



## **Final Report**

# **The Textiles and Clothing Industry in an enlarged Community and the Outlook in the Candidate States**

## **Executive Summary**

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## ***Executive Summary/Conclusions***

In this report, we have analysed the current and future prospects of the textiles and clothing industries (T/C) in an enlarged Europe with particular emphasis on the new member states (NMS) and the candidate countries for EU-membership, Bulgaria, Romania and Turkey<sup>1</sup>.

The textile and clothing industry is an important part of the manufacturing industry in the new member states (NMS) and candidates. In 2002, more than 50 000 enterprises produced textiles and clothing worth EUR 12 bn and employed 624 000 people. Bulgaria and Romania together produced EUR 3.5 bn with a workforce of more than 550 000 persons.

Due to the smaller size of these economies, the relative position of the T/C industry in the NMS and candidates is significantly higher than in the old member states (OMS). Value added (VAD) in the industry amounted to 6% of total manufacturing in the NMS (and 15% in Turkey) but to only 4% in the OMS.

This difference is even more pronounced when it comes to the industry's role as an employer, and the larger numbers employed points to a much lower level of labour productivity in the NMS and the CCs than in the OMS in these industries, with enormous potential for restructuring but equally for significant employment losses lying ahead.

The main reason why the T/C industry in the NMS and the CCs remains competitive, despite its low labour productivity, is the relatively low wage levels enjoyed. This is especially relevant for the labour-intensive segments of the industry. Converted into euros, (at market exchange rates) T/C wages in the central and east European NMS ranged between 14% (Slovakia) and 42% (Slovenia) of the EU-15 average in 2001.

In Bulgaria and Romania they amounted to only 5% and 7% of the average EU level. In Cyprus and Malta, wages are significantly higher, but still below average, and comparable to Portugal.

### *Textiles versus clothing industry.*

The clothing industry, being the more labour intensive and less capital and technology intensive part of the T/C industrial complex, is typically more prominent in the NMS than in the OMS. Slovenia and the Czech Republic are important exceptions here. With regard to the number of enterprises and the number of employees, the NMS' dominance in the clothing industry is even more pronounced. This indicates that on average clothes in the NMS are produced in smaller enterprises than in the OMS, and that within the clothing industry NMS are specialised in the more labour intensive stages of production, often taking the form of outward processing trade (OPT). In Romania and Bulgaria, the weighting of the clothing

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<sup>1</sup> A separate Turkey Supplement is included, and this has its own Chapter on 'Prosectcs' (Chapter 8, in particular 8.4 and 8.5)

industry is at its most pronounced, with the textile industry being of marginal importance in these countries.

*Large and small producers:*

The NMS also have a relatively high concentration of the T/C industry within a few countries, linked closely to the size of these economies. The largest T/C producers are Poland, the Czech Republic and Hungary, together reaching more than 70% of both value added and employment. Poland is the biggest producer by far, and comparable to Spain and Portugal if production is converted at purchasing power standards (PPS). If we also take the CCs into account, Romania is the next biggest producer after Poland.

*Employment:*

The relative position of the NMS with regard to T/C employment is more prominent than with regard to production. Poland, the largest T/C employer among the NMS with 253 000 persons on the payroll, ranks second only to Italy (600 000), and comes ahead of the other T/C heavyweights such as France, Germany and the UK, all of which employ less than 200 000 persons. Taken together, it is comparable in size with the two south-European textile producers, Portugal and Spain. Romania has an even larger workforce than Poland, with 393 000 employees in the T/C industry in 2002.

*Specialisation:*

Measured by the T/C industry's share in total manufacturing *production*, the NMS most specialised in the field are the three Baltic countries and Malta. Among the industrially more advanced countries, Slovenia has a relatively high T/C specialisation. The three CCs, Bulgaria, Romania and Turkey in particular, also have a strong specialisation in the T/C industry.

A notable comparison with the OMS reveals that among the countries with above average T/C production shares, such as Portugal, Italy, Greece, Belgium, Luxembourg and Spain, only Portugal shows a similar high degree of specialisation in textiles and clothing as the Baltic states, Bulgaria and Romania.

*Development of production and employment 1997-2002:*

T/C *production* in real terms (measured at constant prices) declined in the industrially more advanced NMS, namely the Czech Republic, Poland and Slovenia, but typically increased in the industrially less advanced countries, i.e. in the Baltic States, Bulgaria and Romania. In

Hungary, the strong growth at the beginning of the period has started to level-off recently<sup>2</sup>. Only in Bulgaria, Estonia, Lithuania and Romania did growth in the T/C industry outpace that of manufacturing as a whole, indicating *rising* specialisation of the countries in this field. However, T/C *employment* declined even faster than production in the industrially advanced NMS. Labour shedding was particularly pronounced in Poland, leading to a loss of roughly 150 000 jobs between 1997 and 2002. Only in the Baltic States (as well as in Bulgaria and Romania) did a rise in T/C production go hand in hand with a rise in employment.

#### *Labour productivity:*

As we have seen, productivity of the T/C industry in the NMS is significantly lower than in the OMS. Given the problems of international productivity comparisons, our estimates suggest a range between 20% and 40% of the average EU-15 level in 2001 (excluding Malta reaching 70%). Productivity levels are highest in the Czech Republic, Slovenia, Estonia and Lithuania (partly due to the above average share of the textile industry in these countries) and lowest in Latvia, Slovakia as well as in Bulgaria, Romania and Turkey. Productivity growth, along with output growth, points to the presence of 'active' or 'aggressive' restructuring, including investment, innovation and/or moving-up the value added chain.

On the other hand, productivity growth *without* production growth, due to labour shedding only, is a sign of 'passive' or 'defensive' restructuring as a reaction to increased competitive pressure. The first type of restructuring has been observed in Estonia, Hungary, Lithuania and to a certain extent in Latvia as well, while the second type prevailed in Poland and the Czech Republic. Moreover, productivity in the T/C industry declined in Slovenia and showed only a small increase in Slovakia and Bulgaria over the period 1997-2002. In all countries (except Poland), productivity trends in the T/C industry were less favourable than in the manufacturing industry on average.

#### *Labour costs:*

Apart from Malta and Cyprus, with labour costs comparable to that in Portugal, wage levels in the NMS are much lower than in the OMS. Slovenia has the highest wage level by far with annual gross wages of EUR 7952 (42% of the EU average), followed by Poland with only EUR 3805 (22%) and the other NMS, with annual wages hovering around EUR 3000 reaching less than 20% of the average EU-15 level. In Bulgaria and Romania, wages are even lower, amounting to around 1200 EUR (less than 7%). However, gross wages do not include indirect wage costs, such as employers' contributions to social insurance etc.

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<sup>2</sup> For Malta and Cyprus, neither production data at constant prices nor volume indices were available.

Indirect wage costs are typically higher in the central- and east European countries than in the EU-15, with the exception of the Baltic States, Cyprus and Malta. Over the period 1997-2002, T/C wages in national currency increased rapidly in all NMS. However, taking account of inflation, which was considerably higher in these countries than in the OMS, real wages rose much more slowly, showing only a very moderate 'catch-up' with EU-levels (if at all). Also, wages converted into euros (at market exchange rates) went up less than wages in national currency in many countries, due to currency depreciation, but their increase was still significant. This has had a negative effect on cost-competitiveness, especially with regard to the labour-intensive segments of the T/C industry such as clothing and, in particular, outward processing trade (OPT). Moreover, recent currency *appreciations* have started to push-up euro wages in the Czech Republic and to some extent in Hungary, Lithuania and Slovakia as well. The prevailing currency regime will thus play a significant role for the development of the cost-competitiveness of the T/C industry in individual countries.

#### *Unit Labour costs (ULCs):*

Defined as 'labour costs per unit of output', ULCs are showing the combined effect of wages and productivity on costs. In 2002, the share of labour costs in percent of output at current prices ranged between 20% and 25% in most NMS. Changes in ULCs measured at *current* output prices are considered as an indicator of changing profitability, while ULCs measured at *constant* output prices are taken as an indicator of changing international competitiveness.

Measured at constant output prices, ULCs in the T/C industry have risen significantly in most NMS over the period 1997-2002, due to wage increases in national currency outpacing the respective productivity gains. This kind of 'wage-trap' is a general problem in industries with below average productivity growth. With regard to international competitiveness, the development of wages *measured in an international currency* (EUR, \$US) relative to productivity growth may be more relevant. This sort of unit labour costs, those taking into account exchange rate movements, has also considerably increased in most NMS between 1997 and 2002. Given that low wage levels continue in the NMS, this may not be too serious when compared to the OMS. But it is relevant for some countries with already high unit labour costs (e.g. Slovenia), as well as for those with very low ULCs (e.g. Bulgaria, Romania), which are mainly competing with other low-wage T/C producers such as China and India in international and domestic markets.

#### *Female employment /skill levels:*

The workforce in the T/C industry typically shows an above average share of female workers. Therefore, a decline in T/C employment affects women over-proportionately and may cause particular problems with regard to alternative employment opportunities, particular in remote

regions. Notably, the share of women is typically higher in the NMS than in the OMS, in both the T/C industry and manufacturing as a whole. The NMS with the highest share of female employment were the Baltic States and Slovakia, with a share of female workers of more than 80%. Where separate information on the textile and the clothing industry was available, the clothing industry typically showed a higher share of female employment than textiles. Although we do not have comparable data for all countries, the information available suggests that the skill level in the T/C industry, measured in terms of educational attainment, is significantly higher in the NMS than in the OMS.

*Investment including foreign direct investment (FDI):*

Investment in fixed assets is a necessary precondition and also a good indicator for restructuring and modernisation in a particular industry. Foreign direct investment plays a special role in this respect. Investment activity in the T/C industry is at the level of the manufacturing industry on average in most NMS. Average investment per employee reached EUR 1646 in the textile industry but only EUR 453 in clothing in 2001 and is significantly lower than in the EU-15 on average, coming up to EUR 3213 and EUR 1556 respectively. In the textile industry, investment per employee was highest in Malta, Slovenia and Estonia.

In the clothing industry Malta, Latvia, Estonia, Hungary and Slovenia were showing above average investment per employee. Over time, investment increased strongly in Slovenia, the Baltic States and Bulgaria. So far, the T/C industry in the NMS has not been a prominent target for foreign direct investment. The sector's shares in total manufacturing FDI are substantially lower than production shares in most NMS. In 2001 and 2002, a certain slowing-down of FDI activity in the T/C industry along with overall FDI activity in the NMS can be observed, but the 2003 figures point to a certain stabilisation of this trend.

Generally, FDI is higher in the textiles than in the clothing industry, due to the more capital intensive character of the textile industry and the fact that other forms of international production co-operations (e.g. work contracts) play a prominent role in the clothing industry. Foreign penetration of the T/C industry, defined as the share of nominal capital of foreign invested enterprises in the nominal capital of all enterprises (FIE + others) is the highest in Hungary and Estonia, but is also reasonably high in the T/C industry in Romania.

### ***Future prospects - rising and falling stars***

Taking the results from our analysis in Chapters 1-3 and Chapter 4 together, we found basically two types of countries. The first group of countries comprises the industrially more advanced NMS such as the Czech Republic, Hungary, Poland and Slovenia, which have been important T/C suppliers in the past but where the T/C industry seems to be getting into trouble recently.

In the second group, which includes the industrially less advanced NMS such as Estonia, Latvia, Lithuania and Bulgaria, the T/C industry is still small in size but is expanding rapidly and gaining importance in the domestic economies as well as on the international markets. However, there are two countries which do not fit well into this scheme, namely Romania and Slovakia. Romania with a big T/C industry but growing rapidly (at least in clothing) and the Slovak Republic, with a small T/C industry but not yet showing particular dynamism.

The major reason for the problems of the 'falling stars' is rising labour costs along with inadequate efforts towards modernisation, investment and R&D in many cases. Meanwhile, the 'rising stars' are successfully taking advantage of their cheap and skilled labour force, with the Baltic states putting special emphasis on modernisation and technology.

However, all countries are still (cost) competitive with regard to the OMS, but less so if compared to other low-wage T/C suppliers, especially from the Far East. Cyprus and Malta may be assigned to the group of falling stars too, but with their relatively high wage level close to that in Portugal, they probably compare better to the low-wage OMS. It is noteworthy that, while Cyprus focuses on outward processing trade (OPT), Malta has opted for investment in modern technology and high quality original equipment manufacturing (OEM) in order to withstand increasing competitive pressure.

In the industrially advanced NMS also, the clothing industry being more labour intensive has typically come under higher pressure than the textile industry. While in the industrially less advanced economies, the clothing industry is generally expanding faster. This is particularly true for Bulgaria and Romania (important exceptions are Cyprus, Malta and Hungary where the clothing industry is predominant, and Estonia - specialising more in textiles).

#### ***Looking forward: trade and employment trends:***

Looking beyond the WTO (Agreement on textiles and clothing) reforms in 2005, we infer that quota liberalisation and removal will have a more sizeable impact in the clothing sector compared to the textile sector. But it could also be the case that the NMS, candidate countries and Europe's 'near abroad' may be better placed to compete in textiles and in a

limited range of higher value-added clothing products than some groups of developing countries.

We find that the less similar were a set of trade patterns, the less vulnerable they are to quota removal and that the degree of similarity for the enlarged EU's textile products was much smaller than for clothing. Within textiles, it was the new member states, the candidates (including Turkey) who had the highest degree of overlap. But less obviously, the next most similar textiles group was Europe's near abroad or neighborhood countries. This pattern of proximity and similarity was repeated within the analysis of clothing trade.

When we looked at some standard measures of the quality of enlarged EU exports relative to that of foreign suppliers - we found that for the crucial, quota-sensitive categories enlarged EU exports appear to remain of relatively high quality.

Turning to employment losses expected from the ATC, we found that for the NMS in the next fifteen years combined employment losses due to ongoing adverse T/C industry restructuring (over 300 000 jobs lost) would greatly outweigh those due to ATC quota removal alone (under 40 000 jobs lost). In terms of sectoral losses in the NMS, excluding Malta and Cyprus, we find that the textiles industry is likely to shed just under 30 000 jobs between 2005 and 2010 whereas in the same period the clothing industry may lose something in the region of 100 000. Of course by their very nature these calculations exclude possible job creation in other sectors.

Finally, we found a few encouraging signs. Firstly in textiles, we see that roughly half of 'world' trade (46%:43%) appears to be price-elastic and half quality-elastic. Of course, in the price-competitive segment China and Asia are ranked first. But the NMS and CCs and Europe's peripheral (or 'near abroad') countries shared equal second ranking to Asia. Within the (textiles) quality segment clearly the OMS dominate, but in the remainder of the high quality segment we see that NMS and Europe's near abroad countries share roughly equal ranking and here the China/Asian countries are ranked only third.

In clothing, we of course detect an overwhelming emerging superiority for Asian countries, but interestingly the NMS/CC and 'near abroad' are ranked second and third. However, when we examine the *world* ranking of the NMS among the quality-elastic segment of clothing, we find that they are ranked first, near abroad countries second and the China/Asia group a poor third. This at least suggests that the NMS and CCs *could* maintain a limited degree of world competitiveness, at least in the quality end of the clothing sector.

If they can focus on high quality, proximity to market and rapid replenishment of orders, some NMS/CC countries should be able to continue to compete in niche clothing sectors.

## **Conclusions**

The future development of the T/C industry in the 'falling stars' will present them with similar challenges as faced the OMS some years ago. Their success will depend on their ability to increase productivity, to find niche products and to specialise in high-tech and/or high value added products. Hence, a general shift from clothing to textiles is likely to occur. To reduce labour costs, OPT into lower-wage countries (such as the Ukraine, Belarus etc.) is one viable option for these countries. Nevertheless, a certain process of concentration will take place, at least in the textile industry and a further decline of production and in particular of employment in the industry as a whole looks inevitable.

The main competitors for the 'rising stars' come from other low-wage T/C producers around the world (China, India, Turkey, Morocco, Tunisia etc.), even more so, after the phasing out of the 'Agreement for Textiles and Clothing' (ATC) by the end of 2004 when T/C trade among the WTO countries will become fully liberalised. To withstand this competition, they may take advantage of the proximity to their main markets giving them short delivery times and their highly qualified labour force. But they will also have to invest in up-to-date technology to meet the quality standards of the advanced markets and they should try to improve their customer relations. Keeping-up and improving the high standard of training of their work force will be important as well. Looking into the wider future, reducing pure wage work and moving-up the VAD chain will be essential.