house and knitting facility. Moreover, it reached total revenue of \$387 million in 2007. The long history of protection within the Textile and Apparel industries in the US and EU countries, has tended to continue during the recession period. The U.S. textile industry believes

that it has received positive signals from the Obama administration that it will favourably consider special trade action against China under Section 421 of legislation entitled 'China Safeguards'.

Therefore, the substitutes are high as available from local manufacturers and other developing countries

## **5.5 Rivalry among Competitors**

Rivalry within China's apparel export sector is extremely high considering the existence of a large number of players.

Official figures in 2008 indicate that there are about 41,855 garment exporting companies in China with combined annual sales of \$119.81 billion US dollars and that there are hundreds of thousands of smaller operations. According to the China National Textile and Apparel Council's latest industry survey, profit margins averaged at 3.9 percent among textile companies in 2007. Two thirds of the companies surveyed reported an average profit margin of 0.62 percent. Small and medium-sized companies suffered the most, with some on the brink of failure. The survey( Xinhua Agency 2008) conducted by the CNTAC in early March 2008 covered textile and apparel companies in six provinces including Jiangsu, Zhejiang and Guangdong, accounting for 70 percent of China's textile exports.

It is estimated that there are more than 20 million workers in the clothing & textile industry sectors with 13 million rural migrant workers making up the bulk of the labour force. The China National Textile and Apparel Council (CNTAC) is extremely concerned about factory closures and the ability of the country to absorb job losses mostly among the migrant workers.

No official figures have been released by the Chinese government regarding the closure of apparel exporting companies since late 2007 and 2008. Nevertheless, the Hong Kong Trade Development Council reported that in 2007, over 1000 apparel exporting companies closed in Guangdong Province, and in 2008, thousands of variously scaled operations closed country-wide including Guangdong, Zhejiang and Jiangsu.

Low profit margins and the large number of existing players demonstrate that rivalry in this industry is extremely high.

In short, the Chinese garment export sector is an industry of low entry barriers, medium supplier power, high buyer power, high substitutes and extremely high rivalry. It is still an industry that has a lot of local small and medium size enterprises. But considering the high buyer power, high substitutes, especially high rivalry, new entrants should be very cautious of the difficult requirements for success. For SMEs, reliable production workers, good fashion design and ethical standards would help them stabilize customers and stand out from domestic and international competitors.

## **6. Major Challenges to China's Apparel Export Industry**

China's garment export sector is facing several challenges. Some are factors that increase the cost of garment export enterprises, some are factors that reduce the price of products, and the others are factors that lower foreign demand. While challenges pose barriers to many enterprises, some can also be opportunities for individual enterprises to stand out and differentiate from rivals. An old Chinese saying says that "challenges and benefits coexist; opportunities and risks work side by side."

### **6.1 Challenges Related to Increased Costs**

The challenges discussed in this section are mainly those factors that increase the cost for garment exporting enterprises in China including rising labour costs, the appreciation of Chinese Currency Yuan, anti-pollution regulation, and strict bank regulations. These challenges only affect China's garment exporting enterprises.

#### **6.1.1 Increasing Labour Costs**

According to Textiles Intelligence, Werner International data shows the average annual increase in Chinese labour costs over 2004-2007 was 11.8% in the coastal region and 8.6% inland. Under the pressure of domestic social stability and the criticism of western developed countries regarding 'sweatshops', China's parliament, the National People's Congress, passed a new labour law in July 2007 amid complaints of unpaid wages, forced labour and other abuses. The new labour law took effect in Jan. 2008. The main purpose of this law is to improve the

protection to employees' legal rights, especially migrant labours and to toughen punishment for employers that abuse the law. The law stipulates a minimum wage, fixed overtime, severance pay, health and accident care and a pension plan for workers. This has increased costs for firms, especially in labour intensive companies. Previously, migrant labours had no health and accident care or pension plan. Employees were only pay wages based on piece. Employees were required to work over ten hours per day without overtime payment. The more pieces workers did per day, the higher pay they got. Because the level of economic development varied, minimum wages were different between provinces and cities. After the implementation of the new labour law, minimum wage in Guangzhou was 78 US dollars per month, while in Shenzhen and Zhuhai it was 85 US dollars per month. The minimum wage for inland cities like Nancong was 66 US dollars per month.

The new labour law requires that all labour contracts be in writing and imposes significant penalties for employers who fail to comply with this. Employees can claim double salary for months worked without a contract for up to 12 months' salary. It also requires all employers to maintain a written employee handbook setting out the basic rules and regulations of employment. Without an employee handbook, employers will be essentially unable to fire anyone. "The failure to maintain an employee handbook means that an employer will effectively be unable to discharge employees for cause, since "cause" must be determined with reference to the employee handbook. Do it. " (Cooney 2008) This increased bureaucracy and greater financial commitment to workers has acted as a disincentive for garments exporting companies since rising labour costs directly decrease their profits.



Credit Suisse estimates that these laws alone add 15-20% to the cost of running a labour intensive industry, and for small and medium-sized apparel exporters they come at a rough time.

China is already a relatively difficult labour market. The World Bank's 2008 'Ease of Doing Business Report' ranks China 86th out of 178 countries in terms of ease of employing workers - below regional peers such as Hong Kong, Thailand, Vietnam and India with non-wage costs being comparatively high within the region. 'Ease of employing workers' is associated with the expenses of firing workers. Non-wage labour cost measures all social security payments (including retirement funds; sickness benefits; maternity and health insurance; workplace injury; family allowance; and other obligatory contributions). It also includes payroll taxes associated with hiring an employee

**Table 4: Ease of Employing Workers (Ranking out of 178) 2007**

Country and Region	Ranking	Non-wage Labour Cost (%of Salary)
Hong Kong	29	5
Thailand	49	6
Vietnam	84	17
India	85	17
China	86	44
Philippines	122	7
Bangladesh	129	0

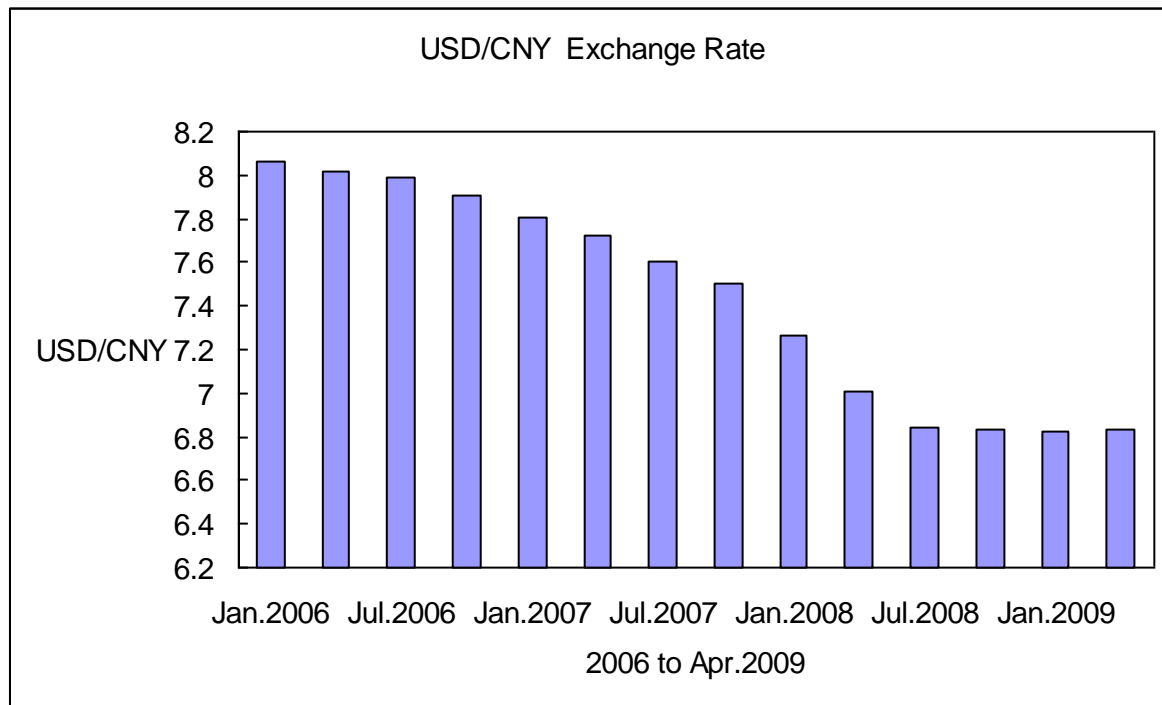
Data Source from World Bank (2007)

### **6.1.2 The Appreciation of the Chinese Currency**

The acceleration of the revaluation of the Chinese Currency, the Yuan (CNY), also known as Renminbi (RMB) – has, no doubt, increasingly reduced textile and garment export profit margins. For China's textile and apparel export industry it has been the ‘salt into the wound’. About 86% of apparel exporting companies trade with international customers in US dollars, including companies doing business with Japan and European countries, as the US dollar is still the dominant currency in business. Therefore, the exchange rate between the US dollar and CNY is crucial to exporting companies in China.

As figure 7 shows, at the end of 2007 the CNY exchange rate was one U.S. dollar against 7.3046 Chinese Yuan an appreciation of 6.9 percent over the previous year. In 2008, the appreciation of the CNY accelerated at a greater pace. As of Jan.2009, the CNY against the U.S. dollar was 1: 6.827.

**Figure 7: USD/CNY Quarterly Exchange Rates from 2006 to Apr.20**



Data Source from Yahoo Finance

The impact of the revaluations of the CNY on Chinese apparel exporters is tangible and costly. It is estimated that the change in the Yuan has consumed most of the profit in China's apparel exporting industry. For China's Apparel Exporting Industry as a whole, the average profit margin is 3.9 percent. The appreciation of the CNY is bound to further reduce profit margins within the textile and garment industries. Many small and medium-sized export-oriented enterprises are accustomed to adding an exchange clause to contracts or to shortening collection period in order to reduce the currency exchange rate. However, the regular length of time for collection is about 90 days after shipment. The time between the placement of an order by an overseas buyer and shipment, is usually over 3 months. Therefore, it is hard to estimate the currency rate for half a year. In addition, buyers are not willing to add anything to product prices

to compensate for undetermined appreciation. Therefore, enterprises are not able to avoid the risk of appreciation.

Because of appreciation, sales in the apparel exporting industry dropped between one and four percent during 2008, the profit margin compression has indeed put in the ground in front of the enterprise.

### **6.1.3 Banking Restrictions**

Apparel manufacturers are under pressure from banks in China. This pressure has taken the form of hikes in loan interest rates, and more restrictions on - loans to enterprises that are characterized by "high energy consumption, high pollution and high emission." This includes the textile and apparel industry. Neither the global financial turmoil nor recent company breakdowns in the Chinese textile supply chain (from key suppliers like PTA-producer Sanxin to thousands of apparel makers) were able to convince Chinese banks to relax their credit policy for the apparel industry - an industry they traditionally approach with caution. Chinese Banks consider the apparel industry as a labour-intensive and a capacity surplus industry, even as a sunset industry, and implement very strict business assessment systems for them. Furthermore, as the industry is a comparatively low profit one, SMEs find it difficult to secure loans from Commercial Banks and turn to other ways of leveraging the increased cost of financing. In clusters like Guangzhou, Zhejiang, private borrowing has become very popular among private enterprises. The monthly interest rate could even hit 3%.

### **6.1.4 Anti-pollution Regulation**

Untreated textile effluents released from industries onto open land seep into the aquifer and increase the concentration of EC, TDS, Na & Cl contamination in ground water. Contamination

has been reported in various regions because of the large number of dyeing and printing units, particularly within the provinces of Jiangsu and Zhejiang. The textile industries use synthetic organic dyes like yarn dye, direct dye, basic dye, vat dye, sulphur dye, developed dye and reactive dye. The large variety of chemicals used in the bleaching and dying process render can be very toxic. These chemicals are used in an attempt to make more attractive and popular shades of fabric for a competitive market. The textile industries are striving to satisfy overgrowing demands in terms of quality, variety, fastness and other technical requirements, but the use of dyestuffs has become increasingly, a subject of environmental concern.

The Chinese government is becoming more aware of environmental issues and requires strict regulations for dye manufacturers and printing units, increasing the cost of operation. Companies are being pressed to invest in expensive new machinery and improve their waste-management systems. Chinese officials can be ruthless on environmental matters, and, in mid-2007, vowed to eliminate some 2,150 polluting firms by the end of 2008. Therefore, as the suppliers of apparel companies, the increasing cost for textile manufacturers directly affect the price of the raw material for apparel manufacturers.

## **6.2 Challenges affected by the competition among low cost countries.**

### **6.2.1 Rising Raw Material Costs**

There has been a substantial increase in the cost of raw materials, particularly cotton, polyester and wool. This has become a major challenge for textile and garment enterprises.. Cotton is the main raw material in textile and apparel products, and cotton prices are a source of anxiety for apparel manufacturers. As the Chinese market becomes more open to world commodity trade, its domestic cotton price moves closer to the world market price. Following

the trend of rapid global increases in the price of cotton, prices in April 2008 reached a peak of \$1.78 / kg.<sup>6</sup>

About 40% of the cotton used in China's garment and textile sector is imported from the United States. Since 2005, India has become the second largest supplier of cotton. India has successfully transformed itself from being a cotton importing country to a cotton exporting country. As one of the main competitors of China's garment export sector, India has increased its competitive advantage in the garment industry.

### **6.2.2 Reducing Unit Price**

According to the statistics of the General Customs Administration, currently, India, Pakistan, Vietnam and other surrounding countries are providing labour costs equal to 68% of those of China. The cheap labour costs not only affect the overseas market share of Chinese garments, but also attract Chinese textile and garment companies to move outside of the country. At present, over 400 Chinese garment companies have invested money to set up factories in Cambodia, and nearly 100 in Bengal. These cheap labour costs have caused the international market price of popular textile to drop sharply. The unit price of some popular textile and garment products of China's garment companies presents a downtrend in price competition, especially for regular sportswear, suits and T-shirts.

## **6.3 Challenges which Lower Foreign Demand**

'Challenges' in this section, refers to those that not only affect Chinese garment export enterprises, but also its competitors including garment enterprises in developed countries and garment enterprises from other low cost countries.

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<sup>6</sup> Sourced from World Bank Commodity Data

### 6.3.1 Ongoing Recession in US and Worldwide

In February 2007, the U.S. sub-prime loan crisis broke out, followed by the world wide recession starting in 2008. It not only triggered fierce global financial market turmoil, but also affected a variety of industries, including the textile and apparel industry.

Although China's total garment export reached \$119.81 billion US dollars, a 4.1 percent increase, the trend was dramatically slimmed, since the increased percentage in 2007 was 20.9%.

**Figure 8: China's Textile and Apparel Export Volume Chart 2006 to 2009**

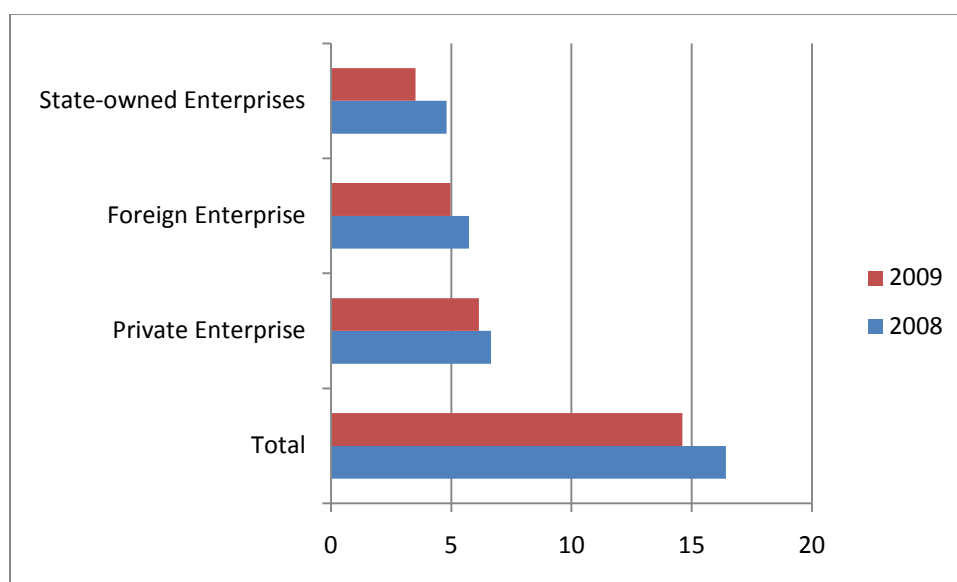


Data Source: General Administration of Customs of People's Republic of China

In addition, exports have continued to slow during the first two months of 2009. Customs data show that in January, China's total textile and apparel export was 21.9 billion U.S. dollars, a decrease of 14.5 percent compared with year 2008. In February, exported textile and apparel products stood at 6.67 billion U.S. dollars, down 35.1 percent. During these two months, total

clothing export product was 14.62 billion U.S. dollars, down 11 percent compared with the number in 2008.<sup>7</sup> Privately owned companies exported 6.15 billion US dollars, down 5.9%; foreign investment enterprises exported 4.96 billion US dollars, down 13.6%; and state-owned companies export 3.51 billion dollars, down 26.9%.

**Figure 9: China's Exporting Statistics for the First Two Months of 2008 and 2009**



Data Source: General Administration of Customs of People's Republic of China

The U.S. economic recession resulted in a decline in consumption level of textiles. American consumer confidence was greatly affected. The United States stepped up its trade protection measures, thereby weakening China's textile products in the international arena; while

<sup>7</sup> Sourced from General Administration of Customs of People's Republic of China  
<http://www.customs.gov.cn/publish/portal0/tab2453/module72494/info164605.htm>



the US Congress' 2009 plan for a "Buy American" rule as part of the economic stimulus package, was condemned as a dangerous retreat into protectionism.

### **6.3.2 Technical Barriers**

During the developing process of world trade liberalization, technical barriers are now becoming a new 'non-tariff trade barrier' along with the gradually weakening of traditional trade barriers. The of the narrow sense, 'technical barrier' mainly refers to the technical regulations, standards and conformity assessment procedures that WTO stipulates in its Agreement on Technical Barriers to Trade. The broad sense of the expression also includes sanitary measures; requests on packing, label and signage; green barriers; information technology barriers and so on which always appear in the forms of technical regulations, standards and conformity assessment procedures. One of the obstacles to the export of garments to developed countries, especially the EU, is product safety and environmental protection. Since the EU has higher technological standards for textiles and garments and a higher standard of living, people have much preferred high-tech green products. On the grounds of protecting ecological environment and consumer health, the EU has set some strict standards for domestic and imported products. However, its real aim is to protect its own garments industry. China's garment export enterprises and other enterprises from developing countries are generally in a weak position with respect to technological innovation and testing standards. For individual enterprises, there is a great opportunity to differentiate technologically and to stand out from domestic competitors and competitors from other low cost countries.

### **6.3.3 Ethical Standards Emerge**

There is widespread concern about child labour in the marketplace. Western non-governmental organizations, the media and labour unions advocate for 'sweatshop-free' sourcing of clothing, by creating awareness among the major consuming groups. They are putting pressure on international buyers to source 'ethically correct' products. Major buyers and retail groups have reacted to these pressures by introducing corporate codes of conduct. Such ethical sourcing standards apply to all developing country manufacturers they deal with, including China. These standards apply to subcontractors as well. Large international buyers apply these rules strictly, as they cannot afford negative publicity.

### **6.3.4 Eco-labels**

Eco-labels are widely recognised in Europe. Textile and garment manufacturers from developing countries are increasingly confronted with the need to adapt to eco-labelling requirements. Eco-labelling schemes currently serve primarily as a marketing tool, and products with eco-labels tend to target niche markets. There is an equal emphasis on the certification of clean production pipelines and limitations on effluent discharges from sourcing shrink proofing and dyeing. All processing agents (detergents, lubricants and sizes) must be biodegradable. Tests are also required to ensure that the garments are washable and colourfast, so that the final product will be durable. There is a concern that access to developed markets will significantly reduce due to consumer boycotts of non-labelled goods and aggressive advertising by protectionist domestic industries. Textile manufacturers in developing countries have difficulty meeting the criteria of Eco-labels. Some garment exporting enterprises have to import textiles, especially fabric, from developed countries in order to make Eco-label products. Thus, the green

niche market's biggest profit is still in the developed countries.

### **6.3.5 Antidumping and countervailing duties**

Anti-dumping rules and duties are likely to come under scrutiny in 2009. A change in the rules governing China's textile and clothing exports involving the expiration of US and EU quotas could put increased competitive pressure on other producers. This could lead to greater recourse to anti-dumping by developed countries concerned with the threat to domestic producers. When China joined the World Trade Organization (WTO) in 2001, there were fears that the country's textile exports would swamp the global market. As a result, a 'textiles safeguard' clause was written into China's accession agreement. The textile safeguard is part of the wording used in the bilateral agreement that the U.S. negotiated with China for China's WTO accession protocol. This clause expired on 31 Dec. 2008.

While the global financial crisis may increase consumer demand for cheaper clothes in the EU and USA, developed countries may become more protectionists to favour their domestic producers. Many governments have already taken action against 'dumping' – the export of products at prices lower than those products are priced in a home market – to defend their domestic industries. A country that is subject to anti-dumping investigations is classified as either a 'Market Economy' (ME) or a 'Non-market Economy' (NME). Both the US Department of Commerce (DOC) and the European Commission (EC) designate eighteen countries as NMEs. China is the main target country as a NME. The consequence of being classified as an NME is that "constructed prices", or the prices from so-called 'analogue' countries, are used to determine whether dumping has occurred and what appropriate dumping duties should be

applied. The use of analogue country data often leads to higher dumping duties, and the choice of an analogue country is a significant source of bias.

There is likely to be a rise in anti-dumping and countervailing duty cases in China, which will pose a real threat to apparel exporters. The use of anti-dumping measures could sharply reduce the benefits of liberalization, as they are non-transparent and unpredictable. Furthermore, most of trading companies in China and other developing countries do not have a solid understanding of these regulations, and governments do not offer updated statistics to enterprises and therefore, most of the statistics from developing countries are inaccurate. In addition, just the announcement of possible anti-dumping investigations can make buyers hesitant to place future export orders because of uncertainty over whether anti-dumping duties will be imposed in the future - an effect known as 'trade chilling'.

## **7 Government Policies to Simulate the Apparel Export Industry**

In China, government policies usually take a vital position in business decisions. The support from the communist government will bring enterprises many benefits from taxes to funding. In March 2009, the Chinese Government announced a stimulus plan that could help shorten the recession in the industrialized world. It provides a four trillion Yuan (\$586 Billion) stimulus to reinvigorate the flagging economy and to ward off the global economic downturn. To invigorate China's textile and apparel industry, the government will allocate funds for companies that produce textiles or apparel, or that operate in the textile printing/dyeing sector, and exporting sectors. The funds are for the purpose of upgrading technology, liquidating cash flows and developing domestic brands. The government believes that stable exports will play a fundamental role in maintaining economic growth, improving resistance against risks and ensuring employment.

### **7.1 Tax Rebate Policy**

Since 1985, China has had in place a tax rebate system in which the federal and provincial governments rebate a certain percentage of value added tax (VAT)<sup>8</sup> to exporting enterprises. The system is designed to support export trade and to increase the international competitiveness of companies involved in this business. From 1985 until now, the tax rebate for different categories

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<sup>8</sup> VAT: Value Added Tax is a consumption tax levied on value added. Businesses are able to recover VAT on the materials and services that they buy to make further supplies or services directly or indirectly sold to end-users. In this way, the total tax levied at each stage in the economic chain of supply is a constant fraction of the value added by a business to its products, and most of the cost of collecting the tax is borne by business, rather than by the state.

products experienced 6%, 15%, 12% various level. With China's trade surplus growing rapidly, the central government has made significant changes to its rebate system in an attempt to influence export growth. Because of the ongoing changes to the system, export tax rebates and exemptions have now become a major cause for concern among most exporting enterprises. Generally, the increase in tax rebates for certain products will boost the export in the industry, whereas a decline in tax rebate would discourage business motivation. The tax rebate system is viewed as the government's policy signal.

Starting from 1 June, 2009, the export tax rebate rate will be increased for over 2400 types of commercial products. This is the third time this year, and the seventh time since August of 2007 that the export tax rebate rate has been increased. Specifically, the list covers 2,486 different types of products, an estimated one-quarter of all exports listed by Chinese customs authorities including garment products, textile products, footwear products, and semi-conductor products. Given the list of products for which the tax rebate rate will be adjusted, it can be seen that the goal of the policy is to expand the global market share for products in which China has an advantage, to stabilize exports of labor-intensive products in order to stabilize employment, and to encourage the development of the high-tech industry.

China has increased the tax rebate on textiles at least 5 times since 2008, most recently, increasing the rate to 16 percent from 15 percent in June.2009. The purpose of this policy is to reduce the burden on enterprises resulting from customs taxes. With external trade figures continually falling, enterprises are naturally happy to see this policy. Because external demand still remains weak, the move will reduce exporters' costs and support the textile and apparel industries. Nevertheless, it is still difficult to determine whether or not the policy can effectively

stimulate enterprise exports. In addition to this, a considerable number of enterprises have voluntarily ceded profits to external parties for the purpose of retaining orders.

## **7.2 Policy to Encourage the Apparel Industry to Move to Central and Western China**

The West Development Policy was made a top government priority in 1999, and the implementation of the Western China development strategy is an important component of the modernization strategy of China. The government also announced steps intended to phase out obsolete capacity, to eliminate energy-intensive, polluting equipment and technology, and to encourage textile and garment makers to relocate from South Eastern parts of China to central and western areas.

Emerging provinces in Central China and Western China are seeking further development despite the global economic downturn. Relocation of the country's apparel industry from East China to Central China was outlined as a major development strategy between 2006 to 2010, the eleventh 'five-year plan' of the Parliament of the People's Republic of China.

**Figure 10: China's Provincial Map**



Data Source: China Map 168 (2009)



## **8. Strategic Recommendations for Enterprises**

After analyzing the challenges China's garment export enterprises are facing and the Chinese government's policy orientation, this chapter covers strategic implications for individual enterprises, mainly the addition of more value to products, the reduction of costs and the exploration of new markets.

### **8.1 Addition of More Value to Products**

Some Chinese apparel producers are satisfied with their low prices, but they are failing to develop their own designs or brands. With low added value, the Chinese apparel industry can only generate modest profits from processing, taking advantage of low cost labor and using high volume strategy. But under the current low-demand economic situation, Chinese apparel exporting manufacturers will have to change their existing strategy, especially those holding abundant capital. They should focus on innovation and the development of their own product brands.

#### **8.1.1 Increasing Value Added**

There is an impression that Chinese apparel products are low priced and low quality, and it is not generally known that some luxury brand products are also made in China. A number of high-end clothing brands including Prada, Coach, and Burberry have begun to outsource their products in China recently, but as a public relations issue, these companies do not promote the fact that their products are made in China. Individual apparel exporting enterprises could opt for

high-end products especially those small and medium size plants. Although the manufacturer's selling price is usually one fifth of the retailer's selling price for the apparel sector, for those luxury brands, the selling price is higher than for no-name brands and superstore brands. For example, the price for Polo's cotton color-woven shirts and Dock's cotton trousers is generally 3 to 4 times that for ordinary products. Enterprises could earn high profits by producing brand-name products.

### **8.1.2 Building Brands**

As statistics shows, over 90 percent of Chinese garment export manufacturers are original equipment manufacturers (OEM), which manufacture products or components purchased by a second company and retailed under second company's brand. It is obvious that in the fashion industry, brand name is a big component of price. China's apparel export companies with sufficient capital could build either their own garment brands or acquire some international brands to increase their profit.

Most recently in Jun. 2009, two Chinese exporting apparel enterprises bought French fashion label Pierre Cardin's 32 clothing and accessories licenses for EUR 200 million (USD \$208 million). The company will participate in design decision-making of products in the licensed category. The main buyer, Shenzhen Jiansheng Trading Company, is a privately owned apparel exporting enterprise in Guangzhou Province. The company has planned to explore the world fashion market by acquiring part of the Pierre Cardin Group.

One successful case is Jiang Nan Bu Yi Clothing Company (JNBY). It used to an OEM manufacturer and founded its own brand JNBY in 1999. The Hangzhou-based company not only builds its own garment products, but integrates into retailer channels. It has a flagship store in

Moscow, and recently opened a new store in Burnaby, Canada.

### **8.1.3 Upgrading Production Equipment**

In order to produce high-end and middleclass garment products of good quality, it is very crucial that the sewing and knitting machines be of good quality. Technical upgrades relate to a company's manufacturing capability and productivity. Moreover, new developments in fibre and other raw material, also require upgrading of machinery. For the apparel industry, upgrading to new machines not only means increasing productivity, but also brings new business opportunities. Upgrading can also help manufacturers shift from labour-intensive to technological operations. The increase in productivity could reduce the dependence on migrant labours and could lower operational costs. Some newly invented products have high requirement for garment machines. For example, seamless underwear has become very popular recently. Fashion companies like Calvin Klein and JC Penny have all launched this category of product but it has to be produced by special garment machines.

Moreover, outdoor sports apparel is highly priced in developed countries, and also requires better machinery and equipment to produce. Exporting enterprises could invest in new facilities to enter the niche market.

## **8.2 Relocation of Production**

Some apparel producers are relocating to other regions in China with lower labour and land costs and a larger pool of job seekers, also taking advantage of different provincial policies for attracting investment. The main trend is from coastal regions to Middle China and Western China.

### **8.3.1 Jiangxi Province**

There are several favourable opportunities for Jiangxi Province to attract more coastal apparel exporting enterprises to relocate there, especially when cost control is crucial. Jiangxi province, which is close to the Yangtze River Delta the Pearl River Delta (Near Guangdong Province) and the Minjiang River Delta Regions all have geographic advantage. The proximity between Central Chinese Provinces and the coastal provinces, as well as relatively better availability of transport infrastructure, favours the growth of Central China. Jiangxi Province has planned to invest heavily in this aspect, including investment in an express railway which is now under construction linking Nanchang and Fuzhou/Putian. After its completion, finished goods can be directly transported to the port of Putian in Fujian Province for export. For example, early in 2008, Hong Kong sweater maker Milo's Knitwear opened a factory in Jiangxi province, some 650 km from Hong Kong, where operational costs are about 20% lower than in nearby Dongguan.

### **8.3.2 Other Relocations**

Another famous setup in Dongguan is that of Dongyue Garment Factory, which has relocated one of its workshops to Heyuan City in the north east of Guangdong province and another one to Hubei province.

Other companies are relocating production to cheaper Asian countries like Vietnam, Cambodia and Indonesia, and even to the commercial hub, Dubai, where Chinese workers have reportedly flown.

## **8.4 Exploration of Growing Markets**

The US, the EU and Japan are the three largest importing countries for Chinese garment products. Throughout the current recession, retailers have frequently cut and delayed orders due to lower demand. Chinese export enterprises should not only maintain or increase the share of these markets but also explore other growing markets.

### **8.4.1 Exploration of Domestic Markets**

China's domestic apparel market has become a ready and more significant market for garment manufacturers as the overseas markets have shrunk. Many garment export enterprises are now in a hurry to seek new ways to survive.

According to the China National Textile and Apparel Council, China's domestic clothing demand in 2008 rose by 27.8 %, 14.5 percentage points higher than the general growth in consumables.

It is also worth noting that Western retailers are betting on soaring clothing consumption, growing quality, and brand awareness in China to create new opportunities for exporters to switch from overseas markets to domestic markets.

Early in October 2008, Marks & Spencer opened a 3,800 square meter flagship store in Shanghai. Brands such as Zara, H&M, Muji, C&A and American Apparel also have a presence in China, while luxury brands like Gucci and Prada cater to the wealthy.

#### **8.4.2 Explore CIS Markets**

The Commonwealth of Independent States includes Russia, Ukraine, and other former Soviet Republics. Russia is one of the BRIC, and other fast-growing developing countries like Ukraine, Kyrgyzstan and other member countries have booming economies as well. As the economy progresses, the demand for garment products is growing. Since CIS has weak infrastructure with respect to light industry, these countries mainly depend on importing textile and garment products. . In 2008, China's garment exports to CIS countries increased 118.1%, which made Xinjiang become the fifth largest garment exporting province in China. Geographically, Xinjiang is very close to CIS. As more and more enterprises move to Central China and Western China, it is easier for garment exporting enterprises to target CIS as new markets. In addition, the weather in CIS countries is cold in winter and so they have a large demand for value added products like down jackets and leather products. Nevertheless, Chinese businesses should consider the risk of political issues in CIS as well as in Xinjiang and should explore the market consciously.

## **9. Conclusion**

Although, the apparel export business is under pressure across China and, since 2008, has been experiencing unprecedented hardship, China's position as the largest garment exporting country in the world is stable since lower costs are a competitive advantage over those of developed countries. Economies of scope, short production times, and complete infrastructures are competitive advantages over other low-cost exporting countries.

China's enterprises will face an uphill battle in export this year, as foreign market demand is shrinking and other negative factors have their effects. Enterprises will be able to navigate the recession if they upgrade move up to a higher range of products with high value added. They might consider relocating their production base and exploring new markets. Those that manage to get through this difficult time will be able to enjoy more opportunities in three to five years as the economy bounces back and the market gets less crowded.

Cheap production labour will not last forever, as the trend in the apparel exporting industry indicates. It is more likely that the sector will gradually decline over time. For individual enterprises, strategic implementation would help them stand out from rivals and continue to grow.

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