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TRADE AND STRUCTURAL ADJUSTMENT

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3. TEXTILES AND CLOTHING

Key points emerging

Trade policy should promote, and not postpone, adjustment

1. Perhaps more than any other sector examined in this volume, the barriers to trade in textiles and clothing are substantial — but are declining more rapidly. From the early 1960s through 2004, quantitative restrictions have allowed importing countries to limit the amount and influence the direction of trade. The quotas of the Multifibre Arrangement (MFA) have been on a phase-out programme over the past decade, and disappeared altogether at the end of 2004. Even without these quotas, import tariffs are much higher on these products than they are on most other non-agricultural products. The tariff and non-tariff barriers in this sector have distorted markets in numerous ways, leading to higher prices for consumers, the maintenance of industries in “mature” economies, the spread of “quota baby” production to some countries that might not otherwise be engaged in this trade, and rents for the more efficient (but restrained) producers.

2. Both in developing and in industrialized countries, the quota regime created the seductive illusion that producers were insulated from competition, and hence did not need to adjust. This point is equally true for the “quota baby” producers in developing countries, many of which existed solely because even the inefficient can thrive with artificially high prices, and for the producers in industrialized countries that have long been under pressure from import competition.

3. It is widely expected that the end of the quota regime will lead to major changes in the pattern of trade. That may be especially true for the smaller and less efficient producers in developing countries. It does not necessarily follow, however, that producers in all but a few countries should see the end of the quotas as the termination date for their industries. All of the case studies offer examples of producers in both industrialized and developing countries that have used the decade of quota phase-out as an opportunity to prepare and adjust. In all cases, the countries in question have reduced trade barriers in anticipation of 2005. Each has done so, however, in somewhat different ways.

4. Bangladesh has reduced the barriers that it had imposed to imports of capital goods and supplies, in order to reduce the production costs of its clothing producers. In addition to easing the burdens of tariffs and taxes, the country has freed the exchange rate and addressed the problems of corruption and administrative inefficiency.¹ The key lesson from the Bangladeshi case is that an export industry cannot be indefinitely sustained solely on the basis of preferential access to restricted markets.

5. The point regarding preferential market access is further demonstrated by the case of Lesotho. While the country has enjoyed preferential access to the markets of the European Union (under the Lomé Convention, the Generalized System of Preferences, and the Everything But Arms programme) and the United States (under the African Growth and Opportunity Act), it was domestic reforms that attracted investment in the first place. The first investments date to the mid-1980s, following a shift in development strategy that combined import-substitution with export-promotion.

6. Similarly, the Mauritian case underlines the importance of domestic economic reforms. Political and macroeconomic stability have been key to attracting foreign investment, as well as improvements in social conditions. The textile and clothing industry has also depended upon an accommodating trade policy. Having abandoned the failed import-substitution policies of the 1960s, the government of Mauritius encouraged production through the establishment of export promotion zones in the 1970s and a structural adjustment programme in the 1980s.

7. The Colombian strategy has included elements that resemble both the Bangladeshi and (as described below) the US approaches. Even more than Bangladesh, Colombia has replaced its earlier attachment to import-substitution industrialisation. By embracing market reforms more fully, Colombia has eliminated the anti-export bias of protectionism while promoting healthy competition among its producers. Colombia has also negotiated numerous free trade agreements in order to secure its access to export markets.

8. Just as Colombian exporters have benefited from their proximity and access to the US market, the clothing industry in the Slovak Republic have taken advantage of their entry into the European Union. Starting with the Europe Agreement in 1995 and culminating in EU accession nine years later, the industry has enjoyed access to the European market. It has used this opportunity to engage in outward-processing operations with European partners.

9. The United States has established a series of programmes and agreements that offer duty-free, quota-free access to its clothing market for imports from selected developing countries. The rules of origin for programmes such as the Caribbean Basin Initiative, as well as the free trade agreements with partners in Latin America and other regions, generally condition free access to the U.S. market on fibre-forward or fabric-forward rules of origin. The intention here is to promote co-production between the textile industry of the United States and the clothing industries of the partner countries. This strategy aims to provide a “soft landing” for U.S. clothing producers (many of which are relocating production in the partner countries), while also providing a new outlet to replace the textile industry’s lost domestic sales.

10. Australian experience with trade policy reform, through lower tariffs and greater access to imported textile, clothing, footwear and leather (TCF) products, has shown how this can be a trigger for successful adjustment, prompting firms to focus on innovative high value, capital-intensive and niche products, and on brand development, customer service and market development. The process of adjustment has, however, been accompanied by substantial transitional budgetary support encouraging innovation and investment intended to help firms to be competitive in a low-tariff environment.

Both the cost and the quality of labour are important

11. It is tempting to conclude that competitiveness in the clothing industry is a simple function of the cost of labour. This conclusion would be based upon the observed facts that (a) labour accounts for a high share of the value of most clothing products, and (b) wages in developing countries are lower than they are in industrialized countries. It therefore comes as no surprise that the long-term trend is for clothing production to migrate from industrialized to developing countries, and then to leave those countries once they attain a certain level of development.

12. This does not mean, however, that countries would be well-advised to compete solely on the basis of low-cost labour. The Colombian case study demonstrates the point that the quality of labour is equally important, especially for a country that hopes to retain a clothing industry even after it reaches the middle levels of industrial development. The key difference is between mere assembly, where the cost of labour is indeed a critical variable, and more sophisticated industries that can engage in more of the value-added operations involved in transforming fabric into garments. In Colombia’s case, the transition from

assembly to full-package production has required the improvement of labour skills, as well as managerial talent, but has paid off in the establishment of a more competitive industry that is in a better position to weather the end of the quota regime. Some firms in Bangladesh are seeking to make that same transition.

13. The workplace environment is also important. The Australian case suggests that greater cooperation and more effective communication between management and employees, including in workplace negotiations, would help deliver a more flexible and productive outcome.

The higher the barriers, the harder the fall

14. The preceding point concerned training to promote adjustment *within* the industry. It is equally important to promote adjustment *out* of the industry, especially in those countries where production is expected to drop — and jobs are expected to be lost — with the end of the quota regime. The end of the quota regime will affect countries at all levels of economic development.

15. Trade adjustment assistance programmes have thus far been more prominent in industrialized than in developing countries. This might be attributed both to supply and demand: the industrialized countries have greater resources to devote to this undertaking, and are also more likely to have a wider range of “mature” industries that face competitive challenges from imports and are in need of assistance. In the case of textile and (especially) clothing, however, it can be anticipated that disruptions will be common to industrialised and developing countries in the coming years. National governments and other funding sources, such as international and regional financial institutions, may need to devote greater resources to such programmes.

16. The Australian case notes that where there is large scale or regionally significant job shocking in the TCF sector, the government will augment generally available labour adjustment measures with sector-specific adjustment support.

17. The US case notes that displaced workers in the textile and clothing industry have been prominent in that country’s trade adjustment assistance programme. Some questions that have arisen in the design and execution of the U.S. programme will merit examination in other countries and institutions that consider programmes in the coming years, including the economic and political rationales for distinguishing displaced workers according to the causes of their unemployment (*i.e.*, whether trade-related unemployment should be treated differently).²

¹ Similar policies have been adopted in Mauritius. (See the case study)

² OECD (2004b).

3.1 BANGLADESH

Introduction

18. The Bangladeshi clothing industry offers a clear example of an export-oriented success story in a desperately poor country, but one that is also marked by serious difficulties and future uncertainties. Beginning from almost nothing in the 1970s, the industry has experienced very rapid growth in employment, production, and exports. Clothing accounted for one-eighth of Bangladeshi exports by 1985, and then grew to two-thirds by 1996 and three-quarters by 1999.³ The opportunities were created by a combination of low wages and a restricted quota system; Bangladesh advanced its ability to exploit these opportunities by enacting economic reforms and obtaining preferential access to some foreign markets. That confluence of favourable conditions and policies has allowed producers to overcome such impediments as natural disasters, poor infrastructure, political instability, corruption, and protection in foreign markets. The main source of uncertainty stems from the abolition of the Multifibre Arrangement (MFA) quotas in 2005. Bangladeshi policymakers and producers recognize that this is both a challenge and an opportunity, and have spent a decade preparing for the coming shakeout.

Challenges and reforms in the Bangladeshi environment

19. Any examination of Bangladeshi development must start from the understanding that this is among the world's poorest countries, and suffers from all of the problems that cause, and are caused by, extreme poverty. These include infrastructural bottlenecks such as inadequate transportation facilities and unreliable power supplies, as well as institutional shortcomings. The country has nevertheless managed to take advantage of the one opportunity that stems from poverty (*i.e.*, the low cost of labour) and to devise means of working around some of its structural disadvantages. Some of the more specific challenges in the Bangladeshi environment, together with the ways in which the Government of Bangladesh has addressed these problems, are examined below.

20. Two caveats are in order before examining these challenges and reforms. First, it must be recognized that not all problems are susceptible to legislated solutions. Bangladesh is subject to recurrent and often devastating floods and tidal waves; natural disasters periodically wreak havoc on the economy in general and the clothing industry in particular. While the country might enhance its ability to cope with natural disasters (*e.g.*, by improving its infrastructure and emergency services), the underlying climatic/geological problems cannot be eliminated.

21. Second, Bangladesh has not kept a consistent pace or direction in its path to reform. Bangladeshi trade policy during the 1970s — the first decade of independence — was based upon import substitution and government intervention, but significant economic reforms were undertaken in the 1980s and accelerated in the early 1990s. Many more advances in trade and other economic policies were made during the stable and prosperous early 1990s than were achieved in the less predictable environment of the late 1990s, when the country became politically unstable. The World Trade Organization acknowledged in 2000 that the government had “liberalized its trade regime, broadened the base on which VAT is levied, strengthened the banking sector’s legislative and regulatory framework, implemented significant adjustments in some administered prices, closed or privatized some loss-making state-owned enterprises (SOEs), and taken steps to improve governance,” but still noted a slow pace of reforms in the “tax revenue base, customs administration, banking, restructuring/privatization of SOEs, and matters of governance.”⁴

22. Since that time, however, Bangladesh has taken several important steps towards a more market-oriented economy. Many reforms have been undertaken in concert with the International Monetary Fund (IMF), as promoted under the Poverty Reduction and Growth Facility and laid out in the Interim Poverty Reduction Strategy Paper.⁵ Some of these steps are inspired by the certain knowledge that the country must be readied for the shocks that will ensue with the end of the MFA clothing quotas. The reforms appear to have paid off in the short term, with exports of clothing experiencing a rebound in 2003;⁶ the question now is whether they will be equally successful in promoting the country's long-term prospects.

Budget, taxes, and tariffs

23. Bangladesh suffers from a persistent government budget deficit and is heavily reliant on trade taxes, but has nevertheless managed to reduce the height of the tariff wall. The maximum tariff rate was lowered from 350 percent in 1991 to 37.5 percent in 2000,⁷ and import-weighted average tariffs on manufactures fell from 51.8 percent in 1990-1991 to 23.8 percent in 1998-1999.⁸ As can be appreciated from the data in Figure 1 (see the Statistical Appendix), the average effective rate of protection was slashed from 75.7 percent in 1992-1993 to 28.6 percent in 1997-1999; the cuts were especially deep for some textile and clothing products (as discussed in a later section). The taxation of imports still accounts for over half of total tax revenues and a large share of corporation taxes are from export profits or taxes on foreign investors. These taxes are partly compensated by various exemptions made available to export-oriented industries (*e.g.*, tax holidays, duty concessions and drawbacks, bonded warehouses, etc.), as well as direct subsidies provided to exporters of textiles and clothing. These mechanisms nevertheless make for a more complicated system that lends itself to abuse (see below).

24. Recent reforms have sought to address both the composition of the government's revenue and the persistent budget deficit. A combination of increased revenue fiscal discipline helped to reduce the budget deficit to 3.5 percent of GDP in Fiscal Year 2003, down from 5.1 percent in FY2001.⁹ In the FY2003 budget, the top customs duty was reduced from 37.5 to 32.5 percent, and the effective average tariff rate was reduced to 24 percent.¹⁰ The government plans to pursue further reforms by moving to a maximum rate of 30 percent in FY2004, and reducing trade taxes even more in the FY2005 budget.¹¹

Government inefficiency and corruption

25. The government's efforts to aid the textile and clothing industry are undermined by "delays in customs clearance, hassles in accessing duty drawbacks, port congestions and various rent-seeking activities."¹² Both the restrictions and the multiplicity of incentive programmes create serious problems with corruption and illicit activities.¹³ In Transparency International's 2003 Corruption Perceptions Index, this is based on surveys from independent institutions. Bangladesh had the highest perceived level of corruption among 133 countries.¹⁴ "There is a general consensus," according to one analysis, "that a lot of wealth made by garment entrepreneurs in Bangladesh was earned through illegal means."¹⁵ The government's own *Textile Policy — 1995* explicitly recognized that "[i]llegal imports of yarn and fabrics in the country is a serious constraint,"¹⁶ and proposed a series of steps to address the problem.

26. While corruption is among the more intractable problems facing Bangladesh, efforts are underway to address it. Working with outside donors, the Government of Bangladesh is promulgating a new law to establish an Independent Anti-Corruption Commission. The problems stemming from the bonded warehouse system may also be reduced by reforms of that system, which was revamped at the end of 2003. Under those reforms, all imports for domestic consumption and most of the export-oriented imports are subject to bank guarantees for import duties (100 percent) and the value-added tax (25 percent).¹⁷ Complementary reforms are also underway in the government procurement system, as well as the withdrawal of tax holidays for the expansion of existing units and the elimination of certain tax exemptions.

Foreign investment

27. Bangladesh has one of the most liberal investment regimes in South Asia, placing no limits on foreign equity participation. Under the *Investment Policy — 1999*, private investment by local and foreign investors is allowed in all but four sensitive sectors (forestry and three security-related fields). The inflow of foreign capital has nevertheless “been low even by South Asian standards.”¹⁸ This may be largely the consequence of perennial problems for which there are no simple cures: Bangladesh’s vulnerability to natural disasters, together with its political instability, reduce the willingness of foreign firms to invest in the country (and sometimes even to place orders with its producers). Nearly all clothing production is carried out by domestic producers, although foreign investors — notably from East Asia — have established some facilities in export-processing zones.¹⁹

28. Foreign investors have nevertheless had a greater influence than the raw figures might suggest. The Korean firm Daewoo was instrumental in a “catalyst model” of industrial development, in which “new industries are developed through successful collaboration between local entrepreneurs and well-established foreign investors.”²⁰ Daewoo’s partnership in the late 1970s with a local firm (Desh) produced the first wave of local clothing entrepreneurs. Significantly, the Daewoo-Desh venture was based on subcontracting and technology transfer, rather than direct investment.

29. Given the already open nature of the Bangladeshi investment regime, the legal regime not an area in which significant reforms are needed. The main goals are instead to find ways to make up for the scarcity of foreign capital while also enhancing the country’s overall attractiveness to investors. One means of leveraging the existing sources of foreign capital is to employ the device of back-to-back letters of credit. This allows entrepreneurs to use the future revenues from clothing exports to finance the necessary imports of fabric and other inputs.

Exchange rate

30. The Bangladeshi *taka* has gradually become subject to market forces. It was made convertible in 1994, when banks were permitted to make international payments and transfers without prior approval from the central bank. Exchange rate policy for the past decade was based on discrete, periodic adjustments of the *taka* that follow movements in macroeconomic indicators and the real effective exchange rate (as calculated on the basis of the trade-weighted basket of currencies). This system was a matter of some controversy. While the WTO opined that these devaluations made “exchange rate policy unduly susceptible to political considerations,”²¹ other observers believed that the government’s efforts to maintain a competitive real effective exchange rate contributed to the success of the clothing industry.²² Some Bangladeshi producers called for either devaluation of the national currency or the creation of a separate exchange rate for this industry.

31. Perhaps the most important economic reform in recent years was the float of the *taka* as of 31 May 2003. This was achieved without major difficulties, and was facilitated by the tightening of monetary policy. The country is now committed to a flexible management of the exchange rate, in which “[i]ntervention in the exchange market will be undertaken only to address disorderly conditions.”²³ The Government of Bangladesh also aims to phase out both the export-surrender requirement and its export subsidies.

Labour

32. While labour is relatively cheap in Bangladesh, it is also relatively unproductive. One study in the late 1990s estimated that it took 25 person-minutes to perform a basic clothing-making operation in Bangladesh, compared to 19.75 minutes in Hong Kong and 14 minutes in the United States.²⁴ Even so, the

unit labour cost was far lower in Bangladesh. As of the mid-1990s, the labour to produce a shirt in Bangladesh cost just US 11¢, compared to US 26¢ in India and USD 0.43¢ in Pakistan.²⁵ Employment in the clothing sector is overwhelmingly female, and is marked by relatively low levels of unionization and wages.²⁶ As of the mid-1990s, daily wages for women in Bangladesh were about 40 percent below those of men.²⁷ Labour disputes are also a source of domestic and international difficulties. Nationwide strikes (*hartals*) are a major source of disruption, and in the 1990s Bangladesh faced possible sanctions over the use of child labour. The latter issue was resolved in 1995 with the signing of an NGO-brokered memorandum of understanding between Bangladeshi clothing producers, the International Labour Organisation, and the U.N. Children's Fund.²⁸

33. Representatives of the Bangladeshi government and private sector recognize that, in order for Bangladesh to compete effectively in the post-MFA environment, it cannot rely solely on the low cost of labour. Effective competition will require that the country upgrade the skills of its workers, both to produce existing lines of clothing more efficiently and to move into new, higher-value lines.²⁹ The Government of Bangladesh has addressed this issue by expanding its programmes for skills development. More may need to be done in this regard, however, with one critic observing that this policy "is being implemented in a somewhat *ad hoc* manner."³⁰ Competitiveness also requires that foreign buyers be assured that orders will not be delayed or cancelled due to disruptions; this in turn will require that the rights of workers be addressed. The Government of Bangladesh reached an agreement with outside donors in May, 2004 to adhere to International Labour Organisation standards in its export-processing zones. As of this writing, the terms that agreement are pending approval by Parliament in the form of a draft "EPZ Workers Association and Industrial Relations Act, 2004."

Characteristics of Bangladesh's textiles and clothing industry

34. The fibre-fabric-clothing complex in Bangladesh is like an inverted pyramid in which the country produces very little fibre and some fabric, but is top-heavy in clothing. While Bangladesh is a major producer of jute, this fibre is not significant in the manufacture of clothing for export; it is instead used primarily for fabrics and clothing that are consumed locally, and for other jute products that are exported.³¹ The domestic and export-oriented clothing markets still "maintain a dual existence with little crossover of entrepreneurial talent or resources."³² Many export garments are made of cotton, and Bangladesh grows very little of the raw material. The cotton-spinning industry cannot keep up with the demands of the clothing sector, and the country produces an even smaller share of the synthetic fabrics that it consumes. The government of Bangladesh's *Textile Policy — 1989* aimed to achieve complete self-sufficiency in fabrics, but this goal proved far too ambitious to achieve. The government opted instead in its revised *Textile Policy — 1995* to aim for "self-reliance in textiles for meeting local demand as well as for supplying fabrics to the [ready-made garment] industry by establishing necessary backward linkages through development of the private sector."³³

35. The limited capacity of the country's textile producers has hampered Bangladesh's ability to capitalize on the successes of the clothing sector, and will place it in a more vulnerable position when the MFA comes to a definitive end. The government has nevertheless taken steps to strengthen the position of the fabric sector. It denationalized the weaving sector in the mid-1980s, and placed textile looms on the list of industries for which government permission was not required for new, private investments. (Some textile plants continue to be operated as state-owned enterprises.) These steps stimulated new investment in the sector, but not enough to keep up with the growing demands of a rapidly expanding clothing sector. Textile mills are hampered by undercapitalization and antiquated technology. One analyst estimated that "90 to 95 percent of the installed spinning capacity in Bangladesh is unsuitable to meet the high performance requirements of modern weaving and knitting machinery or to satisfy the critical demands of the fabrics used in export quality garments."³⁴

36. Bangladesh is thus not an integrated producer of textiles and clothing, but is primarily an assembler of imported inputs into finished garments. Clothing production is largely in export processing zones that are subject to special tax and regulatory regimes, or conducted under similar regimes that are specific to a factory (*e.g.*, bonded warehouses) or a transaction (*e.g.*, duty-drawback). The flow of trade is quite apparent from the data in Table 1 and Figure 2: Bangladesh imports significant quantities of fabric from China and other East Asian countries, and exports finished clothing to North America and Western Europe. The movement in both directions is unrequited; the country imports almost no fabric from OECD countries, and exports almost no clothing to either the developed or the developing countries of Asia. The net proceeds from clothing exports must be discounted for imports of fibre and fabric. The government estimated in 1995 that “value addition from [the clothing] industry does not exceed 20-25 percent of total export proceeds.”³⁵

37. Bangladesh is in a less secure position than India, an integrated producer that grows cotton, produces fabric, and makes clothing. This versatility will stand India in good stead when the quotas end. Many observers expect the price of fabric to surge with increased global demand, and anticipate that some Chinese fabrics will be retained for domestic processing. This may lead to shortages in Bangladesh, which is much more vulnerable to disruptions in supply than is an integrated producer. The clothing industry in Bangladesh is also less agile; the lead time for a project is only around 12 days in India, but 120-150 days in Bangladesh.³⁶

38. How competitive will Bangladesh be in the post-MFA world? It is difficult to answer that question using the existing data, insofar as the MFA quotas have greatly distorted patterns of production and trade. Comparisons of unit costs are not as straightforward as they would be in a truly open market, as can be appreciated from the example in Figure 3. The data seem to show *prima facie* that for one type of cotton shirt Bangladesh enjoys the lowest landed price in the U.S. market. That point is especially true if one looks only at the unit cost of the goods, leaving aside the tariff and the shipping costs. The raw numbers do not tell us, however, whether the lower average cost of a Bangladeshi shirt (\$4.68) *vis à vis* the Chinese product (\$6.89) can be attributed more to (a) greater Bangladeshi efficiency or (b) a deliberate decision on the part of Chinese producers to concentrate on the higher end of the shirt market. As long as China is constrained by quotas, its producers have an incentive to get the most out of each shipment by producing goods at the higher end of the market. When the quotas are gone, the competition may grow more intense in those lower-value market niches where Bangladesh’s production is now concentrated (*e.g.*, T-shirts, pyjamas, jeans, cheaper types of shirts, and so forth). We may see a convergence of production in the coming years. While Chinese manufacturers will have an incentive in the post-MFA market to compete in both the high and low ends, many Bangladeshi producers hope to enter the higher end.

Trade policy

39. The expansion of Bangladesh’s clothing industry has been facilitated by trade liberalization and the creation of an incentives regime. The government reduced the tariff on cotton yarn from 50 percent in 1984 to 7.5 percent in 1995. Liberalization has not been comprehensive, however, with the government seeking to balance the demands of relatively efficient clothing producers against the fears of relatively inefficient textile producers. While the tariff on woven fabrics was reduced from the previous 100 percent rate, it is still quite high. The result, as shown in Figure 1, is a semi-inverted tariff structure in which the effective rate of protection is higher for intermediate goods than it is for finished goods. The high rate of protection on fabric makes it attractive for those who import under duty-free arrangements to “leak” textiles into the domestic market, and these “illegal imports of fabrics and clothing may weaken the protective effects” of the tariff.³⁷

40. In addition to reducing tariffs on raw and intermediate goods, the government provided a series of incentives in the early 1990s. These included an advance income tax deduction of export earnings; a

cash-compensation scheme based on the percentage of local value-added, originally set at 15 percent and later increased to 25 percent; elimination of the tariff on machinery imported for export-oriented sectors; and reform of the duty-drawback system.³⁸ Some of these incentives still have strings attached, with the government seeking to influence the decisions of entrepreneurs. One instrument of government intervention is designed to encourage greater incorporation of domestic materials in clothing. Under 1993 revisions to the *Import Policy Order*, in transactions made under letters of credit the value of the imports cannot exceed 70 percent of the value of the exports (or 75 percent for knit products). This amounts to a requirement that such exports contain 30 percent Bangladeshi value-added.

41. One initiative now under consideration in Bangladesh is the negotiation of free trade agreements (FTAs) with other countries in East and South Asia. A leading objective for these negotiations is the development of new markets for the exportation of Bangladeshi clothing, in order to diversify the country's export portfolio.

42. The MFA is generally credited for the take-off of the Bangladeshi clothing industry in the 1980s and 1990s, as other Asian producers engaged in "quota-hopping" (*i.e.*, transferring production to countries not restrained by quantitative restrictions). The MFA's consequences for Bangladesh were not all favourable. To the contrary, the industry suffered great losses in 1985 following the imposition of quotas by Canada, the European Economic Community, and the United States. At the end of the Uruguay Round, Bangladesh was among the 22 countries on which Canada imposed quotas under the MFA, and among the 28 that were subject to U.S. quotas. The European restrictions never took full effect, and in 1986 the EU granted unrestricted, duty-free access to Bangladeshi textile products. This may explain why in the 1990s Europe surpassed North America as the leading destination for Bangladesh's clothing exports.

43. While the MFA has served to restrict global trade in textiles and clothing, other initiatives seek to promote trade opportunities for developing countries in general and the least-developed countries (LDCs) in particular. Bangladesh has been on the official United Nations list of LDCs ever since the first 24 countries were so identified in 1971. The industrialized countries made a commitment in 2001 to provide free access to their markets for goods exported by the 49 LDCs,³⁹ and reaffirmed it at the WTO's Doha Ministerial Conference.⁴⁰ The EU extends free access to "Everything But Arms" (EBA) imported from Bangladesh and other LDCs, but many clothing exporters find it difficult to meet the EBA rules of origin.⁴¹ The United States also extends special treatment to LDCs, but the preferences extended to Bangladesh are not as generous as those granted to most U.S. partners in Africa, the Andean countries, and the Caribbean Basin. Countries in those regions benefit from programmes that offer duty-free, quota-free treatment to textiles and clothing. Moreover, the United States is now considering the reduction or removal of Bangladesh's privileges under the Generalized System of Preferences (GSP) due to the fact that "[t]he Government of Bangladesh does not provide freedom of association or the right to collective bargaining to workers in its" export-processing zones.⁴² As of this writing, that matter is still under active consideration.

Conclusions and lessons

44. The most significant lesson to be derived from the Bangladeshi case is simply stated: An export industry cannot be indefinitely sustained solely on the basis of preferential access to restricted markets. Trade policy *per se* may have been uniquely significant for this most protected sector in the *ancien regime*, but that will no longer be the case in the coming years. The MFA has had a catalytic effect in two periods. The existence of the quotas served to catalyze development of the industry a generation ago, when Korean producers saw Bangladesh as a useful partner in the "quota-hopping" game, and the phase-out of those quotas has similarly catalyzed the adoption of numerous reforms in recent years. In preparation for the post-MFA environment, the country has taken steps that, it is hoped, will put it in a better position to compete head-to-head with countries that have heretofore been restricted by quotas.

45. The impending end of the quotas has prompted a switch in industrial strategies. Under the MFA regime, Bangladesh's strategy was based primarily on low wages and quota access. The prospect of a more or less level playing field has inspired Bangladesh to address problems that it cannot afford to ignore in the new environment. With varying degrees of success, the country had acted to reduce the tariff and tax burden on entrepreneurs, simplify procedures, reduce corruption, make the exchange rate subject to market forces, enhance workers' skills, and address the demands of labour. These reforms have been more complete in some areas (*e.g.*, freeing the exchange rate) than in others (*e.g.*, labour reform).

46. How will Bangladesh fare in the post-MFA environment? The available evidence regarding the competitiveness of Bangladeshi producers is mixed, and the expectations regarding the country's post-MFA prospects are similarly diverse. "The challenge for Bangladesh is elephantine in size, formidable in magnitude and simply overwhelming in comprehension,"⁴³ according to the pessimistic perspective of one Bangladeshi scholar, but another local team concluded to the contrary that while "in the short run there may be some turmoil and difficult adjustment ... in the long run Bangladesh will come out ahead."⁴⁴ Based upon the reforms that have been undertaken to date, as well as the country's commitment to further steps, there is ample reason to believe that the latter opinion is more accurate.

³ Bhattacharya and Rahman (2000), page 4.

⁴ WTO (2000), page 3.

⁵ IMF (2003c).

⁶ Exports climbed by 9.5 percent in Fiscal Year 2003, led by the ready-made garment sector. IMF (2003).

⁷ Muqtada, Singh, and Rashid (2002), page 6.

⁸ Ahmed (2001), page 36.

⁹ IMF (2003c).

¹⁰ IMF (2003c).

¹¹ IMF, (2003c).

¹² Bhattacharya and Rahman (2000), page 21.

¹³ Quddus (1996).

¹⁴ Transparency International Corruption Perceptions Index 2003, posted to the Internet at <http://www.transparency.org/cpi/index.html#cpi>.

¹⁵ Quddus and Rashid (2000), page 106.

¹⁶ Government of the People's Republic of Bangladesh, Ministry of Textiles (1995), page 19.

¹⁷ IMF, (2003c).

¹⁸ Muqtada, Singh, and Rashid (2002), page 7.

¹⁹ Hossain (2002).

²⁰ Quddus and Rashid (2000), page 3.

²¹ WTO (2000), page 4.

²² See for example Bhattacharya and Rahman (2000), page 8, and Ahmed (2001), Chapter 7.

²³ IMF, (2003c).

²⁴ Study published in 1998 cited in Bhattacharya and Rahman (2000), page 17.

²⁵ Rahman (2000), page 29.

²⁶ See Paul-Majumderr (2002).

²⁷ Women earned 60 percent what men earned in urban pay scales, and 56 percent in rural pay scales. Calculated from data in Rahman (2000), page 29.

²⁸ Quddus and Rashid (2000), pages 102-103 and 227-228.

²⁹ See the recommendations in this regard in Quddus and Rashid (2000), pages 189-190.

³⁰ Rahman (2002), page 90.

³¹ See Sikdar (1990).

³² Quddus and Rashid (2000), page 71.

³³ Government of the People's Republic of Bangladesh, Ministry of Textiles (1995), page 2.

³⁴ Dowlah (1998), page 37. Note that these problems fall more heavily on the woven fabric sector. Local knitting mills can supply nearly 80 percent of the knitted fabrics needed by the export-oriented garment producers, but most woven fabrics are imported. *Ibid.*, page 35.

³⁵ Government of the People's Republic of Bangladesh, Ministry of Textiles (1995), page 15.

³⁶ Bhattacharya and Rahman (2000), page 16.

³⁷ Centre for Policy Dialogue, page 274.

³⁸ Summarized from Bhattacharya and Rahman (2000), pages 8-9.

³⁹ The Brussels Declaration approved at the Third United Nations Conference on the Least Developed Countries called for “improving preferential market access for LDCs by working towards the objective of duty-free and quota-free market access for all LDCs’ products in the markets of developed countries.” Paragraph 6 of the Brussels Declaration, in Third United Nations Conference on the Least Developed Countries, A/CONF.191/12 (July 2, 2001).

⁴⁰ The assembled trade ministers “commit[ed] [them]selves to the objective of duty-free, quota-free market access for products originating from LDCs.” Paragraph 42 of the Doha Ministerial Declaration, Doha Ministerial Conference, WT/MIN(01)/DEC/W/1 (November 14, 2001).

⁴¹ Note that the issue of rules of origin is discussed at greater length in the accompanying case study on Colombian clothing exports.

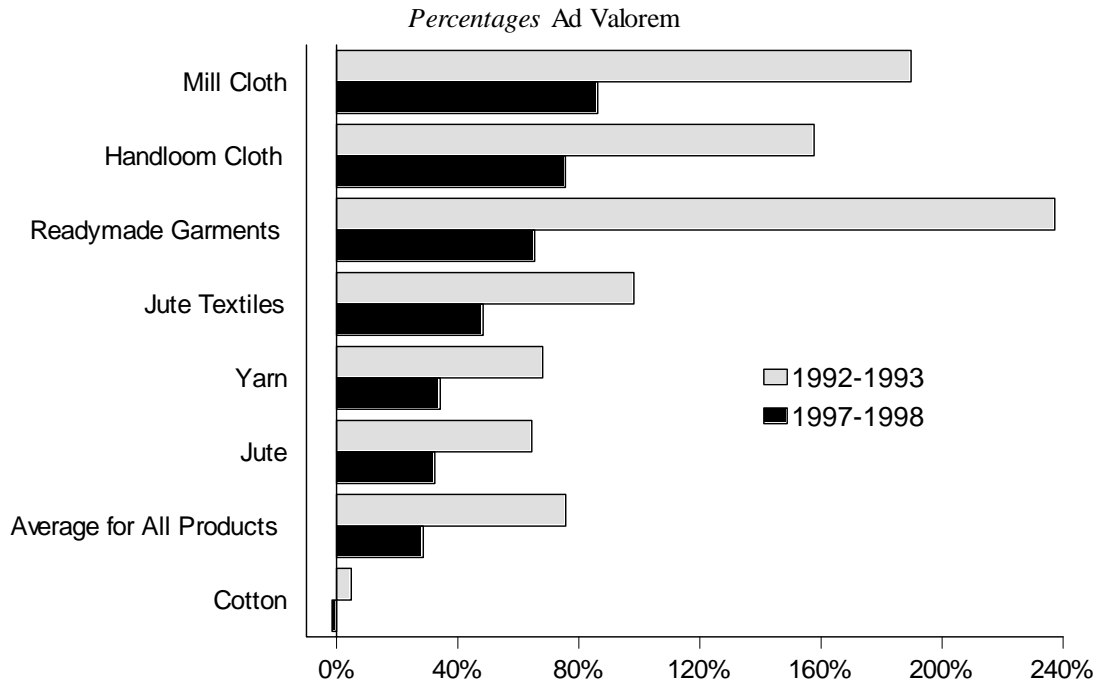
⁴² See Office of the United States Trade Representative, “Generalized System of Preferences (GSP): Request for Public Comments on the Possible Withdrawal, Suspension, or Limitation of GSP Benefits with Respect to Bangladesh” *Federal Register* Volume 69 Number 70 (12 April 2004), page 19258. Note however that removal of Bangladesh’s GSP privileges would have almost no impact on the clothing sector *per se*, insofar as the United States generally does not extend GSP treatment to products in this sector.

⁴³ Dowlah (1998), page viii.

⁴⁴ Quddus and Rashid (2000), page 21.

STATISTICAL APPENDIX

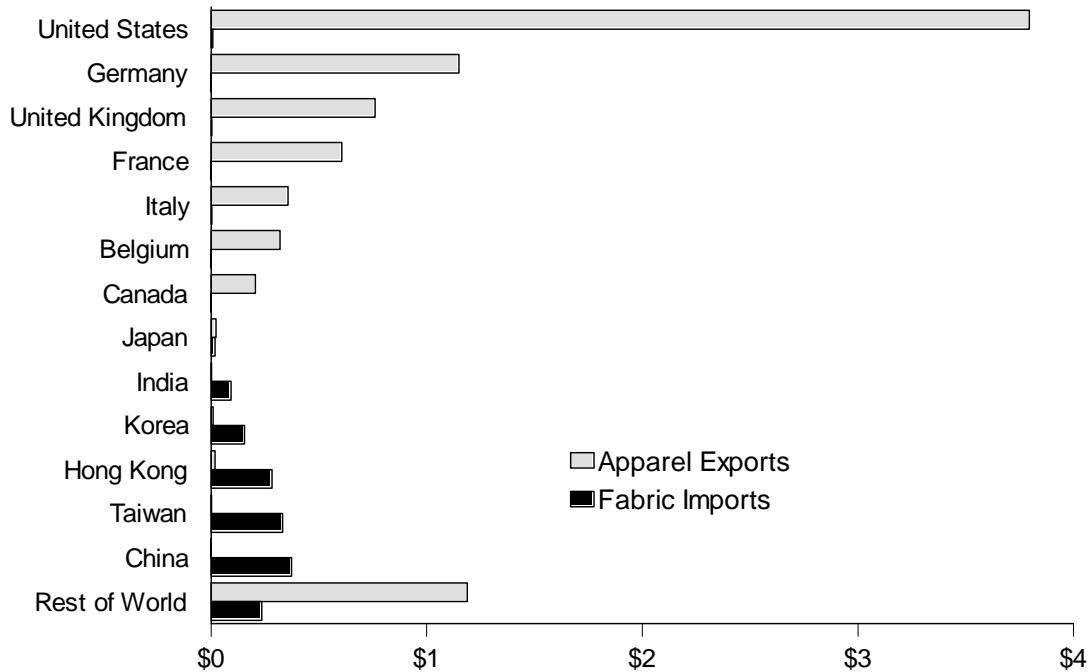
Figure 1: Effective Rates of Protection on Bangladeshi Imports



Source: Based on estimates of the Bangladesh Tariff Commission, as reported in Nasiruddin Ahmed, Trade Liberalization in Bangladesh (2001), Table 5.7.

Figure 2: Bangladeshi Fabric Imports and Apparel Exports, 2001

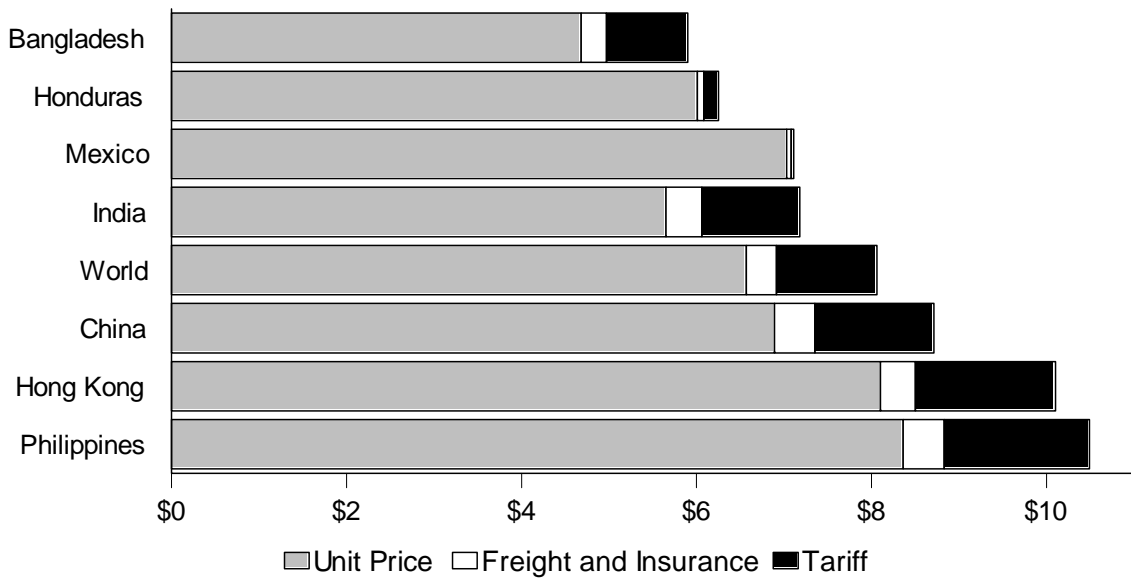
Billions of U.S. Dollars



Source: Calculated from WITS data.

Figure 3: Average Landed Prices for Certain Men's Shirts Imported into the United States from Selected Partners, 2003

Actual Dollars, Based on Customs Value, Imports for Consumption, of HTS item 6205.20.2065 (Men's Cotton Shirts, Not Knitted, Less Than Two Colors in the Warp)



Source: Calculated from U.S. International Trade Commission data.

Table 1: Bangladesh Trade in Fibre, Fabric, and Clothing*Thousands of Current U.S. Dollars*

	1993	1995	1996	1997	1998	2001
Fibre Imports	98,904	114,474	187,375	249,888	302,756	412,730
Fibre Exports	71,448	79,318	73,316	101,899	83,144	51,156
Fibre Balance	-27,456	-35,156	-114,059	-147,989	-219,612	-361,574
Fabric Imports	690,919	1,495,380	1,400,276	1,042,149	1,532,537	1,504,465
Fabric Exports	179,180	275,230	277,114	294,999	278,897	282,445
Fabric Balance	-511,739	-1,220,150	-1,123,163	-747,150	-1,253,641	-1,222,020
Clothing Imports	7,333	198,076	304,777	66,697	120,736	369,589
Clothing Exports	2,611,145	3,937,368	4,436,365	5,376,450	7,567,891	8,432,851
Clothing Balance	2,603,812	3,739,292	4,131,589	5,309,753	7,447,155	8,063,262
Overall Balance	2,064,616	2,483,986	2,894,366	4,414,614	5,973,902	6,479,668

Source: Calculated from WITS data. Note that data on Bangladeshi trade are missing from WITS for some years.

3.2 COLOMBIA

Introduction

47. Colombia offers an example of a mid-level developing country that is in the transition from the protected production of commodity clothing to full-package manufacture of higher-end merchandise. This is a country that must compete not on price alone, but on the ability to provide advanced goods at a superior level of quality and in a shorter turn-around time. It is this strategic perspective that shapes the Colombian view of trade barriers and preferences. Restrictions on market access, both at home and in export markets, are no longer seen in the narrow context of rent-seeking opportunities. These terms of market access are instead viewed in light of their impact on the country's ability to compete at the higher end of the market. These calculations were part of what prompted Colombia to abandon an industrial strategy based on import-substitution industrialization (ISI), which proved to be much more attractive in theory than in actual practice, and to promote forms of preferential trade that facilitate product upgrading. This might be called an "FTZ to FTA" approach, in which the earlier reliance on free trade zones — especially the emphasis on mere assembly of fabric — is replaced by the more advanced operations that are possible in suitably flexible free trade agreements.

The economic and policy context

48. Colombia's ability to compete effectively in the world textile and clothing market depends upon its overall industrial competitiveness. Like many other developing countries, Colombia based its development strategy for decades upon a protectionist foundation. That approach was ultimately abandoned in favour of a market-oriented model.

Commitment to market-opening

49. One study properly described the "evolution of the political economy and trade policies in Colombia" as having followed "a circuitous path."⁴⁵ Like most Latin American countries, Colombia had adopted a policy of import-substitution industrialization in the early 1950s. Beginning in 1960, the government supplemented this approach with a policy of export promotion. The turn towards a truly market-oriented approach did not come until the disruptions caused by the debt crisis of the early 1980s. The initial effect of that crisis was to interrupt a process of liberalization that Colombia had begun in the late 1970s. This first liberalization period (1977-1981) was derailed by a temporary retreat into protectionism (1982-1984), followed by a second liberalization period (1985-1991).⁴⁶

50. Colombia's real commitment to an open economy dates to the early 1990s, with the launching of the *apertura* (openness) policy. While there have been adjustments made across different administrations, the country has not returned to a protectionist orientation. This policy of openness goes beyond trade. It is an example of "second-generation reforms" that several Latin American countries adopted, these being defined as "supplemental measures, refinements of past actions, course corrections, or more far-reaching changes in strategy and policies."⁴⁷ In Colombia's case, the structural reforms during the 1990s dealt with taxes, financial liberalization, privatization, and liberalization of external capital transactions. At the same time, average tariffs declined rapidly from 83 percent in 1985 to 7 percent in 1992.⁴⁸ It is on the basis of these reforms that Colombia is said to adhere to a "competitive" strategy — as distinguished from a "standard" market strategy — in its economic reforms. Whereas the standard strategy is based upon fairly

strict adherence to the tenets of neo-liberalism, in the competitive liberalization strategy such instruments of public policy as “tax and credit incentives for smaller trading companies, export promotion, and job training programmes ... ha[ve] been more actively used as part of a development model based on free trade.”⁴⁹ Chile practiced this approach, for example, with much better results than were achieved by Argentina under the standard strategy or Brazil under a mostly standard strategy.

Exchange rate

51. One key component of *apertura* is a market-driven exchange rate. Since late 1999, when Colombia eliminated its exchange rate band and floated the peso, the Banco de la República has conducted its foreign exchange intervention through options-based mechanisms. This involves the auctioning of calls or puts (depending on whether the bank seeks to buy or sell U.S. dollars), which may then be exercised when the spot rate deviates (through appreciation or depreciation) from its arithmetic moving average for the previous 20 days. In deciding whether to intervene in this way, the bank monitors the accumulation or decumulation of reserves, as well as the volatility of the exchange rate.⁵⁰ This approach, and the volume of interventions, “are designed to slow the rate of change of the peso while letting the market determine its level,”⁵¹ and also avoid creating inflationary pressures.

52. The textiles and clothing industry’s fortunes have always been dependent on fluctuations in the dollar-peso exchange rate. As is always the case for multistage industries, however, changes in the exchange rate have different effects upon producers at different segments of value chain. For textile producers, a devaluation will improve its price-competitiveness *vis a vis* imported fabrics, but may also increase the cost of imported raw materials and capital goods. Those costs might be managed, however, by specializing in fabrics that can be made from domestic inputs and by timing the purchases of imported capital-goods. The problem may be more difficult to manage for clothing producers, where capital investments are less significant but fabrics must be supplied on a regular basis. In each case, however, eliminating the swings in exchange rates makes for a more predictable business environment.

Characteristics of Colombia’s textiles and clothing industry

53. The key fact for the Colombian industry — like its counterparts in OECD countries — is that domestic wage rates are well above those in Asian developing countries. As is the case in nearly all countries, wages are higher for textile workers (typically about \$240 per month) than clothing workers (about \$160 per month).⁵² The Colombian business model seeks to make up for the disadvantage in wage rates through non-price factors in competition. These include the higher skill levels of Colombian workers, superior quality-control procedures, and exploitation of the country’s favourable geographic position.

54. Colombia has gradually moved up the ladder of sophistication in the clothing industry. Analysts commonly distinguish among three types of arrangements in clothing trade, based on ascending levels of quality and involvement.⁵³ (1) mere *assembly* of clothing, often done on a subcontracting basis and usually in special economic zones; (2) *original equipment manufacturing* (OEM) is similar to assembly of low-value, commodity clothing, but is devoted to costlier, branded clothing; and (3) *original brand manufacturing* (OBM), in which the OEM manufacturer has now acquired the expertise needed to design and market its own goods. In the 1960s, most production consisted of simple assembly in free trade zones. By the late 1970s, Colombian firms were producing clothing under license for several major brand-name companies. Today an increasing number of OEM producers are developing their own capabilities in OBM production.

55. Moving up this ladder of sophistication has required that the clothing industry, and the economy in general, address several factors that held back productivity. In a now-classic study of problems in the clothing industry during the 1960s and 1970s, one analyst noted that the main difficulties included low

productivity of the workforce which greatly neutralized the advantages of low wages; lower management productivity, including a lack of appreciation for quality and punctuality; tariff policy restricted the availability of world quality inputs at world prices; export promotion zones existed but did not work; and transportation costs were greatly advantageous to Colombia manufacturers but were not efficiently used.⁵⁴ These bottlenecks have been dealt with in a series of reform initiatives, some of them being undertaken on an economy-wide basis and others being specific to the industry. Cooperation between the public and private sectors has been crucial. In 1989, for example, the Government of Colombia commissioned a series of outside studies of industrial sectors in order to promote their modernization. One such study focused on the textile sector. In a happy coincidence, the industry received and began to adopt the recommendations emerging from this study at a time when it was already pursuing its own self-initiated process of conversion, and at the very time that the government took on the new policy of *apertura*.⁵⁵ The initiatives of the public and private sector thus converged into a shared effort.

56. The clothing industry today has a reputation as a high-quality provider that can meet just-in-time deliveries, especially in such niche markets as women's underwear, babies' clothing, and swimwear. In anticipation of 2005, the industry has been shifting its focus from basic garments to higher-end fashion items, while also offering full-package programmes. These are sourcing arrangements that can provide the entire range of garment manufacturing — clothing design, all steps of textile production, distribution of the finished garment — or any combination of these operations.

Labour, management, and investment

57. One of the major problems in past decades was the lack of competence in the work force and professionalism in management. Both of these issues have been dealt with at the industry level. The clothing industry in particular undertook new training programmes in the early 1990s, seeking to ensure that workers could perform new functions or “have the flexibility required to execute distinct tasks within the same production process” (*i.e.*, multitasking).⁵⁶ While that approach would appear to contradict the logic of specialization, it paid off for the industry. Colombia's plans for the post-2004 environment depend upon its ability to compete in the higher end of the market, including full-package production of quality garments. This in turn depends on the skill levels of its workers, which already compare favourably with competitor countries in Asia. Worker training is therefore a priority in the clothing industry, with the government and private sector jointly holding permanent training programmes.

58. Managerial improvements have kept pace with advances in labour, largely through a process of learning-by-doing. Colombian clothing production is primarily based on trade rather than investment. This is true both for the full-package producers in the higher end of the market, as well as the producers who do contract work for foreign retailers. Local management operates both textile and clothing companies, and most firms in Colombia's textile and clothing sector are owned by Colombians. Producers of manmade fibres, however, are reportedly foreign-owned or have foreign capital investment from companies headquartered in the United States, Mexico, Germany, and the United Kingdom. Colombian policymakers hope to attract new foreign investment in order to enhance its competitiveness in the production of higher-quality fabrics and clothing.

59. The *apertura* did lead to increased trade activity, but was even more significant for the changes that it inspired in the internal operations of the textile industry. Whereas some 38.5 percent of producers said in a poll that they had begun substituting imported inputs for national products, this was much smaller than the percentages who said that they had reorganized their productive processes (73.0 percent).⁵⁷ It was during this period that many firms in the textile industry adopted programmes based on total quality management, just-in-time production, and strategic planning.⁵⁸ The clothing industry undertook similar efforts, especially in total quality management.⁵⁹

Transportation costs

60. Much has been done to take better advantage of Colombia's strategic location. The country is close to the United States, and is the midpoint between North and South America. Colombia is also the only South American country with ports on both the Pacific Ocean and the Caribbean. Its location gives Colombia an advantage in turn-around time, a critical consideration in the higher value-added segments of this industry. That is especially true in co-production arrangements. Shipping U.S.-made and -cut fabric to Asia for assembly can require a turn-around cycle of four to six weeks, which is much less attractive for an Asian producer than the transformation of Asian fabric into clothing (a process that may take only a week).⁶⁰ Colombia can ship products to the United States within three days by sea or three hours by air.

Trade policy

61. The Colombian textile and clothing industry has transformed itself from one based on a protected local market to competition in export markets. This required not only the all-important transition from ISI to an export orientation, but further required that the export strategy avoid the pitfalls of simple assembly and price-based rent-seeking. Under the quotas of the Multifibre Arrangement regime, it would have been easy for Colombia to establish a "quota baby" industry that chased short-term profits in restricted markets. That approach would have a limited shelf-life. The Colombian strategy is instead based upon efforts to be competitive in a post-2004 world. Colombia has taken a series of steps to reverse its earlier policy of protectionism. Those steps were at first limited to autonomous programmes that provided for exemptions from protection, but then moved into reciprocal agreements that provide for the removal of protective barriers on a mutual and negotiated basis.

62. This required a revolution in the expectations of producers, many of which were happily insulated in the ISI system. In the early 1990s, half of all textile producers did not export at all, and only 3.8 percent of them exported more than half of their production.⁶¹ Just over half (51.7 percent) of clothing producers were exporters.⁶² Clothing producers took a more pessimistic attitude towards the *apertura* than did the textile industry, with "entrepreneurs being more concerned about the damage that could be done to them by imports — especially the illegal ones — than they were by the benefits they derived from exports."⁶³ Since then, the clothing industry has experienced rising level of export orientation and a change in mentality.

63. The competitiveness of an export industry is determined in part by its ability to escape the anti-export bias of protectionist barriers. Due to the fact that the Colombian fibre-fabric-clothing chain is only partly integrated, the country is dependent on trade in both directions. While the country grows cotton, production declined during the 1990s and cotton fibre imports now account for more than 65 percent of consumption. Most of the synthetic fibres used by Colombia's textile industry are imported, primarily from the United States.⁶⁴ Trade reforms have helped to enhance the competitiveness of Colombian industry. One study examined the response of textile, clothing, and other industries in Colombia to changes in the level of protection. It found "strong evidence supporting the hypothesis that Colombian plants' productivity is negatively affected by trade protection," due to "an increase in (i) skilled labour intensity of production, (ii) imports of intermediate inputs, and (iii) investments in machinery at the plant level."⁶⁵

64. The improvements in the domestic industry's capabilities have been complemented by shifts in the nature of the trade regime. In past decades tariffs on imported textiles and clothing were set at virtually confiscatory levels, but — under the terms of the Plan Vallejo adopted in 1967 — incentives were available for exporters who imported raw materials and capital goods. The Vallejo Plan allows the tariff-free importation of raw materials for use in finished products that are to be exported. With modifications, it remains in place to this day. That plan, coupled with free-trade zones (FTZs), helped to establish clothing-assembly and OEM production in Colombia. The FTZs permit exemption from income tax on all export

earnings; exemption from all customs duties and value-added taxes on goods and services brought into the zone; the right to exchange, hold, and negotiate foreign currency and to open domestic or foreign bank accounts in foreign currency; and exemption from income tax on all export earnings.

65. While the Plan Vallejo remains in place, it is being overtaken in importance by another, more ambitious regime. In a strategy that might be deemed “from FTZs to FTAs,” Colombia has gradually moved away from simple assembly of commodity clothing in enclaves to more sophisticated production for sale in the markets of its free trade agreement (FTA) partners. FTAs can be more conducive to value-upgrading than are FTZs, provided that their rules of origin are not too restrictive. The current FTA negotiations between Colombia and the United States — as discussed below — are just the latest and largest in a series of steps towards free trade between Colombia and the rest of the Americas. Among the other major steps were the transformation of the import-substituting Andean Group into the Andean Community in the 1990s, based on a common market and “open regionalism” (*i.e.*, simultaneous reduction of barriers to trade with third countries); negotiation of the Group of Three (or G-3) agreement with Mexico and Venezuela in 1994; the Colombia-Chile bilateral agreement (1994); and the launch of the negotiations for a Free Trade Area of the Americas in 1998.

66. The conclusion of an FTA between the United States and Colombia — which may also include Ecuador, Peru, and perhaps Bolivia — will be the culmination of a process that has been underway for two decades. As is discussed at greater length in the case study of the United States on textiles and clothing, much of U.S. textile and clothing policy since the mid-1980s has attempted to encourage co-production with those countries that incorporate U.S.-made fabric into finished clothing. The application of that policy to Colombia has gone through three phases. Prior to the early 1990s, the only available means was to encourage production in FTZs. The U.S. complement to the Plan Vallejo was the HTS 9802 programme, under which imports of products assembled abroad from U.S. components would be subject to tariffs only on the foreign value-added. As can be seen from the data in Figure 1, there is a close correspondence between U.S. exports to and imports from Colombia in this sector. Until recently, those imports and exports were usually two ends of the same transaction: U.S. fabric entered Colombia duty-free under the Plan Vallejo, and the finished clothing entered the United States on reduced-duty basis under the 9802 programme. Usage of the 9802 programme has declined in recent years, however, a development that has been attributed to “a shift in Colombia’s sector trade from clothing assembly-only operations to ‘full package’ clothing programmes in an effort to boost its competitiveness.”⁶⁶

67. The second phase came with the enactment of the Andean Trade Preferences Act of 1991, which was renewed and expanded by the Andean Trade Promotion and Drug Eradication Act of 2002 (APTDEA). The 1991 preferences had not included textiles and clothing, but the 2002 amendments did. Provided that products met the APTDEA rules of origin — which do allow for some use of third-country materials — the goods would receive duty- and quota-free access to the U.S. market. That allowance for the limited use of third-country materials is critically important, as Colombian producers need greater sourcing flexibility in order to continue their transition from simple assembly operations. The early results of the expanded preferences can be seen in Figure 2. While the raw data suggest that some of the U.S. imports from Colombia in 2003 and 2004⁶⁷ may have represented only a change in the dutiable status of existing trade flows, the jump in import values also implies that the preferences stimulated some additional sales. The FTA negotiations offer an opportunity for further transformation of the U.S.-Colombian textile and clothing relationship. That will depend in part on the rules of origin that are negotiated.

Conclusions and lessons

68. The Colombian experience underlines the importance of eliminating the anti-export bias that is inherent in protectionist regimes. While Colombian policymakers sought for decades to reconcile these two aspects of the textile and clothing policy regime, they ultimately had to sacrifice the protectionist barriers altogether. Once the country was committed to open markets, the domestic industry enjoyed the advantages of access to higher-quality, lower-cost imports of supplies and capital goods, while also being exposed to the challenges of competition.

69. Changes in government policy offer only an opportunity to compete. It is the firms themselves that need to take advantage of these opportunities through improvement in their competitiveness. According to one study of the clothing industry, the success of the firms that have performed the best during the *apertura* has been “founded upon their capacity to deal with competition through their controls of production costs, management of sales prices, and improvement in the quality of the goods that they offered for sale.”⁶⁸ Those firms that undertook reforms were then in a better position to serve both the local and export markets.

70. Trade policy can complement these efforts by encouraging the upgrading of products and processes. The Colombian industry has benefited in particular from a complementarity in the trade policy goals of both Colombia and the United States, both of which have acted to encourage co-production operations and the progressive upgrading of Colombian firms’ operations. Through a combination of more liberal government policies, enhancement of managerial and labour skills, learning by doing, preferential trade programmes, and the negotiation of free trade agreements, the Colombian industry has been transformed. What was once a protected industry with narrow goals has developed the capacity to offer high-quality, full-package production. This industry would be in poor shape if it sought to compete with the major Asian producers solely on the basis of price, but it has instead moved into higher-value segments where non-price considerations are equally important.

⁴⁵ Haar and Reyes (2000), page 4.

⁴⁶ This periodization is from Fernandes (2003), pages 9-10.

⁴⁷ Jeffrey Stark (1999).

⁴⁸ Haar and Reyes (2000), page 7.

⁴⁹ Wise, Carol (1999), page 1.

⁵⁰ For further details on these operations, see IMF (2004), page 6.

⁵¹ IMF (2004b), page 17.

⁵² USITC (2004a).

⁵³ This typology, as well as the discussion of different regional models, is adapted from Gereffi and Memedovic (2003), page 1.

⁵⁴ Summarized from Morawetz (1981).

⁵⁵ See the discussion of the Boston Consulting Group study in Jaramillo, Montoya and Ramirez (1996), pages 88ff.

⁵⁶ Jaramillo, Montoya, and Ramirez (1996), page 174; translation from the original by the author.

⁵⁷ Jaramillo, Montoya, and Ramirez (1996), page 108.

⁵⁸ Jaramillo, Montoya, and Ramirez (1996), page 172.

⁵⁹ Jaramillo, Montoya, and Ramirez (1996), page 110.

⁶⁰ McMillan, Pandolfi, and Salinger (1999), pages 21-22.

⁶¹ Jaramillo, Montoya, and Ramirez (1996), page 101.

⁶² Jaramillo, Montoya, and Ramirez (1996), page 163.

⁶³ Jaramillo, Montoya, and Ramirez (1996), page 165; translation from the original by the author.

⁶⁴ USITC (2004a).

⁶⁵ Fernandes (2003), page 3.

⁶⁶ USITC (2003), page 2-32.

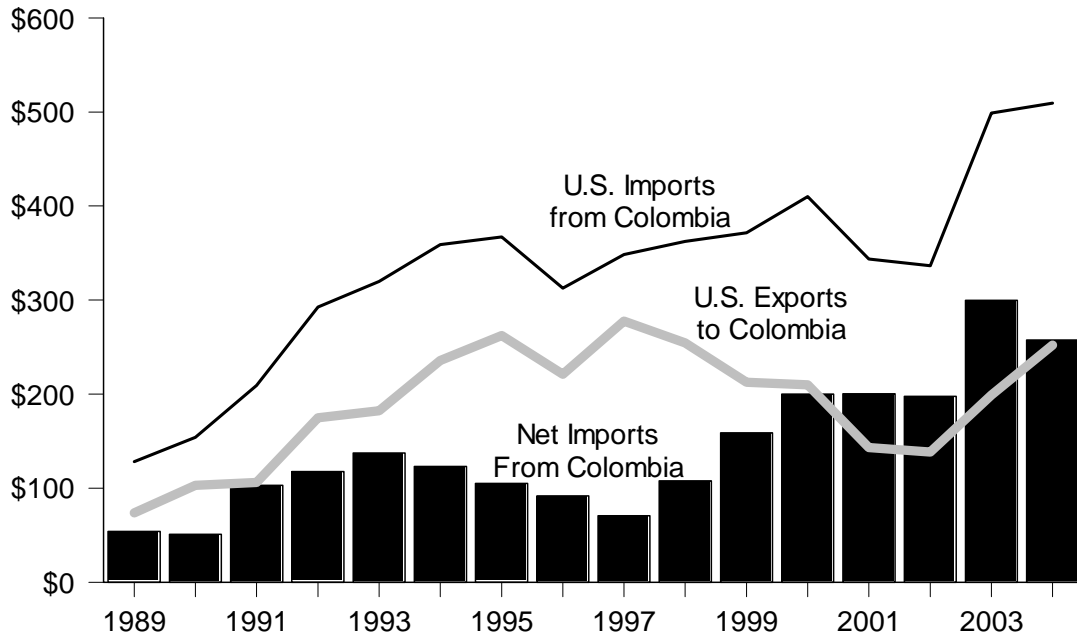
⁶⁷ Imports of qualifying textile and clothing articles from the Andean countries became eligible for preferential treatment with the implementation of ATPDEA, on October 31, 2002, but exporters were not taking full advantage of the new opportunities until 2003.

⁶⁸ Jaramillo, Montoya, and Ramirez (1996), page 182; translation from the original by the author.

STATISTICAL APPENDIX

Figure 1. U.S.-Colombian Trade in Fiber, Fabric & Apparel, 1989-2004

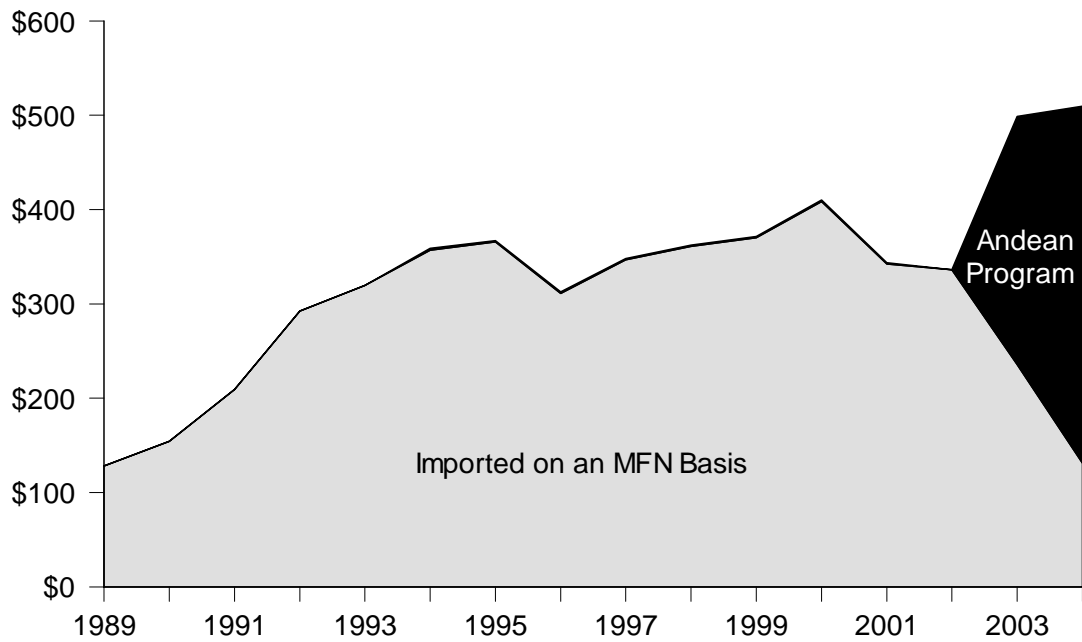
In Millions of Current U.S. Dollars; 2004 Data Projected from January-May Figures



Source: Calculated from U.S. International Trade Commission data.

Figure 2. U.S. Imports of Apparel from Colombia, 1989-2004

In Millions of Current U.S. Dollars; 2004 Data Projected from January-May Figures



Source: Calculated from U.S. International Trade Commission data.

3.3 LESOTHO – THE CLOTHING SECTOR

Introduction

71. Lesotho is a land-locked, least-developed country surrounded by, and to a large extent dependent on, its South African neighbour. Despite that, the country has managed to develop a flourishing clothing industry and become one of the largest exporters of clothing in Sub-Saharan Africa. This case study reviews the Lesotho clothing sector and focuses on government policies that have influenced the expansion and competitiveness of the industry. A combination of factors has helped attract (mainly Asian) investors to the clothing sector: (1) relative political stability, (2) a relatively well-educated and productive labour force, (3) an active export and investment promotion policy, (4) access to South Africa's infrastructure and (5) preferential access to the EU and US markets. Subsequently, the US Africa Growth and Opportunity Act (AGOA) has helped trigger an industry boom, but it is important to emphasise that the first investments occurred long before the introduction of the AGOA.

Economic and social developments

72. At independence, in 1966, the country was totally dependent on agriculture and lacked a manufacturing base. Rapid growth in the 1970s (average real GDP growth of 7% a year) and between 1987-97 (6.4%), first driven by remittances from migrant labour and aid money and later by foreign investments, transformed the economy. Manufactures now make up 18% of GDP, around half of which comes from the clothing sector (IMF, 2004c).

73. Traditionally, the economy has been heavily dependent on workers' remittances, which accounted for nearly half of the GNP during the 1980s.⁶⁹ Declining demand for low-skilled workers in South Africa – in conjunction with domestic civil unrest – has contributed to a severe crisis and dramatic reduction in remittances, down to one fourth of GNP by 1998 (Lundahl *et al.*, 2003).

74. Exports have grown markedly during the 1990s and increased even more dramatically at the end of the decade thanks to the US AGOA. Exports now make up over 50% of GDP, with clothing accounting for three quarters of this figure. Approximately 95% of clothing exports are sold on the US market under AGOA.⁷⁰ Even though all inputs to the clothing industry are imported from Asia and South Africa, the sector's export growth has contributed to lowering Lesotho's large trade deficits. Nevertheless, in 2002, overall imports stood at more than double that of exports and came mainly from the countries of the Southern African Customs Union (SACU).

75. Although remarkable, Lesotho's growth performance has been combined with a low level of formal employment creation and rising poverty, because of factors such as low productivity in agriculture and declining possibilities in South African mines (Lundahl *et al.*, 2003). The official unemployment rate is over 30%. Employment in the clothing industry surpassed that in the public sector in 2001, but has not been sufficient to absorb the loss in other sectors. Moreover, income inequality is among the highest in the world and gender inequality is pronounced. Women have fewer opportunities than men, partly because women are still prohibited from owning and transferring property. HIV/AIDS is taking a heavy toll and life expectancy has declined from 53 years in 1989 to 45 years in 1999. Education has been a priority of the government since the structural adjustment programmes of the late 1980s, and Lesotho's educational attainments are higher than the Sub-Saharan average.⁷¹

Clothing industry developments

Industry performance, structure and impact on the economy

76. The clothing sector has become the main source of economic growth and employment in Lesotho. The origins of the industry date back to the early 1980s, when clothing operations were moved from South Africa to Lesotho to avoid international sanctions, to take advantage of cheap and relatively productive labour, and the country's derogation to the Lomé Convention rules of origin.⁷² Preferential market access to the EU and the US and the provision of incentives contributed to lure investors. The first East Asian investment was made in 1986. Since then the industry has grown at a sustained pace, which only slowed down at the end of the 1990s. A major boost to the industry came from the approval in 2000 of the US AGOA (Gibbon, 2002; IMF, 2004c).

77. The clothing industry has created a large number of jobs for a predominately female labour force. In February 2003, 43 firms with 43,000 employees (90% being women) were reported to operate in the industry, with several investment projects under way. In addition, numerous small manufacturers produce for the domestic market. Chinese Taipei-owned companies dominate the industry and production is almost entirely focused on jeans (60%) and t-shirts (40%) aimed for the US market.⁷³ All inputs are sourced from abroad, but rules of origin that will apply from 2007 have prompted investment in fabric, spinning and knitting facilities (ITC, 2001, USITC, 2004b, and Gibbon, 2002). As a result of the low local value-added, the linkages between the clothing sector and the domestic industry are limited (Integrated Framework, 2003).

78. The private sector is very polarised and there is no internal coordination to voice common concerns to the government. Larger firms tend to rely on their own networks for trade information, while smaller ones are reported to be quite unaware of production standards and market opportunities. Overall, there are very limited links between the foreign-owned export sector and the domestic firms, *e.g.* in terms of providing inputs and services.

Government policies

79. A specific feature of Lesotho is its high dependency on South Africa in terms of macroeconomic policies, trade, investment, transportation and employment. Nevertheless, government policies have played an important role in the development of the clothing sector.

80. The late 1970s saw an important shift in the country's development strategy, with the government adopting an industrial promotion policy that comprised a combination of import-substitution and export-oriented production, and acknowledged a larger role for the private sector (Matlsoa, 1999). This was not enough, however, to overcome the structural weaknesses of the economy (Lundahl *et al.*, 2003). Economic stagnation in South Africa, combined with rising budget and current account deficits, led to a build up of public debt in the 1980s. At the end of the decade, the country embarked on a set of structural adjustment programmes sponsored by the international financial institutions. This co-operation has continued since then with a focus on macroeconomic stability and structural reform.

81. In terms of macroeconomic and trade policy, Lesotho's room for manoeuvre is constrained by the country's membership in the Common Monetary Area (CMA) which comprises Namibia, South Africa and Swaziland, and the Southern African Customs Union (SACU), which also includes Botswana.⁷⁴ The currency is pegged to the South African Rand, which, as a consequence, affects Lesotho's external competitiveness and inflation rate. Lesotho applies the common SACU external tariff policies and trade laws and enjoys duty-free access to other member countries' markets. Half of government revenue comes from customs duties collected and redistributed by the South Africa's National Revenue Fund.⁷⁵

82. The common external trade regime is relatively open, with an average simple tariff rate of 11.4% in 2002, down from 15 per cent in 1997. However, this conceals significant tariff peaks on clothing and inputs, which creates an anti-export bias for Lesotho. In addition, there is a range of less transparent, specific, mixed, compound, and formula duties (Integrated Framework, 2003; WTO, 2003a). A combination of weak institutional capacity and a poor public-private dialogue undermine the ability of the trade policy making process to handle complex policy issues.

83. In terms of external market access, Lesotho's clothing exports enjoyed preferential market access to the European Union under the Lomé Convention and to the United States under the Generalised System of Preferences (GSP) in the 1980s. At the end of the decade, the EU requested that two stages of production be carried out in the country of origin or in an eligible ACP country. After an eight year dispensation period, several foreign producers reduced their activities in Lesotho, while others shifted their exports to the US market to take advantage of unused quota under the MFA. In 2000, the US AGOA was passed into law, which grants qualifying Sub-Saharan countries duty-free access for clothing and a range of other products to the US market. Input must normally originate from the US or another eligible Sub-Saharan country, but this rule will not apply to LDCs such as Lesotho until January 2007.⁷⁶

84. Foreign direct investment has played a fundamental role in the development of Lesotho's clothing industry and its export performance (World Bank, 1998; Lundahl *et al.*, 2003). The country has no foreign investment law but the investment regime is considered to be liberal and non-discriminatory. There are no restrictions on ownership and no history of expropriation. The Investment Promotion Centre, a branch of the parastatal *Lesotho National Development Corporation* (LNDC) acts as a one-stop facility for investors, providing a range of incentives for them.⁷⁷ Although important, incentives were not the main drivers of FDI.⁷⁸ The attractiveness of Lesotho as a destination of FDI resides in a number of factors: favourable international trade agreements (including the exceptions from the EU rules of origin), the productive labour force, access to South African ports and the efficient mechanisms in place for exporters.⁷⁹

Future challenges and opportunities

85. The most acute challenge for the clothing industry in the future might be the changing market access conditions. The threat posed by the phasing out of the special textile provision in 2005 (now postponed to 2007) has induced some companies to invest in backward integration, but the overall impact on the industry is still unclear. At the same time, the elimination of the MFA quotas will probably mean stronger competition from countries like China and other Asian producers. Opportunities include the free trade agreement that is being negotiated between SACU and the US, and the EU's Everything But Arms initiative, even though the rules of origin of the latter need to be clarified (IMF, 2004c).

86. On the domestic side, the government faces major challenges to further develop and diversify the economy. As regards clothing, there is a need to enhance the linkages between the foreign-owned firms and the local economy, by improving the business climate, supporting local entrepreneurs and enhancing on-the-job training. This task is complicated by the weak entrepreneurial culture in Lesotho, the cultural differences between foreign investors and the local population and the declining quality of the vocational skill component in the educational system (Lundahl *et al.*, 2003). Training facilities are lacking, partly because of the reluctance of foreign employers to train and promote local employees (Integrated Framework, 2003). In parallel, HIV/AIDS looms as a major health and development threat.

87. The lack of dialogue between government and the private sector may seriously undermine the country's ability to handle trade-related challenges, such as those enumerated above (Integrated Framework, 2003; Capra-TFOC Consortium, 2003). In this respect, donors have been very active in

supporting the country's trade policy making process, in particular through the Integrated Framework for Trade-Related Technical Assistance (see Box 2).

88. There are concerns that the booming clothing sector may contribute to the spread of HIV/AIDS, since the employment opportunities created has fuelled rural-urban migration of young people. In response, a Private Sector Coalition against HIV/AIDS was launched in 2002 (IRIN, 2003). In addition, the sector might have a negative environmental impact, due to its extensive use and pollution of scarce water. The 2000 Environmental Bill deals with the environmental threat, but stakeholders have been slow to implement concrete solutions (Gibbs and Gibbs, 2002).

Conclusions

89. Lesotho's clothing industry has been called a "*success story*" (IMF, 2004c, p.14) and the sector undoubtedly has made an important contribution to economic growth, exports and employment. However, the spill-over effects to the local economy are limited and it remains to be seen how the foreign-owned export enterprises respond to the changing market access conditions. In any case, the economy has now become dependent on one major industry, which makes it vulnerable. Further diversification and promoting local entrepreneurship should be high on the government's agenda.

Box 1. Integrated Framework for Trade-Related Technical Assistance

The Integrated Framework for Trade-Related Technical Assistance (IF) is a multi-donor programme that aims to integrate trade priorities into national development plans, such as the Poverty Reduction Strategy Papers (PRSPs), of least-developed countries and to assist in the co-ordinated delivery of trade-related technical assistance, in response to needs identified by the LDCs. The programme was initiated in 1997 by six multilateral institutions (IMF, ITC, UNCTAD, UNDP, World Bank and the WTO). Fourteen countries are currently participating in the IF, including Lesotho.

An important element of the IF is the Diagnostic Trade Integration Study (DTIS) – a country report that assesses the participating country's present trade and investment regime, identifies trade bottlenecks and opportunities and suggests recommendations for policy reform and technical assistance. The Lesotho DTIS was finalised in November 2003 and is available on the IF website. The following recommendations are included in the report:

- Engage actively in regional arrangements (SACU and SADC), including pursuing liberalization of SACU's common external tariff, limitations on the use of non-tariff barriers, and regional cooperation in the introduction of trade facilitating measures.
- Undertake efforts to improve the country's investment climate for foreign and domestic investors alike, which includes streamlining the licensing system for new business entrants and foreign trade operations, land management, and the system governing entry of foreigners into Lesotho.
- Invest in infrastructure and human resources, both in long-term education and short-term training, especially in the clothing sector.
- Attempt to improve statistical reporting and administrative procedures

The DTIS recognises that there is great need for external assistance to develop the institutional capacity required to address these issues. As a consequence, a national IF steering committee, with participants from the government, the private sector and donors, has been established to manage follow-up activities (*i.e.* the implementation of technical assistance and capacity building projects).

Source : Integrated Framework (2003), www.integratedframework.org

Table 1. Lesotho: Structure of the Economy

Average percentages

	1976-1984	1985-1994	1995-2002
Agriculture, value added (% of GDP)	30.9	21.2	17.4
Industry, value added (% of GDP)	24.7	33.0	40.9
Services, etc., value added (% of GDP)	44.4	45.8	41.7
Trade (% of GDP)	134.8	135.5	133.3
Exports of goods and services (% of GDP)	16.5	16.9	31.1
GDP growth (annual %)	8.0	5.0	3.3
Employment in agriculture (% of total employment)	40.2	40.0	n.a.
Employment in industry (% of total employment)	34.1	27.9	n.a.
Employment in services (% of total employment)	25.6	32.1	n.a.

Source: World Development Indicators CD-ROM (2004)

Table 2. Lesotho: Export structure

Product name	HS Code 2	1976-84	1985-94	1994-03
Articles of apparel and clothing accessories	84	5.91%	77.97%	86.65%
Non-metallic mineral manufactures, n.e.s.	66	17.97%	7.66%	11.62%
Gold, non-monetary (excluding gold ores and concentrates)	97	0.00%	6.45%	0.60%
Fish, crustaceans, molluscs, preparations thereof	03	0.01%	0.02%	0.36%
Vegetables and fruit	05	3.71%	3.82%	0.31%
Other transport equipment	79	0.29%	0.03%	0.08%
Special transactions and commodities not classified according to kind	93	0.11%	0.16%	0.05%
Miscellaneous manufactured articles, n.e.s.	89	30.32%	0.18%	0.04%
Dairy products and birds' eggs	02	0.00%	0.00%	0.04%
Non-ferrous metals	68	0.01%	0.03%	0.02%

Source: UN COMTRADE Database, SITC Rev. 3.

⁶⁹ At that time almost half the adult male population was employed in South Africa.

⁷⁰ In 2003, the value of total US garment imports from Lesotho amounted to US\$ 392 million. AGOA imports for the same year reached US\$ 372 million. Source: USITC (2004b).

⁷¹ Adult literacy rate is 81.4 per cent, which is much higher than the Sub-Saharan average (63 per cent).

⁷² This derogation allows Lesotho to export duty free garments produced in Lesotho from cotton of non-ACP origin. Productivity levels are at about 70-80 per cent of that in Asian factories for basic garments, but lower for more elaborate items (USITC, 2004b).

⁷³ Major customers in the US include Gap, Wal-Mart, and K-mart.

⁷⁴ See Grandes (2003) for a detailed analysis of the functioning of the CMA and its implications for the various members. Lesotho is also a member of the South African Development Community (SADC), which is engaged in establishing a free-trade area amongst its 14 Member States, but withdrew from the Common Market of Eastern and Southern Africa (COMESA) in 1998.

⁷⁵ Until 2002, South Africa primarily determined tariff rates, but under a new agreement, rates will be set by a separate Tariff Setting Board. See www.tralac.org for details.

⁷⁶ On July 2004 the AGOA Acceleration Act (AGOA III) was approved, extending the previous Act, which would have expired in 2008. Now, the preferential agreements on textiles have been extended until 2015 and the exemption for the "third country fabric" until 2007. See www.agoa.gov.

⁷⁷ These include an export finance facility, long term loans and/or equity participation, unimpeded access to foreign exchange, and general sales tax exemption on capital machinery and equipment for manufacturing industries. Besides

LNDC (www.lndc.org.ls), the Basotho Enterprises Development Corporation (BEDCO) provides finance, training and assistance to indigenous enterprises.

⁷⁸ In this respect, Integrated Framework (2003, p.26) notes that: “Exports to the EU took place well before the EU derogation on local content expired, while export expansion to the US took place even before the local content was allowed under the AGOA. This suggests that Lesotho’s performance could hardly be attributable to special preferences, setting it aside from a large number of developing countries. Furthermore, this suggests that attractiveness of Lesotho to foreign investors goes beyond special preferences, albeit — as far as textiles are concerned — preferences have mattered.”

⁷⁹ Exporters of garment outside SACU are eligible for full duty rebates on all raw material or components used in exports (WTO, 2003a).

3.4 MAURITIUS – THE CLOTHING SECTOR

Introduction

90. Despite preconditions that may be considered unfavourable, such as high population growth and monocrop dependency, Mauritius is now widely cited as a success story in terms of development and economic diversification (Subramanian and Roy, 2001). In less than three decades, it successfully transformed itself into an “upper middle-income” country, experiencing sustained growth of real per capita GDP and developing an internationally competitive clothing industry and a flourishing tourism industry. A combination of (OECD) trade preferences and incentives in the form of Export Processing Zones (EPZ) allowed the clothing industry to grow rapidly. However, what made this possible were strong public institutions and democratic traditions, which facilitated the introduction of well-crafted and widely accepted economic reforms. Preference erosion and a relative decline in international competitiveness now put pressure on the government to help the clothing sector adapt through upgrading and regional integration. This case study reviews the emergence of the Mauritian clothing sector since 1970, placing specific emphasis on the role of government policies in the process.

Economic and social developments

91. Both economic and social developments have been impressive since Mauritius gained independence. The country has enjoyed political and macroeconomic stability, which favoured the inflow of foreign investment and the development of export-oriented manufacturing. The economy has diversified into manufactures (mainly clothing), services (*e.g.* tourism and financial services), agricultural products, and fisheries. These changes are also reflected in trade patterns, with manufactures accounting for around 65% of total exports in 2003. Moreover, from a net recipient of FDI, Mauritius has now become an outward investor to neighbouring countries, such as Madagascar (clothing) and Mozambique (sugar).

92. The economic achievements have been coupled with social improvements. Mauritius today ranks second in Africa in terms of the UNDP Human Development Index. At independence, most people lived in poverty (World Bank, 2002). According to the most recent survey less than 14% of the households fall below the official poverty line (CSO, 2002). Life expectancy at birth increased considerably and infant mortality declined to 64 per 1,000 live births in 2002 – a fourth of the 1970 level (World Bank, 2002, and UNDP, 2003). Income equality is much higher than in other non-LDC sub-Saharan countries (Anker *et al.*, 1998, and CSO, 2002). The status of women has also progressed, through improved education, labour market participation and political representation (World Bank, 2002).

Clothing industry developments

93. The expansion of the clothing industry, facilitated by a wide range of government policies, has been the main driver behind the structural change that has taken place in Mauritius since the 1970s. (Chernoff and Warner, 2002). The main growth period took place in the 1980s, yet slowed down during the 1990s, when the industry was confronted with increasingly difficult market conditions.

Industry performance, structure and impact on the economy

94. Mauritius exported almost US\$ 1 billion clothing (SITC code 84) in 2002, nearly 55% of its merchandise exports, accounting for 1% of world clothing exports. The sector involves more than 200 companies, employing 62,500 workers (13% of total employment), mostly women (CSO, 2004a).⁸⁰ About two thirds of the firms are owned by Mauritian nationals, which mainly export to the European market. Chinese-owned companies mainly export to the US (Gibbon, 2000).

95. The main products are t-shirts, men's shirts, trousers, and pullovers. The all-year demand for these product types makes Mauritius' remoteness and long delivery times to the main markets less of a problem. Production is heavily dependent on imports of intermediary products such as yarn and fabrics. Imports – mainly from China and India, Europe and South Africa – make up about half of the exports (CSO, 2004a; Anker *et al.*, 1998).

96. The sector developed during the 1970s, thanks to capital from sugar exports and foreign investors (mainly from Hong Kong), attracted by cheap labour, preferential access to export markets and the incentives set up by the government. After a dramatic growth during 1970-77 (employment in the sector grew by almost 40% a year), rising labour costs and the appreciation of the exchange rate contributed to reduce the competitiveness of the sector. A second expansion took place during the 1980s, when structural adjustment programmes contributed to economic stabilisation, and the government granted improved incentives to investors (Chernoff and Warner, 2002). The downside of the boom was a significant increase in labour costs. Labour shortages drove up wages, without a corresponding increase in productivity. At the same time, the 1990s witnessed an intensification of international competition. Increased pressure forced inefficient companies out of business; others were compelled to adjust by improving productivity, upgrading their production, importing foreign labour and outsourcing to lower cost location, such as Madagascar (Gibbon, 2000).

97. Some companies have invested in backward integration recently to adhere to the Africa Growth and Opportunity Act's (AGOA) rules of origin requirements. However, moving up the value-chain has occurred within the basic clothing sub-sector. Some producers for the EU market tried to develop their own brands in the 1990s, but failed because of the costs involved and the remoteness of the markets.

98. The impact of the clothing industry on the rest of the economy has been substantial in terms of contribution to growth, export, employment, and poverty reduction, but less so in terms of production linkages (Anker *et al.*, 1998; Chernoff and Warner, 2002). The EPZ sector has created a demand for services in packaging, consultancy, water and other areas, and local enterprises have learnt extensively from foreign companies (UNCTAD, 2001). The room for linkages creation is however constrained by the small size of the economy and the inability of local suppliers to meet world standards requirements in terms of quality and timeliness (Wignaraja, 2002).

Government policies

99. The clothing sector has benefited from a stable macro-economic environment and the adoption of outward oriented policies. On the one hand, fiscal deficits and inflation have been under relative control and the exchange rate has remained competitive. On the other, the government has actively promoted the development of export oriented industries, mainly by establishing an EPZ and joining the Yaoundé Convention, which gave Mauritian exports privileged access to the EC market.

100. The failure of the import substitution policies of the 1960s in reducing high unemployment made it clear that a change in development strategy was needed. However, the government was facing a trade-off, as it sought to develop a labour-intensive export oriented sector without disrupting the import-

substitution industries established in the second half of the 1960s. To solve this trade-off, the government adopted a two-track approach, by insulating the export sector from the import-competing one. The main feature of the dual system was the establishment of the EPZ, which benefited from tax incentives, duty-free imports and loose labour legislations. Combined with public investments in infrastructure, cheap and abundant labour supply and preferential market access, international and domestic investments were attracted into the nascent clothing industry of the EPZ (Bonaglia and Fukasaku, 2001).⁸¹

101. The mix of import substitution and export promotion prevailed until the structural adjustment programmes of the early 1980s, when trade liberalisation was gradually completed. Structural adjustment grew out of a combination of exogenous shocks, such as falling sugar prices, international recession and domestic fiscal imbalance. Key reforms boosting the clothing sector included the introduction of a flexible exchange rate and wage restraint to restore competitiveness. Quantitative restrictions on imports and a number of price controls were abolished (Gulhati and Nallari, 1990). By the mid-1990s, Mauritius was one of the most liberal regimes in Africa although protection was still higher than in the newly industrialising countries in South East Asia (Milner, 2001; WTO, 2001).⁸² In addition, measures were introduced to streamline bureaucratic procedures and further attract investment, such as the adoption of double-taxation agreements, the establishment of a one-stop-shop for investors (the Mauritius Export Development and Investment Authority, MEDIA), export guarantees set up by the Development Bank of Mauritius and tax reforms. The reforms paid off, stability was restored and sustained growth resumed.⁸³ The situation started to worsen in 2000, with a widening fiscal deficit, declining clothing exports and sluggish income growth.⁸⁴

102. The Government has invested heavily in improving the country endowment, both in terms of human and physical capital, and by supporting the private sector through various support structures (see Box 1). The Development Bank of Mauritius and MEDIA have been important vehicles for financing infrastructure and industrial facilities (Lamusse, 2001). A range of public institutions support the private sector in general and the clothing industry in particular (Bonaglia and Fukasaku, 2001; Wignaraja, 2001).

103. Well-managed investment incentives and promotion have played an important role in attracting foreign enterprises and allowing them to exploit the country's comparative advantage to the fullest extent. However, these measures would not have been so successful without the overall conducive macro- and microeconomic environment.⁸⁵

104. A key element for success has been the country's stable and inclusive democratic traditions, based on political consensus, a free media and the respect for the rule of law and property rights. The need for social cohesion – vital in a country characterised by significant ethnic diversity – also fostered relatively strong public institutions and important social protection, including centralised wage bargaining, price controls on sensitive items, and generous social security (Subramanian and Roy, 2001).⁸⁶

105. A number of examples show that this participatory policy environment has been of significant importance to the economy in general and the clothing sector in particular. Firstly, the government was responsive to demands from the business circles to establish the EPZ in 1970. Secondly, ethnical networks were largely instrumental in attracting FDI to the EPZ. Thirdly, a deal was struck between sugar exporters and the government; the property rights of the sugar owners were guaranteed while a share of the sugar rents was transferred to the public sector. In that way, earnings from the sugar exports were available for private investment in the clothing industry, while the government could pay for civil servants and social protection (Subramanian and Roy, 2001). Fourthly, Gulhati and Nallari (1990) argue that Mauritius democratic culture helped the country get through the economic imbalances at the end of the 1970s by providing politicians with early signals about what was wrong in the economy. Finally, the private sector participates in trade policy discussions and negotiations, *e.g.* through the Joint Economic Council, its apex organisation (see Box 2). This enhances the possibility to reach an outcome supported by all actors (Bonaglia and Fukasaku, 2002).

Future challenges and opportunities

106. Mounting global competitive pressures in terms of demands for lower price, higher quality and shorter lead times are putting Mauritius' clothing industry in peril. In view of the failed attempts to move up the value-chain, Gibbon (2000) foresaw a rapid contraction of the Mauritian clothing industry, with the Mauritian enterprises having a future as delocalised mid-market suppliers of basic clothing to the EU and the US, if no reforms were undertaken to increase the sector's productivity. Improved market access through the AGOA has temporarily provided relief to the sector, by promoting backward linkages and increased regional investments and sourcing (IMF, 2003d). By 2003, half of Mauritius' clothing exports to the US benefited from the AGOA, but total clothing exports to the US increased only 10% between 2000 (the year before AGOA) and 2003, and the country has not been granted the exemption for the third country fabric under the new AGOA.⁸⁷ Moreover, the sugar quotas are now being challenged, with possibly adverse consequences for Mauritian sugar production and the availability of domestic capital (IMF, 2003d).⁸⁸ In addition, the government's budget deficit is growing because of falling revenue, poorly managed state-owned utilities and increased public investments, reducing the room for manoeuvre.

107. Acknowledging these challenges, the government has undertaken a thorough examination of the industry's competitiveness within the framework of its *Economic Agenda for the New Millennium* (2000), in view of upgrading the sector's productivity, promoting diversification and attracting new FDI. The insufficient skill composition of the labour force and the poor quality of the educational system have been identified as a major constraint to the development of a competitive and diversified economy. Despite high literacy rates and educational progress, many students still do not finish primary school. Secondary and tertiary enrolments remain low and few take scientific subjects. This compares very unfavourably with the Asian countries Mauritius is competing with.

108. The government aims to transform Mauritius into a high-tech, high-income service and knowledge economy, by increasing competitiveness and productivity of the sugar and EPZ sectors, expanding the ICT and financial services sectors, and bringing about deeper social development and social cohesion (World Bank, 2002). As regards the clothing-dominated EPZ sector, specific measures are being evaluated to favour skills and technological upgrading, re-engineering of business processes, development of clusters and linkages, product and market diversification, as well as encouraging SMEs to become exporters.⁸⁹

109. Deepening regional integration is also an important priority. Neighbouring countries are of increasing importance to the clothing sector, as a destination for investments, a source of inputs and a market for its products. Overall, Mauritius is trying to position itself as a regional service industry hub. The country participates actively in regional co-operation arrangements such as COMESA (Common Market for Eastern and Southern Africa), SADC (South African Development Community) and the Indian Ocean Commission.

Conclusions

110. The clothing sector has played a key role in the transformation of the Mauritian economy away from mono-crop dependency. The core locus of this process is the period between 1983 and 1988, when a 20% unemployment rate was absorbed by the booming clothing industry, an example of a pure structural change according to Chernoff and Warner (2002). A number of favourable circumstances made this possible, the most important ones being preferential access to export markets and a pool of cheap labour. However, it was the government's choice of a dual-track approach to openness, based on an EPZ sector and a gradually liberalised import competing sector, that made it possible to exploit these opportunities. The macro-economy, incentives and support structures were managed in a way that attracted investments into the clothing industry. This was a result of Mauritius' strong civil service, tradition of participatory

policy making, and a focus on social cohesion. It may be difficult for other developing countries to follow a similar path as Mauritius, among other things because of declining global trade preferences and the lack of high quality public institutions (Subramanian and Roy, 2002). Mauritius now needs to move on to the next step of development and diversify into higher value-added activities. This will require reforms to enhance the competitiveness and diversity of the manufacturing sector and substantial investments in human resources and education, areas in which the country has lagged behind. The Mauritian government seems well-aware of these challenges.

Box 1. Public Support Institutions in Mauritius

Throughout the years, the government has actively promoted trade and investment activities in the clothing sector. Four parastatal institutions under the Ministry of Industry, Commerce and International Trade make up the backbone of the system: the Mauritius Industrial Development Agency (MIDA, former MEDIA), the Export Zone Development Authority (EPZDA), the Small and Medium Development Organisation (SMIDO), and the Board of Investment (BOI). A range of other public organisations also support the Mauritian industry, such as the recently established National Productivity and Competitiveness Council and the Industrial and Vocational Training Board. In spite of an impressive institutional framework, government efforts to upgrade technology in the clothing industry are reported to have had limited impact. Wignaraja (2001) concludes that overall, the support institutions have been too constrained in size, financial resources and technical skills to be able to respond to emerging industry needs, even though the situation has improved in recent years. What seems clear, however, is that the Development Bank of Mauritius has played a key role in providing long-term financing and investments in infrastructure to the clothing industry. Overall it is difficult to gauge the importance of the support institutions in the development of the clothing industry relative to other factors. However, even though the direct impact may be limited, they are part and parcel of a strong public framework for promoting business.

Source : www.jec-mauritius.org; Bonaglia and Fukasaku (2002) and Gibbon (2000)

Box 2. Public-private dialogue

The participatory nature of policy-making, through private sector representation in parastatal institutions and regular consultations with industry groups, has had an important impact on the adjustment process. A key mechanism for inclusive politics has been the Joint Economic Council (JEC), established in 1970. It operates as the coordinating body of the major multi-sectoral institutions and industry associations in Mauritius (Chamber of Commerce; Chamber of Agriculture; Employers' Federation; Sugar Producers' Association; Export Processing Zone Association; Bankers' Association; Insurers' Association; Hotels and Restaurants Association). The structure and functioning of JEC enable an enhanced coordination amongst the different institutions while permitting to build an institutional expertise for each represented industry. Hence, sectoral issues are dealt with the relevant industry association, while cross-cutting issues such as national budget, wage negotiations, international trade negotiations are dealt with all the JEC members. The dialogue takes place in a structured manner as well as on an *ad hoc* basis. The JEC is fully funded by its members. Bonaglia and Fukasaku (2002) argue that while the private-public partnership has been a key element in Mauritius' success, there are shortcomings which hamper the pace of reforms such as delays in policy formulation and implementation, and a 'wait-and-see' attitude on the part of the private sector.

Source : Bonaglia and Fukasaku (2002)

Table 1. Mauritius: Structure of the Economy

Average percentages

	1976-1984	1985-1994	1995-2002
Agriculture, value added (% of GDP)	17.4	13.4	8.2
Industry, value added (% of GDP)	25.7	32.4	31.6
Services, etc., value added (% of GDP)	56.9	54.2	60.2
Trade (% of GDP)	100.5	123.6	126.6
Exports of goods and services (% of GDP)	46.3	60.2	62.7
GDP growth (annual %)	4.0	6.4	5.2
Employment in agriculture (% of total employment)	29.4	15.1	14.5
Employment in industry (% of total employment)	24.5	43.0	39.8
Employment in services (% of total employment)	42.9	40.5	45.7

Source: World Development Indicators CD-ROM (2004)

Table 2. Mauritius: Export Structure

Product name	HS Code 2	1976-84	1985-94	1995-03
Articles of apparel and clothing accessories	84	21.82%	52.25%	57.24%
Sugar, sugar preparations and honey	06	63.48%	30.05%	19.31%
Fish, crustaceans, molluscs, preparations thereof	03	2.75%	2.12%	5.23%
Miscellaneous manufactured articles, n.e.s.	89	1.39%	2.82%	4.39%
Non-metallic mineral manufactures, n.e.s.	66	1.09%	1.82%	2.97%
Textile yarn, fabrics, made-up art., related products	65	2.01%	1.95%	1.65%
Photographic apparatus, optical goods, watches	88	1.75%	2.99%	1.52%
Professional, scientific and controlling instruments	87	0.09%	0.25%	0.69%
Animals, live, zoo animals, dogs, cats etc.	94	0.00%	0.15%	0.60%
Fertilizers, manufactured	56	0.17%	0.30%	0.54%

Source: COMTRADE Database, SITC Rev. 3.PART III: ANNEX a2. SECTORAL CASE STUDIES (5-8)

⁸⁰ The employment figures refer to firms located in the EPZ. It should be noted that 9,500 jobs were lost in the garment sector in 2003, compared to the end of 2002, when employment stood at 72,000.

⁸¹ Domestic investment mainly came from exports earnings from the sugar industry. Mauritius has benefited from an export quota to the EU at the internal EU sugar price (which exceeds the world market price under the African, Caribbean, and Pacific/EU Sugar Protocol). Between 1977 and 2000, the resulting rents have amounted to an average 5.4 per cent of GDP per year and made it possible to sustain high investment levels in the Mauritian economy (Subramanian and Roy, 2002).

⁸² In 2001 the average import tariff was around 20 per cent and there were eleven tariff bands, with the highest reaching 80 per cent (WTO, 2001).

⁸³ Annual real GDP per capita growth averaged 7.4 per cent over 1985-89, 5.4 per cent over 1990-94 and, despite slow productivity growth, 5 per cent during 1995-99 (Bonaglia and Fukasaku, 2002).

⁸⁴ Between 2001 and 2002 the volume of exports declined by 9 per cent, with EPZ exports declining by more than 10 per cent. See National Accounts of Mauritius 2003, <http://statsmauritius.gov.mu>.

⁸⁵ The foreign enterprises have brought advanced technologies, know-how, managerial skills, and an industrial culture. However, domestic investors got involved in the garment industry very early and later surpassed FDI, to the extent that a majority of the garment firms are now owned by nationals. The importance of the domestic factors is highlighted by the failure of many other African countries to promote industrialisation through preferential market access and EPZs (Kinunda-Rutashobya, 2003).

⁸⁶ Mauritius is a multi-ethnic society, with a Hindu majority and Franco-Mauritian, Creole and Muslim minorities. This diversity has played an important role in shaping national policies. In the years leading up to independence, it fostered political compromises aimed at protecting minority rights within the Parliamentary system inherited from the British.

⁸⁷ The exemption would have permitted Mauritian firms to import raw materials from countries outside Africa while still benefiting from duty free access to the US market.

⁸⁸ According to an outline released on reform of the EU sugar regime by the European Commission on 14 July 2004, the price ACP producers receive may be reduced by more than one third.

(See http://europa.eu.int/comm/agriculture/capreform/index_en.htm)

⁸⁹ For instance, in an efforts to promote backward integration into spinning and technological upgrading, an equity fund managed by the Mauritian Bank of Development has been set up to invest in EPZ enterprises that upgrade their technology or undergo restructuring (UNECA, 2003).

3.5 THE UNITED STATES

Introduction

111. The focus of this case is on the textile industry, which represents the more technologically advanced segment of the fibre-fabric-clothing value chain. As a general rule, the competitiveness of U.S. producers declines as one moves up that chain into the more labour-intensive processes: The United States is a major producer of cotton and other fibres (agriculture),⁹⁰ and faces increasing competition in the production of fabrics (relatively capital-intensive manufacturing), but faces a more difficult challenge in the clothing sector (labour-intensive manufacturing). Producers of yarns and fabrics have proven to be more resilient than the clothing manufacturers, although their fate is ultimately tied to the fortunes of downstream customers. One of the keys to long-term survival of the U.S. textile industry is to replace dwindling sales to the U.S. clothing industry with exports to clothing producers overseas, especially those engaged in co-production under preferential programmes and agreements.

112. The data in Figure 1 confirm that wages in the U.S. textile and clothing industries — like those in other industrialized countries — are indeed several times larger than those in developing countries. The average worker in a U.S. textile plant earned \$15.11 per hour in 2001. This was lower than the average wage in all of U.S. manufacturing (\$20.32), and above the average wage in the U.S. clothing industry (\$12.17), but much higher than the prevailing wages for textile workers in Chinese Taipei (\$4.52) or Brazil (\$2.28). Comparable data are not available for even less developed Asian countries, where prevailing labour costs are lower still.

Adjustment through improved productivity

113. Firms in labour-intensive industries that are located in high-wage countries can improve their productivity through a variety of means. Prominent among them are specialization and investment in new technology. No matter what approach is taken, however, they typically involve downsizing and will thus imply reductions in employment. Ideally, these approaches will thus be complemented by adjustment-assistance programmes for workers that lose their jobs.

Improvements in productivity

114. Compared to the clothing industry, where the opportunities to substitute capital for labour are quite limited, the textile industry is a relatively capital- and technology-intensive undertaking. The industry has devoted considerable capital to improvements in productivity. Between 1972 and 1992, the real per-employee capital stock in the U.S. textile industry doubled.⁹¹ By the 1980s, the share of shipment value that got ploughed back into new technology was far higher for textile producers (4.0 percent) than it was for clothing manufacturers (1.5 percent).⁹² Reinvestment has been aided by various adjustments to the tax-depreciation schedules in order to accelerate the amortization of these expenses.⁹³

115. These investments have produced results. Using U.S. Bureau of Labor Statistics data, one analysis found that “textile industry productivity has increased more than 3 times over the last fifty years compared to only two times for overall manufacturing.”⁹⁴ The authors reported that while “the number of production workers declined by nearly 17%” during 1987 to 1999, “capital per worker increased from 3% to 6.5%, reflecting the technological changes.”⁹⁵ One business writer noted in 2001 that the industry had

spent \$2 billion annually on new technology over the past decade, and concluded that it “is astonishingly innovative and productive.”⁹⁶ The looms that the industry now uses weave textiles four times faster than machines in the 1980s, and ten times faster than in the 1970s.

116. The reductions in output have not been universal. Producers of textiles and textile products have shifted towards segments in which they serve niche markets profitably, such as industrial textiles and home furnishings. This can be appreciated from the data in Tables 1 and 2, which show trends in the industry during 1997-2001. Output has contracted sharply in some of the lower-end segments, such as yarn throwing and thread production, but has stabilized or even expanded in non-woven and narrow fabrics, and especially in the furnishings industry.

Job losses and trade adjustment assistance

117. Whether jobs are lost to plant closings or to improvements in productivity, there is no doubt that this is an industry with a contracting employment base. Between the end of the Uruguay Round and 2001, employment in the thread, yarn, and fabric industries fell by about one-fifth. This is not as severe as the job losses in the clothing sector, where more than half of all jobs disappeared during that same period.⁹⁷ Moreover, not all job losses in this industry are permanent. One analysis found that the U.S. textile and clothing industry is subject to a high degree of “job churning,” whereby “the sum of job creation and job destruction is substantial.”⁹⁸ Even so, it is evident that adjustment programmes are needed in order to assist the unemployed.

118. The Trade Adjustment Assistance (TAA) programme was first established in 1962, and has evolved through a series of laws since then. This programme offers benefits such as extended unemployment insurance and job-training aid to workers that lose their jobs to import competition. It is especially significant for textile and clothing workers, a group that accounted for about 35 percent of all TAA certifications during 1995-2000.⁹⁹

119. There are two contrasting views on the nature of the U.S. programme. One suggests that it is misdirected on an economic basis, insofar as the unemployment insurance programmes in most other OECD countries are designed to assist all unemployed workers without respect to the cause of their job losses. The contrary view holds that creating a special programme for trade-prejudiced workers is politically wise, insofar as it serves to reduce the extent of domestic opposition to new, market-opening initiatives. Special programmes for workers who lose their jobs to trade liberalization may also be justified on grounds of equity, considering the disadvantages faced by many members of this group.¹⁰⁰ One study highlighted the fact that “displaced workers from the textile and clothing industries ... tend to have low level of education, low skills (and thus earn low wages), and are predominantly women and minorities (including minority women),” and “these characteristics make it more difficult for workers to adjust to changes in the labour market.”¹⁰¹ These are the very workers that are most in need of help.

120. Specific aspects of the programme’s structure and funding are subject to criticism.¹⁰² For example, one review of adjustment policies in the United States and four other OECD countries (France, Germany, Japan, and the United Kingdom) found that “The United States appears to spend the least amount on assisting its unemployed workers among the five countries.”¹⁰³ The TAA programme nevertheless continues to be an important part of the overall U.S. approach to managing adjustment to open markets.

Adjustment through trade policy

121. Adjustment can additionally or alternatively be pursued through trade policy. Here the United States has gone through two periods in recent decades, both of which might be classified within the broad

rubric of management of trade. One was the pursuit of management of trade in a protectionist environment, under which tariffs and quotas were used to restrict import competition. More recently, this policy has given way to the management of liberalization. In this latter strategy, the U.S. market has been opened more widely, and more rapidly, to imports from countries that incorporate U.S.-made fabric in their clothing.

From protection to liberalization

122. The U.S. import market for textiles and clothing has long been relatively closed, both by high tariffs and — since the early 1960s — quotas. The first half of this equation is illustrated in Figure 2, which shows the levels of tariff protection in the United States and many other countries. Two points stand out in these numbers. The first is that the United States is certainly not alone in imposing relatively high tariff rates on textiles and clothing. Many countries, including some OECD members, have bound tariffs in this sector that average more than ten percent. The second point is that nearly all countries impose higher tariffs on textiles and clothing than they do on industrial goods in general. Among the industrialized countries, it is common — as is the case for the United States — to impose tariffs in this sector that are a significant multiple of the average rate for all industrial products. As for the quotas imposed under the Multifibre Arrangement, trade theory suggests that *ceteris paribus* they are even more restrictive than tariffs.

123. Although the United States did not make substantial commitments to cut its textile and clothing tariffs in the Uruguay Round, it did make an even more significant concession. In exchange for other commitments from the developing countries, the industrialized countries agreed to phase out the MFA quotas over a ten-year period. The final phase-out takes place on the last day of 2004. In preparation for that day, the main theme of U.S. textile and clothing trade policy has switched from management of protection to a stepped liberalisation. The objective of management of protection was to prolong the survival of U.S. producers through protectionist quotas, especially by suppressing the rate of growth in imports from China and other Asian suppliers. The objective of the new liberalization is to encourage a “soft landing” for the U.S. industry by encouraging the co-production of clothing with selected partner countries. This is accomplished by negotiating agreements and creating preferential programmes that offer quota- and duty-free market access, but conditioning this preferential access upon strict rules of origin that require the use of U.S. yarn, fabric and (in some cases) fibre.

124. The change in strategy is based on the recognition of three hard facts. The first is that the United States cannot indefinitely support the domestic production of commodity clothing on a large scale. It is possible to engage in profitable niche segments, especially in the fashion industry, but the low end of the market is simply not amenable to competition from low-wage countries. Second, the yarn and fabric industry has better prospects, especially if the declining purchases of a shrinking U.S. clothing industry can be compensated by increased exports to offshore production facilities. Third, not all foreign producers are equally threatening to the interests of the U.S. industry. While some Asian countries do import significant amounts of U.S. fibre, some of which comes back in the form of fabric or clothing, they import very little fabric or semi-finished clothing from the United States. By contrast, much of the clothing imported from the Americas — and especially Mexico and the Caribbean Basin — consists of goods assembled in offshore plants from U.S.-made components. A few simple calculations serve to illustrate that last point. For every dollar’s worth of U.S. clothing imports from the Americas in 2003, the United States exported 3¢ worth of fibre, 36¢ worth of fabric, and 22¢ worth of clothing (much of which was semi-finished product shipped for offshore processing). Altogether, 61¢ worth of U.S. product went out for every dollar that came in. By contrast, every \$1 worth of clothing imported from Asia was matched by just 9¢ worth of total U.S. exports (6¢ worth of fibre, 3¢ worth of fabric, and less than 1¢ worth of clothing).¹⁰⁴

125. These flows are influenced by the differing treatment that is extended to partners under various programmes and agreements. Beginning in the mid-1980s, the United States has devised preferential programmes to facilitate co-production in the textile and clothing sector. Imports from those countries will be given preferential quota and tariff treatment, conditional upon rules of origin that encourage or mandate purchases of U.S. fibre and fabric, as well as certain processing operations in the United States (*e.g.*, cutting and dyeing fabric). The arrangements that underlie this strategy have come in two waves. One consists of the preferential trade programmes that are extended to developing countries in specific regions. The United States extended quota-free treatment to the Caribbean Basin in 1986, and supplemented this with duty-free treatment in 2000. Comparable programmes have also been extended to sub-Saharan Africa (in 2000) and the Andean countries (in 2002). The second wave has come with the negotiation of successive free trade agreements (FTAs). Mexico was first FTA partner to export significant quantities of clothing to the United States. After negotiating this FTA in 1993, the United States has completed agreements with such exporters as Jordan (2001) and Singapore (2003), and — as of mid-2004 — agreements are pending approval or are still under negotiation with *inter alia* Central America and the Dominican Republic, Panama, three Andean countries, the Southern African Customs Union, and Thailand.¹⁰⁵

Conclusions and lessons

126. This case demonstrates that trade policy can serve to promote the interests of an industry that is challenged by import competition, but that the policy need not take the form of blunt protectionism. The U.S. textile and clothing industry had indeed demanded protection from imports for decades, and the policy of protection was devised in order to shield these producers from foreign competition, but that policy was not sustainable on an indefinite basis. Not only did it impose costs on U.S. consumers, but also inhibited the negotiation of ambitious commitments in multilateral trade negotiations. The decision to put the MFA on the table in the Uruguay Round helped to produce a farther reaching set of commitments from all parties.

127. Liberalisation has taken the place of protection and has helped to ease the transition to the post-MFA regime. By providing incentives for co-production arrangements between U.S. producers and their partners in developing countries, this policy has replaced some — though not all — of the sales that U.S. textile producers have lost at home.

128. Trade instruments alone cannot form the basis of an adjustment strategy. The U.S. textile industry has improved its productivity through a combination of specialization and capital investment. While both of these steps enhance productivity, they also impose an adjustment burden on displaced workers. That burden can be relieved in part through trade adjustment assistance programmes for displaced workers.

⁹⁰ The matter of cotton subsidies is outside the scope of this study. The competitive posture of the U.S. producers in this sector is undoubtedly affected by the large volume of government subsidies that they receive, and these subsidies have come under increasing challenge in the WTO from African producers. See *WTO Negotiations on Agriculture; Poverty Reduction: Sectoral Initiative in Favour of Cotton: Joint Proposal by Benin, Burkina Faso, Chad and Mali* TN/AG/GEN/4 (16 May 2003). For our present purposes it is sufficient to note that this is the one sector of the fibre-fabric-apparel spectrum in which the United States is a major exporter that faces little import competition.

⁹¹ Levinsohn and Petropoulos (2001), page 5.

⁹² Murray (1995), page 62.

⁹³ See for example the analysis in Rosen (2002), page 92.

⁹⁴ Christoffersen, Malhotra and Datta (2003).

⁹⁵ Christoffersen, Malhotra and Datta (2003).

⁹⁶ Moore (2001).

⁹⁷ These comparisons are complicated somewhat by the fact that during this period the U.S. Government switched from the old Standard Industrial Classification (SIC) system to the North American Industry Classification (NAIC) system. The correspondence between the SIC and the NAICS is relatively close but imperfect. In 1994, there were 624,400 people employed in the production of textile mill products (SIC 22); by 2001 this fell to 293,900 persons employed in textile mills (NAIC 313) and 209,700 employed in textile product mills (NAIC 314). As for apparel, employment fell from 925,500 persons in 1994 (as classified in SIC 23, “apparel and other textile products”) to 456,500 in 2001 (as classified in NAIC 315, “apparel manufacturing”). See U.S. Department of Commerce (1994) and (2001).

⁹⁸ Levinsohn and Petropoulos (2001), page 13.

⁹⁹ GAO (2001a), page 2.

¹⁰⁰ For comparisons in support of these contentions, see the data reported in GAO (2001a), page 15.

¹⁰¹ OECD (2004b).

¹⁰² For one such critique, see GAO (2001b). See especially the discussion in Appendix V of the experience in El Paso, Texas, which lost numerous textile and apparel jobs in the 1990s.

¹⁰³ OECD (2004b).

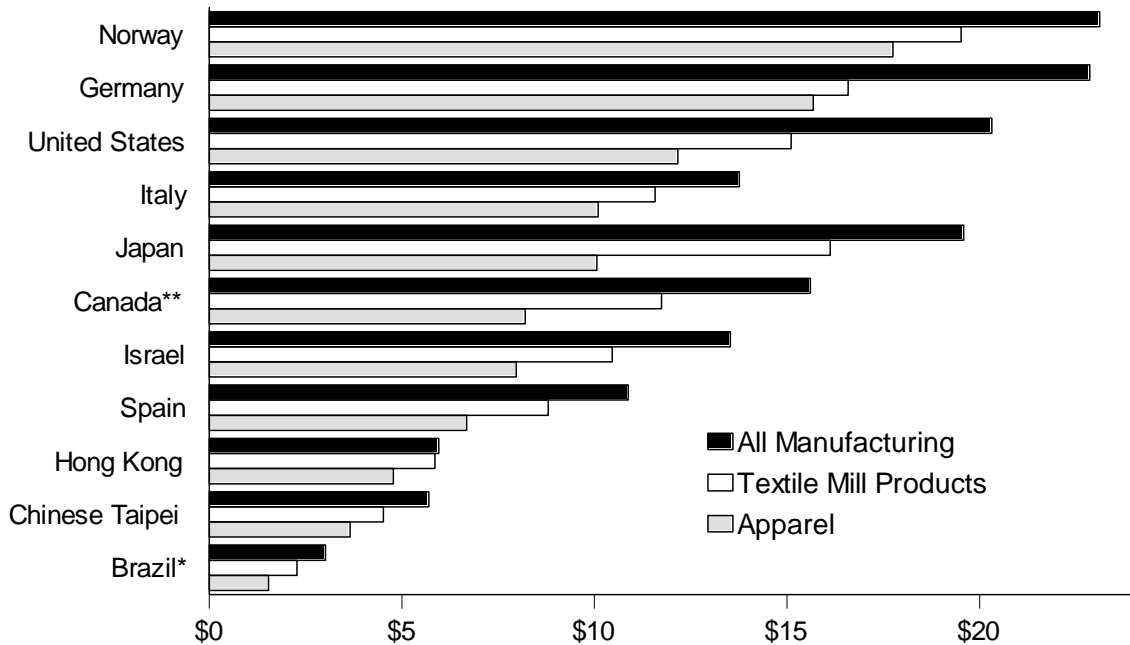
¹⁰⁴ Author’s calculations, based on U.S. International Trade Commission data.

¹⁰⁵ Not all of these programmes and agreements have identical rules of origin. Some of them offer more generous terms to the exporting country, while others require that qualifying products contain substantial quantities of U.S.-origin materials.

STATISTICAL APPENDIX

Figure 1: Wages in Selected Countries' Textile & Apparel Industries

Hourly Compensation for Production Workers in 2001, in U.S. Dollars

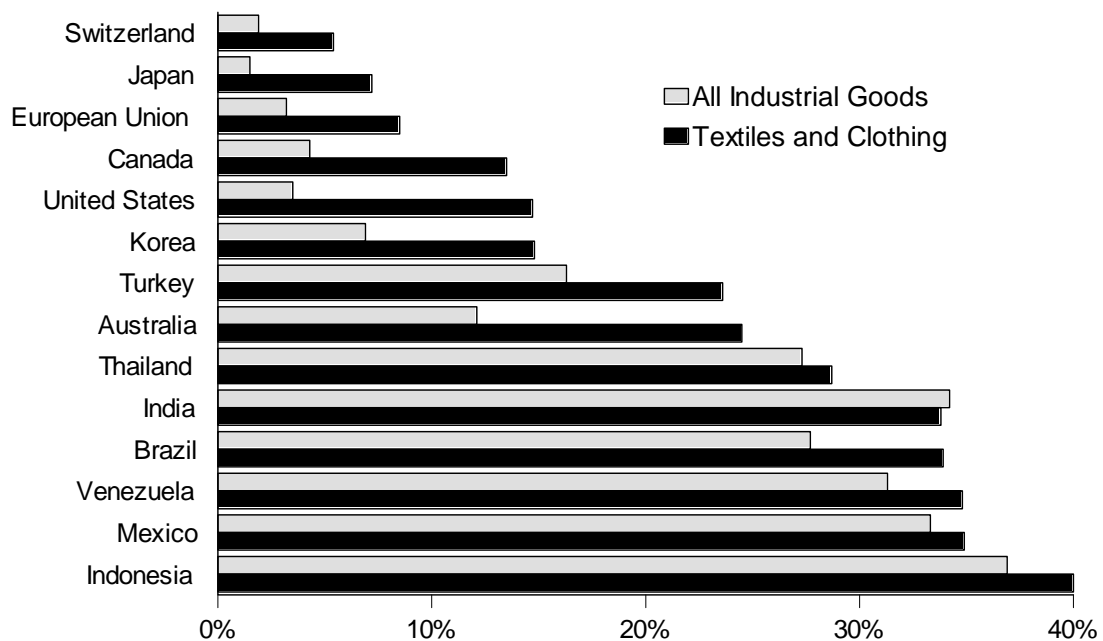


Source: Adapted from U.S. Department of Labor data.

* : 2000 data. ** : 1999 data.

Figure 2: Average Bound Tariff Rates After the Uruguay Round

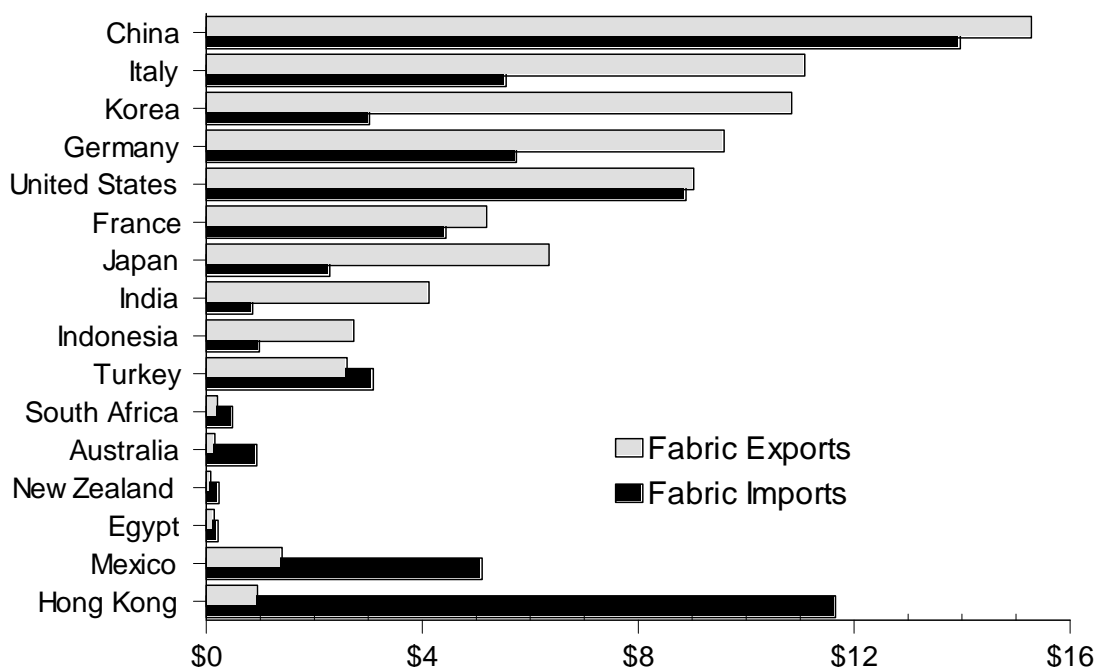
Weighted by Value of Imports from Non-FTA Partners



Source: Adapted from J. Michael Finger, Merlinda D. Ingco, and Ulrich Reinke, *The Uruguay Round: Statistics on Tariff Concessions Given and Received* (Washington, D.C.: The World Bank, 1996).

Figure 3: Shares of Global Trade in Textile Fabrics, 2002

In Billions of U.S. Dollars



Source: Calculated from WITS data (see tables 4 and 5).

Table 1 U.S. Shipments of Textiles, 1997-2001

Millions of Current Dollars

NAICS	Description	1997	1998	1999	2000	2001	% Change 1997-2001
31311	Fiber, Yarn & Thread Mills	12,897	12,669	11,904	11,334	10,030	-22%
313111	Spinning	8,143	7,943	7,216	6,374	5,720	-30%
313112	Yarn Throwing	4,232	4,123	4,376	4,586	4,033	-5%
313113	Thread	522	603	311	374	278	-47%
3132	Fabric Mills	29,980	29,688	27,900	26,410	22,604	-25%
31321	Broad Woven	18,269	18,306	16,655	15,562	13,295	-27%
31322	Narrow Fabric	1,646	1,711	1,834	1,759	1,724	5%
31323	Non-Woven Fabric	4,368	4,416	4,674	4,873	4,407	1%
31324	Knit Fabrics	5,697	5,255	4,737	4,216	3,179	-44%
3133	Finishing & Coating Mills	6,896	6,554	6,245	6,326	5,905	-14%
	Total	49,773	48,911	46,049	44,070	38,540	-23%

Source: U.S. Department of Commerce, Bureau of Industry and Security, *The U.S. Textile and Apparel Industries: An Industrial Base Assessment* (2003).

NAIC = North American Industrial Classification

Table 2

U.S. Shipments of Products from Textile Mills, 1997-2001*Millions of Current Dollars*

NAICS	Description	1997	1998	1999	2000	2001	% Change 1997-2001
3141	Textile Furnishings Mills	20,296	20,658	21,119	22,436	21,793	7%
31411	Carpet and Rugs	11,493	12,070	11,686	12,748	12,659	10%
31412	Curtains, Linens & Household Products	8,803	8,588	9,433	9,688	9,134	4%
3149	Other Textile Product Mills	10,756	10,479	11,570	11,219	10,178	-5%
31491	Textile Bags and Canvas	2,502	2,516	2,606	2,598	2,464	-2%
314991	Rope, Cordage and Twine	777	766	804	821	809	4%
314992	Tire Cordage and Tire Fabric	1,269	1,300	1,428	1,479	1,038	-18%
314999	Products not listed elsewhere	6,208	5,897	6,732	6,321	5,867	-5%
	Total	31,052	31,137	32,689	33,654	31,971	3%

Source: U.S. Department of Commerce, Bureau of Industry and Security, *The U.S. Textile and Apparel Industries: An Industrial Base Assessment* (2003).

3.6 AUSTRALIA¹⁰⁶

129. Australia's textile, clothing, footwear and leather (TCF) industries¹⁰⁷ are experiencing a sustained period of structural change. Major rationalisation of production has reduced sectoral output and employment (down 35 per cent since the early 1990s). The product mix and supply chains are changing. The import share of the domestic market has nearly doubled since the late 1980s, reaching 50 per cent, with exports of Australian TCF products also growing rapidly, albeit from a low base.

130. To a large extent, structural change in the sector is in response to global pressures confronting producers in most developed countries. Intense competition from suppliers in developing countries, reductions in the share of consumer spending devoted to TCF products (down 25 per cent since 1990 in Australia), technological change and more stringent environmental regulation are among the key factors driving change.

131. Until the late 1980s, as in many other developed countries, successive Australian Governments sought to ward off increasing competition from developing country imports through various support measures, including high tariffs and tariff rate quotas. (The effective rate of assistance to the sector peaked at over 150 per cent in the mid 1980s).

132. However, in recognition of the large costs imposed on Australian consumers by this attempt to forestall inevitable and necessary adjustment in the sector, and in keeping with Australia's general tariff reform programme, assistance to the industries has since been significantly reduced. Tariff Rate Quotas were abolished in 1993 and tariffs reduced to a maximum level of 25 per cent in 2000 with further reductions in prospect (see below).

133. Lower tariffs and greater access to imported TCF products have been of considerable benefit to consumers. For instance, the real price of TCF products in Australia has fallen by 20 per cent since 1990 — though factors other than protection reform have clearly contributed to this outcome.

134. Equally, assistance reductions have added to the adjustment pressures confronting Australian TCF producers. Nonetheless, and notwithstanding the recent significant declines in sectoral output and employment, some firms have adapted successfully to the more competitive market environment. An emphasis on innovative high value, capital-intensive and niche products, and on brand development, customer service and market development, have been among the hallmarks of those firms who have made a successful transition, or are capable of doing so in the future.

135. Looking to the future, it is clear that the adjustment process is far from complete. There is still much labour intensive production in the industry (especially in the clothing sector). Large labour cost disadvantages against developing country competitors mean that many firms producing such standardised products will struggle to survive, irrespective of the assistance regime.

136. Such adjustment will not be easy. Many of the industries' employees come from a non-English speaking background and have few skills that could be used in other areas. They also tend to be somewhat older than employees in other manufacturing activities. Also, the inability of some non-competitive firms to meet previously negotiated employee entitlements in the event of closure has become a barrier to them exiting the sector in an orderly fashion, as well as being a trigger for industrial disputation.

137. For (home-based) 'outworkers', adjustment pressures may be particularly severe. As a result of the flexibility that outwork can provide, part of the previous adjustment process in the clothing industry in particular has involved a shift from factory-based to home-based employment. However, with employment in the Australian clothing industry now dominated by outwork, this group of workers is likely to bear the brunt of future contraction in the sector.

138. Against this backdrop, the assistance regime for the TCF industries over the coming decade has been designed to facilitate an orderly adjustment process, without imposing excessive costs on consumers and the wider community. Legislated reductions in tariffs to take effect at the beginning of 2005 will see the maximum rate for any TCF product fall to 17.5 per cent. And, as part of a new assistance package announced in response to a recent report by the Productivity Commission (2003), the Government has announced that tariffs on footwear and most textiles will fall to the general rate of 5 per cent in 2010, with the currently higher rate for clothing and certain finished textile products falling to 5 per cent in 2015. These reductions have been legislated as part of the Australian Customs Tariff.

139. To facilitate adjustment to these further tariff reductions and the broader pressures confronting the sector, the package will also provide substantial transitional budgetary support. Like the transitional regime for the automotive industry, this budgetary support is focussed on encouraging innovation and investment that will help firms to be competitive in a low tariff environment. Further, in keeping with proposals in the recent Productivity Commission report, the Government has announced that where there is large scale or regionally significant job shedding in the TCF sector, it will augment generally available labour adjustment measures with sector-specific adjustment support.

140. In facilitating orderly adjustment, broader microeconomic reform and continued government efforts to improve access for TCF exporters to protected overseas markets will also be important. And there is much that the industry can still do to improve its prospects of operating successfully without special assistance treatment. For example, greater cooperation and more effective communication between management and employees, including in workplace negotiations, would help deliver more flexible and productive outcomes.

141. That said, there is little that can or should be done to stop labour intensive, standardised TCF production from migrating to developing countries. As past experience demonstrates, attempts to do so would be very costly for the community and merely delay the inevitable. This reality is now generally recognised in Australia.

¹⁰⁶ This case study was provided by Australia's Productivity Commission as input to the OECD project on Trade and Structural Adjustment.

¹⁰⁷ This case study deals with textile, clothing, footwear and leather (TCF) industries collectively.

3.7 THE SLOVAK REPUBLIC¹⁰⁸

142. The first industrial textile mills in the Slovak Republic emerged more than 100 years ago and, throughout its centrally-planned period, the economic importance of the textile and clothing industries in the Slovak Republic grew while fulfilling social functions. In the late 1980's, these industries employed 74,300 persons and accounted for 4.7% of total industrial output. Between 1970 and 1985, employment rose by 17,100 supported by an export-led strategy based on an exchange of oil, gas, iron ore and grain with the former Soviet Union.

143. The demise of this barter exchange with the former Soviet Union has had a dramatic impact on the Slovak industries: employment immediately dropped by 16,500 in 1989 and by a further 11,000 shortly thereafter. Between 1989 and 1993, total textile and clothing production declined by 46.5% in volume: cotton yarn production fell by 50.2%; woollen fabrics by 45.2%; and clothing production by 30.5%. Moreover, it triggered a complete shift in the composition of production and a re-orientation of export destinations.

144. To survive through evolving economic circumstances, Slovak suppliers underwent significant transformation by moving from supplying clothes primarily made from domestic fabrics to sub-contracting for EU customers involving imported fabrics. This transformation was facilitated by the outward transaction programmes (OTP) that provided for preferential access to the EU market for clothing products made from EU fabrics. Moreover, the entry into force of the "Europe Agreement" in 1995 granted duty and quota-free access for Slovak textile and clothing products to the EU market and thus helped to prevent further hardships. Between 1993 and 2002, the employment level initially stabilised at about 43,000 and slightly increased to 46,500 by 2002, before falling by 5.3% in 2003 in the face of increased import competition, notably from China, in both the Slovak market and export markets.

145. Despite considerable production and trade opportunities offered under the Europe Agreement since 1995, almost three-quarters the Slovak clothing exports were still carried out under OTP in 2003, *e.g.* involving imported textiles from the EU. This suggests that the Slovak clothing industry has adapted faster than the Slovak textile industry to the high-quality requirements of export shipments destined for the EU market. As a result, the Slovak trade balance is permanently in deficit for trade in textile products and in a surplus position for clothing products.

146. The competitive edge that relatively low wages have given to Slovak producers has been hampered by low productivity, and a concentration on standardised products where international competition is most intense. In 2003, the Slovak productivity level was estimated at 31% of the EU-15 level and 36% of the EU-25. Its low productivity is typified by a low share of high value-added production segments, such as technical textiles and textile finishing, and, conversely, a high share of spinning, weaving and knitting activities. Moreover, the stock of capital used per unit of labour in the textile industry is relatively low: it stood at 58% of the EU-15 level in 2003. The small involvement of foreign investors in the Slovak textile industry is also cited as another explanatory factor for its lagging behind competitors on the technology and productivity fronts.

147. With the elimination of quantitative restrictions on trade in textile and clothing products by the end of 2004, as provided under the WTO Agreement on Textiles and Clothing (ATC), it is clear that the adjustment process of the Slovak textile and clothing industries is far from complete. To facilitate the

restructuring process, the Slovak Government considers that the role of the state centres on setting the framework conditions that enable private entrepreneurs to compete in the new competitive environment and to promote market opening on a reciprocal basis. Government actions are placed within a context of horizontal policies and programmes aimed at: the creation of a favourable business climate; the development of the education system; support for innovation, research and development; support for small- and medium-sized enterprises; and taking advantage of deeper integration programmes afforded at the EU-wide level. In the context of the Industry Development Grant Scheme, Slovak firms can apply for investment funds aimed at: strengthening their competitiveness; supporting innovation and research projects; saving energy; and developing international cooperation.

148. As a newly acceded EU member country as of May 2004, the Slovak horizontal industrial policies will be supplemented by sectoral initiatives defined and implemented at the EU-wide level. Hence, the Slovak Republic intends to take advantage of the resolution approved by the European Parliament on the conclusions of the conference “The Future of the Textile and Clothing Sector in an Enlarged European Union.”

¹⁰⁸ This case study was provided by the government of the Slovak Republic as input to the OECD project on Trade and Structural Adjustment.

4 STEEL

Key points emerging

149. In the steel sector, structural adjustment has posed ongoing challenges to the industry, which has struggled with at least one deep crisis in each of every recent decade. Restrictive trade measures were frequently implemented by governments during such crises to support the industry. These, together with other government supports (such as subsidies) helped to sustain global overcapacity which, in turn distorted steel trade. The steel industry emerged as one of the most heavily subsidised manufacturing sectors in the 1980s. In spite of the improved subsidy discipline established under the WTO “Agreement on Subsidies and Countervailing Measures”, market –distorting subsidies and related government supports remain an issue of concern in steel. With the objective of restoring normal competitive conditions on steel markets governments of all major steel producing economies are engaged in the negotiation of a sector specific steel subsidy agreement under the auspices of the OECD.

150. In response to the crises, efforts were made in some regions to restructure the steel industry, often with the objective of maintaining the domestic steel producing base. In others, notably in Asian and South American economies, the expansion of the steel industry continued. In Europe, governments took an active role in managing the restructuring process while in other major steel producing countries the steel industry adjusted to changes in the market without any specifically tailored governmental restructuring programmes. Economies in transition in South East and Eastern Europe and the Newly Independent States of the former Soviet Union addressed restructuring needs in comprehensive and complex privatisation programmes, most of which ended in the early 2000s.

151. More specifically, in the early period of restructuring in the European steel sector, governments were unwilling to let market forces alone carry out the necessary adjustments in the steel industry. Instead, complex political solutions were pursued which involved massive interventions into the market, trade measures and a broad range of government support measures, including 38 billion ECU of direct subsidies to the steel industry. While overseen by the Commission, most of the restructuring was pursued in a national context which appears to have impeded needed cross-border industry consolidation. That said, the results achieved in terms of capacity closures and the creation of alternative employment for redundant steelworkers are impressive; it is hard, however, to envision that governments would nowadays be prepared to spend comparable amounts of money for the restructuring of their steel industries.

152. Soft interventions and a narrow set of support measures on one side and a stronger involvement of the steel industry on the other characterised the European steel industry restructuring programme in 1992-1994, which also led to a significant reduction of capacity. The emphasis of this programme was to enhance the viability of European steel companies. The European example also shows that steel companies can withstand a deep crisis without any specific government assistance and take the necessary initiatives to adapt their activities to a changing economic environment, if they are viable and competitive. Such industry-driven adjustment was demonstrated in the period from 1998 to 2004, when significant cross-border consolidation of the industry took place.

153. The phasing out of subsidies starting in the 1980s and the privatisation of the European steel companies were key elements for restoring normal competitive conditions on the common steel market. Such normality is reflected in the integration of the Steel Aid Code into the general framework of the

European Union's State Aid Code and the expiry of the ECSC Treaty in July 2002, putting an end to sector specific regulations for the steel sector.

154. In the United States, the restructuring of the steel industry is primarily sought through market forces whereby the bankruptcy process has played a major role in industry consolidation and restructuring. While the Federal Government and the Governments of the States also provided subsidy programmes to assist in the restructuring, the impact of such measures was less significant than in other countries.

155. The Japanese steel industry reorganised through business integration or tie-ups among integrated steel producers, such as the merger and integration of NKK and Kawasaki Steel, as well as strategic cooperation between Nippon Steel and Sumitomo Metals, Kobe Steel and others. The restructuring resulted in a capacity reduction of about 20% by 2002. The industry's continuous efforts directed towards more efficient management have contributed to such reductions. Moreover, Japan's five big steel companies reduced employment from 127,000 in 1993 to 56,000 in 2003, which resulted in a reduction of labour cost in the order of 50%.

156. On the trade front, import measures played an important role in European markets until the mid 1990s and in the United States until recently. Many other countries have also taken trade actions against steel imports, some of which were controversial, and tensions rose in the international steel trade. In the absence of these measures, adjustment pressures would undoubtedly have been higher and resulted in more far-reaching industry adjustment. A high price had to be paid for the protection of domestic steel producers in the form of diminishing competitiveness in steel-consuming sectors.

157. Even in most OECD member countries state ownership or state control of steel companies or the entire sector prevailed until the 1980s. Among major steel producing economies only the United States and Japan did not have strong state influence in the post war era. Privatisation started in the European Union and South America and at the end of the 1990s, most of the steel companies in the transition economies of Central and Eastern Europe, the Russian Federation and India and the principal Chinese companies were privatised.

4.1 THE EUROPEAN UNION

158. In the European Union of then nine member States the peak in steel was reached in 1974, with a capacity for hot rolled products¹⁰⁹ of 179 million tonnes, crude steel production of 156 million tonnes, sales in the EU market of 102 million tonnes, and a workforce of 800 000. Following the first oil shock, production dropped by 19% in 1975. Demand remained weak in subsequent years, competition intensified in third markets and imports into the European Union increased. As a result of declining prices steel producers experienced heavy losses and an increasing number of governments provided subsidies to their weak steel industries in the form of investment aid, social aid, research aid and/or compensation for operating losses. The ban of subsidies under the Treaty of Paris, establishing the European Coal and Steel Community, was effectively set aside in order to deal with the crisis.

159. Using its powers under the Paris Treaty the Commission of the European Union launched a set of measures to mitigate the effects of the deteriorating situation. As a first step, producers were asked to limit their production on a voluntary basis. This approach had little effect on the market, and in May 1977 the Commission introduced by law minimum prices for some products and recommended minimum levels for others. In addition, the Commission negotiated bilateral agreements with the principal steel exporting countries to voluntarily restrain their deliveries to the Common Market. However, the situation on the steel market of the European Union did not improve, because the voluntary engagements did not hold and prices were not maintained¹¹⁰.

160. In October 1980, a state of Manifest Crisis in the steel industry was declared by the Council of Ministers according to the terms of Art. 58 of the ECSC Treaty. Compulsory production quotas, limiting deliveries within the Community and limiting exports, were imposed for each undertaking. This market regulation was linked with a system of fines for any breach of the allocated quotas. Mandatory minimum prices for steel, compulsory production and sales caps on each individual steel producer were applied until mid-1988, and the last of the bilateral steel agreements with the principal steel-exporting countries expired in December 1991.

Table 1. Steel market data 1980-1985

	E.U. 9					
	1980	1981	1982	1983	1984	1985
Crude steelmaking capacity	202.1	197.6	193.0	186.9	170.3	165.7
Crude steel production	128.0	125.0	111.0	109.0	119.0	120.0
Apparent consumption	87.0	79.0	77.0	75.0	81.0	80.0
Imports	10.0	8.0	10.0	10.0	10.0	10.0
Exports	29.0	33.0	26.0	27.0	31.0	34.0
Net trade (Exports - Imports)	19.0	25.0	16.0	17.0	21.0	24.0

Source: OECD.

161. The Steel Industry Restructuring Plan 1980-1985, the so called Davignon Plan, was put in place with the objective to reduce capacity for hot-rolled products from the 172 million tonnes recorded in 1980 to 142 million tonnes or less by the end of 1985. From the end of 1980 onwards, a broad range of actions were taken to improve competitive conditions in the steel market of the European Union:¹¹¹

- A political agreement with all Member States of the EU to prohibit all subsidies for the steel industry as from 1986, with the exception of subsidies for plant closures, R&D and social and regional interventions. Prior authorisation by the European Commission of all subsidies became mandatory.
- Until the end of 1985 Member States were permitted to grant subsidies, subject to the authorisation of the Commission, if the steel company in return would proportionately close capacity and restore financial viability.
- ECSC loans at a favourable interest rate were made available for modernisation and investments.
- Under the Regional Development Fund, programmes such as RESIDER provided financial support to heavily affected steel regions with the aim of creating new economic activities in other sectors of the economy.
- Under the Social Fund, training and re-education programmes for steel workers were provided as well as programmes covering the costs of the relocation of steel workers and the costs of redundancies and early retirement.

162. A presentation of national and individual restructuring plans supported by a quota system, which guaranteed for each company, and thus each Member State, a certain market share, formed the basis for a political agreement on the restructuring programme. It was the task of the governments of the individual Member States together with the companies concerned to determine what capacity should be cut and where and which kind of restructuring at the level of the companies would be necessary to restore its financial viability. However, the final decision on the acceptability of the restructuring programmes of the companies and the authorisation of the subsidies involved in such programmes remained with the Commission.

163. At the expiry of the Steel Industry Restructuring Plan a reduction of the EU's hot-rolling capacity in the order of 31 million tonnes had been achieved, including the carry-over of some closures into 1986. That was some 1 million tonnes of capacity reduction greater than initially envisaged. This figure takes into account the investments that were made in new facilities and the upgrading and modernisation of existing facilities. With regard to crude steel capacity, the reduction was equally impressive. Between 1980 and 1988, when the restructuring plans for the then new Member States Greece, Portugal and Spain expired, crude steelmaking capacity in the EU 12 decreased from 222 million tonnes to 188 million tonnes.

164. Employment in the steel sector of the EU 12 declined from 672 000 in 1980 to 409 000 in 1988, which represented a reduction of the workforce of almost 40%. For example, when British Steel closed capacity on its Corby site in South-East England more than 6 000 jobs were affected. Total employment in Corby, with British Steel dominant, fell from 23 300 in 1979 to 15 900 in 1981. In part, steelworkers took advantage of early retirement schemes, others upgraded their skills in steel or acquired new skills, *e.g.* obtaining Heavy Goods Vehicle Driving Licenses under specific training schemes. Moreover, 400 acres were made available in Corby for the development of other manufacturing sectors under regional development programmes, and by 1984, total employment in Corby had already recovered to 19 700¹¹².

165. The closure of inefficient capacity, the upgrading of existing facilities, notably through expansion of energy-efficient continuous-casting technology and an increasing number of electric arc furnaces led to higher productivity in the EU's steel industry. Productivity gains and a higher rate of capacity utilisation helped the European steel producers to enhance international competitiveness.

166. Between 1980 and 1985 almost 38 billion ECU were spent by the then nine EU Member States in support of the restructuring programmes of EU steel producers. 23 billion ECU were granted for continued operations, 11.5 billions for investment and 2.3 billion ECU for closures. R&D subsidies and spending in the case of emergencies accounted for 1 billion ECU¹¹³. In addition to these subsidies for steel companies, considerable financing was provided under the Regional Fund and the Social Fund for steel communities affected from the restructuring and social measures for steel workers. Thus, the restructuring of the European steel industry placed a heavy burden on the budgets of the Member States and the Community Funds.

167. Overall capacity reductions in the order of almost 20% and the modernisation of the European steel industry achieved under the Davignon Plan underline the success of this plan. The market regulations that were in place during the restructuring period – production quota, minimum prices, voluntary restraint agreements – imposed additional economic costs, but such regulations were viewed as key, taking broader social and economic concerns into account.

168. After a short recovery of steel markets in the period from 1986 to 1990, the situation in steel markets worldwide deteriorated in the following years mainly as a result of the collapse of demand in the former Soviet Union. In 1992, steel consumption fell back to the level of the mid-1980s. Low steel prices led to a global deterioration in the financial situation of steel producers. Even the steel industry of the European Union, which had just emerged from a rigorous restructuring process, was affected and the losses of European steelmakers were close to the levels of the previous crisis period. Requests were voiced to enact again the broad range of measures available under the ECSC treaty in order to cope with the crisis, but the Commission this time adopted a different and less interventionist approach.

169. The overall objective of the three-year programme, which was agreed by the Council on 25 February 1993, was a further significant reduction of production capacity. Such reductions were sought by parallel action involving i) the industry, which was requested to establish a detailed plan for the necessary capacity reductions and ii) the Community putting in place a set of accompanying measures to facilitate restructuring¹¹⁴. In particular, the following measures were adopted:

- In support of the stabilisation of the market the Commission, in accordance with Article 46 of the ECSC Treaty, published indicative quarterly sales guidelines based on information provided by companies. The companies could adapt their production plans in light of the indicative aggregate data. With regard to third country imports, voluntary restraint agreements were concluded.
- In support of the restructuring of the European steel industry additional funding was made available from the ECSC budget to contribute to the costs of redundancy and early retirement. Other programmes of the Community continued to support the retraining of steel workers for other careers outside the steel sector. Furthermore, subsidies were provided to companies reducing their hot-rolling capacity under narrowly defined conditions such as privatisation of the company, restructuring plans, viability studies for the restructured company and the freezing of the company's remaining capacity.

170. By the end of 1994, the Commission decided to abolish the accompanying measures except the social support measures, which expired in 1996. The results achieved under this restructuring programme

reveal the closure of around 11 million tonnes of hot-rolled product capacity and a further reduction of the workforce to 287.000 employees in 1995.

171. More than half of the capacity reduction, 5.8 million tonnes, resulted from voluntary closures by the private sector, which did not benefit from closure subsidies. This demonstrates that in the crisis of the early 1990s a large part of the Community's steel industry succeeded in making the necessary adjustments to a deteriorating market situation without governmental supports. In the crisis of the 1980s, such industry-driven and industry-financed adjustments would have been unimaginable. Moreover, while in the 1980s about 60% of the European steel industry was under state control, virtually all companies were privatised by the time that the restructuring programme expired.

Table 2. EU 12 imports/exports and world trade 1991-1995

E.U. 12					
	1991	1992	1993	1994	1995
World steel trade	117.0	137.0	166.0	177.0	180.0
E.U. Imports	13.6	15.6	12.5	16.7	22.3
E.U. Exports	26.0	25.3	35.0	34.8	25.8

Source: OECD.

172. In spite of the voluntary restraint agreements with major steel exporting countries, steel imports into the European Union increased during the period from 1991 to 1995. The upward trend of such imports was similar to the trend in the international steel trade, which showed an increase of roughly 50% during this period. Steel exports of the EU 12 also increased, but at a much lower rate. This underlines that the protection of the EU steel market may not have played a strong role in the restructuring programme of the 1990s.

Table 3. EU Steel Trade 1998-2002

E.U.15					
	1998	1999	2000	2001	2002
Imports	24.0	22.2	28.6	29.3	26.7
Exports	23.5	23.0	28.6	28.5	25.7
Net trade (Exports - Imports)	0.5	-0.8	0.0	0.8	1.0

Source: OECD.

173. In 1998, the European steel industry again had to adjust production and capacity. Unlike previous crises, the Commission did not intervene to regulate the steel market of the Community nor was a particular restructuring programme launched. In spite of the difficult situation for the European steel industry, the European Union fulfilled its commitment made in the course of the Uruguay Round negotiations to eliminate, over a ten year period, all tariffs on steel. Thus, the steel market of the Community was becoming more and more open when exports from third countries started surging in 1998. By that time, market access was only limited for non-WTO members Russia, Ukraine and Kazakhstan, with which the Community had bilateral agreements imposing quantitative restrictions on imports into the

EU. A safeguard measure to protect the common steel market was introduced in 2002 in response to the safeguard measure taken by the United States to prevent trade from being diverted to the EU market. The EU safeguard measure was set to expire as soon as the US administration's safeguard measure was withdrawn.

174. In the period following the Asian crisis, the European steel industry closed further capacity, created larger firms by mergers and acquisition across national boundaries and intensified the conclusion of specialisation agreements. Such consolidation helped the European steel industry to withstand the recent shocks¹¹⁵. It appears that the European steel industry nowadays is in a far better position than previously to cope with the necessary adjustments to changes in the market without any specific governmental assistance.

175. With regard to closures, capacity of almost 13 million tonnes was permanently rendered inoperable in the EU15 in the period from 1998 to 2002 and further closures in the range of 8 to 10 million tonnes are envisaged between 2003 and 2005. Equally important, recent mergers and acquisitions have shaped the structure of the European steel industry. Starting with the merger of the German steel companies Thyssen and Krupp in the mid 1990s, the merger of British Steel and Hoogovens (Netherlands) into Corus in 1999 and the merger of Usinor (France), Arbed (Luxembourg) and Aceralia (Spain) into the world's largest steel company Arcelor in 2001, four European companies now rank among the world's ten largest steel producers. The synergies gained through mergers and acquisition notably with regard to a more focused specialisation of production and the building of strategic alliances with companies all over the world and the concentration of steel production on the most efficient plants made the European steel industry very competitive. An average productivity of 601 tonnes per employee and year, reported in 2002, and a further projected increase to 645t/m/y in 2005 demonstrate the high level of international competitiveness of the European steel industry and point to continued efforts to strengthen the industry's role in the global steel market and to respond to future challenges.

Box 1. The restructuring of British Steel in the 1990s

The restructuring of the state-owned British Steel achieved one of the most spectacular turnarounds in the country's industrial history: from enormous losses in the late 1970s to profitability by the late 1980s, its successful privatisation in 1988, peak profits of over GBP 1bn in 1995/96 and its merger with Hoogovens to form Corus in 1999¹.

British Steel came under severe commercial pressure in the wake of the financial crisis in South East Asia in the late 1990s, when the direct and indirect effects of the strong sterling exchange rate hit the company harder than other European companies of the Euro zone. The company merged with Hoogovens in 1999 to form Corus. Corus, which at the end of 2000 had a workforce of 32 000 in the United Kingdom, restructured its steel activities in response to the difficult situation on steel markets. It announced the closure of some 3 million tonnes of steelmaking capacity notably through closures of steel plants in Wales and a widely-spread downsizing. The company spent GBP 202 million on redundancy payments and related costs, and GBP 130 million in other rationalisation measures including site demolition and environmental clearance costs. This restructuring was expected to result in a reduction of the workforce in the United Kingdom to 22 000 by 2003.

The Government of the United Kingdom put in place a range of schemes to mitigate the effects of this restructuring both for the redundant workers, jointly financed with funding from the ECSC, and the affected regions, notably South East Wales, at an overall expenditure of GBP 140 million. These schemes did not provide benefits directly to Corus.

 1. Financing the restructuring of British Steel, SG/STEEL/RD(2001)9, p.6

4.2 RESTRUCTURING OF THE STEEL INDUSTRY IN THE UNITED STATES

176. Since the financial crises of 1997-1998 much of the US steel industry has been in serious difficulties. The surge in imports brought steel prices down to a level, at which US producers could no longer produce steel profitably. Moreover, integrated steel producers had problems in funding the so called legacy costs, *i.e.* pension and health care benefit commitments to which they agreed in the 1980s. Most of the integrated steel producers and some of the smaller mini-mills went into bankruptcy.

177. In response to growing congressional concern, the Clinton Administration announced a Steel Action Programme on 5 August 1999. This programme had three main elements:

- Vigorous enforcement of U.S. trade laws, including expedited investigations.
- Bilateral talks to address the underlying problems that caused the crisis, including consultations with Japan and Korea, and an agreement with Russia to limit steel imports.
- Improved import monitoring mechanisms to detect potential import surges.

178. In addition, the Congress passed the Emergency Steel Loan Guarantee Act, which was put in place to assist the financing of weak steel companies, which could not get commercial loans.

179. This programme only temporarily helped to reduce imports, which fell by some 20% in 1999 from the 1998 historical record level, while consolidation in the industry stagnated and steel production in ailing companies continued under the protection provided under Chapter 11 of the US bankruptcy law.

180. When the general economic situation worsened in the following years, President Bush announced a three-pronged strategy to address the structural challenges continually facing the steel industry.

- First, the President directed the United States Trade Representative to request that the International trade Commission initiate an investigation, under Section 201 of the Trade Act of 1974, of whether there was serious injury to the steel industry caused by increasing imports of steel products.
- Second, the President initiated efforts with the United States' trading partners to eliminate inefficient excess capacity in the steel industry worldwide.
- Finally to initiate negotiations on the rules that govern steel trade, seeking stronger disciplines which aim to reduce or eliminate all trade-distorting government subsidies to the steel sector, going well beyond current international rules governing such measures.

181. President Bush took action under Section 201 in March 2002, only after a nine-month investigation found that 10 steel industry products had been seriously injured by a surge in imports that warranted relief.

182. At the time President Bush imposed temporary duties on steel imports, steel prices were at 20-year lows. Relief under Section 201 of the Trade Act of 1974 was put in place for up to three years and reviewed at the mid-term to determine if it was still necessary. This measure, which was vigorously criticised by the governments of steel exporting countries, triggered off a series of trade actions against steel imports worldwide.

183. The Section 201 measure, the closure of Geneva Steel in November 2001 and LTV in December 2001 with a combined reduction of some 10 million tonnes of capacity – some of the capacity reappeared under new ownership –and the closure of inefficient capacity on other sites and a general improvement of the domestic economy may have all contributed to the recovery of the US steel market since mid 2002. Capacity decreased since 2000 and reached its 1998 level of 113 million tonnes in 2003 and employment in the steel sector decreased from 235 thousand in 1998 to 187 thousand in May 2002. Between 1974 and 2003 the workforce in steel fell by 73.4% in the U.S. compared to 70.7% in the EU15. Integrated producers, which accounted for around 60% of total steel production in the 1990s, nowadays produce less than 50%, while mini mills increased production and market share, respectively.

184. After reviewing the ITC mid-term report and economic conditions in late 2003, President Bush lifted the steel tariffs in December 2003. The measures had achieved their intended purpose, to allow needed breathing space so that the U.S. steel industry could regain its competitiveness. Significant improvements in the U.S. steel industry, and other changed economic circumstances, led to the decision to rescind the tariffs, including:

- Steel industry consolidation and restructuring (more than half of steel production capacity is owned by firms that merged or restructured, closing about 4 million tonnes of inefficient capacity);
- Prices that were considerably higher than in February 2002, the month before the safeguard went into effect;
- Increased productivity;
- New labour agreements that increase flexibility and protect retiree welfare;
- Growing demand in other markets, including China and Russia;
- Improving exports for U.S. companies.

185. Consolidation in the steel industry continues, notably in the integrated companies. Profitability has returned to steel producing companies. The U.S. steel industry continues to consolidate, providing economies of scale to and stronger steel companies. In the months since the safeguards were lifted, ISG, the second largest integrated producer, entered into an agreement to buy Weirton Steel, the fifth largest integrated producer. Rouge Steel was acquired by Severstal, the largest Russian producer, and Valbruna Steel acquired Slater Steel in Indiana. In October 2004, ISG announced its plans to merge with Ispat International to form Mittal Steel, the world's largest steel company.

186. Participants in the OECD High-Level Steel Initiative worked for two years to urge governments to identify and close inefficient excess capacity and to develop strong subsidies disciplines through a Steel Subsidies Agreement.

187. The High-Level Steel Group concluded in June 2004 that while significant progress toward an agreement to curtail steel subsidies had been made, key differences remained that require further examination and discussion. In particular, those differences centre on exceptions to the overall subsidies prohibition, preferential treatment for developing countries, and whether excepted subsidies should be countervailable.

188. Participants in the OECD process are consulting each other informally in an attempt to bridge some of those differences, and with the view toward reconvening the High-Level Group sometime in 2005 to assess prospects for concluding an agreement.

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1. Most of the information is taken from S. Cooney, *The American Steel industry: A Changing Profile*, 2003.
 2. Integrated producers produce steel from iron ore.
 3. Minimills generally produce steel from melted scrap.

¹⁰⁹ Hot rolling capacity is the capacity for the transformation of crude steel into finished products such as sheet, bar, rod and sections. Crude steel capacity is the capacity to produce crude steel in the form of billets, blooms, slab and ingots.

¹¹⁰ United Nations – Economic Commission for Europe (1992), pages 3 ff.

¹¹¹ Moffat (1991), p 3ff.

¹¹² OECD (2001a), p.6

¹¹³ European Commission (1986), Table 3.

¹¹⁴ Canevali, p.2.

¹¹⁵ Salerno (2001), p.5.

5. SHIPBUILDING

Key points emerging

189. The structural adjustment of **European shipbuilding** has been an on-going effort, involving both industry and governments, to respond to the marked changes that have driven the world economy, and to keep and improve its competitiveness in what has frequently been a turbulent market.

190. Having dominated the world shipbuilding market for decades until the early seventies, European shipbuilding was more heavily affected than elsewhere when the over-heated market collapsed in the mid-seventies. The downsizing of European shipbuilding continued even when the market began to show signs of recovery in the eighties, and the stagnant production continues to date.

191. Therefore, the structural adjustment policies of European governments in the first instance were focused on how to deal effectively with a shipbuilding industry that was contracting, and at the same time to find new sources of competitiveness other than cheap labour. In doing so, European governments (both member states and the European Commission) formulated shipbuilding policies based on two pillars:

- Recognising the structural deficiencies in shipbuilding (*i.e.* persistent overcapacities), governments tailored policy measures to reduce building capabilities, which, in the context of structural adjustment, led to the reduction of labour forces, thereby alleviating adjustment costs involved with the restructuring of shipyards.
- Governments also made efforts to encourage the industry to find and nurture new sources of competitiveness (but not cheap labour), thus helping to sustain its ability to compete in the market, for example by permitting aid for modernisation/upgrading or for R&D activities.

192. The shape of the restructuring efforts differed among member states. Some countries (*e.g.* Sweden) virtually ceased commercial shipbuilding and diversified into other industries. The restructuring in other countries (*e.g.* France) involved mergers and regroupings of the yards. Another way of enhancing competitiveness was to tailor government policies to enhance competitiveness, for example by promoting technological upgrading (*e.g.* Germany). In other cases, industry clustering around shipping groups helped lessen adjustment pressures on shipbuilding (*e.g.* Denmark).

193. Reflecting the global nature of competition in shipbuilding and the problems to be solved, European shipbuilding policies have been constantly affected by the international dialogue undertaken at the OECD Working Party on Shipbuilding (WP6). Domestic policies were gradually brought in line with the commitments made on the OECD guidelines/arrangements, and these were repeatedly drawn on in promoting structural adjustment.

194. The **Japanese shipbuilding** industry, which in the 1970s had a 50% share of the world market, confronted two rounds of severe crisis caused worldwide by sharp fall-offs in demand for tankers. The first was in the late 1970s and the second in the late 1980s.

195. Guidelines agreed to in the OECD encouraged governments to reduce shipbuilding capacity, and the Japanese Government responded by establishing a Council, composed of experts, industry

representatives and other interested parties, to advise it on possible courses of action. This Council recommended that excess capacity be reduced collaboratively among all Japanese shipbuilders; recommending in 1976 that capacity be reduced by 35% and later in 1987 that capacity be reduced by a further 20%. The Council's recommendations were accepted by the Japanese Government.

196. To attain these reductions collaboratively an association was established to purchase and eliminate excess capacity. The cost of this activity was charged to the whole Japanese shipbuilding industry, and it enabled that industry to successfully reduce its capacity by about 50% throughout the period.

197. The key point underlying the policy making process was that the Japanese shipbuilding industry as a whole recognised the need to substantially reduce its capacity, and accepted at an early stage the need to pay for those reductions.

198. The **Australian shipbuilding** industry did not just restructure itself, but rather it undertook a wholesale transformation to achieve its current strong and competitive position in the fast ferry niche market.

199. One catalyst for this re-invention was a subsidy scheme introduced by the Australian Government in the mid 1970's intended to provide a lifeline to the traditional steel-based shipbuilding industry, but instead fostered re-direction into a new niche market that was open to innovation.

200. This re-invention succeeded largely because it found fertile ground in a thriving, efficient and technologically advanced boat building sector that could relatively easily step up to build fast ferries. By shedding its traditional steel based industry and drawing instead on its small boat experience the new Australian shipbuilding industry tapped into an existing technology and skill base and was able to build itself from the ground up, rather than converting itself from the top down. The strong competition that existed in Australia within that boat sector also assisted the development of a new industry that was able to focus on establishing itself as a more dynamic, technologically advanced and competitive industry.

201. With the removal of the bounty at the end of 2000, the Australian shipbuilding industry moved from a situation from the 1940's to the 1970's where it was receiving substantial subsidies in support of the local industry, to one where the new industry is expected to survive without further government assistance.

5.1 THE EUROPEAN UNION

Historical overview - European shipbuilding in decline

202. With over 60% of the market in the 1960's, European shipbuilding dominated the world market before the global recession began in the mid 1970's. As can be seen in Figure 1, even though the relative market share was gradually declining, European shipbuilding continued to grow until the recession began.

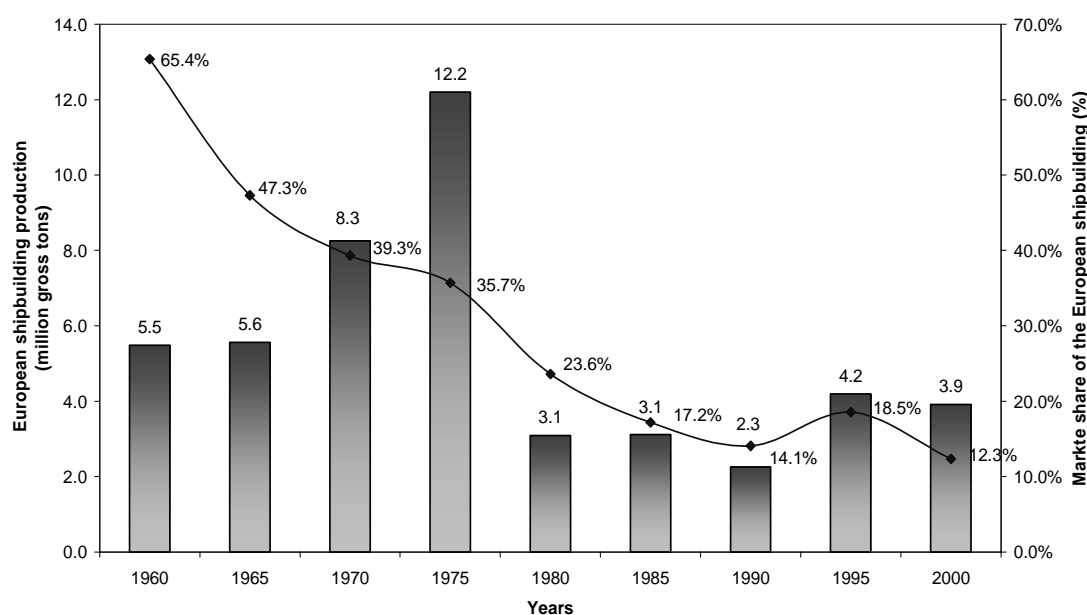
203. This growth was helped by the economic boom of the time, as well as an optimistic anticipation of future economic growth and the ensuing surge in sea-borne transport. In addition, governments' proactive shipbuilding policies, in particular through providing subsidies for favourable export credits, afforded ample grounds for the industry to continue to grow.

204. Going through the recession, European shipbuilding had to endure an unprecedented decrease in production, which decreased more than 70%, from 14.0 mil. gross tons in 1975 to 3.6 mil. gross tons in 1985. However, it is important to note that the decline of European shipbuilding continued, both in production and world market share, even when the market generally began to recover from 1987/88 onwards. In fact, European shipbuilding production never recovered to the pre-crisis level (see Figure 1).

205. Since then new shipbuilding economies, endowed with their own competitive advantages (*i.e.* cheap labour), have gradually taken up the world market. Japan, which had secured a dominant position in the early 1970's, continues to represent a significant market of world shipbuilding and Korea, which was almost non-existent in the 1960's, has rapidly increased its market share.

206. With lower rates of production continuing, the European industry was compelled to shed over 70% of its workforce since 1975 (from 461,988 in 1975 to 129,761 in 2003). Over the years, European shipbuilding had to undergo a long-lasting process of structural adjustment, in some countries even to the point of virtual disappearance of the industry.

207. On the other hand, this situation also forced the Europeans governments to recognise the need to restructure the industry and accelerate efforts to create their own competitiveness in shipbuilding.

Figure 1. Productions and world market share of European shipbuilding (1960 - 2000)

Source: Lloyd's Register Statistical Tables.
100 GT and above. Poland is included from 1995.

Table 1. Workforce changes in selected European countries (1975 vs. 2003)¹¹⁶

Year	1975		2003	
	Employment**	Newbuildings***	Employment**	Newbuildings***
Denmark	18,900	15,300	2,900	2,400
France	40,354	24,938	6,250	4,350
Germany	105,988	71,598	22,000	14,200
Sweden	31,500	25,000	0	0
Total*	461,988	306,047	129,761	90,948

* Members of the AWES (Association of European Shipbuilders and Shiprepairers)

** Workforce directly employed by the shipyards. *** Newbuildings include merchant ships and offshore facilities.

Emergence of Community-wide restructuring policies

208. During the early years of the recession in the 1970's, when the problems of the industry were still believed to be of a short term nature, the European policy response was mainly to provide short term assistance to keep companies running. This was often motivated by social considerations and to secure the supply potential in the expectation of a recovery.

209. However, faced with mounting costs to support the industry in this way, the European governments gradually introduced a more cost-effective and customized way of pursuing restructuring. Also, it became clear during the shipbuilding recession of the 1970's that persistent over-capacity was the major structural problem in world shipbuilding, directly affecting all domestic shipbuilding industries.

210. A series of EC Directives (6th in 1987, 7th¹¹⁷ in 1990) represented milestones in shipbuilding restructuring policy, since these embodied the Community-wide approach of facilitating structural adjustment in the industry. For example, common aid limits ("ceilings") were set for the first time throughout the Community. Although the details vary, the Directives were a bold attempt to respond to the recessions from the 1970's to the late 1980's, taking policy lessons from the experiences during/or after the recession period.

- First, the goals of aid were clarified, and maximum ceilings (as a percentage of the contract value of the ships) were introduced throughout the Community. Provisions were also made for the progressive reduction of such aid from, the 28 per cent "contract-related production aid" set in 1987, to 20% in 1990, 13% in 1992 and to 9% in 1993.
- "Investment aid" was allowed provided that the aid was linked to the restructuring of the yard, so that there would be no increase in the shipbuilding capacity of the recipient yards. If there was, then there had to be a corresponding capacity reduction in other yards in the same Member State.
- "Closure aid" was allowed, not for the yards, but for the workers made redundant as a result of closures, thus ensuring that aid was provided to cover social costs related with the restructuring (for example, payments to the workers, counselling services, vocational training, etc.). Such aid was made available only on the condition that the capacity reduction was genuine and irreversible, and the recipient yards had to be closed for at least five years (this was later strengthened to ten years).

211. With clearly-defined purposes and commitments for reductions in public support for the industry, the EC directives served to gradually reduce building capabilities and/or labour forces, and thereby lessened the adjustment pressure associated with the restructuring.

212. At the same time, the governments also attempted to nurture new sources of competition and sustain the industry's ability to compete in the market:

- In addition to R&D aid that is generally available for the overall industry, selective "investment aid for innovation" was permitted, provided that it related to innovative products and processes that were not currently used in the Member States.
- "Aid for modernisation/upgrading" was allowed as regional investment aid, provided that it was not linked to the financial restructuring of the yard.

213. The effectiveness of the Community-wide policies was enhanced by notification and/or monitoring requirements, which were binding on member countries. Any aid scheme - new or existing - was bound to be notified to the European Commission, which had the task of surveying the compatibility of government aid programmes with the principles of the common market. In pursuance of this objective the European Commission has issued a number of "Directives", binding upon the EC member states, to influence such aid and ensure transparency.

214. Reflecting the global competition in shipbuilding and the need for international co-operation in addressing its structural problems, European shipbuilding policies have been constantly affected by the

international dialogue undertaken at the OECD WP6. Domestic policies were brought in line with the commitments made at the WP6, and the discussions at the WP6 were drawn on in promoting structural adjustment.

215. The “*General Arrangement for the Progressive Removal of Obstacles to Normal Competitive Conditions in the Shipbuilding Industry*”, first introduced in 1972 and finally revised in 1982, prompted member governments (as well as European Commission) to gradually reduce domestic subsidies. The “*General Guidelines for Governmental Policies in the Shipbuilding Industry*”, adopted in 1976 and revised in 1982, directed shipbuilding policies towards reducing building capacities.

Some examples of restructuring in EU member states

216. Specialising in large oil tankers in the 1970’s, Swedish yards were affected more quickly and more sharply than any of the others by the oil price crisis. The magnitude of the crisis, and the mounting adjustment costs to the industry, led the government to co-ordinate the activities of shipyards, notably by ordering new ships for the public account and keeping these in stock in the expectation of recovery.

217. However, by 1985, faced by escalating costs to keep yard activity alive in this way, the government decided to terminate that policy, and chose to promote other industries (such as the automobile industry) which were regarded as more profitable. The result for shipbuilding was a severe drop in the number of jobs, and almost all the major shipyards practically ceased their commercial activities.

218. In France, commercial shipbuilding was considered as a business activity separate from the naval sectors. Military vessels were built in “arsenals”, *i.e.* in shipyards that were dependent on the Ministry of Defence. Therefore, commercial shipbuilding could not benefit from the buffer effects of military orders, and as a consequence was more heavily affected by the recession.

219. During the difficult process of structural adjustment, the government’s shipbuilding policy promoted a series of restructuring activities, mainly through mergers and regrouping of yards. Over the years, these reorganizations finally downsized the whole industry to a few of major yards - with Chantiers de l’Atlantique producing the most technologically-sophisticated ships, and medium sized-yards (Alstom Leroux Navel (Lorient) and Les Chantiers Piriou) focusing on specialised ships such as research vessels. The remaining small yards have focused on building small fishing vessels.

220. In Germany, the policy stance of the government has been that in the first instance the responsibility for adjustment falls to the shipyards themselves, and that they needed to adapt to new market conditions and improve their structures to remain competitive. Therefore, government aid provided to companies to help them over the depression has been regressive and subject to certain conditions. For example, subsidies were granted provided the ships comprised high technology.

221. A major challenge for German shipbuilding industry came from reunification in 1989. Limited aid was provided to modernise former East German yards, under the strict condition of reducing building capacities. Another distinctive feature of German shipbuilding policy has been that it has emphasized the promotion of demand for ships; for example in the form of supported export credits to developing countries. Currently, major yards (*e.g.* Meyer Werft, Aker MTW Werft and HDW) are actively engaged in the building of cruise vessels or large container vessels. Remaining medium yards specialise in medium container vessels or general cargo ships.

222. The restructuring of the shipbuilding industry in Denmark represents an example of concentration of shipbuilding activities around shipping activities. Probably more than in any other country, Denmark’s present shipbuilding industry has been created around yards owned by the big shipowner groups.

223. The close relationship thus created between these two industries - shipbuilding and shippower - served as a shock-absorber for shipbuilding, and this helped prevent abrupt changes in the industry. The largest shipbuilder in Denmark, Odense Steel Shipyard, which is a member of the A.P. Moller-Maersk Group, is active in the building of containership vessels.

Continuing efforts for structural adjustment

224. The commitment to reduce public subsidisation to the industry has been repeatedly reaffirmed, and shipbuilding policies have been constantly tailored by monitoring the supply/demand balance in world shipbuilding. As a consequence, the contract-related operating aid was abolished as of the end of 2000¹¹⁸.

225. Nowadays, European shipbuilding is leading the high-value market of shipbuilding such as cruise ships (which are considered the highest-value sector of shipbuilding), holding almost 80% of world cruise ship orders as of the end of 2003. It is also actively involved in technologically-sophisticated segments such as fast ferries, car carriers or multi-purpose cargo vessels. Small and medium-sized yards focus on specialised vessels (*e.g.* fishing vessels and mega-yachts).

226. Also, efforts continue to capture new sources of competitiveness (*e.g.* finding some niches in so-called “conventional” segments such as containerships, chemical and gas carriers) and thus enable the industry to be stay competitive in the market.

227. Very recently, LeaderSHIP 2015¹¹⁹, a joint initiative between government and industry, was launched to further restructure the industry and enhance its competitiveness. With Community-wide action programmes to enhance competitiveness, the new initiative takes an all-encompassing approach, from creating a “level playing field” in shipbuilding, to increasing RDI (research, development and innovation) activities, and to building a sustainable industry structure (including incentives for consolidation).

¹¹⁶ Workforce directly employed by shipyards, Annual report 2003-4, Association of European Shipbuilders and Ship-repairers.

¹¹⁷ Council Directives 87/169/EEC (26/1/1987) and 90/684/EEC (21/12/1990) respectively on aid to shipbuilding.

¹¹⁸ Council Regulation (EC) No 1540/98 of 29 June 1998.

¹¹⁹ LeaderSHIP 2015 - Defining the Future of the European Shipbuilding and Shiprepair Industry - Competitiveness Through Excellence, 2003, European Commission.
(http://europa.eu.int/comm/enterprise/maritime/leadership_2015.htm)

5.2 JAPAN

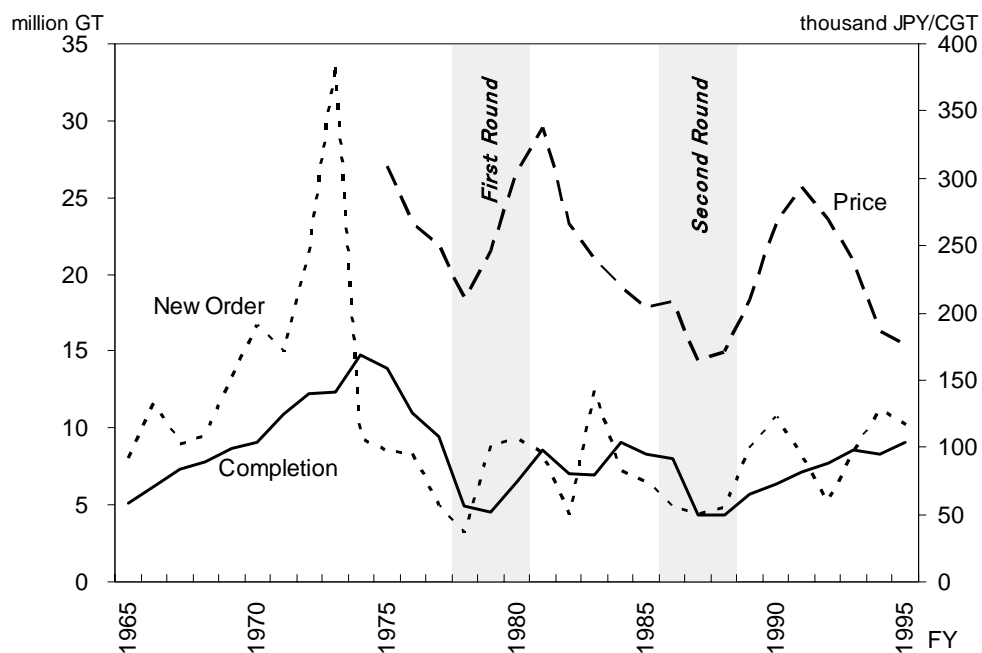
Short history

228. The Japanese shipbuilding industry grew as a key industry during the country's high economic growth after World War II. In 1956 Japan became the world's dominant producer and throughout the period shipbuilding made a great contribution to the Japanese economy as one of its major export industries.

229. In the 1960's, taking advantage of growing world demand for ultra large tankers, Japanese shipbuilding achieved strong growth, and in 1968 increased its share to half of the world total. The industry has kept its competitiveness for decades, and still commands some 35% of world output.

230. However, this growth did not come without difficulties, as the Japanese shipbuilding industry confronted two rounds of severe crisis caused by sharp fall-offs in demand for tankers, the first in the late 1970s and the second in the late 1980s.

Figure 1. Changes in the market of Japanese shipbuilding industry



Source: MLIT, Japan
Note: 2,500GT and over

First round of structural adjustment

231. In 1974 world shipbuilding suddenly plunged into a serious structural recession following the first oil crisis. This was because of a drastic drop in newbuilding orders due to a slackening of the shipping market and the surplus tonnage of ships, particularly large tankers.

232. In response to this crisis the OECD Council Working Party on Shipbuilding in 1976 adopted the "General Guidelines for Government Policies in the Shipbuilding Industry" which was a set of principles aimed at reducing shipbuilding capacity.

233. The conditions in Japan were more severe than in European countries, principally because large tankers occupied a large portion of Japanese production. In 1974, orders placed with Japanese yards dropped by as much as 72% over the preceding year. As well, this was accompanied by a large number of cancellations that almost equalled the new orders that were received, and as a consequence, shipbuilding firms deteriorated rapidly.

Table 1. New and cancelled orders to Japanese shipbuilders

<i>FY</i>	<i>1973</i>	<i>1974</i>	<i>1975</i>	<i>1976</i>	<i>1977</i>	<i>1978</i>
New orders (Million GT)	33.79	9.35	8.50	8.42	4.95	3.22
Cancellations (Million GT)	-	0.91	6.96	7.59	2.80	0.68

Source: Ministry of Land, Infrastructure and Transportation (MLIT), Japan
Note: 2,500GT and over

234. The first round of capacity adjustment was launched in June 1976 following a report by the Shipping and Shipbuilding Rationalisation Council (SSRC). This was established to assist the government in formulating policies for the shipbuilding industry, and consisted of experts in various fields, including shipbuilding representatives.

235. Referring to the OECD Guideline, and the world economic situation at the time, the SSRC strongly endorsed the need for a significant reduction of shipbuilding capacity. In response, the Minister for Transport provided the shipbuilding industry with guidelines concerning shipyard operations, which led to a reduction in hours of operation. Compared to previous years, in the fiscal year 1977 these were reduced by about 30% and by about a further 35% in the fiscal year 1978.

236. In addition, under the pressure of bankruptcies, particularly of small and medium sized shipbuilders, in July 1978 the SSRC submitted another report to the effect that some 35% of the existing shipbuilding capacity should be disposed of. Subsequently, in August 1978, the shipbuilding industry was designated under the "Special Measures Law Concerning Stabilisation of Designated Industries", which provided for loan guarantees to help companies (across all industries) to reduce production capacities. However, by themselves these guarantees did not prove to be adequate to promote sufficient capacity reductions by the shipbuilding industry.

237. In December of the same year, the Designated Shipbuilding Enterprise Stabilisation Association (DSESA) was established for the purpose of facilitating the disposal of capacity. It did this by purchasing excess berths or docks with shipbuilding facilities from shipbuilders, and holding them temporarily until sold to third parties for purposes other than shipbuilding. This enabled the shipyards to close or reduce their capacity immediately, and to use the capital gain to service their debts and fund their retirement liabilities.

238. In order to limit production, an "anti-depression cartel" was also formed in August 1979 by 39 shipbuilders, and exempted from the Anti Trust Law. This allowed shipbuilders to collectively agree to

reduce production, and the cartel took over the administration of the guidelines issued earlier by the Minister for Transport.

239. When this round of structural adjustment ended in March 1980, capacities had been reduced by 37% compared to the previous year.

Table 2. Changes in scales of Japanese shipbuilding industry

	<i>Apr 1979</i>	<i>Mar 1980</i>	<i>Reduction</i>
Shipbuilder	61	44	-28%
Berth or Dock	138	88	-36%
Capacity (million CGT)	9.77	6.19	-37%

Source: MLIT, Japan

Note: Shipbuilders that can build ships of 5,000 GT and over

240. These actions seemed to have produced positive results. The reduced capacity in the shipbuilding industry helped newbuilding prices to bottom out in 1979 for the first time in six years. Signs of recovery became visible and the structural adjustment initially seemed to be performing properly.

Second round of the structural adjustment

241. Although the tonnage of vessels built increased after the first crisis it remained only half that of the earlier peak year, as it also had in Europe. The new shipbuilding economies such as Korea and Chinese Taipei were increasing their share. Additionally, a continued slump was predicted for the shipbuilding industry, and the international situation was bound to become increasingly complex and difficult. In these circumstances, Japan and European countries exchanged views and information at the OECD Working Party on Shipbuilding and other forums.

242. Domestically, in a report issued in March 1983, the SSRC strongly recommended the further restraining of capacity expansion and a capping of production. In that report, the Council, again referred to the policy guidance contained in the agreements concluded by the OECD¹²⁰, and urged the government to respect the obligations laid down in them.

243. The Ministry of Transport then took various steps, including restrictions (as far as were possible) on the development and expansion of facilities, as well as additional restraints on yard operations to reduce output.

244. However, international economic changes since the autumn of 1985, such as the appreciation of the yen against the dollar and the drop in oil prices, were drastic and had a considerable effect on the Japanese economy. Exchange losses also adversely affected international business operations such as ocean-going shipping and shipbuilding. Orders for new vessels received by Japanese shipbuilders decreased by 11% in fiscal year 1985 and by 25% in fiscal year 1986.

245. By this stage the situation of the shipbuilders had become more difficult, and there were rising concerns about the deteriorating employment and economic conditions in districts depending mainly on the shipbuilding industry.

246. In addition to the recommendation prepared in 1983, the SSRC in June 1986 suggested that to stabilize the nation's shipbuilding industry Japan should take the following measures as quickly as possible:

- i) the disposal of excessive facilities to reduce capacity by about 20%;

- ii) strengthening the industrial structure through mergers and acquisitions;
- iii) the promotion of the scrapping of vessels; and
- iv) the creation of demand for shipping.

247. This gave rise to the second round of measures to reduce capacities. This started in early 1987, at a time when world shipbuilding demand was at its lowest, with the formation of a new “anti-depression cartel”.

248. This was immediately followed by the "*Temporary Measures Law Concerning Operation Stabilisation of Designated Shipbuilding Enterprises*" which aimed to facilitate disposal of facilities and the merger of shipyards. The law provided for the purchase of excess facilities, and for loan guarantees by the DSESA¹²¹, which had been created during the first round for the same purpose.

249. By March 1988, the process of concentration facilitated by the Temporary Law led to the reduction in the number of shipbuilders to 26, organised in 8 groups (from formerly 44 builders in 21 groups), and capacity had been reduced by another 24%.

Table 3. Changes in scales of Japanese shipbuilding industry

	<i>Apr 1987</i>	<i>Mar 1988</i>	<i>Reduction</i>
Shipbuilder	44	26	-41%
Group	21	8	-62%
Berth or Dock	73	47	-36%
Capacity (million CGT)	6.03	4.60	-24%

Source: MLIT, Japan

Note: Shipbuilders that can build ships of 5,000 GT and over

250. This ended the second round of structural adjustment, but the restriction on the expansion of individual shipbuilding facilities continued until the government, following the SSRC's new recommendation in 1996, alleviated some of the restrictions, while maintaining the overall capacity capping until 2003.

Conclusion

251. The Japanese shipbuilding industry overcame unprecedented recessions through the 1970s and 1980s by adjusting its capacities to reflect the change in the market. This difficult process to eliminate excess capacity could be developed in Japan because the government policies, and the measures that were implemented by the industry, largely followed the guidance formed on a consensus basis among experts, representatives of the employee and workers in shipbuilding, and other interests

252. Of note is that under the law the cost of the DSESA's operations was charged to all shipbuilders¹²² who remained in the market and who subsequently received new orders. This approach was practicable because the purchase of the facilities was implemented not only upon individual request from a shipyard which wanted to dispose its facilities, but also relied on plans made by groups of shipyards, including those that were to remain in the market. In other words, the measures were developed and executed on the basis of a consensus amongst the industry, stockholders, creditors, government and other interests, and were based on the belief that future incremental benefits would exceed the cost of the measures.

253. While problems have emerged in terms of after effects, including the ageing of engineers and skilled workers, and a stagnation in technological development, Japanese shipbuilding has maintained its competitive edge for almost half century, and still has some 35% share of the world market.

254. Unlike most other industries in Japan that have declined or shifted their facilities to foreign economies to take advantage of cheap labour, shipbuilding was able to adapt to changing situations in the world market, and was able to retain almost all of its industrial activities in Japan.

255. The key point underlying the policy making process was that the Japanese shipbuilding industry as a whole recognised the need to substantially reduce capacity, and accepted at an early stage the need to pay for that reduction.

256. Since the completion of those restructuring programmes the government has ceased all direct intervention in the industry, except for assistance for R&D (especially that aimed at environmental protection) and the Japanese shipbuilding industry has been left to freely respond to subsequent changes in the international shipbuilding market. Japan is also actively participating in the present negotiation in the OECD to establish a global level playing field.

¹²⁰ “*General Guidelines for Government Policies in the Shipbuilding Industry*” and “*General Arrangement for the Progressive Removal of Obstacles to Normal Competitive Conditions in the Shipbuilding Industry*”

¹²¹ This association was reorganised in 1989 as “Association for Structural Improvement of the Shipbuilding Industry” (ASIS) with expanded activities including research on trends in world shipbuilding supply and demand.

¹²² Shipbuilders that can build ships of 5,000 GT and over

5.3 AUSTRALIA

Short history

257. The Colonial Government built Australia's first shipyard in 1797, only nine years after its colonisation by the British. While a number of ships, both commercial and naval, were built since that early beginning, shipbuilding did not entrench itself firmly in Australia's landscape until just prior to the Second World War, when the Broken Hill Proprietary Company (BHP) established a yard in Whyalla (in South Australia) and Evans Deakin established itself in Brisbane. Subsequently, major shipbuilding was also carried out in Newcastle in New South Wales.

258. In terms of production of large, traditional steel ships, Australia's golden age was between the end of WWII and 1972, when these yards built over 70 large merchant vessels. Both the Whyalla and Evans Deakin yard built a number of ships over 50,000 deadweight tons (dwt), with the largest exceeding 80,000 dwt.

An industry in decline

259. As with many of the industrialised (and industrialising) countries in the 20th century, shipbuilding in Australia was considered to be a "strategic industry" from both economic and defence perspectives and supported by the government through import duties and later production bounties.

260. The Australian Government's drive to firmly establish a viable shipbuilding industry in Australia commenced in 1947 when it re-introduced a bounty that had been introduced in 1940, but scrapped in 1943 as no claims had been lodged during the war years.

261. The bounty was a form of subsidy assistance intended to equate the cost of building a vessel in Australia with the cost of building a similar vessel in the United Kingdom. Originally the bounty only applied to vessels built for use in Australia.

262. A bounty was chosen, rather than a tariff on imported vessels, to avoid adding to the cost of shipping operations. Therefore, instead of providing tariff protection to bring the cost of import vessels up to those built locally, the bounty provided a subsidy to local producers to recompense them for the "additional" cost of building the vessel in Australia.

263. If the intent of the bounty was to foster a viable industry in Australia, then it seems that in practice it had the opposite effect. The level of assistance provided to the local shipbuilding industry was high, and therefore much prized by the group of six companies that comprised the registered shipbuilders eligible for the bounty.

264. This restricted application had the effect of limiting opportunities for new entrants to the industry, who had no choice but to operate outside the scheme. Secondly, because of the implied threat that the bounty might be reduced if there were significant profits made on the construction of ships, this acted as a disincentive to the registered shipbuilders against upgrading their facilities to improve efficiency.

265. As was the case in many countries in the post-war period, when the bounty was introduced in 1947 the Australian shipbuilding industry was trying to keep in operation shipyards built or extended during the Second World War. Like its counterparts in other countries the Australian commercial shipbuilding industry built large steel hulled vessels; mostly tankers and bulk carriers.

266. In the mid 1970's these large ships were still being built, but the industry had been facing serious problems for decades. The lack of investment, innovation (as seen earlier partly as a result of the bounty assistance) and difficult industrial relations highlighted the fact that the industry was in crisis. As an example, a shipyard operating in the 1970's employed members of 26 different unions, and disputes related to demarcations and work practices were common.

267. Simply put, the inefficient Australian shipyards were unable to compete either with the skills and technical superiority of the traditional European shipbuilders, nor with the efficiency of newer yards in lower cost countries (at the time) like Japan and (later) Korea. While the bounty assistance helped, this was negated by subsidies provided by governments around the world to their own industries.

The Government's response

268. The response by the Australian Government to the crisis being experienced by the shipbuilding industry was to revamp the bounty scheme in 1975, replacing the original cost-based approach with one based on the selling price of the vessel. This was in turn replaced in 1980 by a new bounty scheme where the assistance was based on the cost of construction of the vessel.

269. In the early 1980's the nominal rate of assistance was 27.5%, but this had declined to 15% by the end of that decade. In the 1990's it declined steadily until it reached 5% towards the end of that decade. By the end of 2003, when the bounty was discontinued, the rate had fallen to 3%.

270. The clear intent of the bounty scheme was to support the local industry, and throughout this time import controls were maintained, although imported vessels meeting specific criteria (principally vessels that could not be built by the local industry) were increasingly permitted. This placed further pressure on the local industry as it was increasingly unable to enter the market for the more specialised and larger vessels.

271. In 1984 the application of the bounty only to vessels intended for use in Australian waters was lifted to assist the industry to take up excess capacity. The new scheme also introduced a more rigorous registration scheme for shipbuilders eligible to receive the bounty.

272. The purpose of this registration was to lead to a more "orderly development" of the industry, by focussing on those most able to succeed in the future. Crucially, unlike the earlier registration scheme that was limited to a fixed number of builders, and therefore had their positions "grandfathered" by the bounty to the clear detriment of the entire industry, this new registration scheme was open to all who could meet the rigorous criteria.

273. This new criteria ensured that the bounty was paid to shipbuilders who had, or could demonstrate, a clear long-term commitment to the industry, and who could be regarded as part of a viable, efficient, outward looking and technologically advanced industry. The new arrangements were also dependent on continuing progress in discussions between the industry and unions to improve industrial relations. This, in turn, was to improve the skill base available to the industry, and contributed greatly to its longer term efficiency.

The impact on the industry

274. The outcomes of these changes to the scheme were largely unanticipated. Originally put in place to assist structural adjustment and rationalisation of the traditional steel-based industry, the new scheme only acted to further accelerate its demise, which had been gathering pace throughout the 1970's and the early 1980's.

275. Instead, and quite unexpectedly, the new scheme, with its emphasis on long term viability, export orientation, technical excellence and efficiency, actually served to nurture an "infant" industry that used different skills, different technologies and new materials, and which built vessels that were far different to those constructed by their predecessors.

276. A quick examination of the changes in employment patterns in selected years during the period of the changeover indicates the fairly rapid reduction in employment in the traditional shipbuilding and repair industry, which since then has focused almost entirely on the construction of military vessels for the Australian Defence Forces (although this has also generated some moderate export activity).

277. While numbers in the "bountiable sector" (*i.e.*, the new fast ferry builders) increased overall employment remained well below that of the "old" sector. A comparison with output from the industry also attests to the substantial improvement in productivity that accompanied the transition.

Australian Shipbuilding Employment and Output Selected Years

Year to 30 June	Employment		Output \$m
	All Shipbuilding	Bountiable builders	
1985	11200	1598	480
1988	7500	2287	822
1992	5600	1982	1469
1996	4100 (est)	3334	1486

278. The particular niche occupied by the new Australian shipbuilding industry covers fast ferries (passenger and passenger/vehicle combinations) and luxury cruisers, patrol boats and yachts. It has been extremely successful in capturing this niche, and has been at the leading edge of technology in design and the use of aluminium and composite material for many years, and production is largely exported.

279. The bounty payments peaked in the late 1980's and early 1990's, driven up by growing production, even though the rate of assistance had been gradually falling. A sharp decline in the rate of the bounty in the mid to late 1990's further brought down the overall bounty payments, which settled at around AUD25 million per financial year between 1990 and 1997. Since then the bounty payments have fallen further as the rate of support continued to decline. The lowest Bounty payments (UAD 5.5 million) occurred in 2001/2002, while in 2003/2004 the figure was AUD 13.8 million.

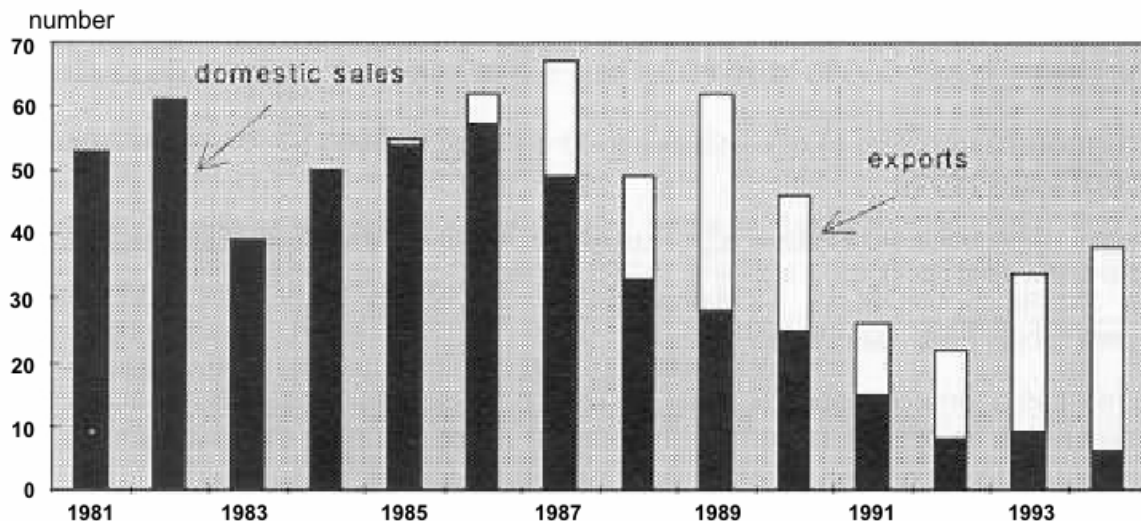
An industry re-invented

280. As noted earlier, the original intention of the revamped bounty scheme in the 1970's and 1980's was to help the restructuring of the original traditional steel-based shipbuilding industry. This did not eventuate and instead the industry re-invented itself into something quite different.

281. None of the traditional shipbuilders survived the transformation, and all of them either closed down or abandoned the commercial market and turned to the manufacture of naval vessels. Their place

was taken by a new breed of shipbuilder, more focused (on smaller fast ferries), using new technologies and materials (aluminium and composite materials) and located in different parts of Australia (primarily in Henderson in Western Australia and in Tasmania). Finally, these new entrants were very export oriented, and this completely revolutionised the industry. The graph below shows, in quite dramatic fashion the transformation that took place between 1981 and 1994. That situation still exists today, and almost all vessels produced in Australia are exported.

Chart 3.1 Sales of bountiable ships: 1980-81 to 1993-94



Source: DIST (1994)

282. In an analysis carried out in 1995 the Australian Bureau of Industry Economics attributed this re-invention to the following factors:

- Fast ferries can be considered as large boats rather than small ships, and many of the current shipbuilders had their origins in advanced design boat building, where there was a stronger technological continuity than in the traditional steel based sector.
- By shedding its traditional steel based industry and drawing instead on its small boat experience the new Australian shipbuilders tapped into an existing technology and skill base and was able to build itself from the ground up, rather than converting itself from the top down.
- Capital requirements were relatively low, and this allowed a number of competitors to emerge, generating strong competition and the flow of ideas and personnel within the industry.
- Strong initial domestic demand for such ships (fed by growing tourism) provided a bridge while the manufacturers developed their export market.

The industry today

283. The Australian shipbuilding industry in 2004 still focuses heavily on aluminium fast ferries and other similar vessels. These have grown incrementally over the years with a passenger/vehicle/cargo fast ferry of 126.6 metres long currently being built by Austal for a European buyer. At present there are

around a dozen shipbuilders with the capability of constructing fast ferries and similar vessels, mostly clustered around Henderson in Western Australia.

284. Over the years the Australian industry had been at the leading edge of design and technology, and has been involved in a number of joint overseas ventures involving technology and design transfers. In particular Austal Ships and Incat Tasmania, have established subsidiaries and joint ventures in the US to tap the Jones' Act market, as well as a growing military application for these types of vessels.

285. On the government's part, it had anticipated as early as 1995 that if the OECD Shipbuilding Agreement had come into force in 1996 as intended¹²³, and Australia joined it, then the bounty would have to be removed immediately. As the Shipbuilding Agreement did not come into force as expected, the bounty was renewed, but with decreasing levels of assistance.

286. The bounty terminated on 31 December 2000, with phase out provisions in place until 31 December 2003 for vessels under contract as of the end of 2000. In 2003/2004 the commercial shipbuilding industry generated a turnover in excess of AUD500 million while the entire Australian shipbuilding industry (including those employed in the naval ship construction sector) employed in excess of 7000 people.

287. This new, subsidy-free status underlines the necessity of a global "level playing field" so that the Australian industry can continue to compete on the international market, and not unexpectedly Australia has participated actively in the present negotiations in the OECD for a new Shipbuilding Agreement to bring about normal competitive conditions in the industry.

¹²³ It has not yet come into force as the US has so far failed to ratify it; a necessary requirement under its entry into force provisions.