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### Author

Graziani, Giovanni

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**Globalization of Production in the  
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**Giovanni Graziani**

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Giovanni Graziani is Professor of Economics at the Università degli Studi di Parma, Italy.

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## 1) Introduction

East European full reintegration into the world economy had already started during the eighties, but the end of the decade and the beginning of the nineties saw a sudden spurt in that direction. This has taken the form not only of a swift trade reorientation towards the West, especially the EU, but also of new forms of inward foreign direct investment (FDI), subcontracting and cooperation agreements with Western enterprises. As a consequence, Eastern Europe has become deeply involved in the larger process of globalisation of production characterizing the international economy, where firms' operations are becoming much more complex and pervasive than traditional arms-length trade and traditional international investment, including both international production and sourcing. Therewith the process of transition to the market appears to be more and more intertwined with Western firms' strategies. It is then of some interest to analyse the extent of such relocation, its various forms and the possible impact on both the relocating and the host countries. International relocation can be analysed from different points of view. The perspective of the present paper is to concentrate on one of the most important trade partners of Eastern Europe - Italy - and on two industrial sectors in which the latter is specialised in production and exports - textiles and clothing, which are also of paramount importance in Eastern Europe's exports.

A few data on production, employment, investment and foreign trade may suffice to show the enormous importance of these industries for Italy. In 1993 this country produced almost 40% of the entire EU production of textiles, including knitwear. The other major EU countries followed rather distanced: France (17% - including household textiles), Germany (16%) and the UK (11%). The corresponding employment for Italy was 30% of the EU total, taking into account also the firms with less than 20 employees. The second most important country - Germany - employed just half of that amount. Finally investment, both total and per head employed, reveals a similar pattern, these two countries being followed by France and the UK.

The ranking is similar in the clothing industry. In 1993 Italy represented 41% of total EU production, 24% of total employment (including firms with less than 20 employees) and headed the investment ranking, both in absolute terms and on a per capita employed basis. It should be added, in this respect, the particular consumption habits of Italians, who devote to clothing a much higher share of their total consumer spending than the other European nationals.

The importance of the internal market is only paralleled by the place of the two sectors in Italian foreign trade. During the last few years Italy has been the second or third world

exporter both of textiles and of clothing products, if one excludes Hong Kong due to the paramount importance of its reexports. She is the first Western supplier of the G7 markets for clothing and first on a par with Germany for textiles. The industry presents the second, and growing, largest positive trade balance in Italian foreign trade. The two sectors together represent 11% of her total exports, but a much lesser share of her imports (5%). However imports tend to grow faster than exports. A growing number of competitors is gaining market shares in the EU, at the expense of the traditional leaders like Italy and Germany.

Import penetration, which has roughly doubled in the last ten years, is but one of the factors that, starting from the late eighties, is exerting growing pressure on the whole industry at a EU level. Production is falling and labour productivity rising much faster than in average manufacturing. The result for the EU has been 639,000 jobs lost in 1988-94, equal to almost 30% of all job losses in the manufacturing industry. Italy was also hit, although less than other European countries for the reasons indicated later.

What is the particular place of Eastern Europe in this process? The CEECs represent only roughly 3% of Italian total trade in textiles, but a much larger share in Italian imports of clothing - 15% -, their importance in Italian exports of the same being minor (2%) (table 1). Almost half of the Italian imports of clothing from Eastern Europe come from Romania and more than one fifth from Hungary, the rest being spread among the Czech and Slovak Republics, Bulgaria and Poland, in the order. Together with an increasing deficit for Italy, the share of clothing in total Italian imports from each CEEC has been increasing recently in all cases, and particularly so from Romania and Bulgaria, where it now stands at 41% and 27%, respectively, and from Hungary (12%).

The two sectors behave asymmetrically: clothing looms from two to eight times larger in Italian imports than exports, while textiles are far more important in Italian exports, at the exception of exports to former Czechoslovakia. This was also the only country with which Italy ran a deficit in textiles (today with the Czech Republic).

Previous studies conducted by the author (Graziani 1993, 1994a, 1994b, 1995) show a generalized relative specialization of the CEECs in most clothing products both on the EU and on the Italian market. Moreover, in both markets import penetration ratios for the same are on the increase.

Does this mean that Italian textile and clothing industry is losing ground vis à vis East European producers? The question is whether international trade data - like surpluses and deficits, market shares, specialization indices and import penetration ratios - by themselves are to be considered reliable competitiveness indicators, if a substantial part of trade flows is in some way or other tied to the importing country.

From this perspective, imports into the relocating country could ideally be divided into three distinct flows: a) 'untied' imports from foreign firms; b) imports derived from non-equity cooperation agreements (in particular from subcontracting) ; and c) FDI-related imports. International relocation of production - taken here to mean not only the physical delocalisation of production abroad, but also the organized sourcing from other countries - affects directly the two latter flows and is then crucial for interpreting the meaning of trade indicators and trends.

## 2) The Italian model until the mid-1980s

International relocation has been almost completely absent in the Italian experience of textile and clothing production until at least the mid-1980s. Contrary to the growing international redeployment of its main EU competitor - Germany -, Italian relations with foreign markets were mostly centered on arms-length exports. The few affiliates abroad of Italian bigger firms had just the task to support the sales network in the recipient country. This explains also why Italy did not incur into the same dramatic employment reduction suffered by Germany, which lost half of it in the last twenty years.

Besides limited FDI, Italian manufacturers did also avoid subcontracting abroad by obtaining its advantages on a purely domestic level.

The logics of subcontracting are well known, all the more so in the textile and clothing industry. Through it, producers look for: 1) lower costs, since the subcontractors do not invoice for indirect costs; 2) more flexible and reactive supply, that can be disposed of in case of ceased necessity; and 3) eventually some expertise and know-how not available in-house.

Subcontracting has always been important within Western Europe. According to a recent survey, in 1992 the clothing subcontracting sector employed in the EU 800,000 workers, including 200,000 artisans and 150,000 illicit workers (Mercer 1994). This is equal to roughly 26% of total EU employment in the textile and clothing industry. Nearly 30% were in Italy and 17% in the UK, the others following suit.

Up to the mid-1980s Italian producers could limit subcontracting almost exclusively within the national boundaries. The following features allowed its coming to life and its efficiency:

a) the main and most original factor was represented by the so-called "industrial districts" (Becattini 1987). Production was concentrating in a small area, with a myriad of interdependent small enterprises, horizontally and vertically specialized in each of the subsectors of the industry. Production of wool in Prato and Biella, silk in Como and knitting

in Carpi are but a few examples of such districts. We are here in a typical Marshallian world of economies external to the enterprise, but internal to the industry, where all the firms, independently from their size, may reap the benefits from a certain clustering of activities. A traditional culture of industrial work, specialized skills both of workers and services, the possibility of rapid exchange of inventions and improvements, coupled with the widespread use of subcontracting, often to the lower paid workers of the so-called informal economy, were enhancing the locational advantages and decreasing the transaction costs, compensating in this way the higher official labour costs vis à vis lower-wage countries (Forti 1994a);

b) most firms were family-run and rather small, a limited number of medium size, as compared to the average West European, while the few larger ones had not yet reached the minimum critical threshold below which a clothing manufacturer is not able to finance the very high costs of internationalization, some of which are typically 'sunk' costs ;

c) the main outlet was represented by the national market, where a very fragmented retail network (in clothing) acted as a relative shelter from foreign competition, limiting the import penetration ratio to a level well under the EU average;

d) progressively, Italian producers had chosen the product differentiation path (especially in clothing), by positioning themselves in the up-market segments, characterized by non price competition and a high fashion-, quality- and value-added content. As one knows, internationalisation of production is all the more convenient the larger the amounts to be produced and the more standardized the productive processes.

e) finally, especially in the textile sector, Italian producers had continually fostered technological innovation, obtaining the highest productivity levels in the world, which allowed them to compete worldwide.

### 3) From domestic to international relocation: the new strategy of Italian firms.

Apart from the progressive erosion of industrialized countries' market shares, by the mid-1980s new features were emerging in the textile and clothing sector.

First of all on the international demand side. Consumption growth started to show the first signs of stagnation, while a general rethinking of the relative value of intrinsic quality as against style was in the making. More in general, a better quality/price relation was sought for. Price elasticity increased also for the high fashion- and quality-content goods. A further factor peculiar to Italy was also at work. Domestic demand started to flatten out at the end of the eighties, bringing it more in line with the demand patterns of the other industrialised countries.

On the supply side, at the domestic level the concentration rate in both sectors was rapidly increasing, while large firms reorganized and diversified their production. At the same time, Italy became a very high cost country, moreover characterized by a rather rigid labour market. Abroad, emerging countries were progressively upgrading the quality of their products, through a continuous learning process. On the whole, price competitiveness tended to become more stringent. Increasing competition was stemming as well from the concentration processes affecting the distribution sector. Large distributors tended to place big orders and to intervene in the choice of styles, quality, timing and service standards (OETH 1994).

A final contingent factor favourable to the internationalisation of production was due to the real appreciation of the lira between 1987 and 1992, which favoured international operations like FDI and subcontracting.

As a consequence, Italian firms started to undergo a rather rapid shift from a purely commercial approach at the international level to a relocation approach. This path was followed not only by large, but also by medium and small enterprises.

Relocation expressed itself in two main ways: non-equity cooperation agreements - licensing, management contracts, but above all subcontracting - with some FDI, in lower wage countries; equity agreements - mostly FDI in the form of acquisitions - at first in the most developed markets;

These two main ways of redeployment obviously respond to different motivations.

At the beginning, relocation in low-wage countries took mainly the form of international subcontracting. The only exception was represented by the textile group Miroglio, which already in 1971 had realized some FDI in Greece, Tunisia and Egypt. In a second phase, the same group has switched to an organization of production based on so called 'platforms', that

have the task of undertaking some downstream operations in the clothing industry and of optimizing the relations with nearby subcontractors.

We have already noted above that the most powerful force behind Italian firms' subcontracting has certainly been the abatement of production costs (cost saving subcontracting). East Europeans subcontractors have been used only in a very minor way as carrying out special functions (specialty subcontracting) or else as capacity reservoirs in case of occasional demand surges (complementary subcontracting).

It can also take various forms. The most widespread is at the start a simple agreement with a local producer in order to buy the final product. At most, the Italian firm bought locally or elsewhere the intermediate products necessary to the productive process. In other cases subcontracting involved the export of semifinished products and the reimport of the finished ones, both without or under the outward processing traffic (OPT) regime.

Very similar in nature to the US operations of offshore assembly provisions in other fields of industry as well, OPT takes place when some phases of the textile and clothing production chain - typically: the sewing phase - are carried out by foreign subcontractors. The latter utilise fabrics provided (and owned) by the subcontracting firm, temporarily exported towards the processing country under an EC tariff exemption regime. Up to the entry into force of the Interim Agreements of the EAs customs tariffs were levied only on the value added abroad. Since then, they were abolished altogether.

On the other hand, acquisitions in the most sophisticated markets allowed Italian producers to attain several objectives: a) to acquire prestigious brand names; b) to adhere more closely to the host nation's consumers' tastes, especially in the medium segments absorbing large amounts of production, and gain market shares from within, keeping a presence in strategic markets; c) possibly, to penetrate third markets and also reimport part of the production; and d) to use the international subcontracting network of the acquired company, especially if it is German.

So Marzotto, one of the top textile group in Italy, has acquired the German clothing company Hugo Boss, with a lengthy experience of subcontracting abroad, mainly in Eastern Europe. The aim is to have in a few years half of its production abroad. Another big group, Miroglio, has secured smaller, but more numerous firms: the clothing companies Caroline Rohmer and Sym Claverie in France and Glaeser, Flick, Skarabeus and Gili in Germany, plus the German textile company Steiger&Deschler (Ulmia). Finally GFT acquired the third German clothing producer, Baumler.

#### 4) EU and Italian outward processing traffic with Eastern Europe: the statistical evidence



As could be easily expected, no precise data exist on the above cited various forms of subcontracting, at the exception of OPT, due to its special tariff regime. This is why the latter will be more closely analysed as an indirect indicator of subcontracting trends, although by no means covering the whole phenomenon.

EU's official trade data allow us only to distinguish 'direct' imports from OPT imports, plus the temporary exports for reimport. The latter are much more important in the textile sector than in the clothing one, which confirms that textile semifinished products are shipped abroad in order to be processed and then be reimported. Since we are here more interested in the processing phase and its end result - mostly the clothing product - our attention will concentrate on import flows.

European Union's OPT imports of MFA clothing products from extra-EU have dramatically increased in recent years. In 1988-1993 their volume in tonnes have risen by 126%, while their share of total imports has passed from 8.1% to 10.1%. Estimates for January-September 1994 indicate a further increase of 18% in volume and the reaching of nearly 12% as a share of total imports of clothing (OETH 1995). The share of the remaining imports ('direct' imports) has fallen accordingly (Table 2).

Germany is the leading OPT importer, with 63% of the total for the EU, followed by Italy (10%), France (9%), Benelux, Denmark and the UK following suit. From a mere quantitative point of view, OPT imports seem thus to have increased their role in the competitive strategy of EU clothing firms. The relative importance of OPT trade in clothing, and for Italy in particular, may be gauged if one compares the above cited data with the ranking of the different EU countries in OPT total trade, that is in all industrial sectors. Here Germany comes again first, but with a lower share (53%), France second (15%) and Italy only third with 12% of the total EU (our calculations from Eurostat). Here too, the progression of the Italian position was very swift, in 1988 being still only fifth with a mere 6% of the total.

Two features deserve particular attention. The relative importance of OPT for individual countries does not follow exactly the ranking given above. In 1993 the share of OPT imports in total clothing imports (in tonnes) was at its peak (16.2%) again for Germany, followed this time by Denmark (14.8%), Italy (9.4%), Benelux (8.4%) and France (7.5%). In 1994 Italian OPT imports have swiftly increased to 15.3% of total imports, placing her just behind Germany (19.6%).

The trend over the period is even more enlightening. Germany, Benelux and France were already substantially engaged in OPT trade with extra-EU countries at the beginning of the period. On the contrary Italy is a real newcomer. In 1988 Italian OPT trade was still minimal (0.4% of total MFA clothing imports - table 2). In six years, and especially over the

last two years, Italian producers have forcefully caught up the gap, showing the fastest rate of increase among the countries under consideration. This is all the more striking, if one considers that in the same period Italian clothing imports more than doubled. On the other hand, France and Benelux even decreased slightly their respective shares of total EU OPT clothing imports. In fact, France was the only EU country to diminish the share of OPT imports in her total imports of clothing. However her position might be grossly underestimated. Official statistics can not take into consideration the extensive amount of imports from the Mediterranean countries which importers have little incentive to declare as OPT, given that trade with those countries is conducted under Preferential Agreements granting tariff free access to clothing imports. Given the traditional links between France and the North African producers, her importance appears accordingly underestimated.

Finally, as could be expected, the share of OPT imports in total imports of textiles in 1994 was much lower: 1% for the whole EU, 3.6% for Germany, 1.2% for France, 0.8% for Italy and 0.4% for the UK. The relative importance of Germany in total EU textile imports is even bigger than in the case of clothing (almost 80%), while Italy has overtaken France in the second position (16%). Here too, OPT imports have grown faster than total imports in the period 1988-94 (OETH 1995).

Since the 1980s Central and Eastern Europe has been at the core of EU OPT trade. Considering OPT imports in all industrial sectors, the whole region, including former Yugoslavia, was already the most important in the world in 1988 for the EU. After the disintegration of Yugoslavia, the CEECs not only absorbed the loss in her share, but even gained another 5% to reach 38% of the world total in 1994, as against 20% for Asia and the Pacific, 13% for North America and 9% for the Mediterranean countries, just to cite the most important sources (our calculations from Eurostat). An even larger part of OPT trade in the clothing sector is conducted with the CEECs: more than half according to official statistics, 43% if we take into consideration the underestimation of the Mediterranean countries (which would, as a consequence, attain first place with almost 50% (OETH 1995).

Given the profound asymmetry characterizing total EU-CEECs trade (Graziani 1993, 1994a, 1995), OPT operations weigh much more in total exports of the East European countries than in total imports of the receiving EU countries. OETH estimates based on 19 clothing categories suggest that OPT imports into the EU loom very large in imports from Poland (78%), Hungary (72%), Slovakia (65%), the Czech Republic (58%), Romania (53%) and Bulgaria (45%). In half of the 19 MFA clothing categories for Poland and Hungary the share is even higher than 80%. Generally speaking, shares tend to be lower for shirts, T-shirts and pullovers, while higher in categories involving tailoring operations and wool fabrics (OETH 1994).

Table 3 shows the relative importance of the two sectors in total Italian OPT imports. Since ISTAT does not publish separate statistics for OPT, I have taken the so called "reimports following temporary exports", which is a larger measure of subcontracting going on. The data concern "non EU Europe", mostly represented by Eastern Europe. One further limitation to the analysis derives from the fact that clothing does not appear by itself, but is bundled together with footwear, leather articles and other accessories. Be that as it may, clothing et al. (23.4% of the total) come second in importance after electric lamps and parts (31.4%), on a par with airplanes and parts (23.4%) (these latter being probably more important in operations with some non Eastern European countries, like EFTA). Textiles represent only 6%, the rest being various machinery and chemicals.

From the same table one will note that the highest share of reimports from non EU Europe in total reimports is in clothing et al. (87.5%), followed by electric lamps (87.1%) and textiles (83.2%).

The particular importance of the CEECs for Italian OPT imports in the textile and clothing sectors can be better understood from table 4, which shows a more disaggregated analysis. In 1994, the reimports from the CEECs as compared to the reimports from the world were the following: more than half for textiles, of which more than three quarters for cotton fabrics (almost wholly concentrated in Hungary), more than 65% for continuous filament fabrics (again concentrated in Hungary), more than one third for wool fabrics (Poland), more than half for hosiery (Hungary) and more than 60% for knitwear (evenly spread). The data for clothing reach almost three quarters (mostly from Romania and Hungary), of which more than 80% in women's outerwear and in men's underwear.

That Italian OPT trade in textiles and clothing is particularly oriented towards the CEECs can further be derived from table 5, which shows the OPT specialization coefficient for Central and Eastern European countries, calculated as the ratio between the OPT share in Italian imports from each CEEC and the OPT share in Italian imports from the world, for the same commodity groups seen above. The results are very revealing. In three commodity groups - knitwear, men's and women's outerwear - the OPT share from all the CEECs is at least four times larger than the same share from the world. Even larger values are obtained for a limited number of countries in the other commodity groups, like cotton fabrics and continuous filament fabrics (Hungary), wool fabrics (Poland), hosiery (Hungary and Romania), men's underwear (Hungary and Bulgaria).

In order to show the contribution of OPT to the dynamics of Italian imports from the CEECs in the three large subsectors of the industry, I calculated in table 6 the dependency ratio on OPT in the period 1988-94 for each CEEC and for the world average, as a comparison. At the world level, the clothing sector's imports are dependent upon OPT for one

fifth of their growth, knitwear and hosiery for 13%, the other textiles only marginally. This dependency, and consequently the contribution of OPT, is from three to four times larger if we consider the CEECs, with peaks of more than 90% in knitwear imports from Poland and Bulgaria, or in clothing imports from Romania (the latter from Poland and Hungary being higher than 80%). In all three sectors former Czechoslovakia is relatively less dependent on OPT, while Hungary is the only country in which other textiles have contributed more than the other subsectors.

All in all Italian OPT imports are very concentrated. In value terms, in 1994 Romania was the largest supplier of OPT clothing products (50% of total Italian OPT clothing imports from Eastern Europe), followed by Hungary (28%), Poland and Bulgaria (8% each) and the Czech and Slovak Republics (7%) (rounded figures calculated from ISTAT). It should be noted that Poland is relatively less, and Romania relatively more, involved in OPT with Italy than with the average EU.

#### 5) The OPT system and its revision.

Until 1982 OPT was undertaken inside the MFA quotas for global textile and clothing imports. Being a temporary export of fabrics mostly for cut, make and trim (CMT) operations, the eventual filling up of quotas would have made it impossible to re-import the finished product. The 1982 regulation established an ad hoc regime, under which specific OPT quotas were set and reserved for EU producers of goods similar to those to be obtained with the outward processing.

Two particular features are of special interest to the present analysis. The EU firms could obtain the right to the benefit only within the limits set by their own government. In this respect, German and Dutch regulations appeared soon much more flexible and permissive than the Italian ones. Moreover, OPT quotas were initially distributed according to the situation existing at that moment, i.e. Germany and the Benelux countries obtained much higher quotas than Italy. Given the strategy of domestic relocation followed at first by Italian manufacturers, there was little incentive for the system to change (Forti 1994b).

In the second half of the 1980s, Italian producers' started pushing ahead international relocation, hitting against the rigidity of national regulation on OPT and claiming quotas as high as their EU competitors. Moreover, as already indicated, the Association Agreements established that reimported OPT goods were duty-free, while reimports within normal MFA quotas continued being subject to current tariffs. As from 1st January 1993, the European single market substituted one undistributed community quota (for every couple of product/country of destination) to the existing national quotas. Finally a new regulation was

approved in December 1994 which included many of the previous or more recent features. Such are for instance the requirement of the similarity between the products imported and those produced in the EU or the one quota at the EU level.

It is very likely that under the new regulation Italian firms should obtain a more equitable treatment than before. Some features of the new regulation, however, seem still to favour entrenched positions of competitors like Germany. Such are the proposals that the value of outward processing can be no higher than 50% of the value of the EU production and that the OPT firms can use non EU materials only up to 14% of their total value of exports.

While the elimination of EU tariffs on OPT imports from the CEECs might explain the recent relative boom of this type of subcontracting, the restrictiveness of the new proposals, coupled with the rate of growth envisaged in OPT clothing quotas for 1993-1995, which are definitely lower than actual growth of imports in 1990-1992, seem to point to a possible brake on OPT expansion in the next future (Corado 1995). As for the CEECs, it should naturally be borne in mind that OPT as a tariff system is doomed to disappear in 1998, when the last tariffs on non-OPT imports will disappear too.

#### 6) Italian FDI in the East European textiles and clothing sector.

Parallel to the explosion of OPT trade with the CEECs, relocation of Italian firms has taken also another more classical form, foreign direct investment (FDI). One could even dare say 'notwithstanding OPT'. In fact, OPT quota regulation has de facto tended to favour OPT imports, which benefited at first from lower, and later from zero, tariffs, vis à vis 'direct' (non-OPT) imports, which face the tariffs still in place in the EU. The point is that 'direct' imports include not only 'untied' imports from foreign firms, but also imports related to non-OPT cooperation agreements (mainly subcontracting) and to FDI. An EU firm will be much surer of being able to re-import its products if it operates under the OPT scheme, than if it simply tries to re-import its products through other subcontracting arrangements or from its foreign affiliates.

In general OPT seemed often the best answer to increasing competition and rising labour costs at home. As an alternative to FDI, it apparently offered national production the well known locational advantages, without having to move capital or to enter equity ventures.

All the same, especially over the more recent years, Italian FDI in Eastern Europe has started to take place also in the textiles and clothing industry, even if it is true, as generally affirmed, that contract agreements are normally preferred in labour-intensive sectors with low technological content.

Official data on the value of Italian FDI do not present a sufficient disaggregation and geographical distribution. I chose then to elaborate on the *database* Reprint of the Politecnico di Milano, which contains data on FDI only in terms of number and types of operations, employment and value of the turnover. The fact that these data concern only productive facilities does not appear to represent a major drawback, since only a minority of equity operations seems to have been established in the commercial sphere. FDI is here defined as that investment destined to acquire durable interests (control, equal shares, minority) in a new or existing enterprise. In accordance with the IMF criteria, portfolio investment is excluded.

Table 7 shows the place of Italian FDI in the textiles and clothing sectors in Eastern Europe as compared: (A) to Italian FDI in all industries in the same region; (B) to total Italian FDI in the world.

Altogether, at the beginning of 1994 Italian manufacturers had invested in 23 East European enterprises, net of disinvestment (Tab. 7A)

As for the CEECs involved, Hungary seems to be the preferred location, with more than one third of the entire operations (9), followed by Romania and Poland with 5 operations each, by Bulgaria with two and finally by the Czech Republic and Slovakia with one operation each (another investment operation was undertaken more recently, in 1994, by Marzotto in the Czech Republic, but is not included in the database). As already seen in the case of OPT, here too then Hungary seems to be the preferred partner and Romania occupies a relatively more important position for Italy than for the EU average.

However, if we take the relative importance of Italian FDI in textile and clothing vis à vis FDI in all industries, Romania and Bulgaria come first: 29% of all Italian FDI in these countries has been made in the textile and clothing sectors. The corresponding figures for the other CEECs are the following: Hungary 20%, Poland and Czechoslovakia 18%. By way of comparison, the same share in Italian total world FDI is only 9%. It seems plausible to affirm, as a consequence, that Italian FDI in textile and clothing is particularly oriented to Eastern Europe.

Table 7B shows clearly the peculiar 'textile and clothing investment orientation' towards the CEECs characterizing Italian firms. Only 7% of the Italian world FDI in all industries is destined to Eastern Europe. This share however almost trebles - to 18% - if one considers Italian textile and clothing FDI in the CEECs as compared to total world Italian FDI in the same sectors. A similar picture emerges if one looks at employment and turnover data. 34% of all the employees of the Italian affiliates in the textile and clothing sector in the world work in Eastern Europe; this share falls to 12% if we consider all industries. Finally, turnover follows a parallel path: 7% as against 3%.

Most of the FDI operations are very recent. All of them have taken place between 1990 and 1993, the only exception being one greenfield investment in Romania in the early 1970s. In fact, most of them concentrate in the last three years, with the following distribution: 3 operations in 1990, 8 in 1991, 4 in 1992 and finally 7 in 1993.

Although the numbers involved are still limited, as is also the time period, it is nevertheless of some interest to analyse various aspects connected with them. 18 Italian companies are involved in the 23 operations. Three of them in fact have entered upon more than one operation : Cantoni (4), GFT and Romalfa (2 each). Half of the 12 major Italian groups in the textile and clothing industry are present in Eastern Europe. To confirm the particular dynamism of large companies and their new strategy, it should be remembered that this FDI often goes hand in hand with further investment in other countries and OPT imports from the same and from other countries in the world.

Local companies formed through FDI are, as expected, relatively small. Only five of them employ more than 600 people and only two have more than 1000 employees.

As for the sectors involved, textiles and clothing operations are almost evenly split: 11 and 12, respectively. Regarding textiles, one third of the investment concerns the cotton industry, the others being rather evenly distributed. This relative importance of textile investment seems to suggest some support activity for the clothing operations in loco.

Concerning the type of operations, there does not appear to be a precise predominance of setting up entirely new enterprises vis à vis acquisitions of existing ones: greenfield investment is for the moment just over one half of the total (13 as against 10). There is on the contrary a definite preference for control operations: majority shareholding and other forms of control are present in 70% of the operations. Equal shareholding appears only once, the rest (26%) being minority holding.

What are finally the basic motivations behind Italian FDI in Eastern Europe? Applying, with some minor adaptations, the subdivision proposed by Dunning (1993), the majority of it has followed a 'resource seeking' logic. This motivation was cited 20 times (71% of the total) by the respondents, 19 of which as the main motivation and 16 as the exclusive one (Tab. 8). In the East European case, these 'resources' sought for are not so much scarce natural resources, but prevalingly low cost labour plus in some case skilled labour. Most of the time the products obtained in the process are meant for reexport. A 'market seeking' behaviour - that is the search to penetrate the recipient or other nearby markets through the affiliate - is only cited 7 times, 4 of which as the main motivation (all in Poland), 2 of which as the exclusive one. One will note here that the extension of the Polish market vis à vis other countries seems to be the main explanation for these differences in behaviour. Finally, 'support investments' - that is destined to favour the parent firm's exports, distribution and

after-sales services - have been cited only once, moreover as a second motivation after 'market seeking' (Legler Polonia). Interestingly enough, this local affiliate of Italian Legler supplies denim material to many plants all over Europe, including VF Corp.'s (Lee and Wrangler jeans) affiliates.

As expected the order of importance of these motivations is rather different from motivations underlying the rest of Italian industrial investment in the CEECs. In the latter case (83 operations) market-seeking investment holds first place (54 citations) only followed at a distance by resource-seeking (40), while support investment is relatively less important (6). This seems to be in line with the general perception of roughly 60 companies from other OECD countries as interviewed by Arthur Andersen in 1993-94 (CCET 1994).

### 7) Non-equity cooperation agreements

When Italian textile and clothing companies could not attain a sufficient external penetration because of a lack of resources necessary to FDI, but still wanted to go beyond pure commercial transactions, non-equity agreements were the third main strand at their disposal. Their peculiar nature of being a very flexible instrument, adaptable to changing international commercial strategies, made it usable by large and medium-small companies alike.

Data on non-equity agreements (NEAs) are scanty. We refer here to the best data bank available in Italy - from the Osservatorio Acquisizioni e Alleanze di Modena -, which relies on indirect sources. Although some caution is consequently required, it is nevertheless interesting to show a few recent broad trends.

Like other forms of international operations, NEAs become more numerous in the second part of the 1980s, although the CEECs still represent only about 10% of the total the world over. Considering the period 1989-96, it appears clearly that, as in the rest of the world, in the CEECs too Italian textile (as opposed to clothing) firms show a very limited recourse to such an instrument (table 9). Out of 13 NEAs, only 2 seem to belong to textile firms, both in former Czechoslovakia, the rest being used by clothing companies.

As for the relative importance of the CEECs involved, NEAs seem to be relatively more numerous with former Czechoslovakia (4 operations), while the other countries, ranked in descending importance, appear to show a pattern similar to the one already shown for OPT and FDI, with Romania and Hungary taking the lead (3 operations each), followed by Poland (2 operations) and Bulgaria (only 1).

Finally, the content of the agreements does not seem to be especially skewed towards any particular form, the productive aims being just slightly prevailing over distribution and



know-how transfer (5 operations as against 4 each for the two latter forms). It is interesting to note, however, that the productive nature of such agreements is relatively more pronounced than in the relations of Italian firms with the Far East, the USA and Japan.

All in all, then, the pattern of non-equity agreements seems to confirm that this third form of international ties too supports the broad trend towards relocation experienced by Italian textile and clothing companies starting from the late 1980s.

## 8) Reasons and features of Italian relocation

After the empirical analysis of Italian OPT and FDI with Eastern Europe, it is of some interest to examine more closely the reasons justifying international relocation and its features in the textile and clothing sector.

The root drive pushing for relocating parts of the productive process abroad is, as shown above, the increasing competition from low wage countries and the necessity to combine the high productivity and technological level at home with the lower labour costs abroad.

But the technical conditions allowing it are also fundamental. In the clothing industry pre-assembly activities (that is designing, grading and marking of patterns, cutting) have increased ever more their capital-intensiveness through progressive automation, while assembly operations (mainly sewing - accounting for about 80% of the value added -) are still very labour-intensive and relying mostly on conventional sewing machines. The application of modern telecommunication networks has allowed for the separation of these two productive stages without sacrificing quality and efficiency (OECD 1994).

According to empirical evidence and personal interviews, Italian manufacturers tend to keep at home the global study, product development, organization and commercialization phases, while relocating the productive phases in low labour cost countries. Progressively, companies tend to maintain in Italy only the productive structures that are capable of responding to small runs and emergency orders in very brief delays or else in upmarket and niche production, requiring specific expertise. From the cost point of view, relocation is more convenient the bigger and more standardized are the amounts of products required. In this sense, the bigger the dimension of the firm, the higher the frequency of relocation should tend to be.

Some changes have however taken place within this general perspective.

- In the past, relocation was confined to the easiest tasks of the productive process. It appeared more convenient to relocate simpler products, more adequate to the skills of the local labour force. This perception is undergoing a thorough revision from two points of view.

First, clothing manufacturers are coming to realize that it is probably less convenient to relocate just the simplest tasks, since they are the ones that can more easily undergo a process of automation and consequently be kept at home. In several cases, the complexity of the operations requires comparatively more human labour inputs, which are cheaper in the recipient countries. The recent acquisition of 80% of the Slovak firm Svikon by GFT to produce men's jackets, one of the most complex clothing operation, is a clear example of such new attitude.

Second, there has been a generalized growth of the average quality level of subcontractors through the learning process. This, among other factors, is pushing more and more Italian entrepreneurs to consider international relocation within a strategy of global reorganization, where subcontractors are seen as pivotal in the supply also of complex and high quality products.

- Traditionally, relocation was limited to lower-middle market products. Today, as a consequence of the changes seen above, redeployment occurs also for the upmarket segments of production and starts to become part of the strategy of smaller, more specialized firms too. It should be remembered that relocation is developing in a cumulative way and by imitation, insofar as also smaller companies come to secure the necessary information.

- Generally speaking, relocation in the textile industry is of lesser importance than in clothing. There are mainly two reasons for this. One is that EU producers, and Italian ones in particular, are more competitive in the more capital-intensive and technology-intensive processes, that characterize most of the textiles production. Suffice it to remember that labour cost is equal to roughly 35-40% of the final product's cost in clothing, while representing 12-16% in weaving and spinning. The second reason is institutional, that is the requirement by OPT regulations that fabrics sent to the subcontractor be of EU origin.

Relocation in the clothing industry is however pulling also relocation in the textile sector, because of the need for the two industrial segments to be geographically close. So, in recent interviews of a sample of 200 firms from six EU countries, 23% of the textile firms interviewed declared having established or preparing to establish a foreign production unit, having as a major area Eastern Europe (Scheffer 1994). Italian producers seem to have gone a long way in a short time towards this direction. The data presented above show that almost half of the FDI operations are in the textile sector (11 out of a total of 23).

### 9) Why relocating to Eastern Europe?

From what has been said up to now, the particular attraction of Eastern Europe as a site for redeployment is understandable.

First, its labour costs are much lower than in Italy or the EU average. In spinning, weaving, dyeing and finishing, total cost per hour in summer 1993 was, compared to Italy, 11% in Hungary, 9% in the Czech Republic, 8% in Slovakia; by way of comparison, they were 2% in China (our calculations from Werner International). According to personal interviews, labour cost per minute in Italian structured clothing firms at the end of 1993 was 350 liras; subcontracting in Southern Italy 280; in Poland and Hungary 55; in Slovakia 40

and in China 20. Apparently, the cost gap of low wage countries with the EU has widened in recent years (OETH 1994).

Labour productivity differences do not offset these large cost gaps. In the three CEECs cited above labour productivity, as measured in terms of value added per employee, reaches between 80% and 90% of the Italian level (which is the highest in the EU), while China reaches 70-80% (personal interviews). Indices of relative productivity estimated by Werner International show a much wider productivity gap: compared to Italy, Hungary, the only CEEC present in the ranking, would be at 45% in spinning and weaving and at 50% in clothing. But even this advantage for Italy would not offset the cost disadvantage. In 1993 Italy had the highest estimated unit labour cost index (labour cost index/productivity index) in the world in clothing and the fourth largest in spinning and weaving. As a comparison, the same for Hungary stood at 17% and 25% of the Italian level (our calculations from Commission 1993).

But all this would still not be enough to justify the choice of Eastern Europe. China or other low wage Asian countries would be preferred. Besides labour cost and productivity, other factors are considered to be determinant for the location of production.

The latter do not concern product quality, which is very often the same as in Italy, since the fabrics, the machinery and the working methods are those employed in the Italian factories.

What instead makes the real difference is the geographical and cultural proximity, coupled with the quality of the labour force. East European countries offer in fact delivery times of two three days, as against 45 days by ship from Asia. This general possibility of quick response to market demand goes hand in hand with the existence in some of the CEECs of a long tradition of production in the sector: in clothing, especially Poland, followed by Hungary; in textiles former Czechoslovakia, which also has a long standing tradition in the production of textile machinery. It should be added that Romania and Bulgaria are rapidly upgrading the ability of their working force in clothing production, also thanks to foreign investment and technical advice.

#### 10) Costs and benefits for the host countries

Is this shifting of production a good thing for the host countries?

Actually relocation could rightly be a matter of growing concern, since several drawbacks might ensue from it.

First, in the longer run host countries might get 'locked in' their present structure of revealed comparative advantages, based on highly labour-intensive activities, while the

exploitation of potential comparative advantages in higher-tech stages of production would be delayed.

Second, a certain share of the national production and exports would strictly depend on foreign firms decisions and performance, hence increasing economic vulnerability. OPT imports being decided by EU firms, this is also an indirect indicator of dependency of Eastern Europe's clothing industry upon the strategies of the former. Subcontracting, by its very nature, makes the subcontractor very vulnerable: a change in conditions, like a wage rise or a fall in productivity, would push to rapid withdrawals of the foreign partner.

Moreover, in the case of the OPT system, which obliges to import textile fabrics of EU origin, the local textile industry would be prevented from developing fully. The dependence on the foreign partner is thus double edged: input-wise and output-wise.

Fourth, it might entail a lasting downgrading of some activities. The case of companies losing their former profile in order to adapt to the foreign customers' needs is not unfrequent. Besides the fact that some functions, like R&D, marketing, financing, might even disappear, since they are provided by the partners.

Finally, regional inequalities might be strengthened, as these activities tend to cluster around particular zones.

Should OPT or other forms of subcontracting then be avoided? The fact is that in many instances firms which enter into such a kind of relationship have no better choice in order to expand their production and exports. For some of them it could even be a matter of life or death.

Furthermore, it certainly should enhance employment and industrial capabilities among the labour force, while imitation and various types of backward and forward linkages could materialise with related industries. These benefits derive from three main sets of factors: East European firms a) secure a guaranteed outlet and are able to market their products under the brand name of their customers and through their distribution channels; b) avoid storage costs of both inputs and output; and c) acquire high quality inputs, capital, technology and managerial experience delivered by the Italian partner. In this respect, the learning process stems from doing at the principal's specifications, but also from direct training often provided by Italian firms.

The crux of the matter is however whether local firms can stand up to international competition once non equity forms of relocation (mainly OPT) should come to an end. Previous historical experiences, like Portugal's, seem to point to a positive answer. It is however questionable whether the Portuguese experience, with its longer opening to the world market, is really relevant in the East European case, only recently fully reintegrated into the international economy. A recent survey of more than 20 firms in the Czech Republic

and in Hungary has showed that only one of them has turned a previous OPT relationship into autonomous production and sale under its own brand (Pellegrin 1996).

### 11) The possible impact on the relocating economy

The impact on Italy might also be ambivalent and probably different in the short and in the longer term. Insofar as subcontracting and FDI represent a substitution of domestic production and a derived demand for foreign cheaper labour, they also tend to induce a contraction of domestic production and employment, and likely of exports, plus the possible erosion of the domestic supplier base. Particular production phases (i.e. assembly activities) and lower-skilled workers tend to be penalised, while the other productive segments and the higher-skilled labour force might on the contrary even be favoured by such a process. By influencing relative factor prices, relocation tends to influence income distribution as well. Industrial restructuring schemes, coupled with intensive workers' retraining, appear here as necessary measures.

One might however suggest that, even with no relocation, the reduction in domestic employment would take place anyway, due to increased challenge from foreign competitors. In this respect, the job losses seem to be caused by a whole range of factors, like productivity gains, competition from other EU redeployers (higher quality segments), relocation to and competition from cheaper labour countries (lower quality productive segments). The latter aspect is further going to gain in importance with the progressive abolition of MFA quotas and the consequent full reestablishment of LDCs' competitive advantage. In this respect, the losses will tend to be lower, the deeper the firms' process of redeployment.

In the longer run, the firms undertaking the various forms of relocation could succeed in enhancing their international competitiveness (that's why they undertake it in the first place!) and, by consequence, expand also their domestic production and exports, thus tending also to offset the initial employment reduction. Meanwhile, relocation, especially under the OPT form, increases Italian clothing firms' flexibility, externalizes some of the production costs and risks and certainly strengthens the position of domestic textile producers, given the requirement of fabrics being of EU origin.

Whether and how far this process will go on is to be seen in the years to come. Certainly the progressive application of the results of the Uruguay Round as from 1995 are bound to represent a powerful incentive to further strides in the globalisation path. On the other hand, the devaluation of the Lira after the end of 1992 might limit, until it holds, the FDI form of relocation.

## 12) The globalisation of the textile and clothing industry: is relocation a one way street?

A few general remarks can be drawn from our empirical analysis.

- The textile and clothing industries are undergoing a rapid process of globalisation in production, as it is also happening for other industrial sectors. Even countries which, like Italy, seemed to privilege domestic subcontracting and limited outward FDI, are now following the more general trend. The microeconomic foundations of globalisation are clearly at work in this case as well: firms' motivations and strategies - in particular Italian firms' desire to restore deteriorating international competitiveness - appear solidly to drive the process.

Although deeply involved in globalisation, some of these so called traditional sectors seem however to behave in a rather different way from other more technology-intensive sectors.

First of all, they do not seem to have gone very far in the globalisation path. Here clothing appears less advanced, if we consider two usual indicators of globalisation, such as international sourcing of intermediates and especially intra-firm trade. The textile industry, with its more global sourcing of intermediate inputs, seems to be slightly far ahead.

The main motivation seems also different. In the more technology-intensive sectors market potential appears to be the principal aim of FDI and subcontracting, while labour cost does not loom very large any more. The contrary seems to be in the case of some very labour-intensive stages of production of the clothing industry, which still represent most of its value-added.

- As previously shown, the technical conditions of production and even more so the application of modern telecommunication networks have only made easier the geographical separation between the more labour-intensive assembly phases and the capital-intensive pre-assembly stages in the clothing industry. The fact that also more complex clothing operations tend to be relocated, while small and medium clothing enterprises and some textile operations start to be pulled in the game, seems to reinforce the perception that low-wage industrialising countries might still consider these sectors as possible candidates for the first industrialization phase.

- However, this process of international relocation might not be as linear as it could appear at first sight. The main reason lies in the new model of production characterising a large part of the industry. Like in other industries, also the sectors under consideration have started requiring a system of lean production, that is just-in-time deliveries, short runs, smaller orders, low inventories and high quality. This is all the more evident in the fashion-oriented industry, where fashion trends emerge and collections follow each other with a

much higher frequency than they used to. Within this perspective, transport costs and, above all, geographical proximity and delivery times tend to be of paramount importance when deciding an outward FDI or a subcontracting operation. In some cases, these factors may even offset the lower labour cost advantage and push to keep the activity at home. When this is not the case, they would certainly push investors to choose the closest locational sites, thus reinforcing the regional agglomeration of the globalisation process, as evidenced also for other industrial sectors. Such a tendency is certainly strengthened by regional preferential agreements, as is the case of the EU association agreements with the CEECs and the particularly favourable OPT regime. In this respect, as far as Italy and the EU are concerned, Eastern Europe offers rather obvious locational advantages vis à vis other lower wage, but more distant Asian producers.



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**TABLE 1** - Structural data of textiles and clothing in the major EU countries

TEXTILES				
	Production 1993, in % of EU total (incl. knitwear)	Employment in 1993, in % of EU total (incl firms with less than 20 empl.)	Total investment in 1992, in mn ECU	Investment per employee, 1992, in ECU
Italy	36.6	30	1,266	4,890
Germany, West	16.3	15	906	4438
France	16.7 (incl. household text.)	13	678	3,910
UK	11.1	14.4	396	2,104

CLOTHING				
	Production 1993, in % of EU total	Employment in 1993, in % of EU total (incl firms with less than 20 empl.)	Total investment in 1992, in mn ECU	Investment per employee, 1992, in ECU
Italy	41.4	24	278	2,165
Germany, West	17.2	15.5	198	1,377
France	17	15	272	1,631
UK	11.1	16	111	724

Source: Commission (1993); OETH (1994)

**TABLE 2** - The importance of textile and clothing in Italy-CEECs trade, 1993

A) Share of the T&C sector in total Italian trade with the CEECs

	Bulgaria		Czechoslovakia		Hungary		Poland		Romania	
	EXPORTS	IMPORTS	EXPORTS	IMPORTS	EXPORTS	IMPORTS	EXPORTS	IMPORTS	EXPORTS	IMPORTS
Textiles	12.4	10.3	6.4	8.2	9.2	4.4	7.3		2.5	
Clothing	9.3	27	3.2	7.5	4.1	12.4	1		3	

B) Share of individual CEECs in Italian imports of clothing from Eastern Europe, in %

	Bulgaria	Czechoslovakia	Hungary	Poland	Romania
	12.4	12.9	22.9	6	45.8

C) Share of Eastern Europe in Italian trade of T&C with the world, in %

	Italian exports	Italian imports
Textiles	2.9	3.2
Clothing	2.3	14.9

Source: calculated from ISTAT

**TABLE 3** - OPT clothing imports as % of total MFA clothing imports

	1988	1990	1992	1993
EU	8.1	9.3	9.9	10.1
Germany	13	14.7	15.8	16.2
Denmark	5	8.2	13.2	14.8
Italy	0.4	0.9	4.7	9.4
Benelux	9.3	9.6	9.9	8.4
France	7.7	9	8	7.5

Source: OETH (1994).

TABLE 4 - Italian reimports from temporary exports to non EU Europe, by sectors, in %, 1993

	Italian reimports from temporary exports to non EU Europe, by sectors, in % of total reimports from the same	Italian reimports from temporary exports to non EU Europe, by sectors, in % of total reimports from the world
Electric lamps and parts	31.4	87.1
Clothing, footwear, leather articles	23.4	87.5
Airplanes and parts	23.4	40.4
Textiles	6	83.2
Machinery	5.6	29.2
Chemicals	3.4	62.3
Precision instruments	2.8	29.7

Source: calculated from ISTAT

**TABLE 5** - Relative importance of OPT clothing imports, 1993

	(A)	(B)
	Italian OPT clothing imports in % of total Eastern Europe	EU OPT clothing imports as % of total clothing imports
Bulgaria	5.8	45
Czech Republic	10.4	58
Slovakia	"	65
Hungary	41.8	72
Poland	8	78
Romania	34	53
Total above	100	—

Source: (A) author's calculations on ISTAT; (B) from OETH (1994).

**TABLE - 6** - Relative importance of Italian textile and clothing FDI in the CEECs, 1993

<b>(A)</b>						
	Number of firms in the T&C	Number of firms in all industries	Firms in T&C/firms in all industries in %			
Bulgaria	2	7	28.6			
Czech & Slovak Rep.s	2	11	18.2			
Hungary	9	44	20.5			
Poland	5	27	18.5			
Romania	5	17	29.4			
Total above	23	106	21.7			
World	127	1459	8.7			
<b>(B)</b>						
	Number of firms in the T&C	Number of firms in all industries	Number of employees in T&C	Number of employees in all industries	Turnover in T&C	Turnover in all industries
FDI in CEECs/FDI in World in %	18.1	7.3	34.1	11.7	7.4	3.2

Source: author's calculations on database Reprint, Politecnico di Milano



**TABLE 7** - Motivations behind Italian textile and clothing FDI in Eastern Europe

	<u>Number of citations</u>	<u>Main motivation</u>	<u>Exclusive motivation</u>
Resource-seeking investment	20	19	16
Market-seeking investment	7	4	2
Support investment	1	none	none
Total number of firms	23	23	23

Memo item: all industries  
excluding the T&C

Resource-seeking investment	40
Market-seeking investment	54
Support investment	6
Total number of firms	83

Source: taken or calculated by the author from database Reprint, Politecnico di Milano.

**TABLE 8** - Motivations behind Italian textile and clothing FDI in Eastern Europe

	<u>Number of citations</u>	<u>Main motivation</u>	<u>Exclusive motivation</u>
Resource-seeking investments	20	19	16
Market-seeking investments	7	4	2
Support investments	1	none	none
Total number of firms	23	23	23

Memo item: all industries  
excluding the T&C

Resource-seeking investments	40
Market-seeking investments	54
Support investments	6
Total number of firms	83

Source: taken or calculated by the author from database Reprint, Politecnico di Milano.

**TABLE 9** - Non-equity agreements of Italian textile and clothing firms.

<b>Country</b>	<b>Number</b>	<b>Clothing</b>	<b>Textile</b>	<b>Distribution</b>	<b>Production</b>	<b>Know-how</b>	<b>Mixed</b> (prod.-distrib.)
Bulgaria	1	1	0	0	0	1	0
Czechoslovakia	4	2	2	0	2	2	0
Hungary	3	3	0	2	1	0	0
Poland	2	2	0	1	1	0	0
Romania	3	3	0	1	1	1	0
<b>Total</b>	<b>13</b>	<b>11</b>	<b>2</b>	<b>4</b>	<b>5</b>	<b>4</b>	<b>0</b>
<b>Memo item:</b>							
Far East	124	n.a.	n.a.	71	7	5	40
North America	57	n.a.	n.a.	21	6	0	28
EC	55	n.a.	n.a.	15	17	1	19
Other	44	n.a.	n.a.	17	12	6	9

Source: Osservatorio Acquisizioni e Alleanze di Modena.